Summary

Background

Over the past decade, electrical power in Sweden has been the subject of thorough review and reform. The reform of the electricity market has resulted in the opening up of electricity operations (i.e. operations producing and trading in electricity) to competition so as to safeguard the interests of consumers by creating the right conditions for effective pricing in the electricity market. Grid operations constitute a natural monopoly and have as such been regulated with a view to preventing companies from using their monopoly position to set unreasonable transmission and distribution tariffs.

One of the main principles of the reform of the electricity market relates to the clear separation of electricity operations and grid operations. The latter have thus been separated from the former so as to prevent or avoid situations in which regulated grid operations are affected by conditions prevailing in the competitive electricity market, such as the transfer of costs to grid operations.

In its Bill 2001/02:56, the government proposed a clearer separation between these two types of operations with a view to further curbing the possibilities of and incentives for undesired subsidies from grid operations to electricity operations. The government proposed that the majority of the members of the Board at a grid company should be barred from simultaneously serving as Board members at a company conducting production of or trade in electricity, and that the Managing Director or CEO of a grid company should be barred from simultaneously serving as the Managing Director or CEO of a company conducting production of or trade in electricity.

The Parliamentary Committee on Industry and Trade, however, felt that the government's proposal required further work, including more careful consideration of issues such as the costs

arising for small companies in the electricity market as a result of the proposal, as well as the risk of cross-subsidisation between district heating companies and electricity trading companies. The ongoing work was to pay special attention to the issue of congruence in the bodies of regulations applying to the operations in question.

Task

This government report was tasked with studying the need for special provisions to regulate the unbundling of grid operations and electricity operations, as well as district heating operations. This task includes assessing the need for more stringent regulations and supervision of the unbundling of the accounts of district heating operations with a view to avoiding cross-subsidisation and price discrimination. Where necessary, it also includes proposing such regulations. In this progress report, proposals are made for such legislative changes and the text below provides a brief presentation of these proposals.

Goals of regulation etc.

An important basic premise for this report has been to encourage the continued expansion of district heating as the preferred heating alternative of the future. It is therefore crucial that both existing and prospective customers should experience a sense of security and confidence in relation to district heating. In performing its task, this report has therefore chosen to adopt a consumer perspective. The overall goal of the regulations we propose is to enhance consumer security through more stringent requirements regarding transparency and the unbundling of district heating operations on the one hand and electricity market operations (i.e. grid operations and operations producing and trading in electricity) on the other.

The requirement regarding transparency and separation is designed to prevent district heating consumers from in practice financing other operations. This might for example occur if shared overheads for the operations are charged only or mainly to district heating operations, or if goods or services purchased and sold

between the operations in question are not purchased at market-based prices. By preventing such cross-subsidisation, we can strengthen consumer confidence in district heating itself, as well as in its pricing.

We propose the introduction into the Swedish Electricity Act (1997:857) of a regulation requiring the separation of district heating operations and electricity market operations.

Unbundling of the accounts of district heating operations

We propose the introduction of an obligation for district heating operations to keep separate accounts. This requirement is designed to cope with the risk of cross-subsidisation and price discrimination inherent in a situation where district heating operations and electricity market operations are conducted within the same legal entity.

The requirement concerning separate accounts for district heating operations is general, and means that these operations shall keep their accounts in such a way that all business events and allocations within the operations can be traced and verified. When a legal entity is engaged in a variety of different operations, it is vital, not least for the consumers, that revenues and expenses for the different operations can be tracked. The details of the form taken by the unbundling of accounts should be a matter for the government to decide.

Separation of district heating and electricity market operations into different legal entities

The increased transparency that results from the requirement concerning the unbundling of accounts has specific limitations. Even when the accounts are unbundled, it remains difficult for a regulatory authority and for others to determine whether district heating consumers are in practice helping to finance other operations within the company.

The operations that should, where necessary, be separated from district heating operations are electricity market operations. There are no significant synergistic benefits to be derived from pursuing electricity market operations together with district heating

operations, other than with regard to electricity generation. We therefore propose a ban on conducting electricity market operations and district heating operations within the same legal entity.

A district heating power plant produces both electricity and thermal energy simultaneously, as part of the same process. The thermal energy is utilised in a district heating system. In view of the limited opportunities for these companies to influence competition in the electricity market, as well as the difficulties of accurately allocating costs to the different activities, we propose that the production and sale at market-based prices of electricity from a district heating power plant should be exempted from the separation requirement. Such production and sales activities shall be considered to be part of district heating operations. In our view, the revenues derived from the sale of electricity from a district heating power plant should be reported separately, but we make no proposals here concerning this matter. Instead, we propose that the government should be authorised to announce further directives concerning the accounts kept by district heating operations.

Separation with regard to management functions

In order to ensure that this report's proposal concerning the legal separation of district heating operations and electricity market operations is implemented in practice and not merely in theory, there should also be a clear separation of management functions (i.e. functional separation). This separation should be limited to situations and functions that may be considered to have a significant influence on operations conducted within the legal entity.

We propose that no more than half the Board members of a district heating company shall be allowed to serve simultaneously as Board members at a company conducting electricity market operations. If half of the Board members do have such double functions, a similar ban shall apply to the Chairman of the Board. A Managing Director or CEO at a district heating company shall be barred from simultaneously serving as the Managing Director or CEO of a company conducting electricity market operations.

Supervision

The regulation of district heating operations proposed here is designed to safeguard the security of district heating consumers and their confidence in district heating as a heating form. In order to achieve this, it must be possible to ensure that the regulations are observed, and to impose sanctions when they are not.

Our proposal is that the regulations concerning supervision included in the Swedish Electricity Act should also, to the extent that they are relevant, apply to district heating operations. This includes issues such as access to information and the possibility of issuing injunctions requiring those responsible for conducting the operations to implement corrective measures. Such injunctions may also be combined with fines. We recommend that the Swedish Energy Agency (Statens energimyndighet) should be appointed as the regulatory authority.

Consequences

The supervision tasks involved in our proposal concerning legislative regulation will entail additional expenses for the government. We propose that these costs should be financed by charging district heating operations a supervisory fee. The size of this fee should be proportional to the quantity of thermal energy sold.

Our proposal will also entail costs for district heating companies. While the requirement concerning the unbundling of accounts does not represent a major financial burden on those who conduct such operations, the requirement concerning legal and functional separation may entail certain costs. Bearing in mind the number of companies affected and their structure, however, the nature of these costs would not appear *per se* to entail a risk of either failure or merger among smaller companies. We have therefore seen no reason to introduce provisions concerning exemptions for smaller companies.