NOTE OF DG ENERGY & TRANSPORT ON DIRECTIVES 2003/54/EC AND 2003/55/EC ON THE INTERNAL MARKET IN ELECTRICITY AND NATURAL GAS

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THE UNBUNDLING REGIME

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A. INTRODUCTION

In order to ensure non-discriminatory access to the network and avoid conflicts of interest it is necessary to separate the network business (natural monopoly) from those activities of a vertically integrated companies which compete on the market, namely production and supply.

Achieving this separation is the purpose of the unbundling provisions in the new electricity and gas directives, which are considerably strengthened in comparison to the previous directives.

The basic elements of the new unbundling regime are the following:

1. Legal unbundling of the transmission system operator (TSO) and distribution system operator (DSO) from other activities not related to transmission and respectively distribution.

2. Functional unbundling of the TSO and DSO, in order to ensure its independence within the vertically integrated undertaking.

3. Possibility of exemptions from the requirement of legal and functional unbundling for DSOs.

4. Accounting unbundling: requirement to keep separate accounts for TSO and DSO activities.

An overview-table illustrating the application of unbundling requirements to TSOs and DSOs, and possible exemptions, is contained in the annex.

In this paper the requirements to be met to implement the above rules are set out in detail, in order to ensure a consistent application in Member States.

B. LEGAL AND FUNCTIONAL UNBUNDLING

1. Relevant provisions of the directives

Article 15 of the E- directive and Article 13 of the G-directive state:

> *1. Where the distribution system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organisation and decision making from other activities not relating to distribution. These rules shall not create an obligation to separate the ownership of assets of the distribution system operator from the vertically integrated undertaking*
> *2. In addition to the requirements of paragraph 1, where the distribution system operator is part of a vertically integrated undertaking, it shall be independent in terms of its organisation and decision making from the other activities not related to distribution. In order to achieve this, the following minimum criteria shall apply: (follow criteria a)-d))*

A similar provision for the transmission system operator is contained in Article 10 of the E-directive and Article 9 of the G-directive.

With regard to DSOs, Article 15, last sentence of the E-directive and Article 13, last sentence of the G-directive state

> *Member States may decide not to apply paragraphs 1 and 2 to integrated electricity/gas undertakings serving less than 100 000 connected customers, or serving small isolated systems.*

Article 30 (2) of the E-directive and states:

> *Member States may postpone the implementation of Article 15(1) until 1 July 2007. This is without prejudice to the requirements contained in Article 15 (2)*

A similar provision for gas DSOs is contained in Article 33 (2) of the G-directive.

2. Basic principles of application

2.1. Application to "vertically integrated companies"

According to the above Articles, the unbundling requirements apply if the network business in question is part of a "vertically integrated undertaking"

.A definition of the term "vertically integrated undertaking" (VIU) is contained in Article 2, No. 21 of the E-directive (and a similar provision in the gas directive):

"vertically integrated undertaking" means an undertaking or a group of undertakings whose mutual relationships are defined in Article 3(3) of Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings [1] and where the undertaking/group concerned is performing at least one of the functions of transmission or distribution and at least one of the functions of generation or supply of electricity;

Article 3(3) of the Council Regulation (EEC) No. 4064/89, to which this definition refers, states:

For the purposes of this Regulation, control shall be constituted by rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on an undertaking, in particular by :

(a) ownership or the right to use all or part of the assets of an undertaking;

(b) rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking.

Thus, a company is considered a VIU under the following conditions:

- the undertaking is at the same time involved in generation or supply of electricity/gas

and

- the network operation is done within the same legal structure

or

- the network operation is done in a legally separate network company which is, however, under the "control" of the supply/generation company, or a holding company, which "controls" a supply/generation company, in the sense of Article 3(3) of the above Council Regulation on mergers (e.g. because the mother company holds the majority of the shares/voting rights of the related network company).

or

- the separate network company "controls" the supply/generation company, is thus at the same time a holding company.

If these conditions are fulfilled, legal and functional unbundling applies and the following steps have to be taken by the VIU:

- a separate network company has to be set up (if it does not yet exist)
- the network company, if it remains under "control" of the related supply/generation company in the sense of Article 3 (3) of the above Council Regulation has to be unbundled in functional terms in the sense of Article 15 (2) for Electricity or 13(2) for Gas, to ensure the necessary independence from the parent company.

[1] OJ L 395, 30.12.1989, p. 1. Regulation as last amended by Regulation (EC) No 1310/97 (OJ L 180, 9.7.1997, p. 1).

- a situation where the network company maintains "control" of the related supply/generation company is incompatible with functional unbundling and, therefore, not permissible under the new directive (for more detail see below under 4.2.1.)

If, on the other hand, the supply/generation company, whilst holding some shares in the network company, does not – or no longer – "control" the network company, the network undertaking in question is not part of a vertically integrated undertaking in the sense of the directive. The result is that the unbundling requirements of Article 15 for Electricity, Article 13 for Gas, in particular Article 15 (2), [13(2) G] do not apply at all.

2.2. The elements of the definition of "control" in the sense of the Merger Regulation

As described above, a network company might or might not be subject to in particular the functional unbundling requirements, depending on whether or not it remains under "control" of a company which is involved in supply or generation.

It is clear that as much certainty as possible must be provided in this respect. A network company needs to know whether, in the sense of the directive, its independence from the supply/generation business is considered to be sufficient or whether it has to take additional measures of functional unbundling to enhance this independence. This might in particular be doubtful in cases where "control" of a related supply/generation company is not obvious, for instance if the latter holds less than 50% of the shares of the network company.

Against this background the directive refers to the definition of "control" set out in Article 3 (3) of the merger Regulation. According to this article, and the notice issued by the Commission on the interpretation of this article[2], a company has, in summary, "control" over another, related company, if:

- it holds the majority of the shares/voting rights of the related company or
- it does not hold the majority of shares, but controls *de facto* solely the related undertaking, due to the fact, for instance, that the remaining shares are widely dispersed over many, smaller shareholders and evidenced by a majority of the votes actually achieved at the last annual general meetings. Furthermore, de facto control of a minority shareholder can also result from a specific contractual arrangement providing the right to actually determine the business policy of the company.

[2] Commission notice, 2 March 1998, OJ [1998] C 66/5

2.3. Exemptions

With regard to DSOs, Member States have the possibility, in national legislation, to provide for *exemptions from* the above described principles of application of legal and functional unbundling to VIU:

- Smaller DSOs (serving less than 100.000 customers) can be *exempted* from the requirements of both legal and functional unbundling. This possibility of an exemption is not limited in time.

- With regard to larger DSOs (serving above 100.000 customers), the requirement of legal unbundling may be *postponed* until 1 July 2007, i.e. the date of full market opening.

Due to these possible exceptions, it is possible that the requirements of functional unbundling are applicable without being coupled with legal unbundling.

Firstly, whilst Member States may delay the obligation to legally unbundle larger DSOs until 1 July 2007, such a possibility does not exist with regard to the obligation to unbundle in functional terms. It is thus conceivable that - until 2007 – larger DSOs are obliged under national law to unbundle the network activities in functional terms without being obliged to create a separate company.

Secondly, a Member State might limit, in national law, an exemption for smaller DSOs to legal unbundling and maintain the obligation to functionally unbundle for all DSOs (or apply to the latter a different, lower threshold)

3. Legal unbundling

3.1. Basic principles

The key message of these provisions is that transmission and distribution have to be done by a separate “network” company. However, the network company must not necessarily own the network assets but must have “effective decision making rights” in line with the requirements of functional unbundling (see below).

The obligation to create a separate company only concerns the network business, i.e. the natural monopoly. All other activities, namely supply and production, can continue to be operated in one single company.

3.2. Legal form of the network company

The vertically integrated company is in principle free to choose the legal form of the network company, provided that the type of company selected provides for sufficient independence of the management of the TSO/DSO from the parent company, in order to fulfil the requirements of functional unbundling.

Therefore, if the general supervision regime foreseen as standard in national law for the type of company selected does not match the requirements of functional unbundling, for instance since it allows instructions of the company owners regarding day-to-business, it is necessary to require its modification through a specific contractual arrangement in the statute of the network company, in order to give the management of the company sufficient independence from the parent company. Likewise, any contractual arrangements which introduce further supervision rights, in addition to the ones foresees as standard in the law and limiting the independence of the network subsidiary, have to be compatible with functional unbundling.

3.3. Combined network operator

A question likely to become of significant relevance in practice is whether a combined network operator, i.e. the operation of several networks of a different nature in one single company, would be compatible with legal unbundling. In particular multi-utility distribution companies, whilst separating their supply business, might wish to operate their, for instance, electricity, gas and water networks in one single company, in order to benefit from synergies.

As regards a combined TSO/DSO for electricity and respectively gas, the directives provide for an exemption from legal unbundling and contain an explicit provision allowing such a combined operation, provided that the accounts are unbundled and that the combined operator is functionally unbundled from other activities of the sector[3].

In contrast, there is no explicit provision on the possibility of a combined network operator involving different sectors. Such a combined multi-sector operator should nevertheless be possible in principle, on the same basis as a combined TSO/DSO. In order to ensure non-discriminatory access to the network and avoid conflicts of interest it is necessary to separate the network business (natural monopoly) from those activities of the vertically integrated companies in which it competes on the market, namely production and supply. In contrast, the operation of different networks in one company does not bear the same risk of discrimination and conflict of interests, provided that separate accounts are kept to ensure transparency and prevent cross-subsidisation.

[3] Article 17 of the E-directive and article 15 of the gas directive

4. Functional unbundling

4.1. Relevant provisions of the directives

Article 15, paragraph 2 of the E- directive and Article 13, paragraph 2 of the G-directive state

> *2. In addition to the requirements of paragraph 1, where the distribution system operator is part of a vertically integrated undertaking, it shall be independent in terms of its organisation and decision making from the other activities not related to distribution. In order to achieve this, the following minimum criteria shall apply:*
>
> *(a) those persons responsible for the management of the distribution system operator may not participate in company structures of the integrated electricity undertaking responsible, directly or indirectly, for the day-to-day operation of the generation, transmission and supply of electricity;*
>
> *(b) appropriate measures must be taken to ensure that the professional interests of the persons responsible for the management of the distribution system operator are taken into account in a manner that ensures that they are capable of acting independently;*
>
> *(c) The distribution system operator shall have effective decision-making rights, independent from the integrated electricity undertaking, with respect to assets necessary to operate, maintain or develop the network. This should not prevent the existence of appropriate co-ordination mechanisms to ensure that the economic and management supervision rights of the parent company in respect of the return on assets, regulated indirectly according to Art. 23(2) [25(2) G], in a subsidiary are protected. In particular, this shall enable the parent company to approve the annual financial plan, or any equivalent instrument, of the distribution system operator and to set global limits on indebtedness levels of its subsidiary. It shall not permit the parent company to give instructions regarding day-to-day operations, nor with respect to individual decisions concerning the construction or upgrading of distribution lines, that do not exceed the terms of the approved financial plan, or any equivalent instrument.*
>
> *(d) the distribution system operator shall establish a compliance programme, which sets out measures taken to ensure that discriminatory conduct is excluded, and ensure its respect is adequately monitored. The programme shall set out the specific obligations of employees to meet this objective. An annual report, setting out the measures taken, shall be submitted by the person or body responsible for monitoring the compliance programme to the regulatory authority referred to in Article 23(1) [25(1) G] and published.*

A similar provision for the transmission system operator is contained in Article 10, paragraph 2, of the E-directive and Article 9, paragraph 2, of the G-directive:

4.2. Management separation (indent a) and b))

4.2.1. Basic principles

The provisions of the directive on management separation require firstly that the management staff of the network business do not work at the same time for the supply/production company of the vertically integrated company. This applies to both the top executive management and the operational (middle) management. Thus, for instance, an executive director of the network company may not at the same time be an executive director of the related supply/production company, and vice-versa. It remains however, possible for an executive director of the holding company to perform a supervisory function in the network company, without being involved in day-to-day decisions.

To what extent a network director can work at the same time for the holding company, which is not at the same time directly involved in production and/or supply because legally separate entities exist for these branches, must be decided on a case-by-case basis. In any case, such double functions can only be permissible if the holding does not take any day-to-day management decisions regarding the supply, production or network branch.

Management separation requires furthermore that "appropriate measures" are taken to ensure the independence of the persons responsible for the network management. It is for Member States to further determine such measures, in the light of national circumstances. However, in order to comply with the directives Member States will clearly have to take appropriate steps to deal with the following issues:

The salary of the network management must not be based on the holding/supply company's performance and be established on the basis of pre-fixed elements related to the performance of the network company. The reasons justifying a replacement of a Member of the Board of directors of the network company at the initiative of the parent company shall be clearly spelt out in the charter of the company.

Whilst mobility of management staff between the various branches of the vertically integrated company remains in principle possible, transfer of staff from the network business to other activities of the company and vice-versa should be made subject to certain conditions. In case, for instance, a manager is appointed to the board of directors of the network company, her/his subsequent recruitment by the holding and/or supply company - after his term with the network business - should not be predetermined from the outset.

The company involved in the network business shall not be allowed to hold shares of the related supply, production or holding company. If the network company holds such shares, it has a direct financial interest in the performance of the related supply branch and, as a consequence, its management is no longer capable of "acting independently". This rule excludes a situation where the network company is at the same time the holding company of a supply/production company. Consequently, a

structure whereby, for instance, a distribution company has traditionally owned the legally separate supply branch is no longer permissible. This, however, does not necessarily require changing the ownership of the network assets. It would be sufficient to create a new company which operates the network without at the same time owning the network assets.

Equally, the issue of shareholding on a personal basis of the management of the network company needs to be addressed in a way that ensures the independence of management. The concern is that if, for instance, executive directors of the network company own many shares of the related supply/production company, conflicts of interests arise. It is precisely for this reason that in a number of Member States national regulators are not allowed to hold energy shares on a personal basis.

4.2.2. Treatment of common services

An important question in the context of management separation is how to deal with *common services,* i.e. services which have been - in a non-unbundled world - often shared between transmission/distribution, supply and perhaps other businesses. Such services typically include personnel and finance, IT services, accommodation and transport. It might be argued that a requirement to systematically duplicate such common services would significantly increase costs without bringing corresponding additional benefits.

It seems appropriate to look at this issue on a case by case basis.

If common services are permitted it shall be required in any case that certain conditions are fulfilled, to reduce competition concerns and exclude conflicts of interest:

- any cross subsidies being either given to or received by the network business are excluded; the ensure this, the service shall be provided at market conditions, which shall be laid down in a contractual arrangement between the company providing the common service and the beneficiary company

- common services shall normally be operated and managed outside the network business – i.e. by the related supply company or, even better, a holding company - unless the network is the predominant user.

4.2.3. Application to not legally unbundled DSOs

In case a DSO is unbundled only in functional terms, but not in legal terms, the basic ideas behind the above principles apply in the same way, leading to the following concrete rules.

- a separate department for the distribution business shall be set up within the vertically integrated entity and be operated as a “profit-centre”
- an executive director for the network department shall be appointed. She or he shall have a specific contract with the company, setting out in particular an exclusive list of reasons for the repeal of her/his appointment. She or he shall not sit on the Board of the vertically integrated company.

- Where individual responsibilities of Board members exist, the member of the Board of the company responsible for the network branch shall not at the time be responsible for supply and/production, at least not for the commercial side of the latter. Responsibilities strictly limited to engineering aspects might be possible.
- the management staff working in the network department must not at the same time have tasks related to the other activities of the sector.
- common services shared between the network department and the other departments of the company shall be subject to certain conditions, according to the principles outlined above
- salaries of the personnel working in the network department shall depend exclusively on the performance of the network business as a "profit centre", established on the basis of pre-fixed elements.
- transfer of staff from the network department to the other departments of the company shall be limited.
- the management personnel of the network department shall not be allowed to hold shares of the company.

4.2.4. Separation between networks of different sectors

The above described general principles on management separation must be strictly applied with regard to the relation between the network business and the supply business of the same sector.

When it comes to the relation of the network business to the network (or supply) business of other sectors more flexibility is possible, for instance, in case of an electricity distributor, its relation to its gas and water activities operated in the same company. In this respect the same basic considerations as outlined above with regard to the possibility to have one, multi-sector network operator, apply. The requirement spelled out in indent a) of Articles 10 (2) and 15 (2) of the E-directive, and Articles 9 (2) and 13 (2) of the G-directive for instance, is phrased in such a way that it applies exclusively in relation to other electricity activities.

However, any flexibility in this respect must be compatible with the overall, general objective of ensuring that the management of the network is "capable of acting independently"[4]. To what extend this requires management separation between activities related to different sectors can only be decided on a case by case basis. A balanced assessment of, on the one hand, the need for independence and, on the other hand, the interest of, for instance, multi-utility operators to look for possible synergies is necessary.

[4] See intend b) of Articles 10 (2) and 15 (2) of the E-directive and the corresponding Articles of the G-directive

4.3. Effective decision making rights (indent c))

4.3.1. Basic principles

All commercial and operational decisions related to the operation, maintenance and development of the network must be made within the network business, without involvement of the related supply business or holding company of the integrated company. This is of particular importance with regard to areas which may have an impact on competition in the supply market, such as the extension or construction of interconnections with other systems.

The network company shall have enough human and physical resources at its disposal to carry out its work independently from other parts of the integrated company. It shall also have sufficient financial means available to fulfil its tasks to maintain and develop the network.

4.3.2. Network operator not owning the assets

The above principles also apply in case the parent company remains the owner of the assets. Whilst also in this case the basic decisions must remain with the network company, the parent company may in principle be involved in the implementation of these decisions, providing that safeguards are in place ensuring that the parent company only executes decisions taken by the network company. Should the parent company not comply with this decision, the network company must have the possibility to intervene by means of step-in rights. Details shall be determined on a case by case basis and shall be laid down clearly in a specific arrangement (See, as an example, the "Agreement on Infrastructure" issued by the Irish Regulator)

4.3.3. Supervision rights of the parent company

The second sentence of intend c) clarifies that the requirement of effective decision making rights is without prejudice to the "economic and management supervision rights of the parent company in respect of the return on assets in a subsidiary". Regarding the scope of this supervision rights, the directive expressly refers to two items: the financial plan of the network company, or any equivalent instrument, and its overall level of indebtedness. Regarding the limits of the supervision rights, the directive is equally clear: not permitted is any detailed day-to-day oversight of the network function by the parent company, notably instructions regarding decisions on the construction or upgrading of lines, which do not exceed the terms of the financial plan.

Within the scope of the approved financial plan, the network company shall thus have complete independence. Furthermore, the financial plan, whilst it can be adopted by the parent company, must be compatible with the requirement to ensure that the network company has sufficient financial means to maintain and extend the infrastructure available.

The directive refers to the financial plan or "any equivalent instrument". This term shall be interpreted restrictively in the sense that only instruments which are functionally equivalent to a financial plan, but which under the respective national terminology are not denominated a "financial plan", may be approved by the parent company.

As regards the composition of the supervisory board of the network company, where it exists, at least two members, depending on the size of the board, should ideally be independent form the interests of the mother company.

4.3.4. Application to not legally unbundled DSOs

In case a DSO is unbundled only in functional terms indent c) cannot apply literally since it deals with the relation of a parent company to its subsidiary, which is irrelevant if all functions are done within the same legal structure. However, the underlying principles of indent c) apply in an analogue fashion. Consequently, the separate distribution department shall have far-reaching decision making rights with regard to the operation, maintenance and development of the network.

The above described independence of the director is without prejudice to the overall responsibility of the senior management of the company, including regarding investment decisions.

4.4. Compliance programme

The purpose of a compliance programme is to provide a *formal framework* for ensuring that the network business as a whole, as well as individual employees and members of the management, comply with the principle of non-discrimination.

Three aspects are important in this respect:

- Contents of the programme, notably specific obligations of employees to meet the objective of non-discrimination;
- Measures to enforce the programme;
- Effective monitoring and regular reporting

4.4.1. Contents of the compliance programme

The compliance programme shall contain rules of conduct, which have to be respected by staff in order to exclude discrimination.

Such rules will relate, for instance, to the obligation to preserve the confidentiality of commercially sensitive information (Article 12 and 16 of the E-directive and Articles 10 and 14 of the G-directive). The compliance programme would thus lay down in detail what kind of information is to be considered confidential in this sense and how it should be treated. It shall also refer to the penalties imposed under national legislation in case of non-respect of confidentiality rules contained in the Directives[5].

[5] Article 23 (9) of the E-directive and 25 (9) of the G-directive obliges Member States to take appropriate measures in case of non-respect of confidentiality rules.

Another set of rules to be respected will relate to the behaviour of staff vis-à-vis network customers. Employees, shall for instance, make clear that they represent exclusively a network operator and shall refrain from any reference to the related supply business. In general, employees shall not give any recommendation on possible suppliers and instead refer customers to generally available information sources.

Measures intended to exclude discrimination would also encompass prohibitions, or limitations, of access for personnel not involved in the network business to the network operator's premises, or part of it, and – most importantly- access to systems for the recording, processing or storage of sensitive data.

4.4.2. Enforcement of the compliance programme

The compliance programme must be actively implemented and promoted through specific policies and procedures.

Such policies should consist, inter alia, of the following elements:

- Active, regular and visible support of the senior management for the programme, for instance through a personal message to the staff form the top management stating its commitment to the programme;

- Written commitment of staff to the programme by signing up to the programme;

- Clear statement that disciplinary action will be taken against staff violating the compliance rules;

- Training on compliance on a regular basis and notably as part of the introduction programme for new staff.

4.4.3. Monitoring and reporting

If the programme is to be successful, its effectiveness needs to be regularly monitored. This is essential not only as a means of ensuring that the programme is working properly but also to enable those areas to be identified which present the highest risks of non-compliance.

The evaluation process shall be carried out in a transparent manner, indicating thereby to employees that their conduct is constantly reviewed against the terms of the programme.

The person or body responsible for monitoring the compliance programme shall be the senior management body or a member of this body. Regarding the annual report, to be submitted by this person or body, guidelines on its contents shall be issued by the regulatory authority.

The annual report shall be approved by the independent members of the supervisory board, where applicable, before submission to the regulatory authority.

4.5. Preservation of confidentiality – "Chinese walls"

The rules on functional unbundling are complemented by the obligation of transmission and distribution operators to preserve the confidentiality of commercially sensitive information (see, for instance, Articles 12 and 16 of the electricity directive).

This excludes for instance, that staff working for the supply business have unlimited access to databases containing information which could be commercially advantageous, such as details on actual or potential network users. Whilst this does not necessarily mean the establishment of separate database systems, specific access rights must be clearly defined and limited to be in compliance with the confidentiality rule.

4.6. Additional measures to re-enforce functional unbundling

It should be noted that the functional unbundling measures contained in the directives are "minimum criteria". Member States may thus consider to further complement the minimum set of criteria by further measures, with a view to ensure utmost effectiveness of unbundling under the specific national circumstances, in particular national company law.

Such measures may include, for instance, the *rebranding* of the network business, with a view to enable customers to distinguish it clearly from the supply business of the company. Separate brands would also help reinforce a culture of separation in the minds of staff. Another measure would be to ensure that the network operator and the supply business are located in *separate buildings*, provided such a measure would be proportionate given the size of the company concerned. Regarding the presentation of the network company on the internet, there should be no link from its home page to the related supply company.

4.7. Implementation of the rules on functional unbundling into national law

The provisions of the directive on functional unbundling need further specification, at Member State level, in order to be fully operational in practice. Several ways are conceivable to provide the necessary specification, with a view to ensure that operators know in advance what to do in order to comply with the rules:

- Specification of the detailed requirements of functional unbundling in national – primary and/or secondary - legislation implementing the directives.

- In advance issue of "guidelines" on functional unbundling, for instance by the regulator

- Specify the functional unbundling requirements in the license for network operators.

Whilst Member States can chose between the above mentioned – and possibly other – suitable approaches, it would clearly not be appropriate to simply transpose the text of the directives literally into national law, without giving on an ex-ante basis further specifications. It seems also recommendable to require TSO/DSOs to submit "ex-ante" a "compliance statement" for approval by the regulator setting out how the operator in question intends to comply

5. Exemptions for DSOs serving less than 100.000 customers

5.1. Basic principles

"100 000 connected customers" shall be interpreted in the sense of "100 000 connections". Consequently, a household is considered to constitute one connection in the sense of the provision, irrespective of the number of people forming part of the household. In contrast, a building comprising – say – 8 apartments shall be considered as having 8 connections in the sense of the provisions. In cases where the exact number of "connections" of a building is difficult to establish a reasonable estimate shall be made by the DSO, in conjunction with the regulatory authority. [Alternative: number of "billed" customers since only if you "bill" a customer you have a relation with him].

5.2. Application in practice – Two basic scenarios

5.2.1. Distribution and supply/generation are done in one single company

In such a case of a single legal entity the application of the 100.000 rule is straightforward: If the undertaking has less than 100.000 customers, i.e. if less than 100.000 customers are connected to the distribution network of the undertaking in question, an exemption is possible, in which case the company can continue to operate the network and supply/generation within the same legal entity. In contrast, if the number of customers is above 100.000, a separate network company has to be created.

When creating such a separate company, the undertaking has two basic choices:

- It can keep all or an amount of the shares of the network company allowing it to "control" the network company in the sense of Article 3 (3) of the Merger Regulation. In this case the network company remains part of a vertically integrated company and, consequently, needs to be independent in functional terms in the sense of Article 15 (2) of the E-Directive and Article 13(2) of the G-Directive.

- It can give up "control" over the company, e.g. by selling all or nearly all shares of the company to third parties. As a consequence, the network company does not form part of a vertically integrated company any more and in particular Art. 15 (2) [13(2) G] does not apply.

5.2.2. An undertaking involved in supply/generation "controls" one – or more – legally separate distribution companies

In such circumstances, since the group of companies as a whole forms on single vertically integrated company, all connected customers of all the distribution companies "controlled" by the undertaking have to be aggregated. Where applicable, to this figure have to be added the customers connected to a distribution network which is operated in the same company structure as the supply/generation business in question.

If the aggregated figure is above 100.000, *all* "controlled" network companies have to be unbundled in compliance with Art. 15, [13 G] even if the companies in questions, when looked at individually, serve less than 100.000 customers.

The underlying reasons for this rule are twofold:

- the exemption from Art. 15 [13 G] is justified to take account of the particular situation of smaller distribution companies. However, a company that controls several network companies which in total serve more than 100.000 customers cannot be considered a smaller company

- without the aggregation of customers, circumvention would be easy: an integrated undertaking could organise its distribution in such a way that the rules on functional unbundling do not apply, namely through the creation of a number of distribution companies which all individually serve less than 100.000 customers.

In the following, three practical examples illustrating the application of the 100.000 customers rule under scenario 2:

1. Company A, involved in supply, buys three network companies, each serving 40.000 customers: All three companies have to be functionally unbundled (or be merged into one or two unbundled companies).

2. Company A, involved in supply, buys five network companies, one serving 120.000, the remaining four each serving 1000 customers: All five companies have to be unbundled (or be merged into one or several unbundled companies).

3. Company A, involved and supply and operating a distribution network of 80.000 customers in the same company structure (i.e. not unbundled), buys a network company serving 30.000 customers: the whole network business, including the 80.000 customers served thus far, has to be unbundled.

5.3. Discretion of Member States in applying the exemption

It must be underlined that the threshold “100 000” was chosen since it was considered an appropriate figure in view of the situation in the Community as a whole. In contrast, when deciding on a possible derogation Member States should primarily consider national circumstances and, as a consequence, lower the threshold when appropriate. As a general rule, the national threshold selected should lead to a result where as many final customers as possible can benefit from unbundled network access.

Furthermore, Member States shall normally opt for a differentiated approach and not systematically exempt all smaller DSOs from both legal *and* functional unbundling. A gradual approach would foresee for the “bigger” small DSO an exemption from legal unbundling, while maintaining functional unbundling, or at least certain elements of functional unbundling. Only the smallest companies would be exempted from both unbundling requirements.

C. ACCOUNTING UNBUNDLING

1. Relevant provisions of the directives

Article 19, paragraph 1-4, of the E-directive and states:

Unbundling of accounts

1. *Member States shall take the necessary steps to ensure that the accounts of electricity undertakings are kept in accordance with paragraphs 2 to 3.*

2. *Electricity undertakings, whatever their system of ownership or legal form, shall draw up, submit to audit and publish their annual accounts in accordance with the rules of national law concerning the annual accounts of limited liability companies adopted pursuant to the Fourth Council Directive 78/660/EC of 25 July 1978 based on Article 44(2)(g) [*] of the Treaty on the annual accounts of certain types of companies [6].*

   Undertakings which are not legally obliged to publish their annual accounts shall keep a copy of these at the disposal of the public in their head office.

3. *Electricity undertakings shall, in their internal accounting, keep separate accounts for each of their transmission and distribution activities as they would be required to do if the activities in question were carried out by separate undertakings, with a view to avoiding discrimination, cross-subsidisation and distortion of competition. They shall also keep accounts, which may be consolidated, for other electricity activities not relating to transmission or distribution. Until 1 July 2007, they shall keep separate accounts for supply activities for eligible customers and supply activities for non-eligible customers. Revenue from ownership of the transmission/distribution system shall be specified in the accounts. Where appropriate, they shall keep consolidated accounts for other, non-electricity/gas activities. The internal accounts shall include a balance sheet and a profit and loss account for each activity.*

4. *The audit, referred to in paragraph 2 of this Article, shall, in particular, verify that the obligation to avoid discrimination and cross-subsidies referred to in paragraph 3 of this article, is respected.'*

Similar provisions for gas undertakings are contained in Article 17, paragraphs 1-4, of the G-directive

[6] OJ L 222, 14.8.1978, p. 11. Directive as last amended by Directive 2001/65/EC of the European Parliament and of the Council (OJ L 283, 27.10.2001, p. 28).

[*] The title of Directive 78/660/EEC has been adjusted to take account of the renumbering of the Articles of the Treaty establishing the European Community in accordance with Article 12 of the Treaty of Amsterdam; the original reference was to Article 54(3)(g).

2. Basic principles

The provisions on accounting unbundling remain largely unchanged compared to the first directives. Given the new requirement of legal unbundling, which leads necessarily to accounting unbundling, they are under the new regime of particular relevance for DSOs which are not legally unbundled.

In should be noted that, unlike legal and functional unbundling, no derogation is possible from accounting unbundling for smaller DSOs. Accounting unbundling is thus the minimum separation requirement to be respected by every network operator, without exception.

The basic principle is that separate accounts have to be kept for network activities related to gas and electricity. Consolidated accounts are possible for all other activities, including the remaining gas and electricity activities. However, as an exception to this rule, until complete market opening, separate accounts have to be kept for sales to eligible and non-eligible customers, in order to avoid cross-subsidisation of the former by the latter.

3. Importance of accurate cost allocation

At least equally important as the principle of accounting unbundling is an accurate application of accounting principles. It is vital that cost items are allocated in a transparent and accurate way to the activities concerned. Notably, any overstatement of the costs of the network business must be excluded. Such inaccurate cost allocation is likely to lead to cross-subsidisation in favour of the supply business and would thus distort competition in the supply market.

Since paragraph 4 of the relevant articles underlines that the audit foreseen in paragraph 2 looks at the issue of possible cross-subsidisation, it is clear that the audit shall examine the way the cost allocation has been done.

It must also be noted that regulatory authorities play a key role in this respect. According to Article 23 (1e) of the E-directive (Art. 25 (1e) of the G-directive) they shall, through monitoring effective accounting unbundling, ensure that there are no cross-subsidies between generation/supply and transmission/distribution.

It should be noted in this context that incentive based regulation ("price caps") of network access charges can be an effective instrument to considerably reduce the incentives and possibilities for integrated companies to shift costs from the supply/production business to the network business. Incentive based regulation, apart from its other advantages, can thus be an effective instrument to reduce the risk of cross-subsidisation.

ANNEX

APPLICATION OF UNBUNDLING RULES TO TSOS AND DSOS

	Legal Unbundling	**Functional Unbundling**	**Accounting Unbundling**
TSO	+	+	+
DSO above 100.000 customers	Exemption possible until 1.7.2007	+	+
DSO below 100.000 customers	Exemption possible	Exemption possible	+