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CONSULTANT REPORT

ON DISTRIBUTION UNBUNDLING AND COMPLIANCE
(TASK 1)

MOLDOVA ENERGY REGULATORY PARTNERSHIP

May 2015

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ON DISTRIBUTION UNBUNDLING AND COMPLIANCE (TASK I)

MOLDOVA ENERGY REGULATORY PARTNERSHIP

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Executive Summary

Implementing the Energy Community *acquis* has proven to be a long-distance run. Eight years after the Energy Community Treaty entered into force, this becomes more and more clear as each country's internal differences force tailored solutions. Back in 2006, many Contracting Parties may have underestimated the profoundness of the reforms required and the stamina needed to push them through. The Treaty itself was designed for a fast sprint: made to expire in 2016 and providing no financial incentives for compliance nor functioning enforcement mechanisms, it is not fit to support Contracting Parties in reaching the objectives which are equally ambitious as the European Union's, but more difficult to achieve on account of numerous historic relics and socio-economic problems.

Moldova has shown the will to catch up with other Contracting Parties in transposing the Second and Third Package and to cooperate with the Energy Community Secretariat in that respect. As important as this task is, it must not consume the complete attention of the Ministry of Economy and the National Agency for Energy Regulation (ANRE). The electricity companies and customers suffer from uncertainty caused by the lack of tariffs and confusion about eligibility as ANRE's attention has been focused on the Second and Third Package. Energy efficiency and promoting renewable energy have also been neglected according to the Annual Report of the Energy Community on Moldova.

Moldova was late with the transposition of the Second Package. Despite the improvements made by the recent amendments to the Electricity Law, the Country still falls short of compliance in real terms. The transmission system operator is legally unbundled, even though the Electricity Law fails to properly transpose Article 10 of Directive 2003/54/EC. Under the Third Package, unbundling needs to be handled strictly, preferably through ownership unbundling. Although Union Fenosa met the deadline for unbundling, the other two still lack and have required more time. The latter two distribution companies are still not unbundled from supply in functional and accounting terms as required by Directive 2003/54/EC as adapted by the Accession Protocol, as well as the Electricity Law's deadline of 1 June 2014. Moldova thus fails to comply with the *acquis*. The Electricity Law requires legal unbundling between distribution and supply starting from 1 January 2015.

The right to third party access (TPA) has been transposed by law. However, its proper implementation is lacking. The reason for this is that ANRE's methodologies for setting network tariffs are either not appropriate or missing. The transmission tariff methodology was revised in May 2013 in order to include the network losses in the cost structure of the company. At present attempts are underway to revise the situation.

Objective

The European electricity market is undergoing major changes. The EU member states are restructuring their electricity industry to allow for more competition which is widely believed to be welfare-enhancing for the final consumers. The gains in welfare will come from the introduction of a competitive electricity market which will lead to lower retail prices. A major complication been electricity markets were almost completely controlled by large, vertically integrated utilities that were formally regulated state monopolies. It has only been realized in recent decades that unbundling of certain functions, such as generation and supply, can lead to competition that typically improves service quality and has the potential to lower prices under certain circumstances.

Key Findings

Although there were some complications around Union Fenosa's suggestion to form a common services company for certain services (HR and IT for example), the issue has been resolved and Union Fenosa will cleanly separate with no commonly shared services. From the viewpoint of the Energy Community such shared services would have been a conflict of interest and Union Fenosa would have to disband the practice eventually.

Today Union Fenosa has completed the unbundling task. The other two distribution networks, RED North and RED Northwest have not. They have requested more time. Although not a major cause of concern for ANRE at this point, it does warrant closer monitoring. Within the body of the Report I have listed a few data requests to insure both distribution networks are making progress on the issue. The issue is that after giving more time to the unbundling process, one or both of the distribution networks will at the end of the process not completed the task or worse have not even started.

From ANRE's point of view the compliance issue is straightforward. The DSO must complete a Compliance Report demonstrating that they practiced non-discrimination towards all suppliers, objectivity, transparency and provided security to commercial sensitive information. ANRE must review it and agreed with the Report. The real issue for ANRE will be when a violation occurs. ANRE will have to examine the complain and its implications, and recommend both solution and, if necessary, damages to the complaining party.

Unbundling

Unbundling is a key requirement for the introduction of competitive electricity markets. The key to the success of injecting competition is ensuring nondiscriminatory behavior from the monopolistic parts of the supply chain. To date, the European institutions have adopted an incremental approach to unbundling. The first Directive on electricity market liberalization (96/92/EC) required the accounts of distribution operations to be unbundled. The following step called for functional unbundling (organizational and decision making independence) and legal unbundling requirements were laid down in the subsequent Electricity Directive 2003/54/EC. This Directive puts in place a consistent set of rules, which provide an adequate balance between the need to ensure non-discriminatory network operation and the right of electricity companies to retain their network assets.

The most important passage related to Distribution is located in Directive 2003/54/EC (June 26, 2003).

“Where the distribution system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organization 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.”

The key words in this statement are underlined. The general concept of this statement is to separate the electricity distribution function from commercial activities. By doing so, this frees up the DSO to operate similar to a transmission system operator (TSO). The DSO will be simply a service provider to anyone that wishes to buy and sell electricity.

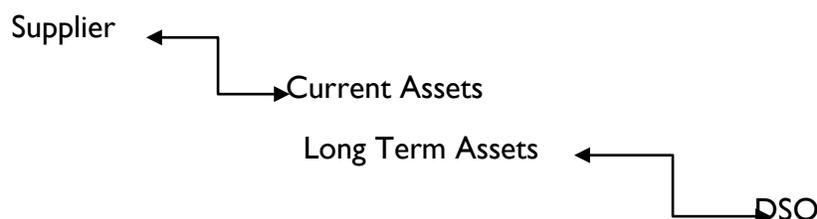
The EU distinguishes four main types of unbundling:

- 1) Functional unbundling (also called management or decision making unbundling) requires that the operational activities and management are separated.
- 2) Accounting unbundling is the least drastic form of unbundling; separate accounts must be kept for the network activities and commercial business to prevent cross subsidization.
- 3) Legal unbundling requires that distribution and commercial activities be put into separate legal entities.
- 4) Ownership unbundling is the most drastic form of unbundling. It requires the unbundled entities to have separate ownership and these entities are not allowed to hold shares in the other activities.

The lightest form of unbundling is management unbundling. This form of unbundling entails setting up separate management for the operation of the network and commercial activities. This business unit can have separate management accounts, but is not required to publish (audited) accounts. In most cases within a distribution system this form does not cause any undue burden as the management of the network itself (a DSO function) and commercial activities (supplier) are within separate units anyway. There does exist some common areas between the DSO and the supplier, and these will be discussed later in the Report.

Accounting unbundling requires the network operator to publish separate (audited) accounts for the network operation. These accounts are then opened to the public and regulatory scrutiny. Figure 1 provides some simplified clarity for the case of separating distribution from commercial activities.

Figure 1. Practical Separation



Within the EU Second Package, the traditional distribution function was to be divided into electricity distribution function (DSO) and a supply function. The most difficult part in the creation of two entities from one company concerns separation of the accounts. However, Figure I shows the separation of the combined distribution companies that currently exist is a relatively straightforward exercise. Within the context of a balance sheet for an existing electricity distribution company, there exist two classes of assets; the first is short term or current assets. This consists of mainly cash, accounts receivable and inventory. The second is long term assets which consist of the infrastructure that is used to deliver the electricity to the final consumer. Within an unbundled situation, the supplier takes control of the current assets of the exiting operation while the DSO will control the long term assets. The lack of comingling of assets allows for unbundling (in this case) to be very simplistic. These classes of assets already have separate accounting within the general ledger. The DSO will have to set up current accounts (cash and accounts receivable) in the aftermath of the th of the unbundling. However, these accounts will have far less complexity than the commercial operations of the supplier. The initial starting account for both the DSO and supplier is called the trial balance. It is the starting point going forward of two separate accounting schemes. Both firms will require an external audit and it is recommended that different audit companies be used.

Legal unbundling requires the owner of the distribution network to set up a separate legal entity that is responsible for the operation of the network assets. This legal entity will have its own accounts, management, and Board of Directors. The key to ownership is a business must be created by filing with both the National Authorities for a business license and with the Regulator for an operational license. In addition, the Board of Directors must be selected. The critical point here is one person cannot be a member of both Boards as that represents a conflict of interest.

Ownership unbundling is the most extreme form of unbundling. The major issue here is a third party becomes involved and they are required to perform an arm's length purchase of the assets. To accomplish this type of transaction requires a third party that 1) wants to own the assets for sale and 2) has access to the capital to purchase it. In addition, the third party cannot have any relationship with the existing distribution company. In other words, the two newly created companies are not allowed to have the same shareholders.

Within Moldova the ownership criteria is not a requirement. All three distribution utilities at present will continue to own the assets. However, all the other steps – separation of management, accounting and legal status – must be carried out. With regard to DSO resources, Articles 26(2) of the Electricity Directives stipulate that a DSO must have as a minimum criteria, “the necessary human, technical, financial and physical resources” to act independently in terms of its organization and decision-making power. Such criteria should not result in preventing the parent company from approving the annual financial plan, or any equivalent instrument, of the DSO or the setting of global limits on the levels of indebtedness of its subsidiary. These are top down decisions as to overall direction of the both the DSO and supply company.

Given that unbundling affects the electricity sector, what would ANRE's role be? Since Moldova wants to be compliant with the Energy Treaty, unbundling is a requirement to allow for freely traded electricity. The actual actions of unbundling do not require ANRE approval . It is recommended that a certain degree of monitoring take place to insure the process does not fall behind. Union Fenosa has completed the task. RED North and RED Northwest are still in the process and have asked for

additional time. Because of this, it would be recommended the ANRE ask for the following documentation for both the supplier and the DSO:

- Business license
- Tax registration
- List of candidates for Board of Directors
- Selection of management
- Organizational chart
- Services contract between DSO and Supplier
- Starting trial balance of each organization

The first five items on the list are small requests just to insure the initial steps have been taken. Such a request would not create any administrative burden towards the distribution company, but will provide ANRE with evidence that the distribution companies are proceeding with the unbundling task.

One task that would be important is a services contract between the DSO and supplier. Even though this Report has pointed out the relatively straightforward division of assets, there remains some functions which the DSO and supplier will utilize together. An agreement needs to be made between the newly created companies on how these services will be handled as separate entities. In a later section of this Report more detail will be provided as to the common areas that should be covered by a services contract.

Once unbundling is complete, the next step is compliance. In this case compliance means the DSO will practice non-discrimination, objectivity, transparency and confidentiality in its operations and towards current and future suppliers.

Compliance Program

The objective of the Compliance Program is to provide for equal position for all entities present in the electricity market which utilize or can utilize services of the DSO. The Compliance audits conducted both internally and externally have shown that the principles of these programs are determining the compliance with non-discrimination, objectivity, transparency and confidentiality. Closer examination of these main tenets will be given below.

To ensure there is no discriminatory conduct and the proper monitoring of this process, Article 26(2) of the Second Package also sets out requirements for the installation of a compliance program. All employees of a DSO must meet the requirements set out in this program and an annual report summarizing the measures taken has to be submitted by a person or body (compliance officer) to ANRE.

Within the Compliance Program, ANRE will have a formal and a practical role. The formal role is to collect the compliance reports at the end of an annual year and evaluate them according to the below described standards. The annual report will merely confirm the DSO has been non-discriminatory, objective, transparent and confidential in its dealings with all suppliers.

The real role for ANRE will be when a violation occurs and a complaint is registered with ANRE concerning the behavior of either the supplier or the DSO. Such actions will be disclosed immediately by the harmed entity. The violation itself will require ANRE to investigate into the alleged activities.

This investigation will be centered about whether non-competitive behavior exists, to the extent it occur and damaged to the affected party. Based on the findings, ANRE can decide what actions to undertake.

As to the criteria ANRE will use to decide if a violation has occurred, the guiding principles will be described next.

Non-Discrimination

The purpose of setting up a DSO is to provide equal access to its infrastructure for all those willing to participate in energy markets. The issue centers around the few functions the DSO and the Supplier currently share within a bundled setting. When they are unbundled into separate entities these common activities must have an agreed to protocol on how to communicate and handle the shared activity. This protocol must be available to any new entrants as well. The Compliance Program looks to uncover and correct any processes practiced by the DSO which would create a situation of discrimination in favor of a certain participant and to the detriment of another one. Of particular importance is the freedom to access and receive electricity to the retail market.

The following is a list of shared services that a bundled distribution network would have and that standard agreements between the DSP and supplier should be reached prior to unbundling;

- Call center
- Centralized remote control
- Distribution billing and payment reminders
- Interruption or reduction of supply and distribution of electricity - payment discipline
- Interruption or reduction of supply and distribution of electricity - technical and operational problems
- Switching of supplier
- Communication with customers
- Participation in traders marketing
- Breach of contractual conditions of distribution

The answer to these common services lies within the agreement of a services contract between the DSO and supplier. The services contract will detail the role of each regarding the common services, the protocol between the two in implementing the common services, and any remedies to the other party should the responsible party not live up to their role as per the contract. It will be important for the agreement to be reached as the cost for the DSO and the supplier to set up their own units to handle these functions will simply increase the price of electricity.

Objectivity

The second condition is objectivity. Within this regard it is expected that the DSO will judge all of its operational activities in a fair, unbiased and truthful manner. From an economic perspective, electricity distribution is considered to be a "natural monopoly" activity, meaning that on this specific market segment one firm can produce a desired output at a lower cost than two or more firms because of both high fixed costs and economies of scale. This explains why distribution tariffs are regulated by the National Regulatory authorities, who define or approve the level of tariffs and/or profits that distributors are allowed to set/make. Requirements to separate these activities are set out in articles 15-20 of the 2003/54/EC Directive "concerning common rules for the internal market in electricity".

It is expected the DSO will operate “with a level playing field” towards all those requesting its services. Most important to this point is that any potential client will be provided the same information to base decisions upon as existing clients already have. Given the DSO will have the monopoly component of the distribution network, such fair treatment is essential to promote the goal of competition within the supplier environment. Such competition will lead to lower prices, better service and the promotion of choice among the final customers.

Transparency

Transparency is operating in such a way that it is easy for others to see what actions are performed. It has been defined simply as “the perceived quality of intentionally shared information from a sender.” The DSO, given its monopolistic structure, has the obligation to share important information concerning its operations to all existing or potential suppliers. Such information would include the structure and composition of the network, the terms and conditions of accessing the grid, any future expansion plans, records of service and repair (past, current and future) to the grid, advance disclosure of network disruption for any reason, pricing, operational data and technical information.

Within this topic we can answer the question of a “common service company” proposed by a Moldovan operator. Although the rationale is a good one – trying to keep cost down – the use of this vehicle would be a major conflict of interest. The point of separating the DSO from supply is to create independent units. Sharing such important tasks as accounting, IT and human resources does not allow for such independence as the supplier with access will have a natural advantage over all others. Even if this “common service company” does succeed in keeping a wall up between the two organizations, the public impression will be the exact opposite. It is discourage any new suppliers from entering the market as from the outside looking in the “common service company” appears to have a nature advantage.

Commercially Sensitive Information

Commercially sensitive information is divided into three groups, with different methods for ensuring non-discriminatory access and information unbundling:

- Public information
- Contractual information
- Confidential information.

Public information is any information that is available to any third person and published in a manner enabling remote access. The types of information would include:

- Anticipated development of the distribution system
- Description of the electricity supply system
- Rules for operating the distribution system
- Application forms for connection and providing distribution line
- Commercial conditions for providing distribution line
- General information on the distribution system operation
- Quality indicators of electricity and services supply Compliance Program and Annual Report on measures adopted for Compliance Program implementation in the preceding year
- Program auditor contact information
- Further information released by the distribution system operator in a manner allowing remote access.

Such information should be freely available at the DSO and available with easy access through a website. In addition to the information there should be a point of contact within the DSO who can further answer inquiries.

Contractual information is that which is included in a contract between the DSO and a contractual partner. This information can be disclosed only to a relevant contractual party on the basis of the contract or to a state administration body on the basis of a legal requirement; for a third party such information is considered confidential. Types of contractual information would include

- Business partner of the distribution license holder
- Point of supply
- Distribution failures and their remedy
- Complaints about the license holder activities and distribution.

Any information on the distribution system affected by the Compliance Program that is not public or contractual is considered as confidential. Such information is as follows;

- Contacts of the electricity license holder
- Archives of the electricity distribution license holder
- Confidential and contractual information on paper (documents) or on other data carriers at the workplace of the electricity distribution license holder
- Access to information systems of the electricity distribution license holder
- Payments to the distribution license holder for electricity distribution.
- All employment contracts, contracts on discharge of office and agreements of confidentiality executed between the DSO and its employees and/or members of its statutory body.

If the party to the contract made with the DSO breaches the obligation of confidentiality concerning the commercially sensitive information, the DSO shall proceed, depending on the character of the contractual relation, in conformity with the relevant contract and generally binding legal regulations governing employment relationships and/or commercial obligation relationships.

Implementation of the Compliance Program

Information about the Compliance Program is to be given to all the members of the statutory body, members of the supervisory board, management and employees. Training of all employees in case of changes of the Compliance Program is organized. Such training is also an integral part of orientation procedures for new employees. Familiarization with the Compliance Program will also follow when new members of the board have been elected, and in case of management has been appointed.

In connection with the introduction of the Compliance Program, the DSO establishes the position of the Program auditor. The Program auditor is responsible for the supervision over implementation of the Compliance Program, adherence to the measures adopted, and for elaboration of the annual report to the Regulator. The method of performing the checks and the Program auditor's authorization are defined by company standards. It is a duty of the DSO to provide the program auditor all the information and documents necessary for a proper performance of his tasks, and to give him other necessary assistance.

Conclusions & Next Steps

The major conclusion is that Moldova is making progress on the implementation of the Second and Third Packages of the Energy Community Treaty. ANRE, for its part, is doing all it can to support the process. Since the process was due to be completed on January 1, 2015 all of it is relatively new. Union Fenosa has completed the task, and if it were not for ongoing tariff issues would be an excellent resource for the RED North and RED Northwest to complete the task as well. It is hoped that the tariff issue will be settled soon and that such support can then be sought so that Moldova will be compliant as to the unbundling process.

Within this Report a couple of data requests have been provided to ask RED North and RED Northwest to insure progress is being made. ANRE as a next step could just ask for the data. The greatest concern would be the insurance that a common services agreement has been agreed upon between the supplier and DSO. From an operation standpoint this is critical from two aspects. The first is to insure the DSO and supplier have a firm agreement as to responsibilities of each. The second is to continue to provide the customers adequate service and a place to turn to when problems arise.

The next steps under this task would be to monitor the progress of unbundling in RED North and RED Northwest. ANRE, on behalf of the customer, should be very persistent concerning the common service agreement. Although not considered within this task it would be important for ANRE to develop procedures when a violation of the compliance terms is realized. Steps should include who within ANRE is responsible for handling the issue, the process and procedures to be used for investigation of the claim and what process to use to estimate damages.

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