

# **Competition Authority Response to CER/01/59: Transmission Infrastructure Agreement Principles Paper**

## **1. Introduction**

Non-discriminatory third-party access to the transmission and distribution networks is crucial to the development of effective competition in the electricity sector. As many commentators, including the Authority and the OECD have stated, the attainment of this objective is best realized when ownership of transmission and distribution assets is entirely removed from the incumbent.

However, in Ireland the optimal solution has not been adopted. SI No. 445 of 2000 provides for a statutory separation of functions between the ESB as electricity transmission network owner (TAO) and a new State owned company, EirGrid as network operator (TSO). In order to enable EirGrid to discharge the functions of TSO, the SI requires that the ESB and EirGrid enter into a contract to be known as the Infrastructure Agreement (I.A.), which is subject to the approval of the CER.<sup>1</sup>

In order to ensure that the principle of non-discriminatory third-party access is maintained, it is important that the effect of the I.A. is to maximize the TSO's control over the transmission and distribution networks so that it may discharge its functions in an independent manner. In the Authority's view, the I.A. should be an attempt to come to a contractual arrangement that will allow the TSO to act as if they were the beneficial asset owner. Such an arrangement, if achieved, would contribute to the development of competition in the electricity industry in the State within the constraints of the SI.

The structure of the remainder of this document is as follows. In Section 2 the regulatory and legislative background to the Infrastructure Agreement is outlined. Section 3 addresses the specific concerns that the Authority has with the Infrastructure Agreement principles as outlined in the CER consultation paper. Some conclusions are made in Section 4.

## **2. Legislative and Regulatory Background**

### ***The EU Directive***

Directive 96/92/EU (the "Directive") on the internal market in electricity provides for the opening up of the electricity markets in Europe to competition in the areas of generation and supply. A key element of the liberalisation process is the requirement of each Member State to establish an independent TSO. The following are key elements of the Directive:

- (i) The TSO must be "designated and entrusted with the operation, maintenance, and, if necessary, development of the system". [Recital (25)]

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<sup>1</sup> The SI also provides that the CER "may" consult the Competition Authority "...for purposes of exercising its power to approve the infrastructure agreement." (Regulation 18(1)(d))

- (ii) The TSO “must behave in an objective, transparent and non-discriminatory manner”. [Recital (25)]
- (iii) Member States must “designate...a system operator to be responsible for "operating, ensuring the maintenance of, and, if necessary, developing the transmission system...in order to guarantee security of supply “ [Article 7(1)]
- (iv) In those Member States where ownership of the transmission system resides with an incumbent vertically integrated electricity undertaking the TSO must be independent “at least in management terms” from other activities not relating to the transmission system. [Article 7(6)]

### ***SI No. 445 of 2000***

The Directive has been transposed into national law primarily with the Electricity Regulation Act (1999) and the associated Statutory Instrument No. 445 of 2000. The SI requires that the I.A. include the following:

- (i) a specification of which assets of the transmission system owner shall constitute the transmission system, including-
  - I. the technical operating limits of such assets, and
  - II. how this specification may change over time;
- (ii) provisions for maintenance and development of the transmission system;
- (iii) provisions regarding construction, connection to and use of the transmission system by third parties;
- (iv) arrangements for the transfer of information between the TSO and the TAO in relation to the Development Plan, its implementation and costs thereof;
- (v) provisions regarding rights and responsibilities for de-energisation and disconnection;
- (vi) the allocation of risk, for insurance or other purposes considered appropriate by the Commission, between the TSO and TAO;
- (vii) provisions regarding the term, termination and renewal of the Infrastructure Agreement; and
- (viii) provisions regarding review of the I.A. and each party’s performance under that agreement.

### ***CER principles for interpretation***

The CER is proceeding on the basis of a functional interpretation of the SI and of Directive 96/92/EC and have specified that the IA should be based on the following criteria:

- (i) compatibility with legislation, recognizing that legislation leaves some policy discretion in interpretation and implementation;
- (ii) consistency between Infrastructure Agreement, Use of System tariff regime, Licenses and Codes;

- (iii) clear demarcation of responsibilities;
- (iv) efficiency through cost minimization – no duplication;
- (v) the needs of customers are met and the interests of connecting parties are protected;
- (vi) customer contracts shall be with EirGrid only;
- (vii) I.A. to form the basis for an enduring stable relationship between TAO and TSO; and
- (viii) transparency – public consultation on Memorandum of Understanding and/or Infrastructure Agreement itself before CER final approval.

### **3. Competition Authority Concerns**

In this section we address the specific concerns that the Authority has with the Infrastructure Agreement principles as laid out in the CER consultation paper. Those concerns relate to:

- the interpretation of the term “construction work” in SI No. 445 of 2000;
- the requirement that the TAO and TSO enter into a project agreement for each development project;
- the role of incentives and penalties;
- the effectiveness of step-in rights; and
- the importance of a clear delineation of TAO and TSO liability.

Each of these issues is dealt with in turn.

#### ***Interpretation of “construction work”***

Regulation 19(a) of SI No. 445 of 2000 states that the ESB as TAO shall

*“...maintain the transmission system and carry out construction work in accordance with the transmission system operator’s plan...”*

The interpretation of “construction work” adopted by the CER in the consultation paper is extremely broad and extends beyond the notion of “construction work” as the physical erection of assets. Instead, the term “construction work” has been interpreted so that the TAO has a significant role in, and in some cases ultimate responsibility for, other related activities.

The CER envisages an eight-stage programme for any development plan. The TAO and TSO are allocated either sole or joint responsibility for each of the eight stages. This division of responsibility is depicted in the table in Annex I.

Apart from the construction stage the TAO also has joint responsibility for procurement and sole responsibility for detailed project design and project review. This proposed

arrangement allows the ESB as TAO excessive control of the transmission system and has the potential to inhibit nascent competition in the electricity sector.

Allowing the ESB to have control of any aspect of the development of the transmission network has a chilling effect on the market. That is, potential entrants to the market perceive that the incumbent competitor has a degree of control over how and when they can become operational. Moreover, potential entrants also perceive that the incumbent has little incentive to facilitate the entry of competitors. The effect is that potential entrants are less likely to enter the market at all and competition is damaged.

Thus, the ESB's statutory right as the sole supplier of construction services on the transmission network should be interpreted so that the TSO's control over the network is perceived to be maximised by potential entrants. To this end, only responsibility for the construction stage should be given to the ESB and responsibility for all other stages to the TSO.

### ***Project agreement***

The TSO and TAO must enter into a project agreement for each construction project undertaken. Section 9.1.2 of the consultation paper states:

*“A project agreement ... will be required for each construction project. The I.A. shall require the project agreement to specify information on the works to be carried out to standards approved by the TSO, a project implementation programme as well as outlining the respective responsibilities and liabilities of the parties.”*

However it is not clear from the consultation paper what procedures will be in place should it prove impossible for the ESB and EirGrid to reach an agreement within a reasonable timeframe or at all. Section 18 of the consultation paper has the following to say of the CER's dispute settlement role:

*“Regulation 18(8) confers on the CER an arbitration role for the resolution of differences and disputes arising from the I.A. The I.A. shall provide for the CER's function, as defined in the S.I., in resolving differences between TAO and TSO. The I.A. shall also require the TSO and TAO to bi-laterally resolve the dispute in the first instance, before referral to the CER. Dispute resolution procedures shall include, inter alia, for the exchange of information to support each viewpoint and for an independent technical adviser to report on technical matters under dispute”.*

From the above passage it appears that the CER's role is one of arbitration and that its function would stop short of the ability to direct the parties. Thus, it seems that the TAO may have some scope to frustrate the activities of the TSO in discharging its functions. From the perspective of potential entrants to the market, this adds an extra degree of uncertainty that may discourage them from entering the market.

We make the following suggestions:

- (i) As an alternative to the negotiated agreement approach we suggest that a contract approach would be more appropriate. That is, the TSO would draw up terms of contract for required construction work and the TAO would have

first right of refusal on that contract. Should the TAO choose to exercise that right, then alternative construction firms could be sought.

- (ii) However, should the contract approach prove infeasible we suggest that there be a reasonable limit placed on the amount of time that it takes to negotiate an agreement and that, in the event that an agreement cannot be reached, the CER should be able to direct the parties to reach an agreement.

An additional point that arises in relation to the project agreement is one of timing. It is not clear from the consultation paper at what precise stage of the development process an agreement is entered into. For instance, do the parties enter the agreement at the stage when the TAO first assumes some responsibility, i.e. at stage 4 of the development and construction process, or is the agreement entered into at an earlier stage, when the planning and feasibility studies have been completed for example?

### ***Incentives and penalties***

Regulation 8(1)(a) of SI No. 445 of 2000 states that the TSO shall

*“...operate and ensure the maintenance of and, if necessary, develop a safe, secure, reliable, economical and efficient electricity transmission system...”*

In order to ensure that the transmission system and works completed thereon are “*economical and efficient*”, both the TSO and TAO need to be incentivised. Thus, it may be appropriate that the activities of the TAO and TSO be benchmarked (for instance, benchmarking may be achieved through comparison with similar work carried out in Northern Ireland). Similarly, a system of penalties and meaningful sanctions may be appropriate.

From a competition perspective the timely completion of work by the TAO is of paramount importance. The CER consultation paper recognises this and in section 8.2.1. where it is stated:

*“The I.A. shall require that inspection and maintenance policies be applied including standards, action levels, and response times for remedial work and repairs. TSO policies and procedures will define the maintenance regime and standards and action levels and timescales for remedial and repair work. TSO will have full information of maintenance work in hand and may prioritise work within the programme to meet system needs. The I.A. shall specify escalation procedures to expedite the process and penalties where targets are not met.”*

It appears from the consultation paper that penalties will only be used in relation to maintenance work. We suggest that penalties should also be used in relation to development projects. However, such sanctions must be meaningful. That is, the magnitude of penalties must be comparable with the benefit the ESB as TAO stand to gain by discouraging or delaying the entry of competitors.

### ***Step in rights***

Regulation 18(6) of SI No. 445 of 2000 states:

*“In case of delay or default by the transmission system owner, the transmission system operator shall have rapid step-in rights to arrange for work to be*

*undertaken by a contractor approved under paragraph (3)(b), by direction of the Commission. The costs of such work to be undertaken shall be borne by the transmission system owner.”*

It is essential to the development of competition that the perception exist among new and potential entrants to the market that any attempts to delay work on the transmission system and frustrate the ability of the TSO to discharge its functions can be countered swiftly and effectively. Thus, the TSO should have rapid step-in rights. The procedures outlined in the consultation document do not achieve this objective. There are five stages outlined in the consultation paper:

- (i) the TSO must notify the TAO of its intention;
- (ii) the TAO is allowed a reasonable period to respond;
- (iii) the TAO must inform the CER and TSO of its position;
- (iv) if the TAO accepts there is a delay then it must suggest a remedy;
- (v) if the TSO still maintains that the TAO is in delay or default and is not satisfied with the TAO’s proposed remedy, then it may request step-in rights from the CER.

The process described above is lengthy and allows the TAO too many opportunities to dispute the findings of the TSO and frustrate it in discharging its functions. The process of triggering step-in rights should be simpler and the TSO should be given greater discretion to determine when step-in rights should be exercised.

In relation to step-in rights, there is an additional point that concerns timing. It is not clear from the consultation paper when step-in rights come into effect. For instance, if the TSO felt that the TAO was delaying negotiations, may the TSO exercise its step-in rights before the project agreement has been finalised?

### ***Liability sharing***

A clear delineation of TSO and TAO liability for the maintenance and development of the transmission system is essential for the development of competition in the electricity sector. An ambiguous allocation of liability has a chilling effect on the market. Should potential entrants perceive that the allocation of liability is not clear or may be subject to dispute by the parties, then they are less likely to enter the market and competition suffers as a consequence.

Regulation 18(4)(d)(vi) of SI No. 445 of 2000 states that:

*“The Infrastructure agreement shall include in such form as the Commission considers appropriate the allocation of risk, for insurance or other purposes considered appropriate by the Commission, between the transmission system operator and the transmission system owner.”*

Section 10 of the consultation paper outlines what the CER considers an appropriate allocation of risk. It is envisaged that risk *“should be allocated according to the activities carried out by the parties.”* However, the manner in which the CER currently envisages allocating activities between the TSO and TAO has the potential to render unclear where liability lies. In general, the greater the extent of involvement of both parties in any

particular activity, the greater the potential for confusion regarding the identity of the party responsible for a defect or delay.

A more satisfactory arrangement would be to allocate risk according to function where the TAO's function is confined to the construction stage only. In this case the delineation of liability would be clearer and the potential for confusion reduced. This arrangement would be more conducive to the entry of new market players and hence to the development of effective competition in the sector.

The issue of indemnification of the TSO in instances where the TAO is responsible for the TSO's failure to uphold the statutory rights of third parties seeking access to the transmission network is addressed in Section 6.1 where it is stated:

*“Third parties seeking access to or use of the transmission system have certain statutory rights enshrined in EU and domestic law. The corollary obligation to accommodate these rights lies with the TSO alone. EirGrid, as TSO, cannot derogate from this obligation. The customer's contractual relationship for access to or use of the transmission system must be with EirGrid alone. To the extent that the TSO may incur a liability to a customer for failing to uphold that customer's statutory rights and that failure is due to the actions or inactions of ESB as TAO in discharging its functions under the I.A. then it is legitimate that the TSO be fully indemnified against this liability by the TAO under the terms of the I.A.”*

Requiring the TAO to indemnify the TSO means that third-parties damaged by delays in or default on maintenance and development work would have to recover damages from the TSO which would in turn seek to recover them from the TAO. Such a procedure would be slow and cumbersome. It would also mean that the TSO would be held primarily responsible for actions or inactions of the ESB as TAO. The likely effect is to render the TSO overly cautious in selecting and designing projects, resulting in possible connection delays and discouraging new entry into generation. One possible approach would be to require the ESB as TAO to enter into a bond up front, out of which compensation would be paid to third-parties pending resolution of the issue of liability.

#### **4. Conclusion**

Unfortunately, developments in the Irish electricity market over the past few years have shown that the current regulatory framework is not conducive to competition. The generation capacity of the incumbent has not been split up or capped. Transmission assets remain in the ownership of the incumbent. Accounting separation is of dubious effectiveness in guarding against cross-subsidisation at the supply level. In the long run, the implementation into Irish law of further European directives on liberalisation may rectify the situation. In the meantime, within the constraints imposed by SI No. 445 of 2000, the best outcome for the promotion of competition is that which maximises the TSO's independence and control of the transmission and distribution systems.

## **Annex I: Allocation of Construction and Maintenance Responsibilities**

<b>Stage</b>	<b>Party Responsible (CER)</b>
1. Conduct Planning/Feasibility Studies.	TSO
2. Develop indicative programme for project stages.	TSO
3. Advance to planning permission.	TSO
4. Preliminary Work for Procurement TSO/TAO.	TSO/TAO
5. Prepare project Detailed Design and Specification.	TAO
6. Construct project.	TAO
7. Project Review.	TAO
8. Issue Declaration of Fitness, Commission and Hand-over.	TAO/TSO