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**INTERPRETATIVE NOTE ON DIRECTIVE 2009/72/EC CONCERNING COMMON
RULES FOR THE INTERNAL MARKET IN ELECTRICITY AND DIRECTIVE
2009/73/EC CONCERNING COMMON RULES FOR THE INTERNAL MARKET IN
NATURAL GAS**

THE UNBUNDLING REGIME

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THE UNBUNDLING REGIME

1. INTRODUCTION

With the adoption of Directive 2009/72/EC ('the Electricity Directive')¹ and Directive 2009/73/EC ('the Gas Directive')², new rules have been introduced on unbundling for transmission system operators ('TSOs') and for distribution system operators ('DSOs').

The present note aims to provide a comprehensive overview of these new unbundling rules. It sheds light on the Commission services' understanding of how the provisions of the Electricity and Gas Directives are to be interpreted. It does however not cover in detail the process of certification of potential TSOs controlled by persons from third countries.

The note aims to enhance legal certainty but does not create any new legislative rules. In any event, giving binding interpretation of European Union law is ultimately the role of the European Court of Justice. The present note is not legally binding.

2. UNBUNDLING FOR TRANSMISSION SYSTEM OPERATORS (TSOs)

2.1 Introduction and general provisions

The rules on legal and functional unbundling of TSOs as provided for in Directive 2003/54/EC and in Directive 2003/55/EC have not led to effective unbundling. The Electricity and Gas Directives therefore provide for a new unbundling regime with the following three models:

- (i) the ownership unbundling model, which is analysed below under 2.2;
- (ii) the independent system operator ('ISO'), which is analysed below under 2.3;
- (iii) the independent transmission operator ('ITO'), which is analysed below under 2.4.

All these models are subject to a certification procedure, which is analysed below under 2.5.

Although these models provide for different degrees of structural separation of network operation from production and supply activities, each of them is expected to be effective in removing any conflict of interests between producers, suppliers and transmission system operators. This means that they should remove the incentive for vertically integrated undertakings to discriminate against competitors as regards access to the network, as regards access to commercially relevant information and as regards investments in the network. The three models should create incentives for the necessary investments and guarantee the access of new market entrants under a transparent and efficient regulatory regime (recitals 11 and 12 Electricity Directive and recitals 8 and 9 Gas Directive). This requirement for effective

¹ Directive 2009/72/EC of the European Parliament and 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 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).

separation should provide general guidance for the interpretation of the unbundling rules of the Directives.

Member States are free to opt for one of the three models, which are on an equal footing in the Directives, under the following restrictions.

- (i) The ISO and ITO models can only be chosen for a specific TSO if on entry into force of the Directives, i.e. 3 September 2009, the transmission system belonged to a vertically integrated undertaking (Article 9(8) Electricity and Gas Directives)³. It is not possible to go from a situation of ownership unbundling to an ISO or an ITO if on entry into force of the Directives the transmission system did not belong to a vertically integrated undertaking. For Member States having several TSOs, only in situations where the transmission system was part of a vertically integrated undertaking on entry into force of the Directives can the ISO or ITO model be chosen. New transmission systems, in particular systems which did not yet exist on 3 September 2009, will have to follow the ownership unbundling regime.
- (ii) A Member State cannot prevent a vertically integrated undertaking from complying with the requirements of ownership unbundling. At the same time, where a Member State has opted for ownership unbundling, either in general or as regards a specific TSO, the vertically integrated undertaking does not have the right to set up an ISO or ITO. A Member State having several TSOs is free to opt for several models for different TSOs. However, once a choice has been made for a specific TSO to apply one of the unbundling models — ownership unbundling, ISO or ITO — all the elements of that model have to be complied with; elements of different models cannot be mixed in order to create a new unbundling model for a TSO which has not been provided for by the Electricity and Gas Directives (Article 9(9) Electricity and Gas Directives provides an exception, see page 5).

Member States intending to designate only ISOs or ITOs on their territory must in any event also transpose the provisions on ownership unbundling into their national law, in view of the fact that they cannot prevent a vertically integrated undertaking owning a transmission system from complying with the requirements of ownership unbundling (Article 9(11) Electricity and Gas Directives).

To ensure a level playing field within the European Union as regards the three unbundling models, an undertaking performing any of the functions of generation or supply in a Member State must comply with the rules on ownership unbundling as regards the acquisition of rights in a TSO in another Member State having opted for ownership unbundling. This means that the supplier in the first Member State cannot directly or indirectly exercise control or any right within the meaning of Article 9 of the Electricity and Gas Directives over a TSO from a Member State that has opted for ownership unbundling (Article 9(12) Electricity and Gas Directives). Article 43 Electricity Directive and Article 47 Gas Directive additionally allow Member States to adopt measures in order to ensure a level playing field, provided that these measures are transparent, non-discriminatory, proportionate and compatible with the Treaty on the functioning of the European Union and European Union law, and provided they are notified to and approved by the Commission in advance. This will require a prior assessment

³ The term ‘vertically integrated undertaking’ is defined in Article 1(21) of the Electricity Directive and in Article 1(20) of the Gas Directive and is further discussed under point 2.3.

on a case-by-case basis, in which the distortion of the level playing field — or the risk of such distortion — must be demonstrated, as well as compliance with the other conditions of the clause⁴.

Since compliance with unbundling rules may impose restructuring of vertically integrated undertakings, Member States benefit from additional time to apply the rules on unbundling. In general, the Directives must be transposed and applied by Member States by 3 March 2011. However, the rules on unbundling of TSOs, which must be transposed by 3 March 2011, must be applied only by 3 March 2012. It is underlined that all three models, including the ISO and ITO model, can benefit from this additional period of time.

Even more time is granted for application of certain requirements of the ownership unbundling model, if the TSO is not part of a vertically integrated undertaking. In particular, in those cases the requirements of Article 9(1)(b) and (c) Electricity and Gas Directives must be applied as from 3 March 2013 (Article 9(4) Electricity and Gas Directives).

For the application of the certification procedure in relation to third countries as provided for in Article 11 Electricity and Gas Directives, the date of 3 March 2013 has been stipulated.

Member States can derogate from the specific rules concerning ownership unbundling, ISOs and ITOs, where on 3 September 2009 the transmission system belonged to a vertically integrated undertaking and at that date arrangements were in place which guarantee more effective independence of the TSO than the specific provisions concerning the ITO model of Articles 17-23 of the Directives (Article 9(9) Electricity and Gas Directives). Under the certification procedure of Article 10 Electricity and Gas Directives, the Commission must verify that the arrangements in place clearly guarantee more effective independence of the TSO than the provisions of Articles 17-23 of the Directives. Only if that is the case can the TSO be certified. The regulatory authority must follow the decision of the Commission in this respect, in accordance with Article 3(6) of the Electricity Regulation⁵ and the Gas Regulation⁶.

Exemptions from the unbundling rules can furthermore be granted for a defined period of time in the case of major new gas infrastructure, i.e. interconnectors, Liquefied Natural Gas (LNG) and storage facilities, provided that the specific requirements of Article 36 Gas Directive are met. A similar possibility is provided by Article 17 Electricity Regulation in the case of new direct current interconnectors. Exemptions for new infrastructure that have already been granted pursuant to Article 22 of Directive 2003/55/EC and Article 7 of Regulation (EC) 2003/1228 continue to apply until the expiry date stipulated in the exemption decision, also after entry into force of the Gas Directive and the Electricity Regulation (recital 35 Gas Directive and recital 23 Electricity Regulation). Unless provided otherwise in the exemption decisions themselves, such exemptions must not be altered by application of the

⁴ The call for a level playing field clause originally came from Member States that wanted to protect their unbundled production and supply companies from acquisitions by vertically integrated undertakings of other Member States.

⁵ Regulation (EC) No 714/2009 of the European Parliament and the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003 (OJ L 211, 14.8.2009, p. 15).

⁶ Regulation (EC) No 715/2009 of the European Parliament and the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 (OJ L 211, 14.8.2009, p. 36).

provisions on new infrastructure set out in Article 36 Gas Directive and Article 17 Electricity Regulation⁷.

2.2. Ownership unbundling

Article 9 Electricity and Gas Directives lay down the following main rules on ownership unbundling:

1. *Member States shall ensure that ...:*
 - (a) *each undertaking which owns a transmission system acts as a transmission system operator;*
 - (b) *the same person or persons are not entitled:*
 - (i) *directly or indirectly to exercise control over an undertaking performing any of the functions of production or supply, and directly or indirectly to exercise control or exercise any right over a transmission system operator or over a transmission system; or*
 - (ii) *directly or indirectly to exercise control over a transmission system operator or over a transmission system, and directly or indirectly to exercise control or exercise any right over an undertaking performing any of the functions of production or supply;*
 - (c) *the same person or persons are not entitled to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking, of a transmission system operator or a transmission system, and directly or indirectly to exercise control or exercise any right over an undertaking performing any of the functions of production or supply; and*
 - (d) *the same person is not entitled to be a member of the supervisory board, the administrative board or bodies legally representing the undertaking, of both an undertaking performing any of the functions of production or supply and a transmission system operator or a transmission system.*
2. *The rights referred to in points (b) and (c) of paragraph 1 shall include, in particular:*
 - (a) *the power to exercise voting rights;*
 - (b) *the power to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking; or*
 - (c) *the holding of a majority share.*

Article 9(1) Electricity and Gas Directives define ownership unbundling. The requirements of paragraph 1(a) to 1(d) are cumulative. Paragraph 2 defines the concept of rights as referred to in paragraph 1(b) and 1(c).

⁷ The Commission issued a declaration to this effect in Coreper on 16 June 2009 with a view to the adoption of the Gas Directive and the Electricity Regulation.

Under paragraph 1(a), each undertaking which owns a transmission system is required to act as a TSO. Compliance with ownership unbundling means that the undertaking which is the owner of the transmission system also acts as the TSO, and is as a consequence responsible among other things for granting and managing third-party access on a non-discriminatory basis to system users, collecting access charges, congestion charges, and payments under the inter-TSO compensation mechanism, and maintaining and developing the network system. As regards investments, the owner of the transmission system is responsible for ensuring the long-term ability of the system to meet reasonable demand through investment planning.

Under Article 9(1)(b)(i) Electricity and Gas Directives, the same person is not entitled to exercise control over an undertaking performing any of the functions of production or supply, and to exercise control or exercise any right over a TSO or a transmission system. Paragraph 1(b)(ii) provides for the same rule but covers the alternative situation of a person exercising control over a TSO, and exercising control or any right over an undertaking performing any of the functions of production or supply.

The definition of the term ‘control’ in Article 2(34) Electricity Directive and Article 2(36) Gas Directive is taken from Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (‘the EC Merger Regulation’)⁸ and should be interpreted accordingly (recital 13 Electricity Directive and recital 10 Gas Directive). Under Article 3(2) EC Merger Regulation, control is 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’. The key consideration in this regard is the concept of ‘decisive influence’. The EC Merger Regulation clarifies that decisive influence can arise in particular from:

- (a) ownership or the right to use all or part of the assets of an undertaking; or
- (b) rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking.

The reference to control thus encompasses both *de iure* and *de facto* control, and also includes both direct and indirect control, through an intermediate subsidiary for example. This is in line with the concept of control under the EC Merger Regulation.

The EC Merger regulation clarifies in its Article 3(3) that control is acquired by persons or undertakings which:

- (a) are holders of the rights or entitled to rights under the contracts concerned; or
- (b) while not being holders of such rights or entitled to rights under such contracts, have the power to exercise the rights deriving therefrom.

For further guidance on these concepts, reference is made to the Commission notices and guidelines on the Merger Regulation⁹.

⁸ OJ L 24, 29.1.2004, p. 1.

⁹ They are available at:
<http://ec.europa.eu/competition/mergers/legislation/legislation.html>.

The concept of ‘person’ in the Directives covers private individuals, companies or any other public or private entities. Typically, the person referred to in Article 9(1)(a) of the Electricity and Gas Directive will be either the company having the supply or network operation activity or a parent company having subsidiaries acting as suppliers or network operators.

The concept of ‘rights’ used in Article 9(1)(b) Electricity and Gas Directives is further explained in Article 9(2), which provides for a non-exhaustive list of these rights. These are, first, the power to exercise voting rights, secondly, the power to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking, and thirdly, the holding of a majority share.

Article 9(2) Electricity and Gas Directives implies that shareholding can only provide financial rights, i.e. the right to receive dividends, but cannot confer any right to take part in the decision-making process of the company or exercise any influence on the company. The concept of voting rights refers to any voting rights, no matter how limited, including voting rights which do not amount to control.

In practice the requirements of Article 9(1)(b) Electricity and Gas Directives can be complied with as follows.

A supplier can keep a direct or indirect shareholding in a network operator or in a network system, provided the following cumulative conditions are met:

- (i) this shareholding does not constitute a majority share,
- (ii) the supplier does not directly or indirectly exercise any voting rights as regards his shareholding,
- (iii) the supplier does not directly or indirectly exercise the power to appoint members of bodies legally representing the network operator or the network system such as the supervisory board or the administrative board, and
- (iv) the supplier does not directly or indirectly have any form of control over the network operator or the network system.

Reciprocally, a transmission network operator may keep a direct or indirect shareholding in a supplier, provided the following cumulative conditions are met:

- (i) this shareholding is not a majority share,
- (ii) the network operator does not directly or indirectly exercise any voting rights as regards its shareholding,
- (iii) the network operator does not directly or indirectly exercise the power to appoint members of bodies legally representing the supplier such as the supervisory board or the administrative board, and
- (iv) the network operator does not directly or indirectly have any form of control over the supplier.

Similar rules apply in case of the presence of a parent company, such as a holding company: a parent company is not entitled to exercise control over a supplier, and directly or indirectly

exercise control or exercise any right over a TSO or over a transmission system. Nor is a parent company entitled to exercise control over a TSO or a transmission system, and directly or indirectly exercise control or any right over an undertaking performing any of the functions of generation or supply (Article 9(1)(b)(i) and (ii) Electricity and Gas Directives).

Article 9(1)(c) and (d) Electricity and Gas Directives provide for the following two additional requirements.

Under subparagraph (c), the same person is not entitled to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking, of a TSO or a transmission system, and directly or indirectly to exercise control or exercise any right over an undertaking performing any of the functions of generation or supply. In practice this rule adds to the rules of subparagraph (b) a specific requirement as regards parent companies or other entities that do not have any controlling interest in a TSO or a supplier. It aims to avoid a situation where a parent company having some influence over a supplier, even minimal, can appoint board members of a TSO. As a consequence, a parent company (or other entity) that holds a majority share, or has the power to appoint board members or exercise voting rights in a supplier, cannot appoint board members of a TSO.

Subparagraph (d) addresses the issue of conflict of interest for board members by prohibiting the same person from being a member of the board of both a supplier and a TSO. It is irrelevant for the prohibition whether the board member of the supplier and the TSO is appointed by the same person or not.

The rules on unbundling apply equally to private and public entities. For the purpose of the rules on ownership unbundling, two separate public bodies should therefore be seen as two distinct persons and should be able to control generation and supply activities on the one hand and transmission activities on the other provided they are not under the common influence of another public entity in violation of the rules on ownership unbundling provided for in Article 9 Electricity and Gas Directives; the public bodies concerned must be truly separate. In these cases, the Member State in question will need to be able to demonstrate that the requirements of ownership unbundling of Article 9 Electricity and Gas Directives are enshrined in national law and are duly complied with. This will have to be assessed on a case-by-case basis (recital 23 and Article 9(6) Electricity Directive and recital 20 and Article 9(6) Gas Directive).

So as to avoid undue influence arising from vertical relations between gas and electricity markets, Article 9(3) Electricity and Gas Directives clarify that ownership unbundling applies across the gas and electricity markets, thereby prohibiting joint influence over an electricity supplier and a gas TSO or a gas supplier and an electricity TSO. The rule however only applies to the core requirements of ownership unbundling of Article 9(1)(b) Electricity and Gas Directives, not to the ancillary rules provided for in subparagraphs (c) and (d).

Article 9(5) Electricity and Gas Directives clarify that ownership unbundled TSOs creating a joint venture which acts as a TSO in two or more Member States can keep the ownership of their network without contravening the requirement set out in Article 9(1)(a) Electricity and Gas Directives.

2.3. Independent system operator (ISO)

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, the Member

State concerned may decide not to apply the rules on ownership unbundling of the Directives, but may designate an independent system operator ('ISO') instead (Article 9(8)(a) Electricity and Gas Directives).

For electricity, the concept of 'vertically integrated undertaking' is defined in Article 2(21) Electricity Directive as 'an electricity undertaking or a group of electricity undertakings where the same person or the same persons are entitled, directly or indirectly, to exercise control, and where the undertaking or group of undertakings perform at least one of the functions of transmission or distribution, and at least one of the functions of generation or supply of electricity'. For gas, a similar definition is included in Article 2(20) Gas Directive. The definition of the term 'control' as laid down in Article 2(34) Electricity Directive and Article 2(36) Gas Directive has been taken from the EC Merger Regulation and should be applied accordingly. Control is 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'. Further explanations on the concept of control are provided under point 2.2.

The concept of 'vertically integrated undertaking' is not limited to undertakings established in one and the same Member State; the concept includes any undertaking or group of undertakings irrespective of place of establishment, where the same persons are entitled, directly or indirectly, to exercise control, and where the undertaking or group of undertakings perform at least one of the functions of transmission or distribution of electricity, or of transmission, distribution, LNG or storage of natural gas and at least one of the functions of generation or supply of electricity, or of production or supply of natural gas.

Where on the date of entry into force of the Electricity and Gas Directives the transmission system does not belong to a vertically integrated undertaking within the meaning referred to above, the rules on ownership unbundling must be followed; the ISO model cannot be applied in such cases.

2.3.1. Appointment and certification procedure

Under Article 13(1) and (3) Electricity Directive and Article 14(1) and (3) Gas Directive, the ISO is proposed by the owner of the transmission system concerned. It is approved and designated as an ISO by the Member State concerned under the condition that it has been certified by the regulatory authority as having complied with the specific requirements listed in paragraph 2 of the Articles mentioned. Designation must also be subject to the approval of the Commission.

As part of the certification procedure, the regulatory authority must ensure in accordance with Article 13(2) Electricity Directive and Article 14(2) Gas Directive that the following conditions are met:

- the candidate operator complies with the rules on ownership unbundling of Article 9(1)(b), (c) and (d) Electricity and Gas Directives (subparagraph (a));
- the candidate operator has demonstrated that it has at its disposal the required financial, technical, physical and human resources to carry out its tasks under Article 12 Electricity Directive and Article 13 Gas Directive (subparagraph (b));
- the candidate operator has undertaken to comply with a ten-year network development plan monitored by the regulatory authority (subparagraph (c));

- the transmission system owner has demonstrated its ability to comply with its obligations under paragraph 5 (subparagraph (d)), see below);
- the candidate operator has demonstrated its ability to comply with its obligations under the Electricity and Gas Regulations (subparagraph (e)).

It should be noted that the burden of proof as to whether the above requirements are met is clearly put on the candidate operator or on the system owner, not on the regulatory authority.

From a procedural standpoint, the general certification procedure (see below under point 2.5) set out in Article 10 Electricity and Gas Directives applies. When certification is requested for an ISO which is controlled by a person from a non-EU country, the certification procedure in relation to third countries under Article 11 Electricity and Gas Directives applies, in addition to the requirements of Article 13(2) Electricity Directive and Article 14(2) Gas Directive.

2.3.2. *Tasks of the ISO*

As regards its tasks, an ISO should be considered as a TSO and has to comply with all the obligations applicable to TSOs under the Electricity and Gas Directives and the Electricity and Gas Regulations. This follows from Article 13(4) Electricity Directive and Article 14(4) Gas Directive:

‘... the independent system operator shall act as a transmission system operator ...’

In particular, this means that each ISO is responsible for granting and managing third-party access, including the collection of access charges, congestion charges, and payments under the inter-TSO compensation mechanism in compliance with the Electricity and Gas Regulations. The ISO is also responsible for operating, maintaining and developing the transmission system. This list of tasks is not exhaustive.

The transmission system owner has no responsibility and no prerogatives as regards granting and managing third-party access.

As regards investments, the ISO has full responsibility for ensuring the long-term ability of the system to meet reasonable demand through investment planning. The Electricity and Gas Directives expressly state that when developing the transmission system, the ISO is responsible for planning, including obtaining the necessary authorisations and for the construction and commissioning of new infrastructure. Again, the transmission system owner has no responsibility and no prerogatives as regards investment planning.

2.3.3. *Tasks of the transmission system owner*

As the owner of the network, the transmission system owner has a number of tasks and obligations which are listed in Article 13(5) Electricity Directive and Article 14(5) Gas Directive.

Its first obligation is to provide all the relevant cooperation to the ISO for the fulfilment of its tasks. This concerns in particular the provision of all relevant information concerning the network.

The network owner must also provide for the coverage of liability relating to the network assets. The Electricity and Gas Directives state that this excludes the liability relating to the tasks of the independent system operator. In practice, it means that the network owner must

cover liability for e.g. the condition of the network, but not for the management of the network. The regulatory authority must review and approve the arrangements between the ISO and the network owner in the context of the certification procedure and then on a continuous basis as part of its monitoring task under Article 37(3) Electricity Directive and Article 41(3) Gas Directive, so as to ensure compliance.

As regards the financing of the network, the network owner is in principle under the obligation to finance the investments decided by the ISO. This however only concerns the investments that have been approved by the regulatory authority. If the network owner does not want to finance the investments itself, it has to give its agreement to the financing of the investments by any interested party, including the ISO. This may mean that the network owner will not become the owner of the new parts of the network that it has not financed.

The relevant financing arrangements are subject to approval by the regulatory authority, which is under an obligation to consult the transmission system owner together with other interested parties, including the ISO.

The network owner is also under the obligation to provide financial guarantees to facilitate the financing of the network expansions unless it has agreed to financing by another party.

2.3.4. Specific duties of the regulatory authority

Article 37(3) Electricity Directive and Article 41(3) Gas Directive provide for a number of specific duties for regulatory authorities when an ISO is designated. These duties are additional to the duties regulatory authorities generally have in the context of the certification procedure (see below under point 2.5).

These specific duties are as follows:

- Monitoring the transmission system owner's and the ISO's compliance with their obligations under this Article;
- Monitoring the relations and communications between the ISO and the transmission system owner. This should include the approval of any contracts between the ISO and the transmission system owner;
- Acting as a dispute settlement authority between the ISO and the transmission system owner. This applies in particular to complaints submitted pursuant to Article 37(11) Electricity Directive and Article 41(11) Gas Directive;
- Approving the investment planning and the multi-annual network development plan to be presented annually by the ISO. This is in addition to the approval of the first ten-year network development plan under the certification procedure in compliance with Article 13(2)(c) Electricity Directive and Article 14(2)(c) Gas Directive;
- Ensuring that network access tariffs collected by the ISO include remuneration for the network owner. Adequate remuneration should be provided for network assets and for new investments made in the network, provided these investments are economically and efficiently incurred. In practice, this means that the investments taken into consideration for the remuneration are approved by the regulatory authority;

- Exercising the powers to carry out inspections, including unannounced inspections, at the premises of the transmission system owner and the independent system operator; and
- Monitoring the use of congestion charges collected by the ISO in accordance with the rules of the Electricity and Gas Regulations.

More generally, the regulatory authority must ensure compliance of the ISO with its obligations, in particular through constant monitoring of the activities of the ISO and of the transmission system owner. In the event of a violation, the regulatory authority is empowered to issue penalties for non-compliance in accordance with the general rules under Article 37(4)(d) Electricity Directive and Article 41(4)(d) Gas Directive. Penalties must be effective, proportionate and dissuasive and should be able to go up to 10% of the annual turnover either of the vertically integrated company or of the ISO, as the case may be.

2.3.5. Unbundling of transmission system owners

If an ISO has been appointed, the Electricity and Gas Directives require legal and functional unbundling of the transmission system owner.

Article 14(1) Electricity Directive and Article 15(1) Gas Directive refer explicitly to the obligation of legal unbundling. The requirement is similar to the provisions on legal unbundling of distribution system operators ('DSOs') and should be interpreted accordingly (see below under point 3.2).

Article 14(2) Electricity Directive and Article 15(2) Gas Directive provide for rules on functional unbundling. These rules aim to ensure the independence of the transmission system owner from other activities of the vertically integrated company not related to transmission, in terms of organisation and decision-making power (subparagraphs (a) and (b)), and require the establishment of a compliance programme (subparagraph (c)). These rules, which are minimum requirements, are similar to the rules concerning unbundling of DSOs and should be interpreted accordingly (see below under point 3.3).

Article 31 Electricity and Gas Directives provide for specific rules on unbundling of accounts. These rules, which apply to electricity and gas undertakings in general, are further explained under point 3.4.

2.4. Independent transmission operator (ITO)

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, the Member State concerned may decide not to apply the rules on ownership unbundling, but may set up an independent transmission operator ('ITO') in compliance with the rules of the Electricity and Gas Directives (Article 9(8)(b) Electricity and Gas Directives).

The concept of 'vertically integrated undertaking' is defined in Article 2(21) Electricity Directive and Article 2(20) Gas Directive, and is explained in more detail under point 2.3. If on the date of entry into force of the Directives the transmission system does not belong to a vertically integrated undertaking, the rules on ownership unbundling have to be followed; the ITO model cannot be applied in such cases.

Under the ITO model, the TSO may remain part of a vertically integrated undertaking. However, numerous detailed rules are provided in order to ensure effective unbundling.

Key provisions concerning the ITO model are laid down in Articles 17-23 of the Electricity and Gas Directives.

2.4.1. Rules on assets, equipment, staff and identity of the ITO

The ITO has to be autonomous. In Article 17(1) Electricity and Gas Directives it is made clear that the ITO must be equipped with all financial, technical, physical and human resources necessary to fulfil its obligations and to carry out the activity of electricity or gas transmission.

The activities of electricity or gas transmission are defined in Article 17(2) Electricity and Gas Directives. They include all the tasks of a TSO under Article 12 Electricity Directive and Article 13 Gas Directive. In addition, Article 17(2) Electricity and Gas Directives list a number of other tasks for which the ITO has to be autonomous. The lists in Articles 12 and 17(2) Electricity Directive and Articles 13 and 17(2) Gas Directive are indicative and not exhaustive. The Directives impose a general obligation on the ITO to be autonomous.

The Electricity and Gas Directives provide for specific rules as regards the assets, the personnel and the financial resources that are necessary for fulfilling the tasks and obligations of the ITO relating to the activity of electricity or gas transmission.

As regards assets, Article 17(1)(a) Electricity and Gas Directives state that these must be owned by the ITO. This obligation concerns not only the network, but also any other assets necessary for the activity of electricity or gas transmission.

As regards staff, Article 17(1)(b) Electricity and Gas Directives stipulate that personnel which is necessary for the activity of electricity or gas transmission must be employed by the ITO. This concerns personnel necessary for performing the core activities of the ITO, including management and network operation.

As regards corporate services, including legal services, accountancy and IT services, which are considered to constitute part of the activity of electricity or gas transmission as defined in Articles 12 and 17(2) Electricity Directive and Articles 13 and 17(2) Gas Directive, the ITO must employ a sufficient number of qualified staff members to handle day-to-day core activities. Only if the ITO has employed a sufficient number of staff members for day-to-day handling of these activities may it, in specific circumstances and by way of exception, conclude contracts with third-party service providers for legal, IT, or accountancy services. The same applies to specific services relating to, for example, the development and repair of the network. The ITO should employ a sufficient number of qualified staff members to handle day-to-day activities in this area, in order to be autonomous. Only if this condition is fulfilled can it, by way of exception, conclude contracts for services in this area with third-party service providers.

The ITO cannot transfer part of its responsibilities relating to the activity of electricity or gas transmission to other entities. For example, it is not possible for an ITO to transfer part of its tasks and responsibilities to other ITOs, with, for example, one ITO assuming responsibility for system operation, another for maintenance, etc.

This requirement concerning autonomy of the ITO does not relate to activities that do not directly concern the activity of electricity or gas transmission, such as office cleaning services or office security services. As regards these ancillary activities personnel does not necessarily

have to be employed by the ITO and contracts for services can be concluded with third-party service providers whenever this is considered appropriate.

A specific regime concerns the leasing of personnel and contracting of services between any part of the vertically integrated undertaking and the ITO. As the ITO should be autonomous and not dependent on other parts of the vertically integrated undertaking, leasing of personnel and contracting of services to the ITO by other parts of the vertically integrated undertaking, including by the DSO, are categorically prohibited (Article 17(1)(c) Electricity and Gas Directives).

Provision of services by the ITO to other parts of the vertically integrated undertaking is permitted only in specific circumstances, in particular if there is no discrimination of other system users, if there is no restriction of competition in generation or supply and if the regulatory authority has approved the provision of the services concerned, in accordance with Article 17(1)(c) Electricity and Gas Directives.

Furthermore, the ITO is not allowed to share IT systems or equipment, physical premises and security access systems with any other part of the vertically integrated undertaking. The ITO is also not allowed to use the same consultants or external contractors for IT systems or equipment, security access systems or auditing, in accordance with Article 17(5) and (6) Electricity and Gas Directives.

Pursuant to Article 17(2)(g) Electricity and Gas Directives the ITO is allowed to set up appropriate joint ventures, including with one or more TSOs, power exchanges, and other relevant actors pursuing the objectives of furthering the creation of regional markets or of facilitating the liberalisation process.

As regards financing, Article 17(1)(d) Electricity and Gas Directives provide for a general rule that appropriate financial resources for future investment projects and/or for the replacement of existing assets must be made available to the ITO by other parts of the vertically integrated undertaking in due time, following an appropriate request thereto from the ITO. These resources have to be approved by the Supervisory Body in compliance with Article 20 Electricity and Gas Directives. The ITO must inform the regulatory authority of these financial resources, in accordance with Article 18(8) Electricity and Gas Directives.

Under Article 17(4) Electricity and Gas Directives, the ITO must not, in its corporate identity, communication, branding and premises, create confusion in respect of the separate identity of other parts of the vertically integrated undertaking. This implies a general obligation to avoid any confusion for consumers between the TSO and the supply company. In order to identify whether there is confusion or not in a particular case, European Union trade mark law may serve as a point of reference¹⁰.

Article 17(3) Electricity and Gas Directives require the ITO to be organised in the legal form of a limited liability company as referred to in Article 1 of Council Directive 68/151/EEC. Article 31 Electricity and Gas Directives provide for specific rules on unbundling of accounts.

¹⁰ See in particular Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trade marks, OJ L 11, 14.1.1994, p. 1, as amended, and Directive 2008/95/EC of the European Parliament and of the Council of 22 October 2008 to approximate the laws of the Member States relating to trade marks, OJ L 299, 8.11.2008, p. 25.

These rules apply to electricity and gas undertakings in general, and are further explained under point 3.4.

2.4.2. *Independence of the ITO*

Article 18 Electricity and Gas Directives lay down the general principle that the ITO must have effective decision-making rights, independent from any other part of the vertically integrated undertaking, with respect to assets necessary to operate, maintain and develop the transmission system. This implies a general requirement of independence as regards network ownership and operation.

In particular, any other part of the vertically integrated undertaking is not allowed to determine, directly or indirectly, the competitive behaviour of the ITO in relation to the day-to-day activities and management of the network, and in relation to activities of the ITO for the preparation of the ten-year network development plan (Article 18(4) Electricity and Gas Directives).

Without prejudice to the decisions of the Supervisory Body under Article 20 Electricity and Gas Directives, this principle is further substantiated by the following rules:

- (i) the ITO must have the power to raise money on the capital market (Article 18(1)(b) Electricity and Gas Directives);
- (ii) subsidiaries of the vertically integrated undertaking performing functions of generation or supply cannot have any direct or indirect shareholding in the ITO. The ITO itself cannot have any direct or indirect shareholding in any subsidiary of the vertically integrated undertaking performing functions of generation or supply, nor receive dividends or any other financial benefit from such subsidiary (Article 18(3) Electricity and Gas Directives). In practice this means that the supply subsidiary and the ITO can be positioned under a common parent company, but cannot be a direct or indirect subsidiary of each other;
- (iii) so as to avoid any preferential treatment, all commercial and financial relations between the ITO and other parts of the vertically integrated undertaking, including loans from the ITO to other parts of the vertically integrated undertaking, must comply with market conditions (Article 18(6) Electricity and Gas Directives) and must be revealed to the regulatory authority upon request. All commercial and financial relations with other parts of the vertically integrated undertaking giving rise to a formal agreement, oral or written, must be submitted for approval to the regulatory authority (Article 18(7) Electricity and Gas Directives); and
- (iv) other parts of the vertically integrated undertaking must refrain from any action impeding or prejudicing the ITO from complying with its obligations and must not require the ITO to seek permission from it in fulfilling those obligations (Article 18(9) Electricity and Gas Directives).

The overall management structure and the corporate statutes of the ITO should provide for a decision-making structure and rules ensuring effective independence of the ITO in compliance with these provisions.

The ITO is under the obligation to establish and implement a compliance programme setting out the measures taken in order to ensure that discriminatory conduct is excluded. The

compliance programme must be approved by the regulatory authority. A compliance officer is to be appointed by the Supervisory Body, subject to approval by the regulatory authority. The compliance officer is specifically in charge of ensuring observance of the compliance programme and has a general role as regards guaranteeing that the ITO is independent in practice and does not pursue discriminatory conducts. The compliance programme and the compliance officer are subject to the detailed rules of Article 21 Electricity and Gas Directives.

From a procedural standpoint, only an ITO which complies with the rules of the Electricity and Gas Directives can be certified and therefore approved and designated as a TSO by the Member State concerned. The certification procedures of Articles 10 and 11 Electricity and Gas Directives are applicable to the ITO model.

2.4.3. Independence of the staff and the management of the ITO

Article 19 Electricity and Gas Directives set out rules on the independence of the management of the ITO. The term ‘management’, used for the purposes of this sub-section, refers to the persons responsible for the top management of the ITO. Depending on the form of the company and its statutes, it covers the members of the executive management of the ITO — which typically will include the Chairman, the Managing Director, and/or Chief Executive Officer — and/or any member of a board having decision-making powers other than members of the Supervisory Body of the ITO.

The Supervisory Body of the ITO is in charge of taking all decisions regarding the appointment and renewal, working conditions including remuneration, and termination of the term of office of the management of the ITO. These decisions must be notified to the regulatory authority and can become binding only if the regulatory authority has not raised any objections within a period of three weeks after the notification. The regulatory authority must ensure that the management of the ITO is professionally independent from other parts of the vertically integrated company, and that its working conditions can actually ensure such independence. The regulatory authority can therefore object to any decision concerning appointment, renewal or termination of office of the persons responsible for the management of the ITO, if it has any doubt as to the professional independence of these persons or as to the justification for their removal.

In addition to the control of the regulatory authority, Article 19 Electricity and Gas Directives lay down specific rules aimed at ensuring that any conflict of interest is avoided as regards the management, but also as regards the employees, of the ITO. These rules include the following:

- (i) The management of the ITO cannot exercise any professional position or responsibility, interest or business relationship, directly or indirectly, with any part of the vertically integrated undertaking, or with its controlling shareholders, other than the ITO, for a period of three years before its appointment. This rule also applies to the persons directly reporting to the management on matters related to the operation, maintenance or development of the network (Article 19(3) Electricity and Gas Directives).
- (ii) The management and the employees of the ITO cannot have any other professional position or responsibility, interest or business relationship, directly or indirectly, with any other part of the vertically integrated undertaking or with its controlling shareholders. This

rule prohibits for example the holding by the management and by employees of shares in the vertically integrated undertaking.

(iii) The management and the employees of the ITO cannot hold an interest in or receive any financial benefit, directly or indirectly, from any part of the vertically integrated undertaking other than the ITO. In addition, remuneration of the management and employees cannot depend on activities or results of any part of the vertically integrated undertaking other than the ITO. This last rule prevents for example the granting to the management of stock options based on the shares of the vertically integrated undertaking.

(iv) After termination of their term of office in the ITO, the management cannot have any professional position or responsibility, interest or business relationship with any part of the vertically integrated undertaking, or with its controlling shareholders, other than the ITO, for a period of not less than four years. The management is allowed to remain within the ITO after termination of their term of office in the ITO, but only in a non-managerial position. This rule also applies to the persons directly reporting to the management on matters related to the operation, maintenance or development of the network (Article 19(7) Electricity and Gas Directives).

The rule under (i) as laid down in Article 19(3) Electricity and Gas Directives only applies to the majority of the management and to the persons directly reporting to them on matters related to the operation, maintenance or development of the network. Where management functions are exercised by a board or a college, this means that the rule of Article 19(3) Electricity and Gas Directives applies to half plus one of the members of the board or of the college. If however one person has essentially all the executive powers within the ITO, the majority rule implies that the rule of paragraph 3 applies to this person. The persons belonging to the management of the ITO who are not subject to Article 19(3) Electricity and Gas Directives and the persons directly reporting to them on matters related to the operation, maintenance or development of the network must not have exercised any management or other relevant activity in any other part of the vertically integrated undertaking for a period of at least six months before their appointment.

2.4.4. Supervisory Body

A key requirement as regards the ITO model is the setting-up of a Supervisory Body.

In addition to the decisions concerning the management of the ITO, the Supervisory Body is in charge of taking the decisions that may have a significant impact on the value of the assets of the shareholders within the ITO. This includes the decisions regarding the approval of the annual and longer-term financial plans, the level of indebtedness of the ITO and the amount of dividends distributed to shareholders.

However, the Supervisory Body cannot interfere with the day-to-day activities of the ITO and the management of the network, or with the preparation of the ten-year network development plan under Article 22 Electricity and Gas Directives.

In accordance with Article 20(3) Electricity and Gas Directives the following rules are applicable to at least half of the members of the Supervisory Body minus one:

(i) The identity and the conditions governing the term, the duration and the termination of office of the members of the Supervisory Body, and the reasons for any proposed decision terminating such term of office, must be notified to the regulatory authority, which can object

within three weeks of notification. The regulatory authority must ensure that the members of the Supervisory Body are professionally independent and that their working conditions can ensure such independence. The regulatory authority may object to any decision concerning appointment, renewal or termination of office of the members of the Supervisory Board, if it has any doubt as to the professional independence of the persons concerned or as to the justification for their removal;

(ii) the members of the Supervisory Body cannot exercise any professional position or responsibility, interest or business relationship, directly or indirectly, with any part of the vertically integrated undertaking, or with its controlling shareholders, for a period of three years before their appointment. A derogation to this rule concerns the ITO itself;

(iii) the members of the Supervisory Body of the ITO cannot have any other professional position or responsibility, interest or business relationship, directly or indirectly, with any other part of the vertically integrated undertaking;

(iv) the members of the Supervisory Body of the ITO cannot hold an interest in or receive any financial benefit, directly or indirectly, from any part of the vertically integrated undertaking other than the ITO. In addition, their remuneration must not depend on activities or results of the vertically integrated undertaking other than those of the TSO; and

(v) after termination of their term of office in the ITO, the members of the Supervisory Body cannot have any professional position or responsibility, interest or business relationship with any part of the vertically integrated undertaking, or with its controlling shareholders, for a period of not less than four years. A derogation to this rule concerns the ITO itself.

As an exception, the rule mentioned above under (i) that the regulatory authority can object to the removal of the members of the Supervisory Body if it has any doubt as to the justification for their removal applies to all the members of the Supervisory Body, and not only to half of the members minus one (Article 20(3), second subparagraph, Electricity and Gas Directives).

2.4.5. Network development and powers to make investment decisions

So as to ensure that under the ITO model the necessary investments are made in the network, specific obligations are imposed on the ITO as regards network development and investment decisions.

The ITO is under the obligation to submit annually to the regulatory authority a ten-year network development plan, following the procedure set out in Article 22 Electricity and Gas Directives. The ten-year network development plan must in particular indicate to market participants the main transmission infrastructure that needs to be built or upgraded over the next ten years, together with a time frame. It has to contain all the investments already decided and it must identify the new investments which need to be executed in the next three years.

When elaborating the ten-year network development plan, the ITO must make reasonable assumptions about the evolution of the generation or production, supply, consumption and exchanges with other countries, taking into account investment plans for regional and European Union-wide networks.

The regulatory authority is under the obligation to consult all actual or potential system users on the ten-year network development plan in an open and transparent manner and must

publish the result of the consultation process, in particular possible needs for investments. The regulatory authority must examine whether the ten-year network development plan covers all investment needs identified during the consultation process, and whether it is consistent with the non-binding European Union-wide ten-year network development plan referred to in Article 8(3)(b) Electricity and Gas Regulations. The regulatory authority may require the ITO to amend its ten-year network development plan.

If the ITO, other than for overriding reasons beyond its control, does not execute an investment which, under the ten-year network development plan, was to be executed in the following three years, the Member States must ensure that the regulatory authority is required to take at least one of the following measures:

- (a) require the ITO to execute the investments in question;
- (b) organise a tender procedure open to any investors for the investment in question; or
- (c) oblige the ITO to accept a capital increase to finance the necessary investments and allow independent investors to participate in the capital.

The Directives make clear that through the implementation of these measures the Member State in question has an obligation of result in that it must ensure that the investment in question is made.

Article 23 Electricity and Gas Directives additionally provide for specific rules concerning the connection to the transmission system of new power plants, storage facilities, LNG re-gasification facilities, and industrial customers.

2.4.6. Specific duties of the regulatory authority

Article 37(5) Electricity Directive and Article 41(5) Gas Directive lay down a list of specific duties and powers to be assigned to regulatory authorities where an ITO is designated. These duties and powers are additional to the duties and powers generally conferred on regulatory authorities as regards TSOs. The list of specific duties and powers is not exhaustive.

These specific duties and powers are the following:

- (a) to issue penalties for discriminatory behaviour favouring the vertically integrated undertaking of up to 10% of the annual turnover either of the vertically integrated undertaking or of the ITO, as the case may be;
- (b) to monitor communications between the ITO and other parts of the vertically integrated undertaking in order to ensure compliance of the ITO with its obligations;
- (c) to act as dispute settlement authority between the ITO and other parts of the vertically integrated undertaking in respect of complaints;
- (d) to monitor commercial and financial relations including loans between the ITO and other parts of the vertically integrated undertaking;
- (e) to approve all commercial and financial agreements between the ITO and other parts of the vertically integrated undertaking provided that they comply with market conditions;

- (f) to request justification from the vertically integrated undertaking as to any proposed decision on investment plans or individual investments, in particular as regards absence of discrimination to the advantage of the vertically integrated undertaking;
- (g) to carry out inspections, including unannounced ones, on the premises of the ITO and other parts of the vertically integrated undertaking; and
- (h) to assign all or specific tasks of the ITO to an independent system operator where the ITO persistently breaches its obligations under the Directives, in particular where it engages in repeated discriminatory behaviour to the benefit of the vertically integrated undertaking.

2.4.7. Review clause

The Commission will monitor closely whether and to what extent the unbundling requirements for the ITO model are successful in practice in ensuring full and effective independence of the ITO. By 3 March 2013, the Commission is required to submit a detailed specific report on this topic to the European Parliament and the Council (Article 47(3) Electricity Directive and Article 52(3) Gas Directive).

2.5. Certification procedure

A TSO can only be approved and designated as a TSO following the certification procedure laid down in Article 10 Electricity and Gas Directives in combination with the provisions of Article 3 Electricity and Gas Regulations. These rules must be applied to all TSOs for their initial certification, and subsequently at any time when a reassessment of a TSO's compliance with the unbundling rules is required.

The regulatory authorities are under the obligation to open a certification procedure upon notification by a potential TSO, or upon a reasoned request from the Commission. Apart from that, regulatory authorities must monitor compliance of TSOs with the rules on unbundling on a continuous basis, and must open a new certification procedure on their own initiative where according to their knowledge a planned change in rights or influence over transmission system owners or TSOs may lead to an infringement of unbundling rules, or where they have reason to believe that such an infringement may have occurred.

The certification procedure is applicable to all unbundling models: ownership unbundling, ISO and ITO. As regards certification of the ISO and ITO models some additional requirements are applicable (see above under points 2.3 and 2.4).

Formally, certification procedures can be conducted as from 3 March 2011, as soon as the provisions of the Electricity and Gas Regulations apply.

Where certification is requested by a potential TSO which is controlled by a person from a third country, the procedure of Article 10 is replaced by the procedure of Article 11 Electricity and Gas Directives concerning certification in relation to third countries. The concept of control is the same as that used in the EC Merger Regulation and should be interpreted accordingly (see above under point 2.2). Under Article 11 Electricity and Gas Directives, the regulatory authority must refuse the certification if it has not been demonstrated:

- (a) that the entity concerned complies with the requirements of the unbundling rules. This applies equally to ownership unbundling, ISOs and ITOs; and
- (b) that granting certification will not put at risk the security of energy supply of the Member State and the European Union. This assessment is to be carried out by the regulatory authority or another competent authority designated by the Member State. The competent authority must in particular take into consideration for its assessment the international agreements between the European Union and/or the Member State in question and the third country concerned which address the issue of security of energy supply, as well as other specific facts and circumstances of the case and of the third country concerned.

The burden of proof as to whether the above conditions are complied with is put on the potential TSO which is controlled by a person from a third country. The Commission must provide a prior opinion on the certification. The national regulatory authority, when adopting its final decision on the certification, must take utmost account of this Commission opinion.

3. UNBUNDLING FOR DISTRIBUTION SYSTEM OPERATORS (DSOs)

3.1. Introduction

The unbundling regime of DSOs laid down in Article 26 Electricity and Gas Directives remains in substance unchanged as compared to the preceding regime. Where the DSO is part of a vertically integrated undertaking, the basic elements of this unbundling regime are the following:

- (a) legal unbundling of the DSO from other activities of the vertically integrated undertaking not related to distribution;
- (b) functional unbundling of the DSO in order to ensure its independence from other activities of the vertically integrated undertaking;
- (c) accounting unbundling: requirement to keep separate accounts for DSO activities;
- (d) possibility of exemptions from the requirement of legal and functional unbundling for certain DSOs.

3.2. Legal unbundling

Article 26 Electricity and Gas Directives require that distribution is performed by a separate 'network' company. The obligation to create a separate company only concerns the network activities. Other activities such as supply and production can be carried on within a single company.

The vertically integrated undertaking is in principle free to choose the legal form of the DSO, provided that this legal form ensures a sufficient level of independence of the management of the DSO from other parts of the vertically integrated undertaking in order to fulfil the requirements of functional unbundling. As a consequence, if the supervision regime provided for by national law for the type of company selected does not match the requirements of functional unbundling, for example because the regime permits instructions from other parts of the vertically integrated undertaking concerning day-to-day activities of the DSO, it is

necessary to require its modification. Likewise, any contractual arrangements introducing further supervision rights, in addition to those provided for by national law and limiting the independence of the DSO, have to be compatible with the requirements of functional unbundling.

3.3. Functional unbundling

3.3.1 Management separation

Article 26 Electricity and Gas Directives require that the 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. Article 26 does not restrict the group of persons responsible for the management of the DSO to the top management, such as members of the executive management and/or members of a board having decision-making powers. Article 26 addresses a wider group of persons, including the operational (middle) management of the DSO.

As a consequence, a manager of the DSO cannot at the same time be a director of the related transmission, supply or production company, or vice versa. Whether and to what extent a manager of the DSO can work at the same time for the holding company of the vertically integrated undertaking if the holding company is not at the same time directly involved in production or supply, because legally separate entities exist for these activities, must be decided on a case-by-case basis. In any event, such a combination of functions can only be permissible if the holding company does not take any day-to-day management decisions concerning the supply, production or network activity.

Article 26 Electricity and Gas Directives furthermore require that appropriate measures are taken to ensure that the professional interests of the persons responsible for the management of the DSO are taken into account in a manner that ensures that they are capable of acting independently. It is for Member States further to determine these measures, in the light of national circumstances; in determining these measures situations such as the following need to be addressed. Independence of the persons responsible for the network management may be put into jeopardy by their salary structure, notably if their salary is based on the performance of the holding company or of the production or supply company, as this may create conflicts of interest. Also the transfer of managers from the DSO to other parts of the company and vice versa may entail a risk of conflicts of interest and requires rules and measures safeguarding independence. Conflicts of interest for the network management may also arise if the DSO directly or indirectly holds shares in the related supply or production company and obtains a financial interest in its performance. Likewise, the issue of shareholding on a personal basis of the managers of the DSO can give rise to concerns as far as independence of management is concerned. Decisions of the parent company to replace one or more members of the management of the DSO may also undermine the independence of the DSO in certain circumstances, notably if the reasons for replacement of members of the management have not been established beforehand in the charter of the DSO.

Situations referred to above need to be addressed by Member States in a way that ensures the independence of the DSO and its management. When shaping the rules on independence of the staff and the management of the DSO, the detailed provisions on independence of the staff and the management of the ITO as laid down in Article 19 Electricity and Gas Directives may serve as a point of reference, where appropriate.

An important question in the context of management separation is the extent to which it is permissible to have *common services*, i.e. services that are shared between transmission/distribution, supply and possibly other businesses within the vertically integrated undertaking. Such services could relate to personnel and finance, IT services, accommodation and transport. It is appropriate to look at this issue on a case-by-case basis. Under Article 26(2)(c) Electricity and Gas Directives the DSO must have at its disposal the necessary resources, including human, technical, physical and financial resources, in order to fulfil its tasks of operating, maintaining and developing the network. This means that the DSO cannot unduly rely on the services of other parts of the vertically integrated undertaking, as the DSO itself must have the necessary resources at its disposal to operate, maintain and develop the network. Provision of services by other parts of the vertically integrated undertaking to the DSO will therefore be limited. Where such services are provided, conditions should be fulfilled to reduce competition concerns and to exclude conflicts of interest. In particular, any cross-subsidies being given by the DSO to other parts of the vertically integrated undertaking cannot be accepted. To ensure this, the service must be provided at market conditions and laid down in a contractual arrangement.

It is recalled that the DSO is not entitled to provide any services to the related ITO (Article 17(1)(c) Electricity and Gas Directives).

3.3.2 *Effective decision-making rights*

The DSO must have effective decision-making rights, independent from other parts of the vertically integrated undertaking, with respect to assets necessary to operate, maintain or develop the network. In order to fulfil those tasks, the DSO must have at its disposal the necessary resources, including human, technical, physical and financial resources (Article 26(2)(c) Electricity and Gas Directives). This does not necessarily imply that the DSO must own the assets. Where another part of the vertically integrated undertaking remains the owner of the assets and puts these at the disposal of the DSO, the basic decisions concerning the assets must remain with the DSO, while the other part of the vertically integrated undertaking may be involved in the implementation of these decisions, provided that safeguards are put in place ensuring that the other part of the vertically integrated undertaking only executes the decisions taken by the DSO.

The requirement of effective decision-making rights is without prejudice to the supervision rights of the vertically integrated undertaking in respect of the return on assets in a subsidiary. Regarding the scope of these supervision rights, Article 26(2)(c) Electricity and Gas Directives expressly refer to two items: the annual financial plan of the DSO or any equivalent instrument, and its overall level of indebtedness. Regarding the limits of the supervision rights, the Directives are equally clear: any detailed day-to-day oversight of the network function by parts of the vertically integrated undertaking other than the DSO is not permitted. Also instructions regarding decisions on the construction or upgrading of the network, if these decisions stay within the terms of the approved financial plan, are not permitted.

Within the scope of the approved financial plan, the DSO must have complete independence. Furthermore, the financial plan, whilst it can be adopted by the vertically integrated undertaking, must be compatible with the requirement to ensure that the DSO has sufficient financial resources to maintain and extend the existing infrastructure.

The Directives refer to the financial plan or ‘any equivalent instrument’. The latter term must be interpreted restrictively in the sense that only instruments that are functionally equivalent to a financial plan, but which according to the applicable national terminology are not denominated a ‘financial plan’, may be subject to approval of the vertically integrated undertaking.

3.3.3. *Compliance programme*

Article 26(2)(d) Electricity and Gas Directives require the DSO to establish a compliance programme, which sets out measures taken to ensure that discriminatory conduct is excluded and to ensure that observance of this prohibition is adequately monitored. The main purpose of a compliance programme is to provide a *formal framework* for ensuring that the network activities as a whole, as well as individual employees and the management of the DSO, comply with the principle of non-discrimination.

The compliance programme contains rules of conduct which have to be respected by staff in order to exclude discrimination. Such rules relate, for example, to the obligation to preserve the confidentiality of commercially sensitive and commercially advantageous information (Article 27 Electricity and Gas Directives). The compliance programme may lay down in detail the kind of information that is to be considered confidential in this sense and how the information should be treated. It may also refer to the sanctions imposed under national legislation in case of non-respect of confidentiality rules. Another set of rules which, for example, can form part of a compliance programme relates to the behaviour of staff vis-à-vis network customers. Employees of a DSO must refrain from any reference to the related supply business in their contacts with customers of the DSO.

The compliance programme must be actively implemented and promoted through specific policies and procedures. Such policies may consist, inter alia, of the following elements:

- active, regular and visible support of the management for the programme, for example through a personal message to the staff from the management stating its commitment to the programme;
- written commitment of staff to the programme by signing up to the compliance programme;
- clear statements 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 induction programme for new staff.

Article 26(2)(d) Electricity and Gas Directives require the DSO to appoint a compliance officer. The compliance officer must be fully independent and must have access to all the necessary information of the DSO and any affiliated undertaking to fulfil his or her task. There is a clear obligation of result. When shaping the specific rules and guarantees for independence of the compliance officer of the DSO, the rules on the compliance officer of the ITO as laid down in Article 21(2) Electricity and Gas Directives may serve as a point of reference, where appropriate.

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 the identification of those areas that present the highest risks of non-compliance. The evaluation process must be carried out in a transparent manner, and may indicate to employees that their conduct is being reviewed against the terms of the compliance programme on a continuous basis. The compliance officer must on a yearly basis submit a report to the national regulatory authority, setting out all the measures taken. This report must be published (Article 26(2)(d) Electricity and Gas Directives).

3.3.4. Additional measures to ensure functional unbundling

Article 26(3) Electricity and Gas Directives require that where the DSO is part of a vertically integrated company, Member States must ensure that the activities of the DSO are monitored by regulatory authorities or other competent bodies so that the DSO cannot take advantage of its vertical integration to distort competition.

The DSO in its communication and branding cannot create confusion in respect of the separate identity of the supply company of the vertically integrated undertaking (Article 26(3) Electricity and Gas Directives). This implies a general obligation to avoid any confusion for consumers between the DSO and the supply company. In order to identify whether or not there is confusion in a particular case, European Union trade mark law may serve as a point of reference¹¹.

It should be noted that the rules on unbundling contained in the Electricity and Gas Directives are minimum rules. Member States may therefore consider supplementing the minimum set of rules with further measures, with a view to ensuring effectiveness of unbundling.

3.3.5. Preservation of confidentiality

The rules on functional unbundling are supplemented with the obligation of DSOs to preserve the confidentiality of commercially sensitive information obtained in the course of carrying out their business, and with the obligation of DSOs to prevent information about their own activities which may be commercially advantageous being disclosed in a discriminatory manner. This means, for example, that personnel working for the supply business must not have privileged access to databases containing information that could be commercially advantageous, such as details on actual or potential network users (Article 27 Electricity and Gas Directives).

3.4. Accounting unbundling

The provisions on accounting unbundling in the Electricity and Gas Directives remain largely unchanged as compared to the preceding legislation.

The basic principle laid down in Article 31(3) Electricity and Gas Directives is that companies have to keep separate accounts for each of their transmission and distribution

¹¹ See in particular Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trade marks, OJ L 11, 14.1.1994, p. 1, as amended, and Directive 2008/95/EC of the European Parliament and of the Council of 22 October 2008 to approximate the laws of the Member States relating to trade marks, OJ L 299, 8.11.2008, p. 25.

activities related to electricity and gas. Consolidated accounts are possible for all other activities, including their remaining electricity and gas activities.

Unlike legal and functional unbundling, no derogation is possible from the rules on accounting unbundling in the case of smaller DSOs. Accounting unbundling is thus the minimum separation requirement to be respected by every network operator, without exception.

For accounting unbundling, an accurate application of accounting principles is of fundamental importance. It is vital that cost items are allocated in a transparent and accurate manner 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 favouring the supply business and thus distorting competition in the supply market.

It should be noted that regulatory authorities play a key role in this respect, in view of their duty to ensure, through monitoring effective accounting unbundling, that there are no cross-subsidies between, on the one hand, transmission and/or distribution and, on the other hand, generation and/or supply. Since Article 31(4) Electricity and Gas Directives underline that the audit provided for in Article 31(2) looks at the issue of possible cross-subsidisation, it is clear that the audit will examine the way costs have been allocated.

3.5. Exemptions for DSOs serving less than 100 000 connected customers

Smaller DSOs serving less than 100 000 connected customers can be exempted from the requirements of both legal and functional unbundling (Article 26(4) Electricity and Gas Directives). This possibility of an exemption is not limited in time.

The Directives do not provide a definition of the term ‘connected customers’. ‘Connected customers’ could reasonably be interpreted as meaning: ‘connections’. According to such an interpretation a household is considered to constitute one connection within the meaning of the Directives, irrespective of the number of people forming part of the household. In contrast, a building composed of, for example, eight apartments, is considered to have eight connections within the meaning of the Directives.

3.5.1. Application in practice — two basic scenarios

Where distribution, supply and/or generation are performed in a single legal entity, the application of the 100 000 rule is straightforward. If the undertaking has less than 100 000 connected customers, i.e. if the distribution network in question has less than 100 000 connections, an exemption is possible, in which case the company can continue to operate the network and its supply/generation activities within the same legal entity. In contrast, if the number of connections 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 the shares in the network company, allowing it to control the network company within the meaning of Article 3(3) EC Merger Regulation. In this case the network company remains part of a vertically integrated undertaking and, consequently,

needs to be independent in functional terms within the meaning of Article 26 Electricity and Gas Directives; or

- it can give up control over the company, for example by selling shares in the company to third parties. As a consequence, the network company does not form part of a vertically integrated undertaking any more and in particular Article 26 Electricity and Gas Directives no longer apply.

If an undertaking involved in supply and/or generation controls one or more legally separate DSOs and the group of companies as a whole forms one single vertically integrated company, all connected customers of all the DSOs served by the undertaking have to be aggregated. Where applicable, the customers connected to a distribution network which is operated in the same company structure as the supply/generation business in question have to be added as well.

If the aggregated figure of connected customers is above 100 000, all controlled DSOs controlled by the same company or person have to be unbundled in compliance with Article 26 Electricity and Gas Directives even if the companies in question, when looked at individually, serve less than 100 000 connected customers.

Hereunder, three practical examples illustrate the application of the 100 000 connected customers rule:

1. A company involved in supply buys three DSOs, each serving 40 000 connected customers: all three companies have to be functionally unbundled (or be merged into one or two unbundled companies).
2. A company involved in supply buys five DSOs, one serving 120 000, the remaining four each serving 10 000 connected customers: all five companies have to be unbundled (or be merged into one or more several unbundled companies).
3. A company involved in supply and operating a distribution network of 80 000 connected customers in the same company structure (i.e. not unbundled) buys a DSO serving 30 000 connected customers: the whole network business, including the network serving the 80 000 connected customers, has to be unbundled.

3.5.2. *Discretion of Member States in applying the exemption*

The threshold of 100 000 connected customers was chosen since it was considered an appropriate figure in view of the situation in the European Union as a whole. However, when deciding on a possible derogation, Member States may consider national circumstances as well and, as a consequence, lower the threshold where this is appropriate.

In particular, Member States may choose not to systematically exempt DSOs with less than 100 000 connected customers from both legal *and* functional unbundling. A more gradual approach is possible. In such an approach only the smallest sized DSOs would be exempted from both legal and functional unbundling requirements. The relatively bigger sized DSOs — with still less than 100 000 connected customers — would only obtain an exemption from legal unbundling, while maintaining the requirement of functional unbundling, or at least certain elements of functional unbundling.