European Regulators Group for Electricity and Gas - Guidelines for Good Practice on Regulatory Accounts Unbundling

1 This document represents the response of National Grid to the Consultation Paper "Guidelines for Good Practice on Regulatory Accounts Unbundling", published by the European Regulator's Group for Electricity and Gas (ERGEG) on April 28th 2006.

2 The context for the Consultation Paper is one where historically many European energy utilities have been vertically integrated and there has been little or no competition in areas such as energy retail. As a pre-requisite for increased competition, the EU wishes to achieve the unbundling, or separation of business activities. Consistent with this, by July 2007, distribution network operators with more than 100,000 customers will have to be unbundled in legal terms. However, they may still be under the same, common ownership as other entities carrying out activities in competitive markets, such as energy retail.

3 ERGEG has now consulted on Guidelines for Good Practice for Regulatory accounts, both for energy networks with more than 100,000 customers, which will shortly have to unbundled legally, and those with fewer than 100,000 customers, which will be exempt from that requirement. These guidelines are focussed upon circumstances where network owners are still part of an integrated energy organisation, and also where the network owner, even if legally unbundled, remains in the same group as other companies using its network. The guidelines seem to fall broadly into two categories:

(a) those proposing an increased level of transparency over the relationship and trading between the network operator and other members of the same group; and

(b) those proposing rules on how these entities should trade with each other.

4 In addition, specifically in the case of entities which operate more than one network (multi-utilities), guidelines are proposed for how costs should be allocated between different network activities. These are intended to address a concern that such entities may allocate costs towards those networks which are less vulnerable to competitive forces, and away from those which are more vulnerable.

5 Our response is made up of two parts, a general comment and also responses to the specific questions asked by the Consultation Paper.

General Comment

6 In general, we believe that, in order to achieve effective competition, it is most effective route for entities carrying out network activities to have separate ownership from other entities carrying out activities where there is competition involving the use of these networks, such as energy retail. Where there is common ownership there will be an incentive for the network owner to have preferential arrangements with the retailer, whether this be favourable

financial treatment, or from other non-financial arrangements, such as access to its network.

7 Importantly, under common ownership, even where the network owner does not favour the retailer, it will be difficult to avoid the perception that this is the case, a perception which is likely to damage the development of competition.

8 However, we recognise that, in the short term, it may not always be possible to achieve separate ownership. In these circumstances, in order for competition to be able to develop, we believe that the network operator must be, in organisational terms, separate from the rest of the activities carried out by the group to which it belongs.

9 In addition to being separate in organisational terms, we believe it is very important that the relationship between the network owner and other members of the group is absolutely clear, and that national regulators have sufficient information on transactions between the network operator and other members of the same group to judge whether or not they are efficient and on normal commercial terms. Unless national regulators have and use this information, there can be no confidence that the network operator is not favouring its affiliates, which would damage the development of competition.

Response to Specific Questions

Question 1: Are there any other general guidelines you would like to propose in order to improve cost separation between integrated network companies and other services provided within the group or even within the network company (e.g. for "multi-network companies)?

10 The Guidelines contained within the Consultation Paper address the areas of information on material transactions with affiliates, and information on the legal relationships (for example, shareholdings) of the network operator with affiliates. We believe that intra-group transactions and legal relationships are the key issues relating to Regulatory accounts, and that, consequently, no other general guidelines are required.

Question 2 concerns Guideline 1, which applies to Legally Unbundled Companies (i.e. those with over 100,000 customers) and specifically concerns trading with related parties. Guideline 1 states that:

"*The Network Operator is required to publish all major transactions with affiliated companies in their regulatory accounting statements. In some jurisdictions however rules of confidentiality might restrict publication.*

Thresholds should be defined by regulators. The thresholds should not be higher than those included in the national (or EU) legislation for public procurement. The publication should contain the following items:

- *Purchases and their value (descriptions of purchases, including whether tendering procedure was used)*
- *Kind of sales and their value (descriptions of sales, including information on participation in tendering procedures)*

- *Financing costs (including dividends paid to affiliated companies, derivatives etc)*"

Question 2 asks "Are the mentioned transactions sufficient to cover economic relations between network and affiliated companies?"

11 We believe that the transactions listed above are sufficient to cover the economic relations between network and affiliated companies, as these appear within regulatory accounts. However, it is important to note that there are other, arguably more important, aspects to this relationship which are outside the scope of regulatory accounts, such as arrangements over access to networks.

12 In respect of whether or not there should be a requirement for publication, we believe that, under IAS24, there already exist rules for the publication of information on trading and relationships with related parties. We suggest that, unless a very good case can be made to the contrary, information required in excess of that should be provided to the national regulator, on the grounds of commercial confidentiality.

Question 3 relates to Guideline 2, which applies to Legally Unbundled Companies, and specifically concerns structural relationships. This states that:

"The network operator is required to forward all structural elements of affiliation to the regulator:

- *Exact kind of affiliation with competitive parts of the gas and electricity value chain*
    - *Active (network company is share holder in other company, extent of direct and indirect shareholding)*
    - *Passive (other company is shareholder in network company, extent of direct and indirect shareholding) Exact kind of affiliation with competitive parts of the gas and electricity value chain*
- *Other relationships such as credits, loans, guarantees, long term contracts, usage rights (description of kind of service)*
- *Small affiliations may be published in summary reports*

Question 3 asks "Do you agree that these pieces of information should not be published but only made available to the regulators? Do you agree that the additional information included under G2 may constitute an economic incentive for unequal treatment of affiliated and non-affiliated companies?"

13 In respect of the first question, as stated in paragraph 12 above, we believe that information in excess of that required under IAS24 should, unless a very good case can be made to the contrary, be supplied to the national regulators, rather than be published more widely.

14 In respect of the second question, we agree that the additional information required under G2 about cross-shareholdings, loans, guarantees etc may well constitute an economic incentive for the unequal treatment of affiliated and non-affiliated companies because information would be required only about a subset of these transactions.

Question 4 relates to Guideline 4, which applies to Legally Unbundled Companies and Legally Integrated Companies, and specifically concerns cost allocation and the sharing of economies of scale and scope. Guideline 4 states that:

"Every change of allocation method initiated by utilities has to be justified. In general the method has to follow two major principles:

- *A clear definition of all necessary network services is the basis for deciding whether a service in principle is a network service;*
- *And costs may be allocated according to the relation of stand alone cost*

However, some regulators may want to use traditional keys to allocate overhead cost."

Question 4 asks "A clear definition of necessary network services is supposed to be the basis for cost allocation. Do you agree that in order to treat economies (of scale and scope) it is proposed to use the method of "stand alone cost"? Could you imagine different practical solutions to allocate economies? If so, what are the specific advantages of those methods?

15 Our response to this question is on a matter of principle, and also in respect of the detail.

16 In principle, we believe that a distinction should be made between what is reported in the regulatory accounts and the judgement of the regulator of what is an efficient level of costs that should be borne by customers.

17 The regulatory accounts should inform the national regulators and other users of those accounts of the financial effect of the transactions which have happened and cost allocations which have been made. It is then a matter for the judgement of the national regulator as to what costs are or are not efficient, and so should or should not be borne by customers.

18 Consequently, we do not believe it desirable that there should be a guideline setting out the basis which should be used to allocate costs in regulatory accounts. Instead, we believe that the national regulators should have full access to the contractual arrangements between the network owner and other group companies, and should only fund those costs which they believe to be efficiently incurred.

19 In respect of the detail, we believe that the allocation of economies of scale and scope for joint services on a stand-alone basis (i.e. pro-rata to what it would cost each business separately) is very subjective and could lead to a

wide range of outcomes in many circumstances. We believe that an alternative method of cost allocation, such as a usage basis, would be reasonable and more robust.

Question 5 relates to Guideline 5, which applies to Legally Unbundled Companies, and concerns trading with related parties. It states that:

"The network operators will define all share services in a SLA (service level agreement): they will be able to choose between two possibilities of proving market conformity of agreed prices:

- *If a tendering procedure is possible adequacy of the price may be proven by a successful (i.e. receiving several competitive offers) tendering*

- *If the relevant service is very special and competitive tendering not possible, the network operator has to include in the service level agreements with affiliated companies in the broad sense of G2:*

    - *A clear definition of the services procured*

    - *A rule how cost is calculated*

    - *That the regulator has the right to access all information necessary to evaluate the correctness of cost calculation*

    - *That the contract is subject to final approval by the regulator*

- *Otherwise cost will not directly be accepted in OPEX but assessed according to its efficiency*

Question 5 asks "Working competition via public tendering should guarantee market based prices. Do you agree that these prices should be accepted as market based and do you have any proposals on how to calculate cost in case of non-market based procurement (for instance in case of specific services which are provided by the affiliated company)?"

20 As for question 4 above, we believe that a distinction needs to be drawn between what is reported in the regulatory accounts and the judgement of the regulator of what is an efficient level of costs that should be borne by customers.

21 The regulatory accounts should inform the national regulators and other users of the financial effect of the transactions which have happened, including between members of the same group, and cost allocations which have been made. It is then a matter for the judgement of the national regulator as to what costs are or are not efficient, and so should or should not be borne by customers.

22 Consequently, we do not believe it desirable that there should be a guideline setting out the basis upon which the network operator and other members of the group should trade. Instead, we believe that the national regulators should

have full access to the contractual arrangements between the network owner and other group companies, and should only fund those costs which they believe to be efficiently incurred.

Question 6 relates to Guideline 6, which applies to Legally Unbundled Companies and specifically concerns leased assets. Guideline 6 states that:

"The cost for a leased asset base shall not exceed the cost incurred if the assets would have originally been part of the RAB of the network company. The cost is normally calculated as:

*(approved RAB) * (approved) WACC*

The network operator has to disclose information on these assets. To be able to assess the adequacy of the (often leasing) contract, the contract shall include the right of the regulator to get information on the assets, their book value, yearly depreciation, all detailed information which is necessary to calculate the theoretical cost of capital."

23 As for questions 4 and 5 above, we believe that the regulatory accounts should report the transactions which have happened, rather than dictate the form of the contracts themselves. We believe that the role of the national regulator is to ensure that inefficiently incurred costs are not funded by customers, whether costs are treated as opex or as capex.