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Report on the ITO Model

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Progress towards completing the Internal Energy Market

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1. INTRODUCTION

Directives 2009/72/EC ('the Electricity Directive')[1] and 2009/73/EC ('the Gas Directive')[2] introduced new and stricter rules on the unbundling of transmission system operators ('TSOs'). Under these Directives, part of the Third Energy Package, three possible unbundling models were provided: ownership unbundling, independent system operator ('ISO') and independent transmission operator ('ITO').

It is the aim of the present Staff Working Paper to provide an assessment of the ITO model and the extent to which it is capable of sufficiently and adequately ensuring the effective separation of transmission networks from generation and supply interests. Hereby the Commission is fulfilling its legal obligation, under Article 47(3) of the Electricity Directive and Article 52(3) of the Gas Directive, to submit a report outlining the extent to which the unbundling requirements under Chapter V resp. IV have been successful in ensuring full and effective independence of transmission system operators.

At the set-out of this monitoring exercise, the Commission had issued opinions on 26 ITOs which has enabled it to gain in-depth insight in how the rules are applied and what the most relevant issues are in each individual case. In all cases, the Commission has brought forward its suggestions to the relevant national regulatory authorities on how the ITO-provisions should be interpreted in the case at hand. The conclusions presented in this document draw not only on this experience, but also on a study commissioned by the services of DG Energy which analysed the functioning of the ITO model in practice *inter alia* through detailed questionnaires and follow-up interviews. The written questionnaires were distributed to three target groups: i) National Regulatory Authorities (NRAs) from jurisdictions in which TSOs have been certified under the ITO model; ii) TSOs certified under the ITO model and iii) network users. All NRAs from jurisdictions in which ITOs operate participated in the questionnaire and so did 24 out of 26 certified ITOs and 20 network users from across the EU. The majority of the responses came from respondents in Western and Central Europe, while some responses were received also from Southern and Eastern Europe.

2. STATE OF PLAY

Where on the date of entry into force of the Electricity and Gas Directives, i.e. 3 September 2009, the transmission system belonged to a vertically integrated undertaking, a Member State could decide not to apply the rules of full ownership unbundling, but to provide for an independent transmission operator. The ITO model under the Third Energy Package permits TSOs to remain part of a vertically integrated undertaking ('VIU') as long as a set of detailed behavioural and structural criteria, laid down in Chapter IV of the Gas Directive and Chapter V of the Electricity Directive, are respected.

The Directives also provide for a certification process whereby the NRAs assess compliance of the TSOs with the unbundling model of their choice. While the certification procedure is applicable for all unbundling models, additional requirements are in place for those TSOs who choose, in countries where the ITO model is available as an option under national law, to follow the ITO model.

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[1] Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC (OJ L 211, 14.8.2009,p. 55).

[2] Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC (OJ L 211, 14.8.2009,p. 94).

At the time of writing of this document, there were 26 certified ITOs in 10 EU Member States (Austria, Czech Republic, France, Germany, Greece, Hungary, Ireland, Italy, Slovakia and Slovenia). The majority of the certified ITOs are operating in the gas sector (21), while only five ITOs are active in the electricity sector.

In addition, a certification of one TSO under the ITO model was rejected in 2013, while another TSO decided to withdraw its application for the ITO certification. Moreover, there is a limited number of remaining TSOs which are likely to be certified as ITOs but for which a certification process at European level has not started yet.

3. MAIN FINDINGS

The findings as set out in this Chapter reflect the Commission's assessment of the effectiveness and the implementation of the various elements that together make up the ITO-model. The findings, which are backed to a large extent by the responses to the questionnaires, are however inevitably of a preliminary nature given that we are still in the early days of implementation of the ITO-model.

Autonomy Requirements

The Directives require that in order to be autonomous vis-à-vis any other part of the VIU, ITOs must be equipped with all financial, technical, physical and human resources. It is the Commission's provisional impression that in general the autonomy requirements for ITOs under the Third Energy Package are applied and work in practice to ensure the autonomy of the ITO vis-à-vis its parent undertaking and other parts of the VIU. This is also supported by the NRAs and ITOs themselves in their written submissions to the inquiry, in which they confirm that they consider the ITO to be sufficiently independent from the VIU. No formal complaints have been submitted to the Commission's Directorate General for Energy by market participants in this regard and the vast majority of responses from the network users to the questionnaire confirmed that they have had little or no reason to complain about the autonomy of ITOs they are directly working with. It should however be highlighted that half of network users that responded (10) indicated that they are themselves part of a VIU.

Independence of the TSO

The Gas and Electricity Directives require the ITO to be independent from the VIU, in particular with regards to decision-making rights, the power to raise money on the capital markets and its corporate structure. In its certification opinions, the Commission has frequently raised issues related to these points, especially where various contracts between ITO and VIU had remained in place or where it was unclear to what extent the ITO had the disposal over sufficient funds to ensure autonomous investment decisions. In general, these issues have subsequently been implemented by the respective NRAs and ITOs. It appears from participants to the inquiry, the NRAs, ITOs and network users alike, that the related rules under the ITO model are now working in practice and ensure independence of the ITOs. In fact, it was noted that the level of independence of the TSOs had generally improved with the implementation of the unbundling requirements. There were only a few instances in which respondents reported that NRA investigations were triggered in relation to the independence of the ITO. In all cases described in the questionnaires warnings of the regulator were taken into account.

Significant monitoring of compliance with the unbundling rules occurs in relation to commercial and financial agreements between ITOs and other parts of the VIU. Responses by

both NRAs and ITOs indicate that ITOs comply with their obligation to notify commercial agreements with its VIU to the NRA and that the NRAs scrutinize those agreements carefully. Furthermore, there appears to be a regular communication between ITOs and the NRAs in relation to possible issues and where guidance from the NRA is needed concerning independence (or autonomy) of the ITO, thus solving potential issues during informal consultations.

Independence of the staff and management of the TSO

The Directives set out specific rules aimed at ensuring that any potential conflicts of interest of the management and employees of the ITO are avoided. On the basis of the certification decisions by the NRAs as scrutinized by the Commission in the context of the certification procedure, the Commission is of the impression that these rules have been implemented and applied to an acceptable extent. That is to say, the certification decisions suggest that it is generally ensured that the people working for the ITO no longer have an interest to favour the VIU over other network users.

All NRAs participating in the study confirm that their impression is that the provisions work in practice and effectively ensure independence of the management and employees of the ITO vis-à-vis its parent undertaking and other parts of the vertically integrated undertaking. While acknowledging that the ITO model has improved the effective separation of transmission and generation/supply activities, one Regulator did highlight, however, that it was ultimately impossible for the NRA to fully assess whether the ITO is acting independently in carrying out its day-to-day activities.

ITOs participating in the questionnaire provided examples on how Compliance Officers monitor and ensure the independence of staff and management. For example, nearly all Compliance Officers indicated that they attend meetings of the management, supervisory board and/or stakeholders. Other examples of monitoring include conducting in-house training, liaising with the Human Resources and conducting on-the-spot audits. Responses also indicate that the so-called 'Cooling On/Off period' of three/four years for the persons responsible for the management and/or members of the administrative bodies of the ITO is often seen as too long by TSOs and some NRAs, which in their opinion prevents selection of the best candidates for positions at the ITO.

Supervisory Body

Pursuant to the Directives the Supervisory Body is responsible for decisions of the ITO which may have significant impact on the value of the assets of the shareholders in the TSO. The Supervisory Body, however, may not be involved in day-to-day activities of the ITO, management of the network and the development of the network development plan. Most respondents to the questionnaire confirmed that the Supervisory Body rules are implemented in practice and are considered to be effective. In particular, the Compliance Officers of all ITOs reported that they monitor and ensure independence of the Supervisory Body by attending meetings and checking reports and minutes. Some ITOs have chosen to introduce a Code of Conduct or Ethics Code to provide additional guidance and clarification. Two TSOs did report, however, occasions when the parent undertaking or other parts of the VIU attempted to interfere with day-to-day activities of the ITO, but these unsuccessful attempts were detected on time and refused.

Two NRAs indicated that the current rules on the Supervisory Body may not be working that effectively in practice. The responses suggest that in some situations the Regulator had no possibility to act against the VIU, which would imply that strengthening of NRA powers vis-

à-vis the Supervisory Body, or alternatively strengthening of the independence requirements of the Supervisory Body needs to be considered.

It was suggested that the independence requirements for members of the Supervisory Body should be made stricter (currently independence requirements must apply to a minority of the members of the Supervisory Body only). Also, it was indicated that clarification would be welcome with regards to the scope of information rights of shareholders in the context of cooperate governance and reporting duties vis-à-vis its parent company.

The Commission acknowledges that the rules related to the Supervisory Body may, even when they are applied strictly, not always result in a situation in which it can be easily monitored and determined that any undue interference of the members of the Supervisory Body is indeed prevented.

Compliance Programme and Compliance Officer

The Directives require that ITOs establish and implement a Compliance Programme to ensure that discriminatory conduct is excluded and compliance is adequately monitored. Equally, a Compliance Officer has to be appointed by the Supervisory Board and approved by the NRA, who is responsible for reporting on the compliance of the ITO with its obligations.

In order to draw conclusions on how the programmes and officers work in practice, the Commission has largely relied on the outcomes of the study. Compliance Programmes, which normally are available to all employees and are made public in some cases, are generally seen as an effective tool in helping to monitor ITOs' compliance with the unbundling requirements. Some respondents, however, raised some concerns in this respect. One regulator was of the opinion that the Programme is a "toothless tiger" (a written promise of the ITO to comply with the rules), while another NRA highlighted that the Compliance Programme is effective from a TSO's perspective as part of self-regulation, indirectly implying that there are some doubts on the effectiveness of the Compliance Programme from this Regulator's point of view.

All of the Compliance Officers reported taking active steps to positively monitor the compliance of the ITO and there were no reports on obstructions of the Compliance Officer by the VIU. As a related matter, almost all respondents were of the view that the Compliance Officers are sufficiently equipped to carry out their tasks effectively. It seems that regular exchanges between Compliance Officer and the NRA help to ensure effective monitoring of compliance with the unbundling rules. This involves regular compliance reports which the officers prepare for and submit to the NRAs as well as meetings in order to check whether monitoring is effective and Compliance Officers fulfil their tasks.

Many Compliance Officers indicated that additional guidance or the establishment of a network of Compliance Officers would be welcome tools. A suggestion was also made to grant a right of the Compliance Officer to request clarification from the VIU in situations when possibly non-compliant actions are initiated not by the TSO but the VIU.

Network development and powers to make investment decisions

The Directives require ITOs to set up a ten-year network development plan (TYNDP) on an annual basis identifying both the investments already decided upon and new investments which need to be executed within the next three years in order to ensure that the necessary investments are made in the network. As a general comment, it is too early to judge whether the establishment of TYNDPs is a guarantee for a sufficient degree of investment in the networks.

All ITOs have already adopted their first set of annual TYNDPs and, in the responses to the questionnaire, the majority of these ITOs confirmed that they have sufficient resources to finance them. Only one ITO responded that it did not have the resources required to finance the necessary investments but there were no indications whether this is due to influence by the VIU. No formal complaints were submitted to the relevant NRAs in relation to the TYNDP, but there are reports that two NRAs successfully intervened in the past to ensure the appropriateness of the TYNDP.

The majority of network users participating in the questionnaire confirmed that they have been consulted on the TSO's TYNDP by the NRA or the TSO itself, which illustrates that the respective provisions in the Directive regarding consultation on the TYNDP usually work in practice. Equally, as indicated by nearly all network users, the TYNDPs effectively ensure that the necessary infrastructure investments are identified, planned and executed appropriately. This is a view shared also by nearly all NRAs and ITOs. Nevertheless, the suggestion was made by some TSOs that it would be useful to harmonise the different intervals for network development plans at national (1 year) and European (2 years) level.

Concerning investment decisions, there appears to be no difference between the levels of investment made by TSOs under the ITO or the OU model in countries where both models exist. In two instances the lack of financial resources to carry out the necessary investments was highlighted by an ITO and a Regulator. A couple of ITOs noted that the question of whether they have sufficient financial resources is not related to the fact that they have adopted the ITO model. Given that only the first set of annual TYNDP has been adopted, it might be too early to fully assess whether all the necessary investments are being carried out in practice.

4. CONCLUSIONS

As a first remark it needs to be underlined that ITOs have been certified only since 2012 and have been operating under the new rules for a very short period of time. It is therefore too early to draw definite conclusions on the functioning of the model and the actual independence of the ITOs in practice. Also, compliance checks are still ongoing to ensure the correct implementation of the existing unbundling requirements under the Gas and Electricity Directives in the national legislation of the Member States in which the ITO model is implemented. Finally, several stakeholders indicated in their questionnaires that it is too early to suggest significant changes to the ITO model.

That being said, the ITO study underlines the initial assessment of the Commission that at present, in the view of the Compliance Officers, but also of NRAs and the majority of network users who responded to the questionnaire, most requirements related to the ITO model seem to work in practice and are usually sufficient and adequate to ensure effective separation of the transmission business from generation and supply activities in the day-to-day business. This suggests that the notion that the positive effects that unbundling has on facilitating cross-border trade as well as security of supply can also materialize in market areas where the network is operated by an ITO.

Although ensuring compliance under the ITO model appears to be burdensome for both the NRAs and the TSOs involved, this does not mean that the ITO model is not effective in separating transmission and generation/supply and ensuring investments in the networks.

Provisions designed to ensure autonomy, independence of the ITO and independence of the staff and management seem to be working well. Compliance Officers seem to have sufficient

powers to execute their role effectively and to monitor compliance of the ITO with their respective Compliance Programmes. Equally, ITOs are actively consulting with the NRA with regards to commercial and financial agreements between ITOs and other parts of the VIU.

Nevertheless, careful monitoring is essential with regards to the requirements for the Supervisory Board and its independence from the VIU, provisions concerning Cooling On/Off period, effectiveness of the Compliance Programme and ITOs ability to ensure that the necessary investments are made in the network.

Whilst the ITO model so far appears to function well in practice, it may be further improved, for instance, by strengthening the independence of the Supervisory Board, specifying the scope of the Compliance Programmes and developing common guidance and a network of cooperation for Compliance Officers, as well as harmonising the timeframe for network development plans at national and European level. Therefore, the Commission will continue to monitor the implementation and effectiveness of the unbundling requirements under the Third Energy Package. The Commission will also continue to be vigilant to ensure that ITOs and VIUs comply with the EU competition rules.