



**DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
COMMITTEE ON COMPETITION LAW AND POLICY**

Working Party No. 2 on Competition and Regulation

VERTICAL SEPARATION IN REGULATED INDUSTRIES

-- Finland --

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Experiences with vertical separation / integration in regulated industries in Finland

General position on vertical separation and price control in regulated industries in Finland

1. In Finland, different regulations have been issued on separation in several vertically integrated and regulated fields mentioned in the OECD questionnaire, e.g. in the electricity and natural gas markets, telecommunications markets and postal operations. On the other hand, no obligations on separation have been imposed e.g. on the locally owned water and sewage facilities and ports. The provisions on separation are mainly based on the special regulation governing each field and the more precise rules and regulations given on the basis of it. Additionally, e.g. the EU Directive for an Internal Market in Electricity, the EU Directive for an Internal Market in Natural Gas, the EU Directive on Postal Services and the Directives and recommendations in the field of Telecommunications contain rules on separation and cost allocation, which are binding to Finnish legislation.

2. The competition legislation effective in Finland does not include provisions on vertical separation. The amendment of the Competition Act (No 303/1998), enforced on 1 October 1998, contains a special provision on the electricity market, according to which the same owner may only have a 25% share of the electricity transmitted at 400 V in the distribution grid in Finland. The FCA has e.g. issued several statements on various regulated industries in the context of which it has proposed that the business activities of companies having a monopoly or special rights be differentiated in accounting from other, often competitive business activities.

3. Finland does not rely on price regulation according to a fixed formula, neither a price cap nor revenue control. The monitoring is based on a post-facto case-specific assessment of reasonableness, fairness and non-discrimination but intervening with pricing also has a preventive effect. The objective of competition law is, above all, the maintenance of competitive prerequisites and spurring of market decisions. The actual decision-making of the company is not intervened with by means of the competition law; instead e.g. the allegedly illegal nature of the pricing realised is examined. Companies set their prices autonomously without having to submit their price menus or plans to raise prices for regular investigation.

4. To assess a reasonable return of capital, the WACC model (Weighted Average Cost of Capital) has been used by the Energy Market Authority¹ (hereinafter EMA) in network operations, and by the FCA in electricity network operations, district-heating, telecom (fixed connections and subscriber lines) and harbour services; this has included the CAP (Capital Asset Pricing) model to define the return of own capital.

5. Since the provisions on vertical separation have, of individual fields in Finland, so far had the most effect in the electricity market and since accounts have been made on separation and its effects, in what follows, the FCA shall concentrate in more detail on the provisions on vertical separation concerning the electricity market in particular and the accounts on separation.

¹ The Electricity Market Authority changed to Energy Market Authority on 1 August 2000, and, at the same time, the Finnish Natural Gas Market Act took effect.

Electricity market Act, the provisions on separation therein and the separation accounts

The Electricity Market Act and the provisions on separation contained therein

6. The Electricity Market Act (No 386/1995), effective from 1 June 1995, brought competition into the electricity market. The aim has been to eliminate the obstacles for competition and to remove unnecessary regulation from that part of the market where competition is possible, i.e. in the production, sales and foreign trade of energy. Since 1 November 1995, all electricity users with a power requirement exceeding 500 kW have been free to choose between suppliers. At the beginning of 1997, the 500 kW limit was removed and, in principle, competition has been free for all but tendering has required the purchase of an hourly registering meter and the related data transmission connections. This has, in effect, prevented small users from tendering suppliers. With the amendment of the Electricity Market Act (332/1998), effective from 1 September 1998, the obligation of households to purchase the registering meters was removed, and from 1 November 1998, it was removed from other small users, i.e. small users no longer need expensive meters and hence have the opportunity to tender the electricity sellers.

7. According to the Electricity Market Act (28 §), the net operator and the electricity vendor shall separate all network operations, electricity sales and electricity generation from each other and from all other trade operations. Under the Electricity Market Act (29 §), unbundling means that the electricity trade operations to be separated shall for each financial period be made the subject of their own income statement and, in the case of capital-intensive operations, also the subject of a balance sheet. According to the Electricity Market Act (30 §), a municipal establishment or federation of municipalities engaged in electricity trade shall be separated for accounting purposes from the municipality, and shall be made the subject of its own income statement and balance sheet for each financial period, which shall be comparable to financial statements drawn up for limited companies.

8. As a book-keeping measure, the companies in the Finnish electricity market are now required to separate the transmission and distribution from the other business activities, such as production and sales. Some distribution companies have taken this a step further and reorganised their activities into separate companies.

9. The EMA is responsible for the monitoring of the provisions of the Electricity Market Act including those on the electricity operations contained therein; it is also responsible for granting, cancelling or changing network licences including the construction of power lines, for supervising grid access and pricing, gathering statistics and information, and assessing the efficiency of the network companies. No special sanction has been imposed for the violation of the provisions on separation; by its decision, the EMA may require the party which has breached the provisions to redress its faulty action or neglect.

10. The Natural Gas Market Act, effective from 1 August 2000, also contains provisions corresponding to the Electricity Market Act on the separation of natural gas operations.

Vertical integration in the electricity market

11. The majority of the incumbent electricity companies are vertically integrated, i.e. several different business operations are conducted at the same company, such as tendered electricity production and sales operations and electricity network operations operating as a monopoly. There are more than a hundred electricity vendors in Finland, the majority of which are also active in the distribution network business. The same companies are often also simultaneously involved in district heating and natural gas activities. Recently, a number of independent electricity suppliers and dealers, who are not involved in network activities, have entered the market.

12. The selling of electricity can be divided into two parts: wholesale and retail. The largest electricity wholesalers sell electricity directly to large-scale customers and electricity retailers. The largest electricity wholesalers also own distribution companies. Fortnum and the Swedish Vattenfall, in particular, have expanded their operations to distribution by purchasing transmission electricity plants.

13. The vertical integration of the electricity producer and wholesaler into electricity transmission may narrow down the scope of the wholesale markets of electricity which are sensitive to competition pressures. Vertical integration may also occur via distribution and chain agreements when electricity producers seek to guide the operations of the distribution plants. A potential problem related to vertical integration is also the pricing of wholesale electricity to own and other retailers when the wholesaler may place the retailers in a competitively unequal position.

Accounts on vertical separation in the electricity market

14. According to the June 2000 report of the working group **examining the unbundling of electricity business operations and its development** set up by the Ministry of Trade and Industry ("Report by working group 2 on the unbundling of electricity business operations", Ad hoc committee reports by the Ministry of Trade and Industry 2000), the present separation of business activities in bookkeeping has proved defective and there is a need for a more transparent separation. According to the report, problems in separation have been caused by the ambiguity of the provisions on the unbundling of the electricity operations and the cost and profit allocation of the various operations. In the legislation, no detailed stand has been taken as to how companies should organise the business operations to be separated. No binding formula or model has been defined for the separated bookkeeping on the level of legal provisions. Additionally, there have been some problems in separating the common costs between the various business operations and in the division of the balance, for the current provisions do not provide precise instructions on which amounts of capital belong to which business operations. The defectiveness of the provisions on the unbundling of electricity business operations is problematic, particularly for the functioning of the monitoring of the ban on cross-subsidisation in the Electricity Market Act and the reasonable pricing of the electricity network operations.

15. The working group proposed that the provisions on the unbundling of the present business operations in bookkeeping should be made stricter and the separation be made more transparent, particularly with respect to the allocation of common costs. The working group also proposed that network operations should be incorporated or differentiated into a separate state-owned enterprise, co-operative or federation of municipalities in such a way that the network licence holder could not engage in electricity trade in the same company nor produce energy notwithstanding certain exceptions. According to the proposal, the obligation to incorporate or transfer into a state-owned enterprise would not concern the smallest electricity companies i.e. those selling less than 70 GWh of electricity per year.

16. **In the report of the working group on vertical integration** ("Vertical Integration of the Electricity Market", Ad hoc committee reports 11/1997 by the Ministry of Trade and Industry), the incorporation of the network functions is recommended as one solution to prevent the negative effects of vertical integration. The report states that the incorporation should be made following certain rules in such a way that the monopoly and tendering functions be clearly separated from each other. Additionally, it was found in the said report that the obligation to incorporate would help to distinguish between network operations and the sales of electricity and thus increase transparency. (Cf. ANNEX 1)

17. In 1994, the Ministry of Trade and Industry commissioned a **background report** on the preparation of the Electricity Market Act **on the Separation of Electricity Trade Operations** ("Separation of Electricity Trade Operations", Ad hoc committee reports 18/1995 by the Ministry of Trade and Industry). Four different models for separating operations were examined in the account: 1) a

model where only the tendered business operations are separated, 2) a model where only the monopoly operations are separated, 3) a model where the network and sales operations are separated into profit-making units which have an income statement and balance sheet and 4) a model where network operations and the production of electricity are separated into profit-making units, which have an income statement and balance sheet and the sales of electricity is separated and an income statement drawn up for it. The account recommended model 4, as of all the options reviewed, it brought up the possible cross-subsidisation between the different functions and enabled the monitoring of the fairness of cost allocation of joint production. In the said investigation, the models on separation did not contain a demand for the organisational separation of the business operations. (Cf. ANNEX 2)

Provisions on the separation of the telecom market and postal operations

Telecom market

18. Under the Telecommunications Market Act (No 396/1997) (20 §), a telecom company shall separate its telecom network and telecom service operations from each other and from its other business operations. The Ministry of Transport and Communications may prescribe that the various constituent functions of the telecom network and telecom services be separated from each other when the telecom company has a considerable market power in more than one telecom network or service offered by it.

19. Under the Act, the Ministry of Transport and Communications shall issue more detailed instructions when necessary on the realisation of separation, the drafting of the income statements and balance sheet and the publication of the information. The Ministry of Transport and Communications has issued a decision on the separation of the functions of the telecom operations (No 472/1997). According to it (2 §), the following constituent functions shall be separated from each other: 1) local telecom operations, 2) long-distance telecom operations, 3) international telecom operations, 4) NMT telecom operations, 5) GSM telecom operations, 6) DCS telecom operations and 7) data transfer based on fixed connections.

20. During early 2000, the Ministry of Transport and Communications has revised the instructions on the separation of telecom companies. The revised instructions are aimed at alleviating the obligations of the smaller companies and, on the basis of the experiences gained, to specify the earlier instructions. One of the main amendments concerned the limiting of the obligation on separation to companies, which have a total turnover of more than FIM 120 million.

Postal operations

21. Under the decision on postal services (7 §) by the Ministry of Transport and Communications (No 111/1999), effective from 10 February 1999, the provider of a general service shall use calculation methods, which show the reasonableness and cost-accountability of the prices of the various services. In its internal accounting, the provider of a general service shall separate from each other the general and basic services and other services. The internal accounting system shall follow systematic and objectively verifiable principles of cost-accounting. The provider of a general service shall deliver the description of the accounting systems to the ministry.