



Florence School of Regulation

Workshop

**In cooperation with ERGEG Task Force on Unbundling, Reporting
and Benchmarking (TF URB)**

Unbundling of energy undertakings in relation to Corporate Governance Principles

BERLIN

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Report

Dr. Nicole Ahner (FSR)

The 25th of September 2009, the European Regulators Group for Electricity and Gas (hereafter “ERGEG”) in cooperation with the Bundesnetzagentur and the Florence School of Regulation organized a Workshop on unbundling and corporate governance in the 3rd Package. The workshop was organized to present and discuss the practical impacts of implementing *inter alia* the 2009 Electricity Directive 2009/72/EC Natural Gas Directive 2009/72/EC (hereafter “EU-Directives”) into national law. Participants came from transmission system operators, regulatory authorities, academia and the European Commission. The objective of the workshop was to introduce those problems that might arise when transposing the new legislation into national law, namely with regard to the implementation of ownership unbundling, the new Independent System Operator (hereafter “ISO”) model and particularly the Independent Transmission Operator (hereafter “ITO”) model. In this respect, possible impacts on corporate governance rules - principally based on the 2004 OECD Corporate Governance Codex on the unbundling of energy utilities - have been highlighted.

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I. Introduction

The unbundling, i.e. the separation of the network business (natural monopoly) from the activities of production and supply is a pre-requisite for effective competition and thus a key component of the liberalization process in Europe. Achieving this

separation is the purpose of the unbundling provisions in the new electricity and gas directives: With the coming into force of the third legislative package (01/03/2011), a new unbundling regime will be introduced with the EU-Directives. The implementation of the required forms of unbundling into national law affects the compliance of energy utilities and network operators with corporate governance obligations as anchored e.g. in the OECD Corporate Governance Code as well as the respective national corporate laws. Both the regulators as well as the Member States when implementing the EU-Directives have to be aware of these governance issues in order to perform adequate regulation.

The workshop provided an overview of the upcoming rules on unbundling, particularly the construction of the ITO model and the basics of the EU company law and corporate governance. Furthermore, effects of the financial crisis and regulatory performance have been addressed, followed by a case example from the telecommunication sector. The final discussion involved the identification of potential areas of conflict between corporate governance and the ITO model, illustrated in the framework of the corporate law.

II. The Legislative Framework for the Corporate Governance Structure of European Energy Utilities

by Mag. Johannes Mayer (E-Control)

The legislative framework of the new unbundling system provides for the three different models for different degrees of structural separation. At first glance, the ISO and particularly the ITO model seem to be the less interfering and thus the analysis concentrated on these models.

1. General Principles of Unbundling

Assessing the impact of the new unbundling regime on corporate governance at national level, the guiding principles of unbundling need to be clarified. First, the unbundling of functions implies that the management and staff of the system operator shall not be involved in any competitive business, i.e. generation, production and supply of energy. Another crucial requirement is their independent identity: According to Article 17 (4) of the EU-Directives, the TSO shall not in its branding create confusion in respect of the separate identity of the vertically integrated undertaking. Secondly, effective unbundling demands for the unbundling of professional interest, i.e. there is a need for ensuring independent incentives, only related to the network business. Thirdly, the unbundling of decisions is necessary: Ensuring effective decision-making rights means that decisions must be made independently from competitive business units. Lastly, the unbundling of information

requires that there is no privilege in information flows between the network operator and the integrated company.

2. The Independent System Operator (ISO) Model

As an exemption to full ownership unbundling, Articles 13/ 14 f. of the EU-Directives provide for the ISO model. It foresees the appointment of an independent system operator whereas the vertically integrated company retains the ownership of the network on the condition that it is actually managed by a completely independent company or body. The ISO is responsible for operating, maintaining and developing the transmission system and investment. Conversely, the asset owner has no responsibility and no prerogatives with regard to investment planning, which basically reduces its function to a financial investor. The asset owner is under the obligation to finance the investments decided by the ISO and approved by the regulatory authority. Financing can only be denied in case of violations; if the financial framework fits, there is the obligation to finance. The asset owner has to provide for the coverage of liability relating to the network assets. According to the Article 14 (5) (c) (natural gas) and/or 13 (5) (c) (electricity) of the EU-Directives, this excludes the liability relating to the tasks of the ISO. Thus, it is rather questionable which liability remains for the asset owner, which can only be that the asset owner must cover liability e.g. for the condition, but not the management of the network. Since the ISO model is a strongly regulated alternative, its popularity is rather low in the Member States and even lower in the undertakings.

3. The Independent Transmission Operator (ITO)

The third option besides ownership unbundling and the ISO model is the setting up of an ITO. Here, the energy companies remain vertically integrated. In practice this means that the TSO has to own the necessary assets (network and any other assets necessary for the activity of transmission), and must be equipped with sufficient human, technical, physical and financial resources in order to ensure independent decision making and carry out the activity of electricity or gas transmission. Eventually, the EU-Directives provide for an independent decision-making right of the ITO concerning the assets necessary to operate, maintain or develop the transmission system. Finally, the ITO must have *inter alia* the power to raise money on the capital market through borrowing and capital increase. Other basic characteristics of the ITO are the confidentiality of information flows as well as the required independent management and staff. Staff which is necessary for the activity of electricity transmission, i.e. for performing the core activities of the ITO including management and network operation, have to be employed by the ITO. Whereas contracting of services by the vertically integrated undertaking to the ITO is prohibited, *vice versa* the provision of services by the ITO to the vertically integrated

undertaking is allowed under specific circumstances, if the national regulatory authority approves it.

Part of the ITO model is the establishment of a supervisory body – not a constitutive element in all of the allowed legal forms referenced to by Council Directive 68/151/EEC. The supervisory body is in charge of decisions with significant impact on value of assets of the shareholders within the ITO, i.e. the approval of the budget, financial plans, the level of indebtedness of the ITO and the amount of dividends distributed to shareholders. However, the supervisory body has no say in the day-to-day activities of the ITO. The independence of the supervisory body is ensured by the requirement that at least half of its members minus one must be professionally independent of the vertically integrated company, which has to be ensured by the national regulatory authority.

4. Conclusion and Remarks

The main idea of unbundling is the utmost separation of two integrated parts of a company. The holding company acts either as a ‘qualified bank’ or has to divest. All relations, i.e. services, financial, commercial are either not allowed or have to be approved by the national regulatory authority. All communication has to be monitored by the national regulatory authority as well. In the light of the corporate governance principles, there seem to be general unbridgeable obstacles. Problems arise particularly with view at the necessary monitoring and the restrictions on information flows: if for instance all communications have to be monitored, which goes up to even e-mails, there is an enormous amount of work to do so which has decisive impact on the respective company as well. Problems start with the identification of what has been communicated which even leads to disturbances of the everyday business. Moreover, information also those that are relevant, e.g. personal decisions, obviously are delivered to the holding company. However, even the idea of unbundling of information is clear in principle, its remains open which are *relevant* information.

Particular problems arise when it comes to the issue of branding. The EU-Directives provide for clear differentiations in order to avoid confusion for the customer: the TSO shall not, in its branding, create confusion in respect of the separate identity of the vertically integrated undertaking. The scope of interpretation of this provision is rather broad, since it is e.g. not explicitly said that different brands are required. Interpreted broadly, e.g. the names of TSO and the supply company could remain the same. However, the Community trademark law can serve as a point of reference which leads to the result that it will not be possible to use the same name.

III. EU Company Law and Corporate Governance

by Prof. Dr. Jaap W. Winter (de Brauw Blackstone Westbrock & University of Amsterdam)

The upcoming unbundling rules need to be seen in the light of the EU company law and corporate governance. Corporate governance rules were created mainly in order to protect outsiders (for example shareholders, creditors or employees). Shareholders of companies bear the ultimate risk for they are served last if anything goes wrong with the company. The system tries to stress the Principal – Agent roles in companies. Company law in the EU still varies from one Member States to the other. The process of harmonization is related to the right of establishment of companies. Most of the initiatives taken at EU level in the area of company law have been based on Article 44 (2) g (ex 54) of the Treaty establishing the European Community which appears in the chapter devoted on the freedom of establishment, i.e. the right of entities, once established in the EU to move their enterprise within the EU. This freedom could not be used fully if the respective company laws are not similar to a very large extent. At this point the idea of harmonisation started: the harmonisation of a number of minimum requirements makes it easier for companies to establish themselves in other Member States, i.e. where the regulatory framework is similar and might ensure legal certainty in intra-Community operations.

1. Harmonisation Process

However, the view at the harmonization process shows only fragile results. Resulting from a tendency of the Member States to agree only on what they have already at their own national level company law as an outcome of harmonization, there is little substance. For example, the 13th Company Law Directive 2004/25/EC, which covers (hostile) takeovers of public listed companies which were meant to facilitate the level playing field for takeover bids, instead led to the opposite. However, understood as a motor of convergence, the European Court of Justice (ECJ) contributed to a large extent to harmonization. According to its relevant decisions on the freedom of establishment, the Member States cannot refuse to accept or apply their own company law rules on companies incorporated in other Member States. As a consequence of the respective judgments, e.g. Germany and France started making their company law simpler in order to reduce the incentive to establish legal forms such as the UK limited. Thus, harmonization took place in an 'alternative way'. The result is a sweeping development of simplification and flexibilisation of Member States' company law by national initiatives. There is convergence to common denominator rather than harmonisation by agreement. Nevertheless, the EU approach is on a wobbly basis. The system is not really working since it is not delivering what it could deliver. If this continues the system will move to an American, more detailed regulation approach. The infrastructure is very weak because there is no code requirement for the Member States. France for instance has a voluntary code system, with no legal obligation for companies to follow this code. Moreover,

there is no consistent system of monitoring and amendment of codes and no understanding of quality of explanations. In sum, the code experiment in the EU is not taken seriously enough. Naturally, there is a strong protection of national interests. While assuming having a proper governance regulation and system in the EU, in the end the code system might not work at all. In order to create a more stringent system there is a need for a new governance agenda. There is of course no evidence whether the governance EU style works, and if, so why and when (and why and when not). Finally, serious concerns remain.

2. Conclusion and Remarks

Against this background, the construction of the ITO model makes no sense, seen from the governance perspective. One decisive example is the role of the supervisory board: its function is restricted to the key fundamental position. If that is the only task of the supervisory body there will be a clash with most Member States' corporate laws, because there, they have much more tasks. If they do not follow them, liability issues towards their principals (shareholders) arise. Nevertheless it has to be kept in mind that, with the 2009 EU-Directives, it is rather a purely technical question to transform the unbundling requirements, particularly to construct the ITO model into national law, than it is up to the market to react on it, i.e. up to the players, energy companies and the security markets whether they accept the legal separation. The task to find just a way to transform it into the respective national law is legally (in a technical sense) possible without problems. Despite the legal feasibility, however, the EU-Directives seem to predict that the ITO model is almost impossible to implement. The practical implementation will demonstrate it.

IV. Lessons from the Financial Market Crisis Designing Supervision and Control of Transmission System Operators

by Prof. Dr. Helmut Siekmann (Institute for Monetary and Financial Stability, IMFS)

1. Introductory Insights from the Financial Market Crisis

Basic insight from the financial market crisis is that measures of self-regulation have demonstrated a very poor performance. The participation of regulated industries in the process of law-making ought to be eliminated as far as possible. From financial markets it can be also learned that government influence is of ambiguous nature. There is no clear evidence that intervention of politics caused or exaggerated the crisis. If the field to be regulated is so crucial for the common welfare, governments

have to step in and in case of distress they need close control of it. A full transparency of risks is indispensable. With regard to the financial crisis, the widespread complexity of norms was a major contributing factor. A natural monopoly in reality usually decreases the average costs, but not necessarily. Examples for natural monopolies are railroads, natural gas and electricity networks or telecommunication. In order to make competition possible in natural monopolies, the European and national energy legislation provides for three regulatory instruments such as the free and non-discriminatory access to the infrastructure for competing energy producer, the regulation of tariffs for using the transmission-networks and the unbundling of the vertically integrated companies.

2. Legal Basis for Ownership Unbundling

Regarding the competence of the Community to introduce ownership unbundling, Article 95 EC Treaty, the internal market competence has been used. Since electricity as well as gas were qualified as goods, this competence title could be consulted since it allows for the creation of a European internal market, i.e. an area where goods as electricity and natural gas circulate freely. The ownership unbundling of vertically integrated companies actually pursues the objective to improve the conditions for a functioning of the internal energy market. The different level of unbundling in the Member States causes the concrete danger of hampering the cross border exchange of goods such as electricity or natural gas. A barrier for exercising this power, which has been discussed broadly in the legal literature, could be seen in Article 295 EC Treaty, which states that the EC Treaty shall in no way prejudice the rules in the Member States governing the system of property ownership. Here there is a field of tension between the Community objective of a harmonization of the internal market and the interest of the Member States not to lose the freedom of manoeuvre in this area. The decision depends on the interpretation of the system of property ownership in Article 295 EC Treaty. According to a rather tight interpretation of the ECJ, Article 295 EC Treaty does not prevent the EC from introducing the separation of vertically integrated companies: Article 295 EC Treaty must be interpreted in a way that it *only* determines that *nationalization or privatization* of property ownership is not an issue for the Union, but for the Member States themselves.

3. Supervision and Control of the Vertically Integrated Enterprise

The EU-Directives try to secure the independence of those parts that stay in natural monopoly, such as the transmission network. The stipulated independence of the TSO means effectively independent decision-making rights. There are, however, some problems, such as unclear boundaries, unresolved conflict of interest, the appropriation of funds for investments in transmission system and an opaque

incentive structure. Eventually too many details will be left to individual agreements which are not transparent to the capital market. On the other hand, it should be noted, that system operators in a regulated environment are a very low risk business since operators virtually have a “taxing power” towards network users. Limiting the influence on the TSO within the vertically integrated company therefore does not create the same kind of problems of limitation of liability as in competitive markets.

In parallel to the legal provisions on unbundling, there is the European Regulators Group for Electricity and Gas (ERGEG) 2008 Guidelines on “Functional and Informational Unbundling”. These legally not binding guidelines are of questionable legal status. There is some evidence in legal doctrine that this kind of cooperation and/or group, are risky constructions from a constitutional law point of view.

With corporate governance principles the problem is similar: all those codices are no legal norms, they might have a legal implication but they are no legal norms as such. Their function is primarily to foster capital markets and their efficiency. An important theme of corporate governance is to ensure the accountability of certain individuals in an organization through mechanisms that try to reduce or eliminate the principal-agent problem. Since the corporate governance rules are no legal norms, their implementation in national statutes does not prevent the national legislation to set up different rules for utilities. The future might be the adoption of guidelines by the Commission, Article 14 (3) Electricity Directive, and/or Article 15 (3) Natural Gas Directive which allow for the adoption of guidelines “designed to amend non-essential elements of the Directive by supplementing it”.

Additionally, there are the framework guidelines of the Agency for the Cooperation of Energy Regulators (ACER) based on Article 4 of new Regulation (EC) No. 713/2009. Also these guidelines are non binding. It is already problematic that the ACER gets the power to issue guidelines. And even though being named “guidelines”, in essence, they have to be binding, whereas the ACER lacks the necessary competence.

Regarding the monitoring/ controlling via the national regulatory authorities, there is something new in the EU-Directives, which is the guarantee of independence: “Member States shall ensure that the regulatory authority ensures that its staff and the persons responsible for its management do not seek or take direct instruction from any government or other public or private entity when carrying out regulatory tasks”, see Article 35 (4) Electricity Directive; Article 39 Gas Directive. In sum, the requirements for autonomy and independence are very strict. Conversely, it has not been proven that political influence on supervisory agencies contributed in a significant way to the present crisis or other major malfunction of the economy. It is questionable whether these provisions can be upheld in view of democratic principles in EU-law and e.g. in the German Federal Constitution.

4. The Agency for the Cooperation of Energy Regulators

Concerning ACER, already its supervisory power is rather questionable: ACER was established by Article 1 (1) of Regulation (EC) 713/2009. The creation of ACER was based on the single market clause of Article 95 of the EC Treaty. The ECJ in its judgement in the 'ENISA' case confirmed that the establishment of Community agencies can be based on this legal basis. The ECJ here had the first time the occasion to decide whether the establishment of agencies is generally possible under Article 95 EC Treaty and confirmed it. It is however questionable that there is a proven need for that agency in the energy market as required in this provision. The problematic issues is also if and to what extent powers can be given to the required extent to such an agency. It is a recognized principle that the EU cannot establish independent authorities with wide discretionary powers (institutional balance). The so-called *Meroni*-doctrine is an indicator: 'institutions cannot confer upon the authority, powers different from those which the delegating authority itself received under the Treaty'; 'for a delegation of powers to be compatible with the Treaty, it had to involve only clearly defined executive powers the exercise of which can, therefore, be subject to strict review in the light of criteria determined by the delegating authority.'

5. Conclusion and Remarks

The separation and unbundling issue is not problematic from legal point of view. Non-compliance with corporate governance principles does not create major problems for the companies since corporate governance codes are not even codified law. More problematic seems to be the competences and tasks of ACER. Where is the actual gap that ACER might fill? Experience shows that whenever the cost and benefit are not in the same country it is very difficult for the national regulatory authority to decide in the European interest. At the moment, the regulatory authorities are bound by national legislation, i.e. they concentrate on the national interest and national benefit and there is nothing that allows for considering the European interest. In sum, being in alliance with the basic principles of EU law, ACER is supposed to have not more and/or no stronger competences.

V. A case example: BT Openreach

by Dr. Chris Doyle (Apex Economics)

Finally, the case example from the telecommunication sector, the case of "BT Openreach" demonstrated that for example those governance structures established in order to oversee Openreach in the UK have functioned effectively. The oversight combines self-regulation (reinforced by legally binding commitments) independent audit and external regulation. The structure in practice is complex, but probably no

more than similar structures found in the financial sector. The governance arrangements have adapted well to changing circumstances. The process was not an extreme effort for the regulator, but only an administratively detailed (hence relatively costly) process and has cost BT Openreach a huge amount of money to establish and increase Opex. The European Commission has advocated the need for functional separation as an ultimate measure. There is much opposition to functional separation among operators and regulators. A number of national regulatory authorities have chosen not to apply functional separation, others have threatened application, and some incumbents have volunteered application. In sum, the case study demonstrated feasibility; however, it is unclear whether the form of unbundling implemented in the case would be fully compatible with the requirements of the energy Directive.

VI. Open Discussion with Panel

Nicolaas Bel (European Commission)

Johannes Kindler (Vice President BNetzA, Germany)

Jose Braz (ERSE, Portugal)

Prof. Dr. Helmut Siekmann (Institute for Monetary and Financial Stability, IMFS)

Chair: Prof. Dr. Theodor Baums (University of Frankfurt)

The panel discussion guided by Prof. Theodor Baums emphasized the implementation of the ITO model and related to the preparatory note for ERGEG Members on the Panel provided by Karsten Bourwieg (BNetzA) and Sven Rode (BNetzA).

1. The Legal Form

Article 17 (3) of the EU-Directives offer different options for the choice of corporate structure for the ITO. The ITOs shall be organised in one of the legal forms as referred to in Article 1 of Council Directive 68/151/EEC. Not included in this Directive is for instance the *Societas Europaea*, a form of European public limited company that has been possible since 2004. It is questionable why this legal form has not been included and whether the Member States when implementing it might be allowed to correct it. While it can be argued that the European “*effet utile*” obliges Member States to fill the gap, the Commission seems very reluctant about extensive interpretation of the Directives.

With regard to the adequate legal form, despite several advantages, the discussion showed that the legal form of a private limited company or limited liability company (LLC), for example the French S.A.R.L. or the German GmbH, would not be the best solution. Generally, the independence of the TSO should be as much as possible designed on the basis of existing corporate law. A public limited company (e.g. the

German Aktiengesellschaft (AG)) is the most appropriate legal form for the ITO since this form includes most of the preconditions the national regulatory authorities need in order to monitor the ITO adequately. The legal framework of the German AG provides constitutive rules, which adequately define the relationship between the different bodies within the cooperation. The elements of the public limited company cover furthermore most of the specifications of the EU-Directives. Most of the national and international company laws stipulate an executive board, a supervisory board and a general assembly. Such legal foundations ensure a proper corporate structure. Moreover, there are detailed transparency rules that a public limited company has to follow. Mostly these are laws regarding accounting and reporting duties (due to the nature of this legal form). The company is required to report regularly and has to provide detailed information because of shareholder protection and interest of stakeholders. Such safeguards are qualitative monitoring, supervising and support the transparency of the ITO. Here also the question of the limits of transparency in an unbundled company arises: whereas the corporate law requires for information, the unbundling rules do not allow for information to be given to the vertically integrated company.

Also, the compromise character of the ITO model might have led to taking less care of the relevant corporate governance aspects. Another issue as regards the fact that unbundling leads to a specific energy corporate law is for the Member States to avoid problems in transposing and executing the EU-Directives for those energy undertakings, particularly those that are listed on a stock market in Europe or overseas. In sum, less detailed publicity obligations, as well as less constitutive rules and an anticipated company law which might lead to complicated statutes and clauses, and which will additionally lead to an extensive contract review of the national regulatory authorities (also to legal uncertainty) argues against the legal form of a private limited company or a LLC.

2. The Constitution of a Financing Obligation of the Vertically Integrated Company

Another crucial innovation is the constitution of the financing obligation for the vertically integrated company (Articles 17 (1) d and Article 18 (1) b) of the EU-Directives), which needs to be interpreted: An unlimited risk bearing would be contrary to the international as well as national corporate laws for public limited companies. The risks must be identified for an unlimited liability of the vertically integrated undertaking for the ITO. Despite the fact that the TSO business is low risk business (Prof. Dr. Siekmann: taxation power) it might create a formal problem for shareholders of the vertically integrated undertaking. How must the obligation for the vertically integrated undertaking be described in order to limit the shareholders risk to the obligation to finance necessary investment in the grid? In this light, the question arises whether such discrepancies might be removed via contractual arrangements between the ITO and the vertically integrated undertaking. Those will have to be

approved by regulators, therefore need clear legal basis. It is most likely that the investment levels are drastically increasing due to the need for new lines, such as for the integration of off-shore wind. Regarding the financial arrangements between the parties, the question arises as to whether the establishment of a financing obligation must be understood as a general liability of the vertically integrated undertaking. What if the ITO decides to invest in other business areas out of the energy sector, i.e. is the mother company liable for those matters?

3. The Supervisory Body

With view at the supervisory body, stipulated in Article 20 of the EU-Directives in the sense of a classical public limited company, there could be conflicts caused between the mother company and their shareholders: it is unclear whether the shareholders rights and the need for information and other duties of the vertically integrated undertaking might collide with the respective rules of the Directive.

The ITO model means not only the unbundling of accounts but also the possibility for the vertically integrated undertaking to consolidate the ITO in its annual report. The requirements for financial consolidation of the ITO in the vertically integrated undertakings annual report in the respective national laws have to be considered when designing the ITO rules in Member States.

4. The Compliance Officer

Concerning the compliance officer, its tasks shall include diverse types of mandate, such as e.g. data protection officer or internal auditor. With view at its duties, it is questionable whether it will be considered as a “foreign body” in practice. The role of the compliance officer needs further description, particularly it must be clarified whether it is comparable to existing bodies within compliance rules.

Finally, the assignment of duties to the ITO management, particularly the day-to-day business in relation to the rights of the supervisory body must be treated carefully. There are doubts whether this in relation to corporate laws is well defined in the Directives or whether a clarification in national rules is required in order to avoid misinterpretation.

5. Independence of staff

Discussion arose furthermore on the issue of TSO staff shareholding of the vertically integrated company. Whilst the wording of the EU-Directives is quite clear on the separation of interests and individual shares, it was debated if a ban on sales for

retirement purposes could make a difference for shares as part of the pension plan. More so shares as part of a fund whose portfolio cannot be influenced by the staff members has no potential for discriminative influence of TSO staff.

6. Cash Pooling

Cash pooling as financial relationship between the TSO and the vertically integrated undertaking is indirectly referred to in Art. 18 (6) of the EU-Directives. Participation of the TSO in the cash pool of the vertically integrated undertaking was a point of discussion. Cash pooling agreements must not be a way to weaken the independence of the TSO. At the same time, it raises issues of credit standing of the pool operator if TSO loans money into the cash pool.

VII. Conclusion

by Prof. Dr. Jean-Michel Glachant

The workshop has confirmed that the implementation of the EU-Directives will lead to a special energy corporate law which will deviate in singular points from the existing corporate law. Possible deviations from the corporate governance principles will not be problematic since the Directives provide for normative legally binding regulation, whereas the respective codes do not. Technically the transferal of the unbundling requirements, particularly also the ITO model are feasible options. It is the end result which is decisive: even if the end result of one model should not be positive, there are still two other models.

Questions to be discussed further are however whether particular forms of implementation of the EU-Directives will allow for bypass the unbundling measures as well as those crucial points of practical implementation of the ITO model at national level, which has been proven to be from corporate law viewpoint a crucial issue. In the remaining 18 months before the transformation of the third package into national law there is still interpretative guidance needed in order to tackle the governance issues which arise when constructing the envisaged ITO model.

Basically ten points have been identified which demand for further clarification/interpretation:

First of all, the adequate legal form of the ITO needs to be identified. A second point which needs clarification is the financing obligation for the vertically integrated undertaking. Thirdly, the tasks of the supervisory body need to be brought in line with the respective corporate structure. As a fourth point, the legal status of the management and fifthly, the role and function of the compliance officer need to be clarified. Moreover, a sixth question concerns the right to information and to check it. A seventh issue is the nomination of the director or CEOs and their dismissal. The right to allocate cash and dividends is the eighth issue to be further discussed and

the ability to issue shares, bonds and to significantly borrow money (= to issue corporate debt) the ninth. Eventually the last and tenth question concerns the new unbundling regime in relation to corporate governance concerns the investment plan (•conception •discussion •information) as a matter submitted to owners' right.

In conclusion, the workshop demonstrated the need for a better understanding of practical implementation issues as regards the 'third', the ITO model.

Annex:

- Programme and list of participants
- Presentations Powerpoint Mag. Johannes Meyer, Prof. Dr. Jaap Winter, Prof. Dr. Helmut Siekmann, Dr. Chris Doyle

FLORENCE SCHOOL OF REGULATION Workshop

In cooperation with ERGEG Task Force on Unbundling,
Reporting and Benchmarking (TF URB)

UNBUNDLING OF ENERGY UNDERTAKINGS IN RELATION TO CORPORATE GOVERNANCE PRINCIPLES

German Regulatory Office premises (Bundesnetzagentur)
Fehrbelliner Platz 3
10707 Berlin

OUTLINE & PROGRAMME

BACKGROUND

Berlin, 25 September 2009

Paper in annex: "Unbundling of energy undertaking in relation to Corporate Governance Principles" by CEER (Council of European Energy Regulators).

OBJECTIVES OF THE WORKSHOP

To clarify the ways in which corporate governance rules can provide a satisfactory solution to the principal-agent problems in the case of network companies. This is particularly relevant to the cases of vertically integrated companies or groups.

PROGRAMME

- 09.30 - 09.45 Registration
- 09.45 - 10.05 Welcome address and introduction to the workshop
Johannes Kindler (Vice President BNetzA, Germany)
- Session 1** *Unbundling and Corporate Governance*
Chair: **Johannes Kindler** (Vice President BNetzA, Germany)
- 10.05 - 10.25 *The legislative framework for the corporate governance structure of European Energy utilities on the basis of the Third Energy Package*
Johannes Mayer (E-Control)
- 10.25 - 10.45 Questions and discussion
- 10.45 - 11.05 *Current status of the European debate on Corporate Governance*
Jaap Winter (De Brauw Blackstone Westbroek & University of Amsterdam)
- 11.05 - 11.20 Questions and discussion
- 11.20 - 11.40 Coffee break
- 11.40 - 12.00 *Lessons from the capital crisis and influences on energy undertakings*
Helmut Siekmann (Institute for Monetary and Financial Stability, IMFS)
- 12.00 - 12.20 Questions and discussion
- 12.20 - 13.50 Lunch
- Session 2** *Discussion on Regulation and corporate governance*
Chair: **Theodor Baums** (Professor, Goethe University, Frankfurt, former President of the German government committee "Corporate Governance")
- 13.50 - 14.15 *A Case Example, the case of BT Openreach*
Chris Doyle (Apex Economics)
- 14.15 - 15.15 Panel discussion with:
Nicolaas Bel (European Commission)
Johannes Kindler (Vice President BNetzA, Germany)
José Braz (ERSE, Portugal)
- 15.15 - 15.45 General discussion
- 15.45 - 16.30 *Conclusions*
Jean-Michel Glachant (Director, Florence School of Regulation)

Workshop proceedings:
Nicole Ahner (Florence School of Regulation)

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E-CONTROL

WS Corporate Governance and Unbundling



The Legislative Framework for the Corporate Governance
Structure of European Energy Utilities

Johannes Mayer

25 September 2009

E-CONTROL

Principles of Unbundling



Unbundling of Functions

- Separation of management and of employees
- Independent identity of distribution system operator

Unbundling of Professional Interest

- Independent incentives, only related to network business;

Unbundling of Decisions

- Vertically integrated company is pure financial investor ('first bank')
- Decisions of investment, maintenance and operation fully independent

Unbundling of Information

- No privilege in information flows between Network Operator and integrated company

The ISO Model (Independent System Operator)



Governing Principle:

- Separation of Ownership of Assets and all decisions taken by fully unbundled TSO (operation, maintenance, investment)

Consequence:

- Asset Owner is reduced to financial investor
- Asset Owner in principle has to invest or to agree to third party financing following the decision of the System Operator
- Asset Owner has to cover liability relating to network assets and to provide guarantees to facilitate financing

The ITO Model (Independent Transmission Operator)



Governing Principle:

- Vertical integration of network company and competitive business

Consequences:

- TSO has to own necessary assets,
- TSO has sufficient resources for independent decision making (human, technical, physical, financial)
- Independent decision making concerning assets
- Power to raise money on capital market through borrowing and capital increase

The ITO Model (Independent Transmission Operator) – cont'd



- Independent information flows
- Independent management and staff;
- Commercial and financial relations have to be approved by national Regulatory Authority
- Supervisory Body to take decisions with significant impact on value of assets, i.e. approval of budget, financial plans, level of indebtedness and dividends distributed to shareholders
- No say in day-to-day activities
- 50%-1 of SB members independent of vertically integrated company

Conclusions



Main idea of unbundling is utmost separation of two integrated parts of a company

Holding company acts either as a 'qualified bank' or has to divest

All relations (services, financial, commercial) are either not allowed or have to be approved by the NRA

All communication has to be monitored by the NRA

Information



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Thank You for Your Attention !

DE BRAUW
BLACKSTONE
WESTBROEK

EU Company Law and Corporate Governance

Jaap Winter

Berlin

25 September 2009

EU Involvement in Company Law

- Basis is freedom of establishment
- Effective use of freedom requires harmonisation of company law, art. 44 (g)
- Peculiar objective: with a view to making protections for members (shareholders) and others (creditors, employees) equivalent
- Avoid race to the bottom
- Not: efficient company law facilitating business activities across borders

Harmonisation Process

- Formalities of company law, little substance
- On substance Member States disagreed on how to harmonise
- Protections of others troubling
- Creditors: nobody outside Germany believes in restricting capital maintenance provisions of 2nd Directive
- Employees: European Company Statute and Directive and Cross-Border Merger Directive to help defend German Mitbestimmung

On Shareholders and National Interests

- Clashes on Takeover Bids and controlling shareholders
- 13th Directive to facilitate level playing field for takeover bids
- Member States protecting national interests, outcome is opposite of level playing field
- Majority of listed companies has controlling shareholders
- Often mechanisms applied that enhance control disproportionately
- After much deliberation and intense lobbying no action

EU Court of Justice Motor of Convergence

- Decisions on freedom of establishment: Member States cannot refuse to accept or apply their own company law rules on companies incorporated in other Member State
- Result sweeping development of simplification and flexibilisation of Member State company law by national initiatives
- Convergence to common denominator rather than harmonisation by agreement

EU on Corporate Governance

- Development in last 10 years primarily for listed companies, driven by harmonisation of securities legislation and governance scandals in US and EU
- Dominated by principal – agent discussion: how to ensure that management operates in interests of shareholders
- National best practice codes, comply or explain
 - **Flexibility**
 - **Accountability**
- Focus of codes on organisation and functioning of boards
- Non-binding EU guidance on non-executive directors and director remuneration (additional 2009)
- Corporate governance disclosure (4th and 7th dir)

Focus EU Approach

- Board performance
 - separation Chairman – CEO
 - increased role of non-execs
 - committees
 - independence
- Shareholder engagement and dialogue
 - Boards to account for governance structure
 - shareholders to challenge boards
 - using their rights to enforce

Wobbly Basis of EU Approach

- Governance codes plus comply or explain are experimental
- Intuitively sound but no assurance of success
- No tested infrastructure
- Assumption of shareholder control

Weak Code Infrastructure

- No Code requirement on Member States
- Only art. 46a 4th Dir:
 - Listed company required to comply or explain under Code it is subject to or voluntarily applies
- Double and no application as result of basis of Code in listing rules or corporate law
 - Air Berlin Plc
 - Forum recommendation; no response from Commission
- No consistent system of monitoring and amendment of Codes
- No understanding of quality of explanations

EU Difficulties with Shareholder Enforcement: Cross-Border Voting

- Lack of efficient cross-border voting infrastructure
- Chains of security intermediaries
- No clear right of ultimate investor to exercise voting right
- No obligation of security intermediaries to facilitate
- Forum: create intermediary obligation in Shareholders Rights Directive
- But no: SRD no solution
- Paradox: US restricted rights but efficient voting system, EU strong rights but underdeveloped voting system

Controlling Shareholders and Disproportionality

- Majority listed companies on Continent have controlling shareholders
- Controlling shareholders explain to themselves
- Regulatory pressure of Code reduced/removed
- Enhance role for independent NEDs? Enhance role of regulators?
- Exacerbated by disproportionality
- Incentive to abuse: costs disproportionately borne by outside shareholders
- Forum recommendation: enhanced qualitative disclosure
Commission: no action on proportionality, not even enhanced disclosure

EU Not Taking the Code Experiment Seriously

- Management and controlling shareholders determine national agenda's
- Concerns ride the trend of national protection (13th Dir)
- National governments determine EU decisions, current Commission is weak, not even trying
- Weakens EU in transatlantic debate with US: no idea of effectiveness of EU approach
- EU will get US style compliance and enforcement which it says it does not want
- Worse: we dull ourselves into illusion of having proper governance regulations and systems

Study on Code Infrastructure

- RiskMetrics commissioned by EU Commission
- Market wide monitoring may help to raise quality of explanations
- Shareholder engagement concentrated in few hands
- Intensive monitoring by regulators in some markets with strong controlling shareholders (Spain, Portugal)
- Risk of enhanced regulatory framework, replacing dialogue with shareholders
- Changing institutional investor behaviour: concentration of investments, engaged share ownership?

The Need for a New Governance Agenda

- We don't know whether governance EU style works, and if so why and when (and why and when not)
- Serious concerns remain
 - Experimental nature of codes, without established code infrastructure
 - Dilution of code and comply or explain effects by controlling shareholders
 - Lack of transparency of control structures
 - Lack of shareholder voting legal and practical infrastructure
 - Shareholder voting manipulation, empty voting
 - Continued incontestability of control
 - Lack of understanding of minority shareholder protection

Lessons from the Financial Market Crisis Designing Supervision and Control of Transmission System Operators

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Syllabus

- A. Foundations
- B. Transmission System Operators
- C. The Vertically Integrated Enterprise
- D. Regulatory Authorities of Member States
- E. Agency for the Cooperation of Energy Regulators - ACER
- F. Conclusions

A. Foundations

- I. Basic Insight from the Crisis
- II. Competition in a Natural Monopoly
- III. Unbundling
- IV. Structure of Transmission System Providers

A.I. Basic Insight from the Crisis

1. Measures of **self-regulation** have demonstrated a very poor performance.
2. The **participation** of regulated industries in the process of law-making ought to be eliminated as far as possible.
3. Government **influence** is of an ambiguous nature.
4. There is no clear evidence that **intervention of politics** caused or exacerbated the crisis.
5. If the field to be regulated is so crucial for common welfare that governments have to step in, in case of distress, governments must have **close control** of it.

A.I. Basic Insight from the Crisis

6. In essence, regulation of such an industry has to be exercise of **police power**.
7. Full **transparency of risks** is indispensable.
8. The widespread **complexity of norms** was a major contributing factor.
9. Oversight on a global or **European level** is indispensable only under certain, narrow pre-requisites.

A.II. Competition in a Natural Monopoly

Natural monopoly:

$$c(x_1+x_2) < c(x_1) + c(x_2)$$

for all $x_1, x_2 > 0$

in reality usually, but not necessarily
decreasing average costs

A.II. Competition in a Natural Monopoly

Examples for natural monopolies: network economies

- railroads
- natural gas
- electricity
- [telecommunication]

A.II. Competition in a Natural Monopoly

Basically two alternatives:

- Competition for the market (e.g. commuter railroad service)
- Free and non-discriminatory access to the infrastructure (e.g. electricity, long distance train traffic)

A.II. Competition in a Natural Monopoly

Corollary:

- Strict supervision of (private) monopolies
- Organizing the competition for the market
- Permanent control of the free and non-discriminatory access
- Charges for using the transmission-network

A.III. Unbundling

Crucial distinctions:

- Ownership of infrastructure
- Possession of infrastructure (e.g. lease)
- Maintenance of infrastructure
- Investment in infrastructure

A.III. Unbundling

Separation of

- (Transmission-)Infrastructure
- Production
- Transport
- Supply (Distribution)

A.III. Unbundling

Unbundling does not necessarily require economically and legally separate entities with no ties – of any kind.

A.III. Unbundling

1. Separate enterprises for the (transmission-)infrastructure and the production, transport, distribution
 1. “Siblings” of such firms
 2. Either one is mother or daughter of such an enterprise
2. Vertically integrated firms
3. Ownership or right of property

A.IV. Structure of Transmission System Providers

1. **Separate ownership of infrastructure**
with operation, maintenance, and investment by the owner
2. **Fully vertically integrated enterprise**
with all functions concerning operation, maintenance and access to the infrastructure separated within the firm
3. **Partially vertically integrated enterprise**
seperate ownership of infrastructure but with operation, maintenance, and perhaps investments by a person other than the owner

B. Transmission System Operators

B. Transmission System Operators

Options of the Directives 2009/72/EC (electricity) and 2009/73/EC (natural gas):

1. Ownership Unbundling – OU (Art. 9 I)
2. Independent Transmission Operator – ITO (Art. 17-19 II-VIII)
3. Independent System Operator – ISO (Art. 13 I 1 – electricity, Art. 14 I 1 – natural gas)

B. Transmission System Operators

Ownership Unbundling

- Competence of Article 95 Treaty
- Compatibility with Article 295 Treaty?
- Unlawful taking?
(protection of property, e.g. ECJ 2002 I – 9011 at No.29 –
Roquettes Frères)
- Infringement of occupational freedom?

C. The Vertically Integrated Enterprise

- I. The Set-up
- II. ERGEG-Guidelines
- III. Principles of CEER
- IV. Guidelines of the Commission
- V. Rules set up by ACER

C. I. The Set-up

Stipulated independence:

Effectively independent decision-making rights for the transmission system operator

Problems:

- Unclear boundaries
- Unresolved conflicts of interest
- Appropriation of funds for investments in transmission system
- Risks off-balance sheet possible
- Incentive structure opaque

C. I. The Set-up

Eventually too many details will be left to **individual agreements** which are not transparent to the capital market.

C. I. The Set-up

- **Composition of Supervisory Body**
- **Role of Compliance Officer**

C.II. ERGEG Guidelines

ERGEG-Guidelines for Good Practice of 15 July 2008 are of **questionable legal status**.

- European Regulators Group for Electricity and Gas (ERGEG) is neither an organ nor an institution of the EU
- It is doubtful whether the necessary mandate by the federal government to act in matters of foreign relations has been granted.
- The group has no competence to set any type of legal norms.

C.III. CEER Critical Corporate Governance Issues

Council of European Energy Regulators (CEER): “Unbundling of energy undertakings in relation to Corporate Governance Principles”

- Corporate governance principles are **no legal norms**.
- The function of corporate governance principles is primarily to **foster capital markets** and their efficiency.

C.III. CEER Critical Corporate Governance Issues

- Provisions safeguarding the independence of the transmission system operator have **no direct on the capital market.**
- Indirect effects have yet to be proven and might be minute depending on the **revenue** the transmission system operator may collect.
- Corporate governance principles and their implementation in national statutes do not prevent the **national legislation to set up different rules for utilities.**

C.III. CEER Critical Corporate Governance Issues

- In essence, the key question will be the **magnitude of the user charges** the transmission system operator is entitled to collect.
- Only **existing rights** of shareholders might deserve **protection**. New investors know what they are going to get.
- Utilities have always “enjoyed” special treatment by legislation.

C.IV. Guidelines of the Commission

Guidelines adopted by the Commission pursuant Article 14 sec.3 (Directive electricity), Article 15 sec.3 (Directive natural gas)

“designed to amend non-essential elements of this Directive by supplementing it”

C. V. Rules set up by ACER

- Framework guidelines of the Agency for the Cooperation of Energy Regulators (ACER), Article 4 e Regulation (EC) No. 713/2009 of 13 July 2009
 - Non binding
 - Adressed at the Commission
- Recommendations to assist national regulatory authorities, Article 7 sec. 2 Regulation
- Framework for cooperation of national regulatory authorities, Article 7 sec. 3 Regulation

D. Regulatory Authorities of Member States

D. Regulatory Authorities of Member States

Guarantee of Independence:

“Member States shall ensure that ... the regulatory authority...

(a) ...

(b) ensures that its staff and the persons responsible for its management:

– (i) ...

– (ii) do not seek or take direct instruction from any government or other public or private entity when carrying out regulatory tasks”.

(Article 35 sec.4 Directive 2009/72/EC – electricity; Article 39 sec.4 Directive 2009/73/EC – natural gas)

D. Regulatory Authorities of Member States

“In order to protect the independence of the regulatory authority, Member States shall in particular ensure that:

- (a) the regulatory authority can take autonomous decisions, independently from any political body, and has separate annual budget allocations, with autonomy in the implementation of the allocated budget, and adequate human and financial resources to carry out its duties; and
- (b) (...)”

(Article 35 sec.5 Directive 2009/72/EC – electricity; Article 39 sec.5 Directive 2009/73/EC – natural gas)

D. Regulatory Authorities of Member States

- It has not been proven that political influence on supervisory agencies contributed in a significant way to the present crisis or other major malfunction of the economy.
- It is very questionable whether these provision can be upheld in view of democratic principles in EU-law and in the German Federal Constitution.
- The independence of the ECB and its member central banks is explicitly guaranteed by primary EU-law (Art.108 Treaty) and by the Federal German Constitution, Art.88 sentence 2 GG.

E. Agency for the Cooperation of Energy Regulators (ACER)

- I. Setting up the Agency
- II. European Supervision of Financial Markets
- III. Democratic Rule and Institutional Balance
- IV. Structure of ACER
- V. Lack of Control

E.I. Setting up ACER

ACER has been established by Article 1 I of Regulation (EC) 713/2009 of 13 July 2009

- Based on Article 95 of the Treaty
- Power to adopt individual decisions
- Legal personality
- Not only a decentralised network

E.I. Setting up ACER

- Article 95 Sec.1 sentence 2 Treaty
 - “approximation of the provisions laid down by law, regulation or administrative action in Member States”
[„Angleichung der Rechts- und Verwaltungsvorschriften der Mitgliedsstaaten]
- Need for European regulatory agency questionable
 - Not necessary for non-binding framework guidelines
 - Breach of contract procedure in case of insufficient transformation of directives

E.II. European Supervision of Financial Markets

- European Systemic Risk Council (ESRC)
- European System of Financial Supervision (ESFS)

E.II. European Supervision of Financial Markets

European Authorities replacing the „level3“ committees

- Commission of European Banking Supervisors (CEBS)
- Commission of European Securities Regulators (CESR)
- Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

E.III. Democratic Rule and Institutional Balance

Meroni-doctrine

To protect democratic principles the European Court of Justice ruled in the “Meroni” case (EuGH Urteil vom 13.06.1958, Rs. 9/56, Slg. 1958, 11) that only bodies with an democratic legitimization are authorized to render legally binding decisions. It developed the principle of preserving institutional balance and emphasized the limitation of delegating powers to independent European institutions. No discretionary power was to be delegated to such entities.

E.III. Democratic Rule and Institutional Balance

Meroni-doctrine observed?

- Article 7 Sec.1 Regulation “individual decisions”
- Article 7 Sec.3 Regulation “framework for cooperation”
- Article 7 Sec.7 Regulation “decide ... on access and security”
- Article 8 Sec.1, 2, 4 Regulation “competence ... by Guidelines of the Commission”



E.IV. Structure of ACER

- Administrative Board
- Board of Regulators
- Director
- Board of Appeal
- Financed by subsidy from the Community, fees, voluntary contributions, legacies, donations
- OLAF (**O**ffice européen de **l**utte **a**nti-**f**raude) is fully applicable

E.V. Lack of Control

- Almost no supervision by governments or EU-organs
- Guaranteed independence of members of the Board of Regulators
- Weak judicial control

F. Conclusions

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Unbundling of energy undertakings in relation to Corporate Governance Principles

*Florence School of Regulation Workshop in cooperation with ERGEG Task
Force on Unbundling, Reporting
and Benchmarking (TF URB)*

A Case Example: BT Openreach

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Telecoms vs Energy in the EU

- Vertical network industry
 - Regulated bottlenecks
 - Unbundling of some services (local loop)
 - No mandatory unbundling of businesses
 - Functional separation is proposed as an ultimate measure
 - Why pressure for unbundling?
 - Non-price discrimination
- Vertical network Industry
 - Regulated bottlenecks
 - Unbundling of network services
 - Mandatory legal separation of ITOs allowing common ownership

Models of Unbundling

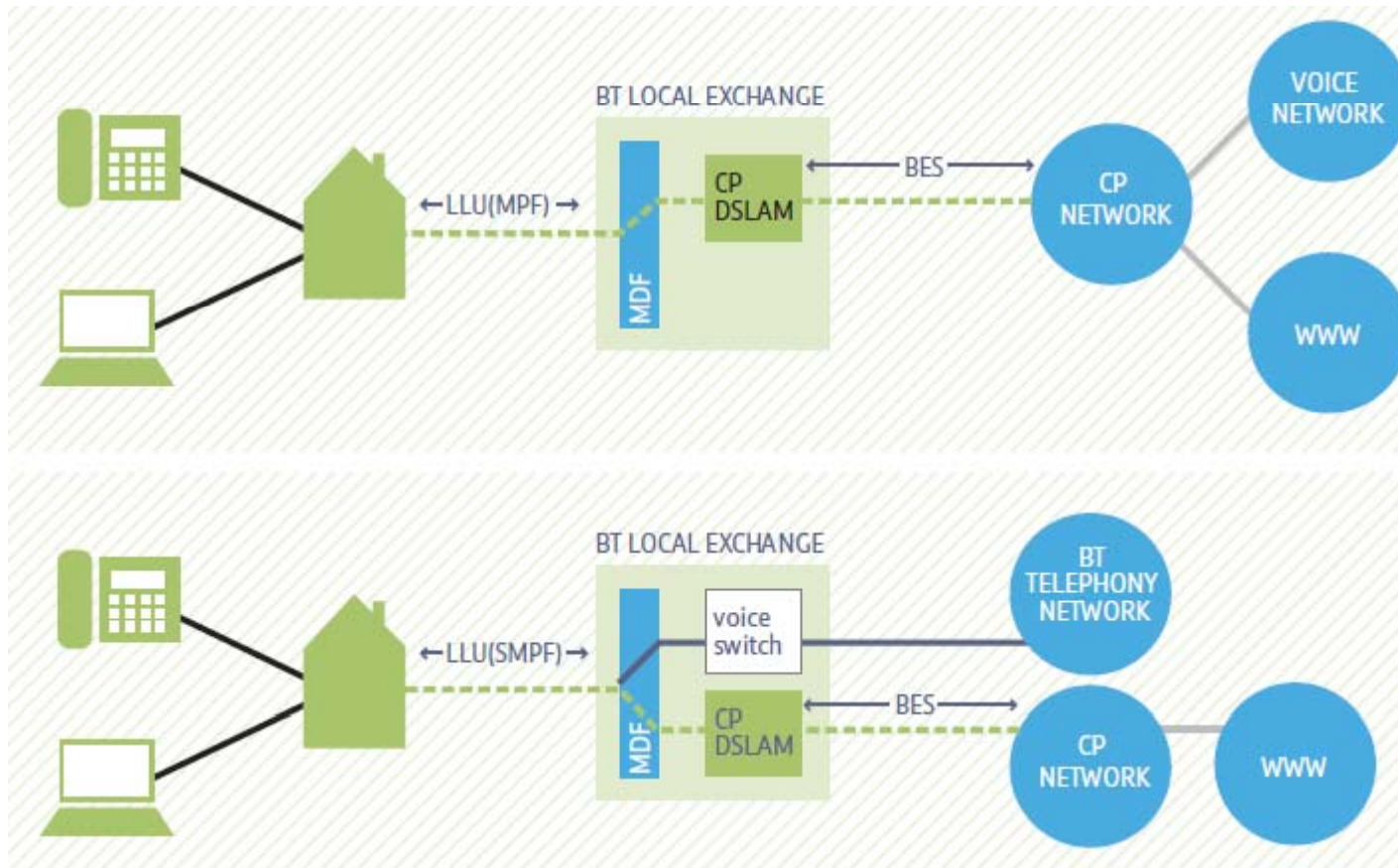
6	Ownership separation (in whole or part)	Full structural separation – may involve club ownership of bottleneck
5	Legal separation (separate legal entities under common ownership)	Legal separation (which may or may not embody elements of functional separation)
4	Functional separation with localised incentives and/or separate governance arrangements	Variants on functional separation
3	Functional separation	
2	Virtual separation	Variants on accounting separation
1	Creation of a wholesale division	
	Accounting separation	

BT Openreach: Overview

- Openreach owns, maintains and develops the BT access network which links homes and businesses to the networks of Britain's communications providers
- Customers are given equivalent access to the BT local access and backhaul networks, this enables them to provide their customers with everything from analogue telephone lines and calls packages, to high speed broadband connections and complex networked IT solutions
- The regulator Ofcom launched a Telecommunications Strategic Review (TSR), December 2003
- After extensive public consultation, Ofcom accepted a set of Undertakings, or legally-binding commitments, offered by BT (**supported by UK competition law**)
- Undertakings signed between BT and Ofcom on 22 September 2005
- Openreach operations started January 2006

Apex Economics: Regulation and Competition Analysis

www.apexeconomics.com



----- Openreach responsibility and line of service

Principles of Unbundling

1. Unbundling of functions
 - YES
2. Unbundling of professional interest
 - YES
3. Unbundling of decisions
 - NO – BT Group plc is not a pure financial investor
4. Unbundling of information
 - YES

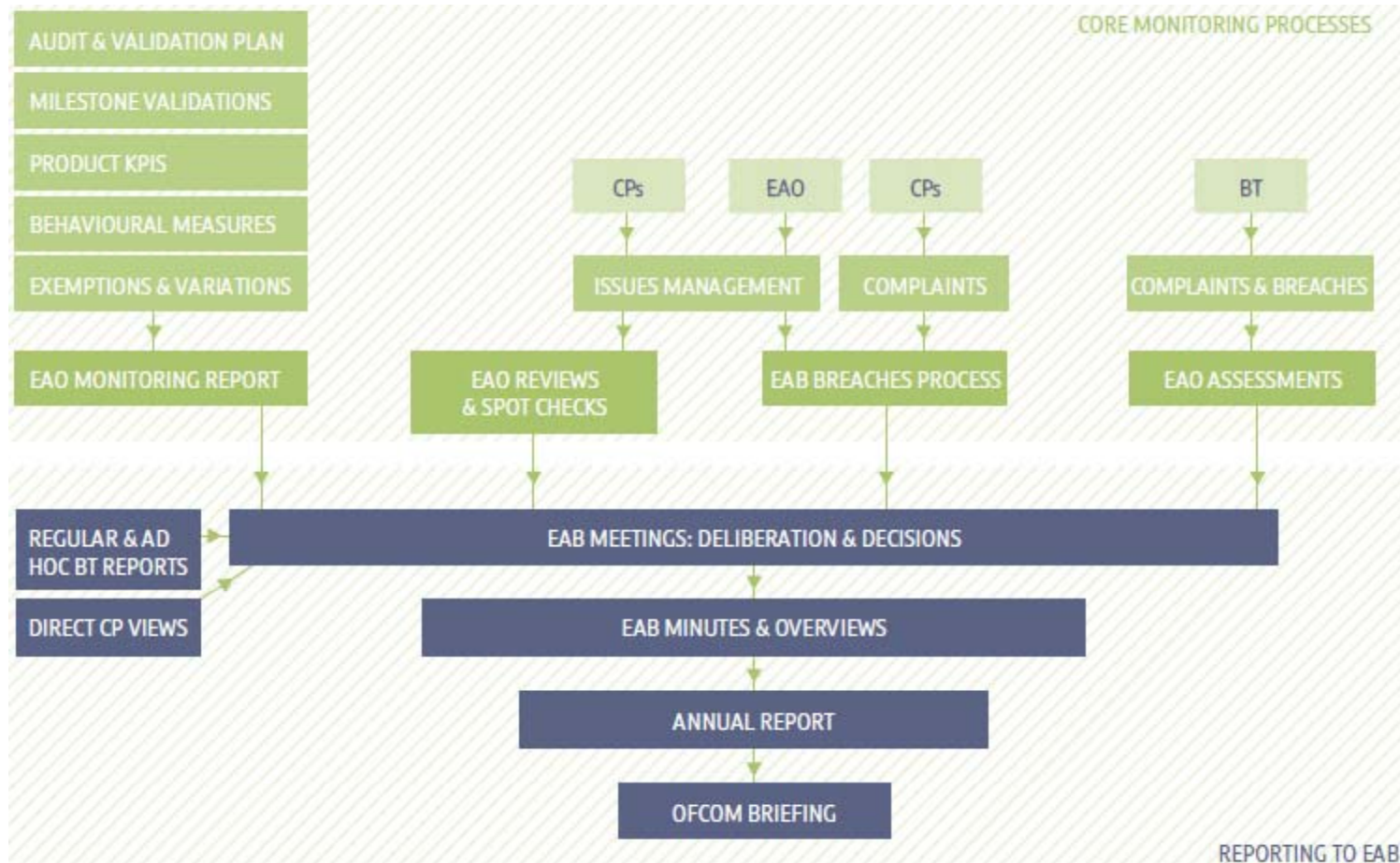


The Undertakings

- The establishment of Openreach requires BT to adhere to the commitments in the Undertakings
- The Undertakings have required:
 - Changes to BT's internal systems, processes and ways of working.
 - Updating and developing employees' skills and
 - The implementation of a Code of Practice
- Openreach has changed fundamentally the way employees are incentivised
 - The Openreach senior management reward structure is, for example, linked solely to the performance of Openreach
- Openreach remains part of the BT Group, though it is a separate business with its own:
 - Headquarters,
 - Identity
 - Financial reporting and
 - Commercial principles
- The progress and performance of Openreach in meeting the Undertakings is monitored by an independent Equality of Access Board (EAB)

Equality of Access Board

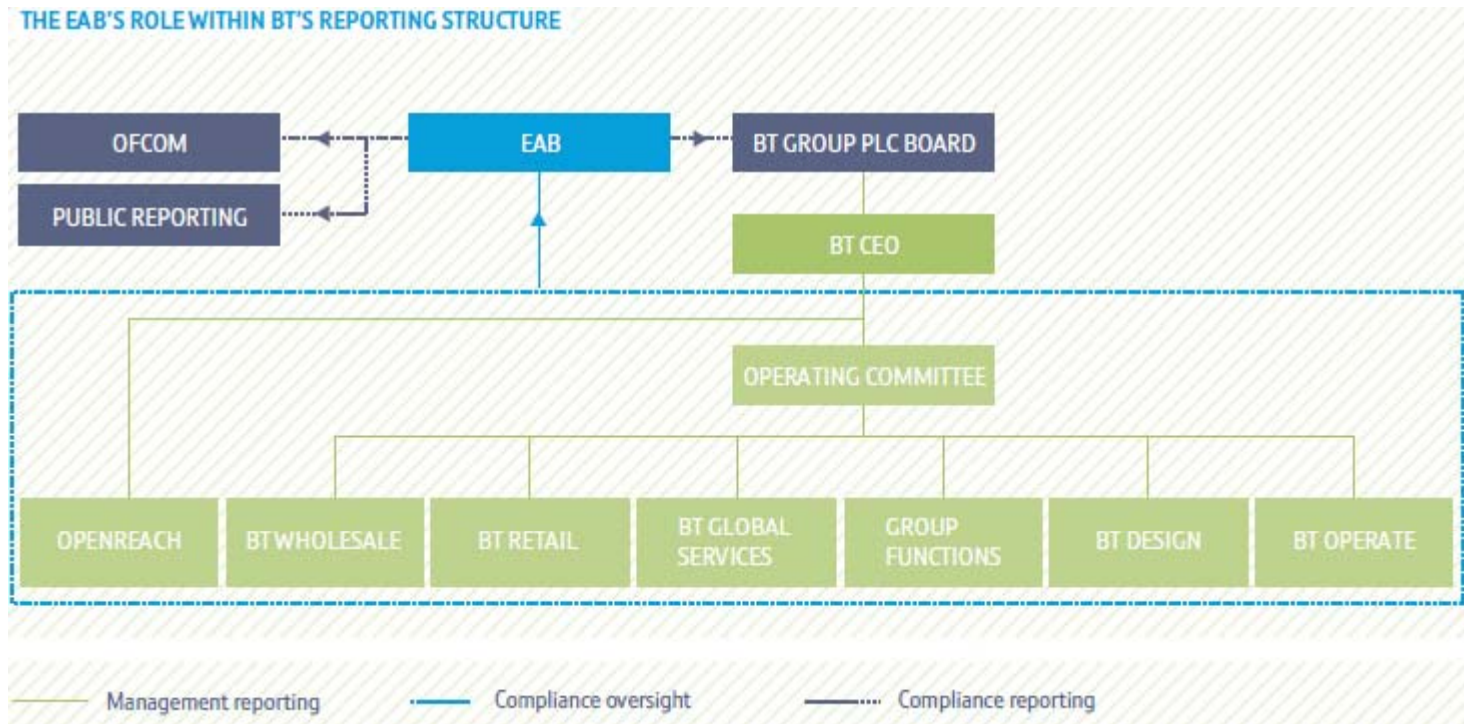
- Established November 2005
- The EAB monitors compliance with the Undertakings
- The EAB also assesses the delivery of Equivalence of Inputs by Openreach and regularly reports to the BT Group Board and to Ofcom
- The EAB is a committee of the BT Group plc Board. It is supported by the EAB Secretariat and the Equality of Access Office (EAO)
- The EAB consists of five members: three independents, one BT Group plc non-executive director and one BT senior manager
- The EAB shall publish in June each year an annual report on its activities as a distinct part of BT's annual regulatory compliance report. The EAB annual report shall be audited by independent external auditors



Openreach governance Structure – monitoring compliance

Formal and informal channels are used

CPs = Communication Providers



EAB role within BT

BT Governance Structure

- The governance structure that was established in 2005/6 has remained largely unaltered in function
- The current framework consists of the:
 - Enterprise Programme Board: a group-wide body for setting policy and direction, managing priorities, resolving issues and ensuring consistency across BT's lines of business
 - BT Group Undertakings Programme Team: supports the Enterprise Programme Board by providing regular monitoring and reporting information on BT's delivery of the Undertakings
 - BT's line of business Undertakings programme delivery offices:
 - provide detailed Undertakings progress reports to the Undertakings Programme Team and to the EAB.

Governance and Investment

- 5.28 With effect from the BT financial year 2006/2007, AS shall establish an annual operating plan which shall be submitted to the BT Group plc Board for approval. Once approved, execution of that plan shall be the responsibility of the AS CEO and the AS Management Board. The plan will establish the budget, including capital and operating expenditure, for AS. The plan shall include plans and targets for implementing and applying those sections of these Undertakings applicable to AS for the relevant year. Following each year of operation of AS such plan shall include a commentary on the previous year's implementation and application of these Undertakings as they apply to AS. The annual operating plan and commentary shall be shared with the EAB.
- 5.29 The AS CEO shall have delegated authority from the BT Group plc Board to authorise capital expenditure of up to £75 million within the annual operating plan referred to in section 5.28. This limit may be varied from time to time at the discretion of the BT Group plc Board. Ofcom and the EAB shall be notified of such variation within five working days.

EAB Opinions

- “satisfied that these [governance structures] are functioning well and that it is effective in monitoring progress and advising BT on future steps”
 - Page 7 EAB Annual Report 2009
- “worked well in terms of monitoring and reporting but there are elements of BT’s governance of specific processes, for example, Openreach billing and product management processes that need to be improved”
 - Page 15 EAB Annual Report 2009

Ofcom Opinions

- “Our annual evaluation continues to indicate that the net effect of the Undertakings to date, both for competition and consumers has been positive”
 - Executive Summary, Ofcom, Impact of the Strategic Review of Telecoms: Implementation Review, May 2009
- “We consider that Openreach has made good progress in becoming a functionally independent entity. It is now a recognised brand that is operating on a more stable, business as usual, basis.”
 - Para 5.14, Ofcom, Impact of the Strategic Review of Telecoms: Implementation Review, May 2009
- “The EAB has continued to build its organisational credibility by performing its compliance duties in an effective and objective manner.”
 - Para 5.20, Ofcom, Impact of the Strategic Review of Telecoms: Implementation Review, May 2009
- We continue to remain of the view that the Undertakings are an appropriate and comprehensive solution to the competition concerns that we set out in the TSR
 - Para 1.40, Ofcom, Impact of the Strategic Review of Telecoms: Implementation Review, May 2009

Competitors' Opinion

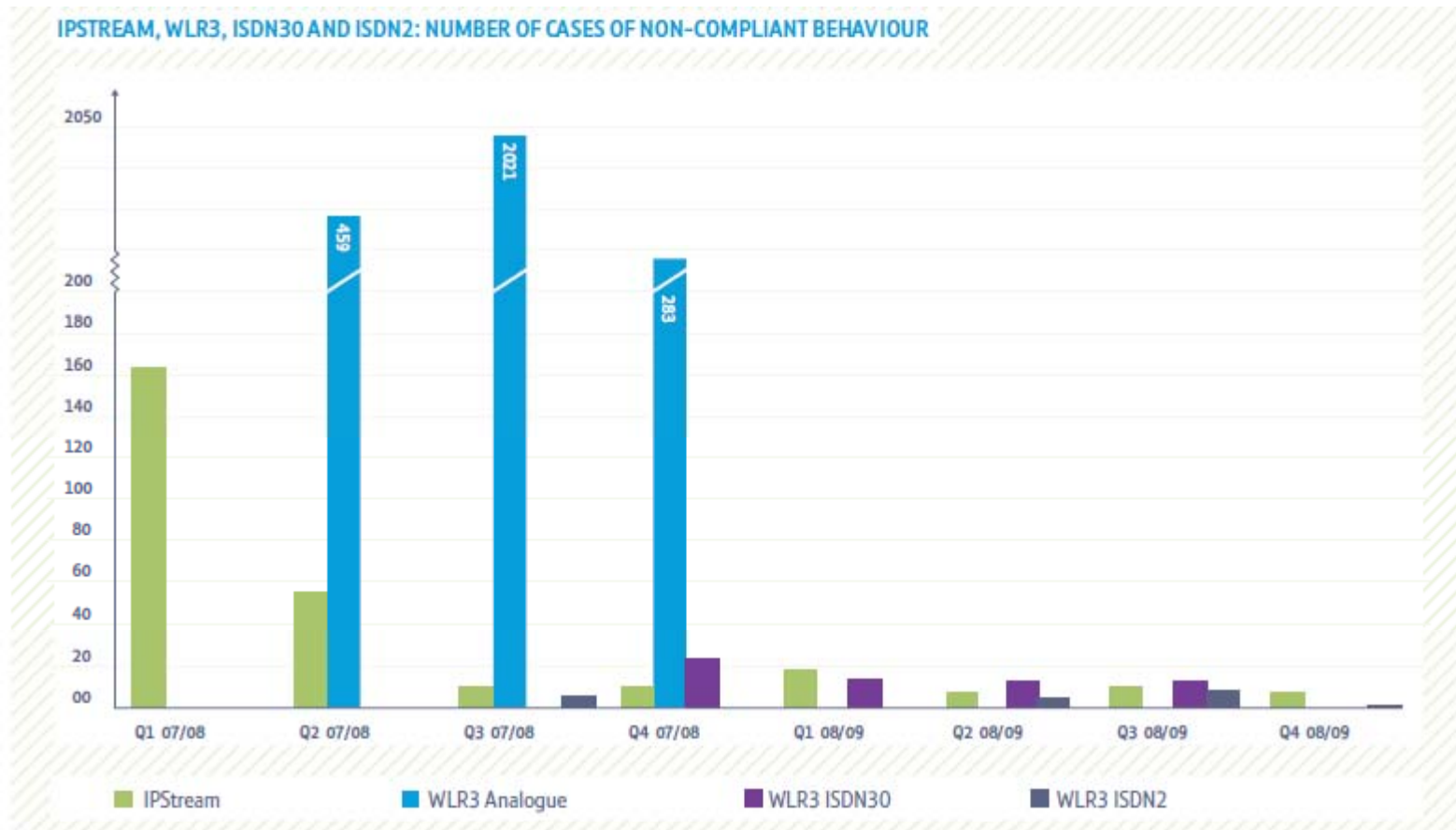
- “We enjoy the partnership relationship we have with Openreach, rather than us being just another customer and Openreach just another supplier.”
 - Justin Fielder
 - Director of Research & New Technologies, BSkyB

Independent Opinion

“The implementation of functional separation in the UK to date has not been without its problems. The unravelling of the numerous relationships that bound Openreach with the rest of BT has been complicated, probably more so than anticipated when the undertakings were agreed in late 2005. As the relationships have been unwound, BT has asked for exemptions and variations from the undertakings as well as for more time. If nothing else, the difficulties that have been encountered should be sufficient for any government/regulator that is considering the replication of the UK approach to functional separation to think twice.”

“Is Functional Separation BT-Style the Answer?” Jason Whalley & Peter Curwen, *Communications & Strategies* no. 71, 3rd quarter 2008, pp. 160-161.

Compliance Performance



Source: BT

Concluding Remarks 1

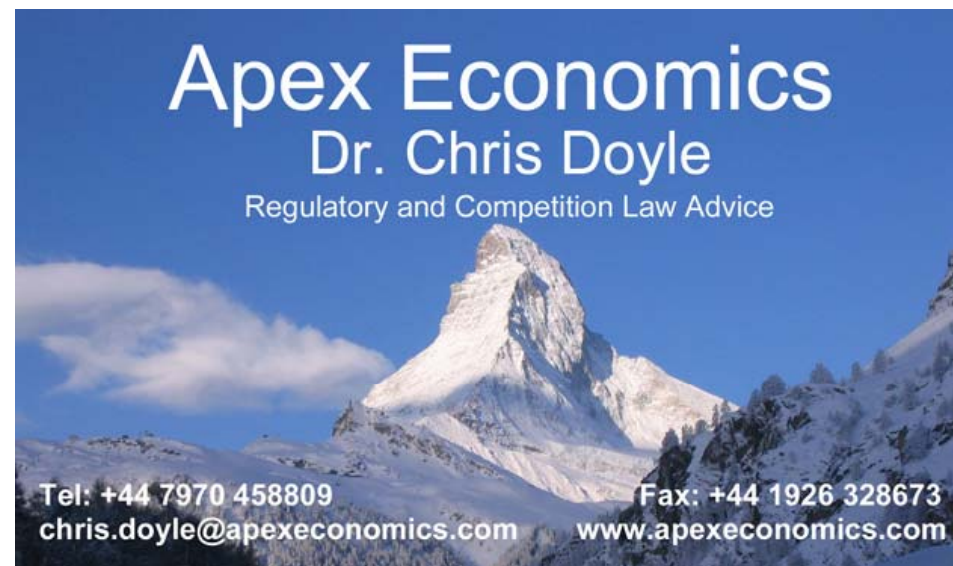
- The governance structures established to oversee Openreach in the UK appear to have functioned effectively, though a number of difficulties have emerged
- The oversight combines self-regulation (reinforced by legally binding commitments – ‘the undertakings’), independent audit and external regulation
- The structure in practice is complex, but probably no more so than similar structures found in the financial services sector
- The governance arrangements appear to have adapted well to changing circumstances
- Has it been a nightmare for the regulator?
- No – but it has been administratively detailed (hence relatively costly) and has cost BT more than £100m to establish and increased opex

Concluding Remarks 2

- The European Commission has advocated the need for functional separation as an ultimate measure
- There is much opposition to functional separation – among operators and some regulators (e.g. Arcep in France)
- A number of NRAs have chosen not to apply functional separation (Opta in NL), others have threatened application (UKE in PL), some incumbents have volunteered application (Telecom Italia, Telia-Sonera)
- Jury still out on the net benefits/costs in the UK – study required
- Outside the EU separation has been considered in Australia where the Federal Government announced on 15 August 2009 structural separation (legal separation) of the incumbent Telstra – a model similar to the third energy package

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Thank you