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# UNBUNDLING OF DISTRIBUTION SYSTEM OPERATORS

## GUIDE AND REQUIREMENTS FOR PRACTICAL IMPLEMENTATION

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### 1. RATIONALE

*To create a level playing field at retail level, the activities of distribution system operators should therefore be monitored so that they are **prevented from taking advantage of their vertical integration** as regards their competitive position on the market, in particular in relation to household and small non-household customers<sup>1</sup>.*

### 2. INTRODUCTION

All DSOs in the Energy Community are bundled with one or more energy activities. In most Contracting Parties they are legally bundled with supply activity. In many CPs they are legally bundled with generation and supply.

Articles 26, 30 and 31 of Electricity Directive 2009/72/EC<sup>2</sup> and Gas Directive 2009/73/EC<sup>3</sup> define key requirements for unbundling of Distribution System Operators (DSO) aimed to ensure their independence in a vertically integrated undertaking (VIU) from the supply branch and to prevent market distortion through cross-subsidization and discrimination of other supply companies. Ministerial Council Decision 2011/02/MC-EnC4 requires implementation of the legal provisions by 1 January 2015<sup>5</sup>. A Commission's Interpretative Note on The Unbundling Regime<sup>6</sup> from 22 January 2010 ("Interpretative Note") explains requirements more in detail.

The rules stated in the Directives are minimum requirements; national legislation may define more strict requirements, depending on the organisation of the sector.

It is of outmost importance to properly transpose obligations related to DSO unbundling, thus enabling DSOs to perform their role of a fair market facilitator.

### 3. UNBUNDLING REQUIREMENTS

#### 3.1. Legal unbundling

The Directives do not leave any room for flexibility: DSOs must have a **separate legal form**: "*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. Those rules shall not create an obligation to separate the ownership of assets of the distribution system operator from the vertically integrated undertaking.*"<sup>7</sup>

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<sup>1</sup> Electricity Directive 2009/72/EC, recital 26 and Gas Directive 2009/73/EC, recital 25.

<sup>2</sup> OJ L 211 of 14.8.2009, p 55 et seq.

<sup>3</sup> OJ L 211 of 14.8.2009, p 94 et seq.

<sup>4</sup> Including the Third Energy Package in the Energy Community

<sup>5</sup> The obligation was, so far, only met by Serbia and Albania (for electricity).

<sup>6</sup> [http://ec.europa.eu/energy/sites/ener/files/documents/2010\\_01\\_21\\_the\\_unbundling\\_regime.pdf](http://ec.europa.eu/energy/sites/ener/files/documents/2010_01_21_the_unbundling_regime.pdf)

<sup>7</sup> Article 26(1) Electricity and Gas Directives.

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An **exception** exists for DSOs serving less than 100.000 customers or closed distribution systems<sup>8</sup>. The threshold of 100.000 customers is not limited to a single legal entity of a vertically integrated undertaking but must refer to the whole customer base of the integrated undertaking. Contracting Parties may opt to not allow any exemption or to decrease the threshold. Already to the Third Package adjusted existing legislation in Serbia (electricity and gas) and Albania (electricity) both include the 100.000 customer threshold and the possibility to operate closed distribution systems; the same is the case for most of the draft laws prepared in the remaining 6 Contracting Parties.

### 3.2. Functional unbundling

When DSO is part of a vertically integrated undertaking, it must comply with requirements related to functional unbundling. As elaborated in the Interpretative note on Unbundling Regime, functional unbundling must include:

- **Management separation**
- **Independence and effective decision making right of a DSO**
- **Separate identity in communication and branding**
- **Preservation of confidentiality of commercially sensitive information by DSO (non-disclosure in discriminatory manner)**

#### 3.2.1. Compliance Programme

To ensure that functional unbundling takes place and is maintained in a permanent and systematic manner, DSOs must **develop a compliance programme** and **appoint a compliance officer**.

The regulatory authority or other national body will have right and duty to monitor functional unbundling and compliance programme in particular. The compliance officer is the key figure responsible for *permanent and continuous* monitoring the application and effectiveness of the compliance programme is working, for evaluation of the effectiveness of the applied policies, procedures and measures, and for regular reporting to regulatory authority. This report must contain elaboration of the taken measures and their effectiveness as well as any risk for non-compliance. The report must be published.

To fulfill his task, the compliance officer must be fully independent and must have **access to all the necessary information**, not only of the DSO but of any affiliated undertaking.

The scope of the compliance programme will depend on the complexity of integrated undertakings, their legal form and the already established management and supervisory system.

The Interpretative Note explains that the compliance programme shall set out measures taken to ensure that discriminatory conduct is excluded and to ensure that conduct of DSO staff in this aspect is adequately monitored. It is a **formal framework** for ensuring that the entire network activities as well as individual employees and the management of the DSO comply with the principle of non-discrimination. The compliance programme shall explicitly define policies and procedures to be observed by management and staff. Such policies may consist, inter alia, of the following elements:

- active, regular and **visible support of the management** for the programme;
- **written commitment of staff** to the programme by signing up to the compliance programme;
- indication to **disciplinary action** which will be taken against staff violating the compliance rules;
- **training on compliance on a regular basis** and notably as part of the induction programme for new staff.

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<sup>8</sup> Articles 26(4) and 28 of the Electricity and Gas Directives.

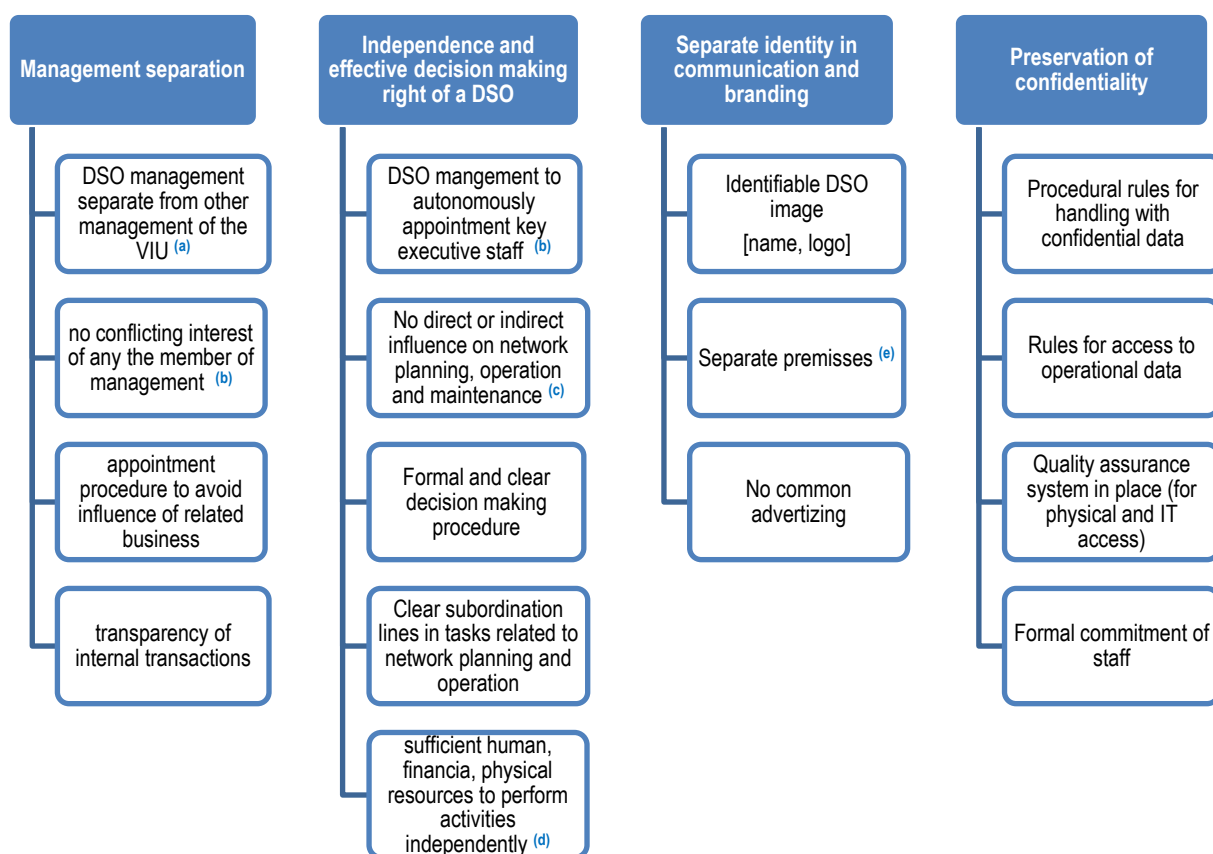
### 3.2.2. Functional Unbundling Toolbox

Implementation of each requirement can be monitored against a set of procedural indicators. An example of a toolbox is presented hereinafter:

1. written procedures in place, applicable for all DSO, covering the internal structure for conduct and communication in decision making, daily operation and relations with external entities;
2. compliance programme in place based on the written internal rules and formal commitment;
3. independent supervision and certification of compliance;
4. rules of procedure communicated to all staff in formal way.

Further to this, DSOs may consider the introduction of formal Quality Management procedures. Such set of formal procedures will significantly facilitate monitoring and implementation of the compliance programme. Formalized procedural rules in conformity with imposed unbundling requirements certified by authorized institution, checked and verified in regular intervals will provide official evidence of compliance.

The overview graph hereinafter schematically shows a detailed breakdown of indicators that contribute to fulfillment of the four obligatory functional unbundling pillars.



**Legend:** the elements necessary for compliance with the functional unbundling pillars shall more in detail entail the following measures:

<sup>(a)</sup> Management staff of the DSO shall not participate in corporate structures of the VIU or of its any subsidiary responsible, directly or indirectly, for the day-to-day operation of the production, distribution and/or supply of natural gas. In this regard:

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- Members of the Management Board, the General Manager, as well as operational management (*i.e.* heads of units) of the DSO shall not be employed by the parent company or its any subsidiaries engaged in generation/production and/or supply and shall not be appointed as members of any corporate body of these companies, including supervisory and management boards;
  - the parent company may be represented in the Supervisory Board of the DSO, though having in mind that such representatives shall not be involved in day-to-day DSO-related decisions. Based on international best practices in management and good business conduct, however, it is highly recommended to form the Supervisory Board of the DSO from independent experts.
- (b) Appropriate measures shall be taken in order to ensure independence of the management staff of the DSO and to secure its professional interests in performing assigned functions related to day-to-day DSO-related activities. In particular, the following minimum measures shall be applied:
- The salary of the General Manager of the DSO shall not be based on the performance of the parent company and shall be established on the basis of pre-fixed elements related to the performance of the Network Company<sup>9</sup>;
  - Employees shall be subject only to the authority of the management of the DSO and Promotions and sanctions can be decided only by the management of the network company<sup>10</sup>;
  - The reasons justifying a replacement of a member of the Supervisory Board and/or Management Board, or of the General Manager of the DSO at the initiative of the VIU shall be clearly spelt out in the Statutes of the Network Company<sup>11</sup>;
  - Transfer of management staff of the Network Company to the parent company or its any subsidiaries engaged in the generation/production and/or supply and vice versa shall be made subject to transparent conditions clearly spelt out in the Statutes of the DSO, including that any of such transfers shall not be predetermined from the outset<sup>12</sup>;
  - The DSO shall not be allowed to hold shares of the parent company or its any subsidiaries engaged in generation/production and/or supply;
  - Shareholding interests of the General Manager and/or other management staff of the DSO in the parent company or its any subsidiary engaged in generation/production and/or supply shall be clearly limited so as to ensure independence of the DSO's management staff and to prevent any potential conflict of interest<sup>13</sup>.
- (c) Decision-making rights of the DSO should not preclude the mother company exercising its economic and management rights in respect of return on assets in the DSO. In particular, the mother company may approve the annual financial plan, or any equivalent instrument, of the DSO and set global limits on the levels of its indebtedness. However, the mother company in no manner whatsoever shall be permitted to give instructions regarding day-to-day DSO-related activities. Furthermore, within the scope of the approved financial plan, the DSO shall have complete independence. These requirements shall be elaborated in the Statutes of the DSO.
- (d) Including enough resources to prepare decisions, evaluate alternatives and to be assisted by external consultants. The network company could choose to benefit from general services performed by the parent company if it demonstrates that this choice results in lower costs and it does not imply any undue dependence. Such services shall be provided under precisely defined contracts, which are to be kept at the disposal of the regulator. Certain services,

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<sup>9</sup> ERGEG, Guidelines of Good Practice on Functional and Informational Unbundling for DSOs, Ref: C06-CUB-12-4b (15.7.2008).

<sup>10</sup> *ibidem*.

<sup>11</sup> *ibidem*.

<sup>12</sup> *ibidem*.

<sup>13</sup> *ibidem*.

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especially strategic ones such as the legal, regulatory and controlling services, have to be established in the network company.<sup>14</sup>

- (e) Physical separation that restricts access to facilities and geographical separation including separate buildings.<sup>15</sup>

Annex 1 provides a [checklist](#) indicating points of relevance to assess functional unbundling, as well as documents and other evidence as a basis for such assessment.

### 3.3. Accounting unbundling

The provisions of the Directives are very strict<sup>16</sup> as regards the need for DSOs to be unbundled in terms of accounting. They have to draw up, submit to audit and publish its annual accounts.

The Interpretative Note provides only few additional points to further explain this requirement. As a standing rule no derogation is possible and even small DSOs and closed distribution systems, which may remain legally bundled with other activities, must keep separate accounts for their network activities. The minimum requirement (in case of legally bundled entities) is preparing a balance sheet and income statement. Regulatory overview of accounting unbundling is another key requirement<sup>17</sup>.

Finally, accounts and financial report must be audited. The scope of audit may be subject to specific regulatory requirements with the aim to ensure that there is no cross-subsidization between activities. In this case an audit has to examine the way costs have been allocated.

Article 31 of the Gas and Electricity Directives explicitly requires that **annual accounts** are disclosed in accordance with the rules of national legislation concerning annual accounts of limited liability companies adopted pursuant to the Fourth Council Directive 78/660/EEC<sup>18</sup>. This provision, as explained in Interpretative Note, for accounting unbundling requires **accurate application of accounting principles**.

In the EU and all Contracting Parties International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) are used as accounting principles. Basic principles defined in these standards related to fair presentation of the financial position, assets and liabilities, income, changes in capital and statement of cash flow, must be followed by DSOs with different operating segments and all its related undertaking. This refers to treatment of property, plant and equipment, including revaluation, impairment of assets, leases, borrowing costs, inventories, provisions and contingencies etc.

Standards defining **segment reporting** and **related party disclosures** are crucial in this exercise. Accounting policies have to ensure that transactions with related undertakings and internally procured or provided goods and services are recognized at fair value.

In accordance with IAS 14 Segment reporting and IFRS 8 Operating segment, the basis for inter-segment pricing must be defined and disclosed. In case of related undertakings, IAS 24 must be applied, including the disclosure of nature and amount of transactions, nature of relationship where control exists, such as from parent – subsidiary relationships, entities under common control, associates, individuals who, through ownership, have a significant influence over the enterprise and close members of their families, and key management personnel. In case of associated undertakings, IFRS 8 (Associates and joint ventures) and IAS 28 (Investment in associates) must be applied.

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<sup>14</sup> *ibidem*.

<sup>15</sup> *ibidem*

<sup>16</sup> Article 31 of the Gas and Electricity Directives.

<sup>17</sup> Article 30 of the Gas and Electricity Directives.

<sup>18</sup> The Council Decision lists provisions concerning the presentation and content of annual accounts and annual reports, the valuation methods used and their publication in respect of all companies with limited liability.

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Accounting policies of the undertaking shall be analyzed for compliance with the unbundling requirements. Audit will have to confirm if accounting policies are in place to ensure fair presentation of the financial position of the DSOs and its transactions with related undertakings.

The audit of financial statements shall confirm that **inter-segment prices** are fairly established, in accordance with sound accounting policies and that goods and services procured from related parties are charged at fair value. Measuring the fair value of these goods in this respect shall be based on the accounting policies of the undertakings, respecting the accounting principles and standards.

Services of general and administrative nature may also be provided from related parties, be it special service center for this purpose or a segment in another undertaking.

The principle mentioned above, i.e. that the network company could choose to benefit from general services performed by the parent company if it demonstrates that this choice results in lower costs and it does not imply any undue dependence. Such services shall be provided under precisely defined contracts, which are to be kept at the disposal of the regulator.<sup>19</sup>

Sound policies would require establishing a service agreement to measure the scope and quality of provided services. Keys for allocation of respective costs of service must be determined in a transparent manner. These keys are also subject to audit, in accordance with Article 31 of the Directives.

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<sup>19</sup>ERGEG, Guidelines of Good Practice on Functional and Informational Unbundling for DSOs, Ref: C06-CUB-12-4b (15.7.2008).

## Annex 1. Checklist for functional unbundling

	Check-list	Status (Explanation – Evidence)
<b>Separate company</b>		
1.	Is DSO activity properly identified in national classification system in accordance with <a href="#">NACE 2 classification</a> [Class D activity 35.13]	Classification of activities
	Is a separate network company established to perform all functions related to the operation of the distribution network and provision of distribution-related services?	Act of establishment, indicating activities as written in the company founding act and court registration
2.	Is the Company authorised by the NRA for the distribution system operation and provision of the distribution-related services?	License issued on____ valid through:
3.	Does the DSO company have legal authorisation (registration) to conduct any other energy related activity? If yes, specify as indicated in the court registration act	List or other activities and indicate their code in NACE classification
4.	Is the DSO company authorized by NRA for any other activity? If yes, please specify.	List activities and valid licenses issued on____ valid through____
5.	Does the company earn any income from other activities falling in the D class NACE 2? If yes, please specify.	List the activities and share of annual turnover earned from respective activity [in %]
<b>Corporate status</b>		
1.	What is the type of establishment of the DSO? (holding company, parent company, subsidiary, other)	Act of establishment and registration
2.	How is the governing structure for the, vertically integrated company defined in national legislation? (the roles of management board, supervisory board, shareholders etc as defined in the legislation)	Corporate law, energy legislation
3.	What is the ownership structure? Indicate any owner/shareholder possessing interest in production, transmission or supply business and his respective shares	List all shareholders with > 5% shares in equity and if any of them have interest in production, transmission or supply
4.	Is the DSO related with any other energy undertaking, either as controlling or controlled entity? If yes, please list all related undertakings and type of relation / association.	List company's names and their main activities and type [parent company, subsidiary, controlling owners, controlled, etc]
5.	Does any production, transmission or supply undertaking have interest (participating interest <sup>20</sup> or exercise significant influence) in DSO?	
6.	Does the DSO have any interest in undertaking operating in production, transmission or supply?	
<b>Roles, powers and responsibilities</b>		
1.	What are the corporate bodies?	Corporate law and Statute
	What is the organisational structure of the DSO?	Chart of organisation
2.	Appointment and competencies of management board – tasks and subordination lines for each assignment.	Procedure of appointment, code of conduct and job description
3.	If supervisory board is (will be) established (respective law), specify the procedure for appointment, tasks,	Corporate statute

<sup>20</sup> Interest held by one organization in the shares of another organization, provided these shares are held on a long-term.



	Check-list	Status (Explanation – Evidence)
	competencies and subordination lines per assignment, if any - to confirm that management of related undertakings has no influence on the appointment and members have no interest in any of its related undertakings	
<b>Independence of management</b>		
	Management: refers to management and to the persons directly reporting to them on matters related to the operation, maintenance or development of the network)	
1.	Persons responsible for DSO (management and senior executives) are professionally independent from other parts of the VIU and capable to act independently.	Corporate Statute
2.	Persons responsible for the management of the DSO do not participate in company structures of the vertically integrated undertaking responsible, directly or indirectly, for the day-to-day operation of production, transmission or supply activities.	Affidavit of not holding interest or receiving any financial benefit / shareholders register
3.	Manager of the DSO, including all senior executive staff cannot at the same time be involved in managing the related transmission, supply or production company, or vice versa.	Affidavit [organisation chart of related undertakings on request]
4.	Working conditions of the management of DSO can actually ensure such independence, including remuneration to management and senior managing staff:	Work Contract - to Verify that remuneration does not depend on operation of related businesses in VIU
5.	Transfer of senior staff from DSO to related undertakings and vice versa –	Corporate Statute
6.	The management of DSO cannot exercise any professional position or responsibility, interest or business relationship, directly or indirectly, with any part of the VIU, or with its controlling shareholders, other than the DSO, for a period of three years before its appointment and four years after the termination of its term	Corporate Statute
7.	Removal of management – procedure, justification and appeal	Law / Act on establishment / Corporate Statute
<b>Independent decision making on network operation</b>		
1.	DSO must have at its disposal the necessary resources, including human, technical, physical and financial resources	Act on establishment / Corporate statute
2.	The DSO must have effective decision-making rights, independent from other parts of the VIU, with respect to assets necessary to operate, maintain or develop the network.	Corporate statute / Code of conduct - Procedural rule on financial management
3.	Responsibility for network development and powers to make investment decisions must not be shared with persons outside DSO in the VIU, except in respect of return on assets	Corporate statute / Rules on procedure
4.	Supervision rights of the vertically integrated undertaking in a subsidiary remain limited on financial plan and level of indebtedness	Corporate statute / Procedural rule on financial management
5.	DSO must have the power to raise money on the capital market sufficient to maintain and develop its infrastructure	Corporate statute
6.	All commercial and financial relations between the DSO and other parts of the VIU must comply with market and must be revealed to the NRA upon request	Internal rules of procedure
7.	Other parts of the VIU must refrain from any action impeding or prejudicing the DSO from complying with its obligations related to network operation	Internal rules of procedure
8.	Other parts of the VIU must not require DSO to seek permission from it in fulfilling its obligations related to network operation	Internal rules of procedure
<b>Additional measures</b>		
1.	Communication and branding - Separate identity of DSO	Corporate statute



	Check-list	Status (Explanation – Evidence)
2.	Protection of confidentiality of commercially sensitive information	Rules on procedure certified under the quality assurance system
3.	Regulatory oversight to confirm that DSO cannot take advantage from its vertical integration to distort competition	Sector law / rules of procedure of NRA
4.	Rules of conduct which have to be respected by staff in order to exclude discrimination, prepared by DSO and approved by NRA	Compliance programme
	Compliance officer	Report on yearly basis
<b>Accounting unbundling</b>		
1.	Shared services	Internal rules on financial management / financial control
2.	Procurement practice	Procurement legislation /Internal rules on procurement
3.	Disclosure of internal transactions	Accounting policies in accordance with <a href="#">Directive 83/349/EEC</a>
4.	Audit of financial statements	Financial legislation and Sector law