



GEODE Position Paper on Ownership Unbundling

Among the most important proposals in the European Commission's Energy Package published on January 10, 2007, is that of Ownership Unbundling between energy networks and supply and generation activities.

GEODE believes that vertical integration may be a barrier to the development of a well functioning competition in the electricity and natural gas markets.

The Internal Market Report and the Sector enquiry suggest that there is a risk of "discrimination and abuse when companies control energy networks as well as production or sales, protecting national markets and preventing competition. Such a situation also creates a disincentive on vertically integrated companies to invest adequately in their networks, since the more they increase network capacity, the greater the competition that on their "home market" and the lower the market price."

We find, however, that the reports would benefit from a clearer distinction between the issues associated with transmission, and those associated with distribution. The reasons for this will be elaborated below. Though the reasoning is in general applicable for natural gas, we have used only the power market not to complicate the text.

The role of the TSO

A transmission system binds together the different parts of a country or a region to a playing field for market players. The physical structure of the transmission network determines the possibility for customers and producers to make business deals. The more transmission capacity in relation to the power flow the better the competition. Insufficient transmission capacity to and from an area limits the range of suppliers that the customers in the area can choose between. If there is a limited number of producers in the area, these producers may be able to exercise market power during longer or shorter periods. Hence, it is important to ensure that the owner of the transmission network, the TSO, does not have an incentive to let his own production interests influence his investment planning on the networks side.

The role of the TSO is also to manage the operation of the power system, maintaining stability and balance between supply and demand in the system. In doing so he must have the right to directly affect the operation of power plants in the system. For the credibility of the market it is important that there can be no reason to suspect the TSO of favouring its own power plants¹.

In short, the TSO has a crucial role to play to ensure a level playing field where buyers and sellers can meet.

¹ Regarding natural gas this can be read as either production or storage.

Note: Since gasstorage can be considered as a transmissionline with transport velocity = 0, it could be difficult to argue the separation of transmissionline- and storageownership



Since the areas where conflicts of interest may occur range from investment management and decisions, to operations, it is difficult to see a better way of ensuring transparency than ownership unbundling between transmission and power generation.

The experience from the Nordic markets shows in a good way the virtues of such a solution.

The role of the DSO

The role of the DSO differs from that of the TSO in important ways. The DSO provides the network through which the local customer obtains access to the power from a big number of suppliers available on the transmission grid.

It is important that the DSO is operated separately from any supply company in order not to offer privileged access to information of other advantages to any supplier. Hence legal and functional unbundling is of great importance.

Differently from the case with the TSO, however, the DSO must always have the capacity to transport the power needed by the customers in his area. This means that it is impossible for a company owning both supply and distribution to discriminate against suppliers other than its own by not investing sufficiently or by operational actions. In other words the DSO does not have the same areas where conflicts of interest may occur as the TSO.

For distribution there is a recognised need for legal unbundling under the supervision of a strong regulator.

Practical problems of unbundling DSOs

Add to that, that while the number of TSOs in Europe is less than 40, there are well over 2500 DSOs, belonging to privately and municipally owned energy companies. The difficulties of arranging ownership in case of DSO's unbundling is indeed complicated. Not only will buyers for all these companies have to be found, the remaining DSO's would still suffer the limited transportation capacity. There is a great risk that many of those companies would end up in the hands of one of the big energy groups. Since the present owners are likely to keep the infrastructure, an obligation to dispose of one of the activities would probably lead to concentration on the supply side as it would also weaken local activities in energy efficiency and investments. This is not in line with the wish for more competition, nor with the outlines of the European Council on Energy Efficiency and Renewable Energy .

In synthesis, **GEODE** finds that the reasons for ownership unbundling are much more compelling for transmission than they are for distribution, and the difficulties, in the latter case, in carrying out such an unbundling would be that much greater.

Our conclusion is therefore that ownership unbundling, when required, should logically be made at the transmission level, whereas legal unbundling within a robust regulatory framework is sufficient at the distribution level.



Exemption for small DSOs

In this context, the issue of exemption from the legal and functional unbundling requirements for companies with less than 100.000 distribution customers deserves to be analysed.

Small local companies often play an important role for customers in distant or small places where the interest and ability of bigger companies to carry out a good service for the network customer may not exist. For very small companies, it may not be economically viable to duplicate all managerial and administrative functions. Hence, as an exception, common managerial functions should still be allowed for small groups, e.g. < 100.000 customers.

The regional ISO – an interesting addition, not an alternative

In the Commission's report, the issue of regional ISOs (independent system operators) as an alternative to ownership unbundling is discussed. In our view it is more of an interesting addition than an alternative.

The process of creating regional electricity markets is now under discussion in the "mini-fora" process and may lead to a situation where a regional ISO complements the work being done by the unbundled TSOs inside the region.

The Nordic members of GEODE are of the opinion that in the Nordic market, with more than a decade long experience of unbundled national TSOs, a regional ISO may be necessary in order to coordinate operation of the regional transmission networks with all its interconnectors and also to work out plans, make decisions on investments and how these are to be financed for network extensions in order to optimize the system from an all-Nordic perspective.

Legal Aspects

The distinction between ownership unbundling on the transmission and the distribution level is not only economically justified but also legally mandatory, particularly with regard to fundamental rights. Ownership unbundling interferes with the constitutionally guaranteed right of ownership. Due to the different grid characteristics, this interference can be legally justified on the transmission level whereas ownership unbundling on the distribution level is disproportional and therefore violates the right of ownership.

On transmission level, ownership unbundling is essential to resolve the systemic conflict of interest inherent in the vertical integration of supply and network activities. In fact, it is the only means to ensure choice for energy users by more competition and to encourage investments in infrastructure. On distribution level, however, ownership unbundling is neither appropriate nor necessary to foster competition and encourage investments. On the contrary, stronger unbundling rules would lead to a higher level of market concentration and less competition. From a legal point of view, ownership unbundling on the distribution level has to be considered as an infringement of the principle of proportionality and – as a result – the right of ownership.



The same holds true for the concept of an independent system operator which economic goal is to reduce the number of balancing markets to facilitate market access for newcomers. On the transmission level, the ISO-concept is an alternative means to establish a truly integrated energy market. As reducing the number of balancing markets is restricted to the transmission level, the ISO-concept on the distribution level is neither necessary nor appropriate and would therefore violate the right of ownership.

Barcelona, 29th March 2007