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Fact Sheet on Unbundling¹

Why is “effective unbundling” necessary?

If a company wants to compete in the electricity or gas markets, it has to have access to the existing monopoly networks. Achieving effective competition requires that Transmission System Operators (TSOs) act - and are perceived to act - independently of commercial interests in the market (such as electricity generation, gas shipping, production and supply) in a strictly non-discriminatory manner – i.e. effective unbundling.

The European Regulators believe that the model required in new EU legislation is, in principle, **ownership unbundling**. From our experience (and as confirmed by the European Commission’s Sector Inquiry), the ineffectiveness of the existing (“legal”) unbundling arrangements is a significant reason for the slow pace of market integration and the slow growth in cross border trade observed in EU electricity and gas markets. The “legal unbundling” regime, which was introduced by the 2003 Directives, to be implemented by 1 July 2004, hasn’t worked. The rules were too vague and implementation by Member States so far is patchy.

What main types of discriminatory behaviour result from insufficient unbundling?

The potential for undue discrimination will always exist where a vertically integrated company undertakes both competitive and monopolistic businesses. This is because a network business can favour the competitive company in its own group over other competitor businesses.

The European Regulators have listed all the activities of the monopoly network, where the potential for discrimination exists and identified for each the potential for discrimination: access principles – such as (but not exclusively) slowness to connect competitors, investment decisions (e.g. failing to invest to remove bottlenecks), and the scheduling of maintenance.

In summary, at TSO level, the potential for undue discrimination will inevitably reduce competition, and distort both investment and prices across borders.

Should new unbundling measures only be applied to transmission or also to distribution?

The potential effect of discrimination by Distribution System Operators (DSOs) varies regionally, is regionally more restricted, is mainly confined to final customers (e.g. discrimination to reduce switching) and generation units connected at distribution level, and may allow vertically integrated incumbents to enjoy dominant market positions in local markets. ERGEG has not recommended that European measures be brought forward to apply ownership unbundling or an ISO at the distribution level².

¹ FactSheet Reference No: FS-07-04.

² ERGEG is currently conducting a public consultation on draft Guidelines on Informational and Functional Unbundling – these are what regulators consider to be an appropriate way for companies to realise functional unbundling under the **present** legal framework.

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Should gas and electricity be treated differently?

No. There is no justification for a lower level of unbundling in gas than in electricity as the potential for discrimination is the same for electricity and gas. The growing dependency on gas imports from outside the EU's does not justify a less rigorous approach to unbundling in gas, and in many countries where gas is used to generate electricity, problems in the gas market will also affect the electricity market. However, added sensitivity may be warranted in terms of the time allowed for *implementation* in Member States of ownership unbundling in gas, given the need to avoid uncertainties in ongoing negotiations with external players beyond the EU's borders.

Will unbundling cause security of supply concerns with foreign suppliers buying up EU firms?

Competition Commissioner, Mrs. Kroes, has clarified that "any third country supplier active in any European energy market would have to comply with the same unbundling rules and compete on the same basis as all other companies in the sector. Such suppliers **could therefore not own or acquire network operators in the Community or at the very least not in countries where they have actual or potential supply interests.**"

Referring to how the EU's competition rules already provide a safeguard against negative effects arising from mergers and takeovers, Commissioner Kroes stated "The best way to respond to the challenge of external energy dependence is to build a large and diverse European market – with greater access to alternative sources of energy. This requires investment to expand our import and interconnection infrastructure". ERGEG's proposals for a European System of Energy Regulation will provide the regulatory climate essential for these investments in European infrastructure.

Ownership unbundling or the ISO model?

With **ownership unbundling** the network is operated and owned by one independent company (with no interests in the competitive markets of production, generation, shipping or supply) which clarifies the incentives and responsibilities of the TSO.

The **ISO model** separates at least the ownership of the assets (which stay with the vertically integrated firm) from the operational tasks of the former network company – thus reducing the scope for discrimination. The central questions with ISO models are how to define the tasks of the independent system operator (ISO); and how to manage and regulate the relationship between the asset owner and the ISO.

ERGEG clearly recommends that **in principle "ownership unbundling" of transmission should be the model required in new EU legislation³.**

ERGEG has compared the ISO and Ownership unbundled models, and details of the unbundling experiences of the UK⁴, Portugal⁵ and Italy⁶ are described in "case studies".

³ See "ERGEG's response to the EU Commission Communication "An Energy Policy for Europe"" (C06-BM-09-05), 6 February 2007 and ERGEG's advice on the 3rd legislative package input "Unbundling" (C07-SER-13-06-1-PD), 5 June 2007. Visit www.ereg.org.

⁴ The electricity market in Great Britain currently has both an ownership unbundled TSO (in England and Wales) and an ISO model (Scotland) – the ISO model has a number of disadvantages compared to ownership unbundling: congestion costs are relatively higher partly because the asset owner is responsible for investment in new infrastructure while the operator is responsible for congestion management, and the interface between the operator and asset owner is complex and must be regulated closely.

⁵ Legal unbundling in Portugal produced no visible improvement and it was only with full ownership unbundling that consumers of electricity benefited from higher levels of investment, improved quality and lower prices.

⁶ Italy originally introduced an ISO model in electricity, but due to inherent inefficiencies and difficulties in coordination between the asset owner and operator, in 2005 it moved to ownership unbundling resulting in a 30% increase in investment, and a doubling in the number of authorisations in the last 3 years.

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Of the ISO models, how “deep” should an ISO model be?

Viewed just from the perspective of minimising discrimination, a **deep ISO** (and not a shallow ISO) model may be able to significantly improve the situation relative to today's (legal) separation model. This would mean most of the decisions relating to the transmission network being taken by the ISO. But for an ISO model to be sufficiently deep it will necessarily be more complex and require greater regulation than having companies that are ownership unbundled.

Compared with the ownership unbundled model, heavy, intrusive, burdensome and potentially costly regulation is required to manage the inherent, potential conflict of interests between the monopolistic and competitive elements of vertically-integrated companies in the ISO model, without any additional benefit to consumers.

Impact of effective unbundling on Investment

Case studies undertaken by the regulatory authorities of Portugal (ERSE), of United Kingdom (Ofgem) and of Italy (AEEG) indicate that full ownership unbundling did not depress investment (and in all cases investment increased in practice) and improved network performance. However, ownership unbundling cannot remove all the barriers to the investment that the EU's network require – an EU regulatory framework that stimulates investment is also needed⁷ (see separate Fact Sheet on a European System of Energy Regulation: Regulatory and EU Network Bodies). Furthermore, some issues which hinder the delivery of investment projects e.g. planning rules, are beyond the remit of energy regulators.

Would a Regional System Operator resolve the unbundling problem?

No. If national system operators want, in due course, to merge to form a Regional System Operator (RSO) (also called Regional Independent Operator (RIO)) this is to be encouraged. But **improving market integration does not remove the need to resolve** the EU's deep-seated problem of undue discrimination on the part of vertically-integrated companies. Effective unbundling would have to be a prerequisite of an RSO model.

⁷ Effective Unbundling would address one key barrier to investment – namely the incentives on TSOs. ERGEG has recently published the conclusions of its public consultation on the Cross Border Framework for electricity transmission network infrastructure (E07-ETN-01-03) which addresses other barriers such as land permits.



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Where can I get further information?

ERGEG was established by the European Commission (in November 2003) as the **European Commission's advisory body** on internal EU energy matters. ERGEG (www.ergeg.org) and CEER (www.ceer-eu.org) aim to create EU-wide electricity and gas markets, acting **in the interest of the EU energy consumer**.

This FactSheet (FS-07-04) was issued by the European Energy Regulators to reflect their advice given to the European Commission.

Should any member of the EU Institutions require the (free and timely) independent advice of the European Energy Regulators on any energy issue (big or small), contact the Secretary General:

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Other useful FactSheets:

- FactSheet on the new 3rd package of energy legislation (FS-07-03)
- FactSheet on a European System of Energy Regulation: Regulatory and EU Network Bodies (FS-07-05)