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Ownership unbundling of energy distribution companies in The Netherlands

Christoph Tönjes, August 2005

This paper provides an overview of current discussions around the Dutch Minister of Economic Affairs' proposal to require *ownership unbundling* for Dutch electricity and gas distribution companies. Resources consulted for this briefing include: publicly available policy documents, reports, and discussions which occurred during CIEP's energy seminar on ownership unbundling, held on 9 February 2005, at the Clingendael Institute.

The Ministry's proposal

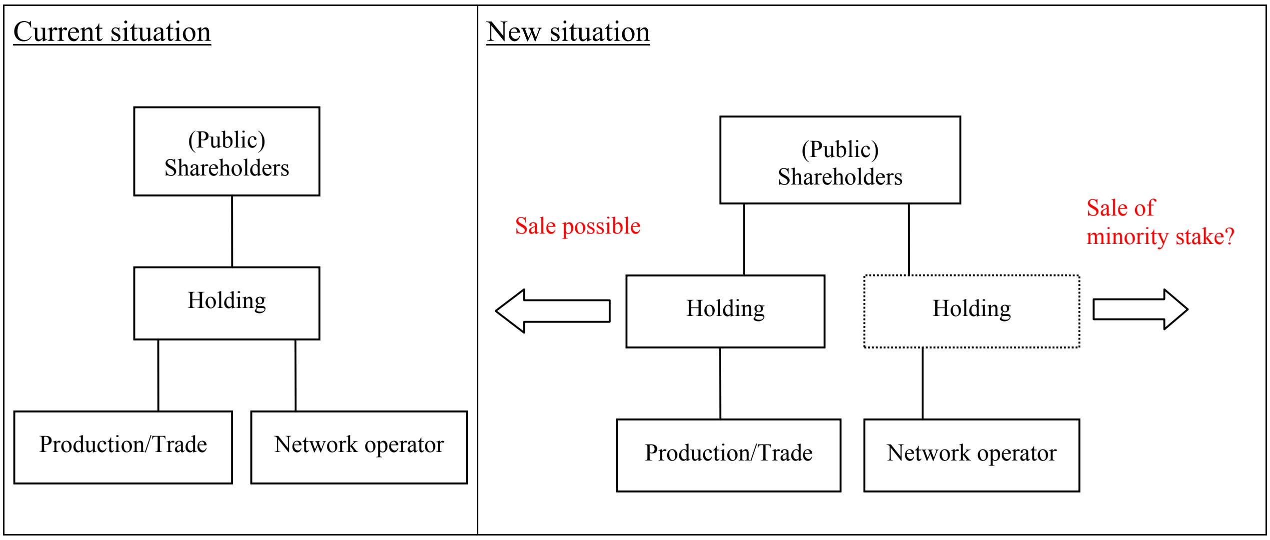
In a letter to Parliament, dated 11 October 2004, the Dutch Minister of Economic Affairs outlined plans to further split Dutch electricity and gas distribution companies. Amendments to the Electricity Act (*Electriciteitswet,* 1998) and the Gas Act (*Gaswet,* 2000) will forbid the simultaneous ownership of shares in network operators and shares in production and/or trade undertakings, by 1 January 2008 at the latest[1]. This means that the current holding structure must be restructured (cf. figure). To avoid forced sales of assets, ownership restrictions will not apply to the current shareholders. Network ownership must reside with the group of companies of which the network operator is itself part of.

Almost all Dutch gas and electricity distributors are currently owned by local governments. The trade and production companies which will come into existence via the split-off can be privatised immediately after the unbundling is finalised. For the network companies, the Ministry favours an obligatory majority stake for public bodies, while minority stakes may be sold to private investors. The Minister views the need for a decision on network privatisation possibilities only to be necessary after the unbundling has taken place. However, it is acknowledged that foresight on this would be helpful for both current owners and future investors in adapting to the new structure of the Dutch energy sector.

[1] The original proposal provides for a deadline of 1 January 2007. This has been postponed to 2008 in order to give distribution companies sufficient time to arrange the split in an orderly manner.

The proposal provides for the transfer of operational control of transmission lines with a voltage equalling or exceeding 110 kV to the national transmission system operator, TenneT. No explicit provisions have been made for the ownership of these lines.

Ownership unbundling in the Netherlands



Source: adapted from MinEZ (2004b).

Drivers of ownership unbundling in the Netherlands

Discussion around unbundling ownership must be understood in context of ongoing debates on structure and ownership in the Dutch energy sector. These debates arose in the early 1990s and received more focus around 2000, when privatisation became a political issue. This political agenda is the main driving force for the current ownership unbundling debate, although the sometimes unclear separation of network activities from the commercial activities of the holding company has furthered the argument for full ownership unbundling.

In this vein, local governments have repeatedly expressed their desire to sell stakes in distribution companies. Many representatives of these bodies do not see the need for government to engage in activities that can be handled by the private sector. Further, they would not like publicly owned undertakings to be exposed to large commercial risk. Commercial risk for Dutch energy companies is regarded as having increased with the liberalisation of energy markets. According to some shareholders, there would be only a small possibility for current shareholders to influence actual business operations. Finally, the selling of interests in energy companies could generate significant short-term cash flows for the current shareholders.

On the other hand, there is a wide-ranging agreement among Dutch political parties that energy networks should be subject to the strong control of public bodies and a preference for public ownership is clearly evident across the political spectrum. This has led to the inclusion of a privatisation ban for the networks in the current Electricity and Gas Acts for distribution companies.[2]

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[2] Shares in networks can only be sold to other parties who do already own networks in the Netherlands. The networks are all owned entirely by local governments, except for Obragas and Haarlemmermeergas, which are owned by RWE (RWE acquired the shares at a time when the Gas Act did not explicitly restrict privatisation). Notably, the expectation at the start of the liberalisation process was that this restriction would be of a temporary nature and that once liberalisation of markets was implemented and adequate regulation in place, privatisation of networks would become possible. Currently, there is no applicable restriction on the sale of commercial activities.

The Minister's proposal meets both objectives outlined above: 1) current shareholders can sell the commercial activities and probably minority stakes in the networks, and 2) the networks remain under control of public shareholders.

Proclaimed advantages

The two objectives identified as the main drivers could of course be achieved via legal unbundling and restrictions on public shareholders selling their network activities. The forced splitting-up of the existing company structures thus aims at achieving additional objectives:

- *Incentives for discrimination with respect to network access should be structurally removed.* Although network access reportedly works very well, this could change as shareholders change and commercial objectives become increasingly important. Specifically, the Ministry's letter states that the proposals aim to protect the independence of the Dutch networks and to guard them against possible take-overs by foreign energy companies.[3]
- *Network cross-subsidies of commercial activities should be removed and a 'level playing field' should be achieved*. Cross-subsidies do not have to involve cash flows. Stable network revenues, for example, can contribute to a good credit rating for the whole group of associated companies, lowering capital costs and increasing financing opportunities also for the commercial parts of the group. The Ministry's letter to Parliament refers to a KPMG report on the market model currently applied in the Netherlands. The report concludes that new entrants to Dutch market electricity supply are subject to a competitive disadvantage because it is more difficult for them to provide the financial deposits required by network operators.[4]
- *Improving NMa/DTe's compliance function*. It is generally perceived that the DTe could act more effectively and efficiently in overseeing network operators' legal requirements, if they are fully separated companies.[5]

Moreover, government's perception is that public bodies should not be too exposed to commercial risk. The split should enable the current public shareholders to sell-off commercial activities and retain relatively risk-free, regulated network operations. Due to the profitable risk profile, the network companies could be refinanced by increasing the level of debt which would free additional financial means for the current shareholders in the short-term. One financial analyst estimated that through the sale of commercial activities, the sale of minority share in the networks and refinancing about 90% of the roughly € 23.5 billion public capital currently bound in the distribution companies, could be released from the companies and put at the disposal of the current shareholders.[6]

Another envisaged benefit of the split is that the network companies would become pure network companies, able to operate independently, concentrate better on their core business, and thus become more efficient.

The Ministry explicitly states that it considers the Dutch distribution companies as being too small to survive independently in a wider European energy market and that it expects them to be taken over by larger (foreign) players sooner or later. Structural changes need to be undertaken now to protect network independence for the long run.

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[3] MinEZ (2004b: 4).

[4] KPMG (2004).

[5] DTe is the Dutch energy regulatory body. As of 1 July 2005, it was fully merged with the Dutch competition authority NMa.

[6] Currently, the future possibility of a minority privatisation of the networks is speculative. No steps have been taken in that direction yet (see above). Moreover, some distribution companies estimate less potential capital release through refinancing, since certain credit ratings would have to be maintained.

Disadvantages and concerns

The main Dutch electricity and gas distribution companies are strongly opposed to the Ministry's plans.[7] In their view, ownership unbundling is "an unnecessary and disproportionate measure for ensuring fair market competition." They point out that:

- Network access is adequately regulated in the Netherlands and complaints about access terms and tariffs are practically nonexistent. Moreover, the latest amendment to the Gas and Electricity Acts would provide NMa/DTe with increased power that should be tested before further reaching structural measures are taken.
- The one-off costs related to ownership unbundling would be substantial. Transferring assets from one company to another triggers certain taxes (*overdrachtsbelasting* – transfer tax). Information technology systems most probably would require adjustments, and use of 'shared service centres' for administering customer contacts would most likely be banned, raising administrative costs. Additional financial harm could also stem from necessary adjustments in Cross Border Leases (see the Annex).[8]
- The credit rating for the unbundled generation and supply companies will be significantly lower than for the integrated companies due to changes in the risk profile. Financing of new investments in new generation capacity will become more difficult. Energy companies state that they would have to reconsider current investment plans in the event of ownership unbundling being enforced.[9]
- Dutch generation and supply companies will be subject to competitive disadvantage vis-à-vis their European competitors, who are at large integrated companies. No comparable plans to those of the Dutch Ministry of Economic Affairs are foreseen for any other European Union member state or at the level of the European Commission. Indeed, many EU member states are moving slowly to implement the current EU Directive requiring only legal unbundling.
- The exclusion of electricity and gas suppliers as shareholders of Dutch network companies would cut-off these networks from innovative foreign (integrated) companies. In the long run this could put them at an efficiency disadvantage as technological innovations might be introduced later than possible and at a higher cost. Other investors might not be able to bring the benefits to network companies that companies active in the same sector could.
- The exclusion of electricity and gas suppliers as shareholders of Dutch network companies might be in conflict with the Treaty establishing the European Union in terms of restricting the free flow of capital.[10]

Most of the current shareholders would not be in favour of ownership unbundling due to concerns around potential negative consequences. Moreover, privatising minority stakes in the network companies might prove to be difficult: energy companies are excluded as shareholders and other possible investors such as pension funds and financial investors might be willing to pay comparatively low prices due to their risk adversity. If the ownership restriction applied only to companies active in the Dutch markets, foreign energy companies might still be reluctant to buy minority network shares as it would foreclose the Dutch commodity market for them.[11]

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[7] Cf., e.g., Blom (2004).

[8] Neither the distribution companies nor the Ministry have published any meaningful estimates of the magnitude of the financial burden to be expected.

[9] 'Nuon wil komende zeven jaar tot 1200 MW nieuw productievermogen bouwen.' Energeia Energienieuws, 14 March 2005, <www.energeia.nl>.

[10] The Ministry argues that such a restriction is possible because being in the general interest of the Dutch people would be a sufficiently compelling reason (cf. Articles 56 – 60 of the Treaty establishing the European Union, Official Journal C352, 24 December 2002).

[11] In June 2005 the Dutch energy distributor NRE was sold. The supply activities were acquired by E.ON Benelux. More interestingly, a minority stake in the network activities (49%) was sold to Macquarie European Infrastructure Fund, an Australian-based investment fund targeted at institutional investors, such as pension funds. According to one financial

Additionally, the companies indicate that the proposed unbundling plans would conflict with the industry policy objectives of the Ministry of Economic Affairs. In particular, industry policy stipulates that European law requirements are not to be exceeded during the national implementation, as well as that the international competitiveness of Dutch industries should be supported.

Position of other actors

Parliament

The Netherlands are governed by a coalition of the Christian-Democratic Party (CDA, 44 out of 150 seats in Parliament), the Liberal Democratic Party (VVD, 27 seats) and the Democrats D66 (D66, 6 seats). The main opposition party is the Labour Party (PvdA) with 42 seats in Parliament. As evidenced in parliamentary discussion on 8 December 2004, the governing coalition appears to be divided over the question of ownership unbundling. VVD and D66[12] assert the absence of convincing alternatives to ensure the independence of networks and are in favour of ownership unbundling; the CDA is more reserved and appeals for a cautious approach. In particular, the CDA is concerned about the consequences of ownership unbundling for Cross Border Leases and fears substantial payments to US investors will become due. Also arguing for public majority ownership of networks, the CDA favours a solution in which unbundling would only be required if the current shareholders were disposed to selling (parts of) the distribution companies.

The Labour Party clearly joins the VVD and D66 in their support for the Ministry's plans. Also the Socialist Party (SP, 8 seats), the Green Party (GL, 8 seats) and the ChristianUnion (CU, 3 seats) are in principle in favour of the split.[13]

In general, there appears to be significant distrust of foreign energy companies. The protection of Dutch networks from being sold abroad is a prominent feature of discussions and in the main is not challenged by any major political party.

Overall, there appears to be a clear majority in Parliament in support of the unbundling plans as suggested by the Ministry. However, as of yet no majority within the governing coalition backs the main elements of the proposals, with CDA having doubts about the practical implications of their implementation.

Employees' organisations

The LME, a cooperation of works councils in the energy distribution sector, strongly objects to the Ministry's plans, in general agreeing with the arguments brought forward by the distribution companies and stressing the potential significant loss of employment in the Dutch energy sector.

Outlook

At the time of writing, the Ministry of Economic Affairs appears determined to go through with the proposed unbundling of energy companies. Discussions with the main energy companies have been

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analyst, the deal values the network much higher than comparable deals in which energy companies had been involved (at 16.5 times earnings before interest, taxes, depreciation, and amortization (EBITDA) compared to an average of earlier deals of 10.3 times EBITDA [see Brouwer 2005]). As stated above, the deal needs government approval which cannot be granted under current legislation. Therefore, a 'generous' time period has been agreed upon to receive government approval eventually.

[12] No representative of D66 was present in the meeting referred to. Information is derived from the D66 website, <www.d66.nl>, 19 March 2005.

[13] Other parties were not present at the meeting on 8 December 2004. In general, the need for additional information regarding consequences of the plans was acknowledged by most political parties during the meeting. Notably, the Labour Party representative took the opportunity to signal support for the creation of a 'National Champion', made up of the generation and supply activities of some of the unbundled energy companies. According to him, such a 'National Champion' would be able to capture sufficient economies of scale to survive independently in the European market.

taking place, including dialogue on possible alternatives and amendments to the plans.[14] These discussions have not led to any agreement that would stop the Ministry from advancing its plans. The Dutch Cabinet passed the proposals as presented and is, as of July 2005, awaiting advice from the Council of State. Thereafter, draft legislation will be presented to Parliament. Meanwhile, public discussions continue.

[14] 'Nuon: nog druk overleg met EZ over alternatieven splitsing.' Energeia Energienieuws, 14 March 2005, <www.energeia.nl>.

Blom, R., Boersma, M., van Halderen, L and Luteijn, D., Verzoek om bereikt accord met Ministerie van Economische Zaken mee te wegen in de besluitvorming terzake splitsing van energiebedrijven. Letter to Prime Minister J.P. Balkenende. 15 March 2005 (incl. enclosures).

Discussions focused on the question of how to achieve a more independent position for the network operator while maintaining the option to consolidate the networks on the group balance sheet of the respective integrated group of energy companies.

Relevant Resources

Policy documents

Ministry of Economic Affairs (MinEZ) (2004a) Visie op de toekomstige structuur van de energiemarkt. 31 March. <http://www.minez.nl/content.jsp?objectid=13912>

Ministry of Economic Affairs (MinEZ) (2004b) Aanpak splitsing energiebedrijven. 11 October. <http://www.minez.nl/content.jsp?objectid=26471>
English translation:
<http://investorrelations.eneco.nl/USER_FILES/WEBSITES/wbsIR/FILES/LetteroftheMinisterofEconomicAffairs.pdf>.

Ministry of Economic Affairs (MinEZ) (2004c) Gevolgen splitsing energiebedrijven voor Cross Border Lease contracten. 7 December. <http://www.minez.nl/content.jsp?objectid=28330>

Reports referred to in the Ministry's policy documents

KPMG Business Advisory Services (2004) Onderzoek modelovereenkomst netbeheerder en leverancieer binnen het leveranciersmodel. August.
<http://www.dte.nl/images/12_24925_tcm7-488.pdf>

Dienst uitvoering en toezicht Energie (DTe) (2004) Advies taken en activiteiten van de netbeheerder na splitsing. 16 December.
<http://www.dte.nl/nederlands/actueel/nieuwsberichten/Advies_taken_en_aktiviteiten_vd_netbeheerder_na_splitsing.asp>

Organisation for Economic Co-operation and Development (OECD) (2001) Restructuring Public Utilities for Competition. <http://www.oecd.org/dataoecd/6/60/19635977.pdf>

The industry's position

Blom, R. (2004) Letter to the Minister of Economic Affairs on behalf of Eneco, Essent, Delta and Nuon regarding the plan of approach for unbundling. 25 October.
<http://www.essent-finance.nl/downloads/LettertoMinisterofEconomicAffairs.pdf>

Further reading

Van Damme, E.C. and Kanning, A. (2004) Opsplitsing van regionale energiebedrijven: Onderzoek voor de Provincie Noord Brabant. Provisional version. University of Tilburg, 28 April.
<http://www.tilburguniversity.nl/tilec/publications/reports/opsplitsing.pdf>

Mulder, M., Shestalova, V. and Lijesen, M. (2005) Vertical separation of the energy-distribution industry. CPB document No. 84. CPB Netherlands Bureau for Economic Policy Analysis.
<www.cpb.nl/eng/pub/document/84/doc84.pdf>

Brouwer, D. (2005) The future financial shape of the electricity industry. The emergence of infrastructure focused investors. Presentation for the Eurelectric Annual Convention. Vienna, 13 June.

Annex: Cross Border Leases

The following brief introduction of Cross Border Leases (CBLs) is solely for illustrative purposes and does not intend to provide investment advice or documented fact on particular instances. CBLs play an important role in ownership unbundling in the Netherlands. For the purpose of informed debate and discussion, the following outlines some key elements of CBLs and important concerns and issues of current relevance.

The issues around Cross Border Leases (CBLs) play a significant role in discussions on ownership unbundling in the Netherlands. There are concerns that changes in the structure of Dutch gas and electricity distribution companies could affect already arranged CBLs. This would engender a significant financial burden for the companies. In the following, the basics of CBLs are explained and possible problems with respect to ownership unbundling are indicated.

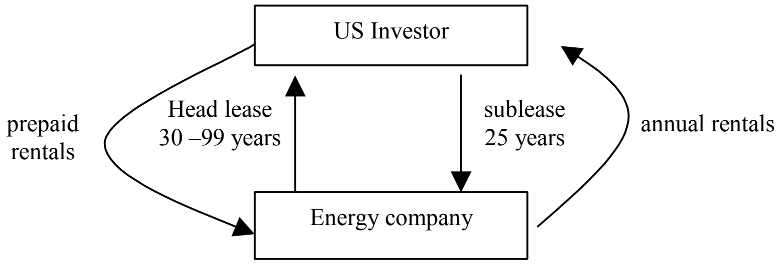
CBLs are transactions in which an investor based in the United States buys or leases assets abroad and then immediately leases them back to the lessee. The US investor benefits from such a transaction through the realisation of US tax advantages which are in part transferred to the original owner of the asset. Between 1994 and 2002, CBLs were conducted for a large number of Dutch power plants and gas and electricity networks.

Structure of a Cross Border Lease (simplified)

The US investor leases an asset, for instance an electricity grid, for a period exceeding the usual lifetime of the grid by at least 25%. Usually, this so-called ‘head lease’ is conducted for a duration of 30 to 99 years, depending on the kind of asset. The asset is immediately leased back to the original owner for a much shorter time period, in the case of electricity and gas networks often for an approximately 25-year period (sublease). Principally, both leases cannot be terminated before their end-date. The original owner receives a purchase option for the head lease which can be executed at a predetermined price the moment the sublease ends. The original owner maintains full control over the asset and also has the obligation of properly maintaining it. In simple terms, one can say that due to differences in tax systems, both parties are able to depreciate the value of the asset in their accounts.

The rentals for the head lease are prepaid to the original owner in one single sum. Part of this amount is set aside by the original owner to cover the rentals for the sublease while eliminating exchange risks (defeasance structure). As the US investor shares his tax benefits with the original owner, the payment for the head lease exceeds the sum necessary for the continuous payment of the sublease. The net effect for the original owner is often between 3 and 6 % of the value of the asset.

CBL structure (simplified)



Ownership unbundling and CBLs[15]

The American Jobs Creation Act of October 2004 effectively eliminates tax advantages for new cross-border leases. It is thus in the interest of US investors that CBLs are not altered before the end of the sublease. A 'material alteration' in the contract would bear the risk of US tax authorities considering the amended CBL as a *new* transaction, incurring less favourable tax conditions. In such an event, US investors might want to (or have to) terminate the CBLs, which consequently would entail a (partial) repayment of the financial benefit for the energy company to the US investor.

Considerations about CBLs and ownership unbundling include, but are not limited to:

- Essentially, Cross Border Leases do not have to change due to forced unbundling of distribution companies. However, certain restructuring approaches for the companies might be foreclosed: if the CBL is conducted with the current holding company, that holding company will have to go on as the network (holding) company and the commercial activities will have to be spun off. Otherwise the CBL would have to be transferred to the (possibly newly created) network company, which might be considered a 'material alteration' of the original contract.
- Companies active in generation and trade might face worse credit ratings after being split from the network activities. CBLs often have a minimum credit rating requirement for the lessee of the sublease, which might endanger some CBLs for power plants remaining with the trade companies. This could be remedied by providing additional collateral.
- The potential effects of transferring control of the transmission lines with a voltage equalling or exceeding 110 kV to TenneT are still unclear. These lines are usually not covered in separate CBLs but are subject to a CBL also covering lower voltage lines. It is equally unclear what will happen to heat distribution networks, at times covered in the same CBL as gas and electricity networks of individual distribution companies.

Whether or not any necessary changes in the CBLs will eventually result in financial consequences for Dutch distribution companies will depend on the stance adopted by the US tax authorities as well as very much on the way potential risks are divided between parties in the actual contracts. The latter being confidential information, observers will have considerable difficulty estimating the potential financial consequences.[16]

In addition to possible changes in the structure of CBLs, a more foundational problem could stem from the stipulated objective to maintain majority ownership of public bodies and indefinitely deny the possibility of completely privatising the networks. CBL agreements include provisions for the termination of the sublease. For instance, the sublease can be terminated if the energy company defaults on the rentals. In such a case, full control of the network would be transferred to the US investor, for the future however, this might be in violation of active restrictions on privatisation.

The CBLs for networks (between 1998 and 2001) were undertaken at a time when it was generally expected that privatisation eventually would be allowed (when the liberalisation of gas and electricity

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[15] See also: MinEz, 2004c.

[16] During the CIEP seminar on ownership unbundling (9 February 2005), the value of all Dutch electricity and gas distribution networks and power plants was estimated at roughly € 18 to 20 billion. If one assumes that all of them are subject to CBLs and that the net benefit of a CBL is about 4% of the value, Dutch companies might have received about € 750 million from the CBLs. Tax benefits accruing to US investors could be of a similar size or slightly higher. Based upon this very rough estimate, claims for the repayment of tax benefits granted by the US could range anywhere in between 0 and € 2 billion. It appears likely that the claims, if any, will be closer to zero than 2 billion, given that probably not all assets are subject to CBLs, not all CBLs will be challenged and not all the risk will have to be born by Dutch distribution companies. However, newspaper reports put the financial risk at USD 5 billion (Het Financieele Dagblad, cited on <www.energeia.nl>, 25 November 2004).

In the spring of 2005, the Dutch Minister of Economic Affairs repeatedly stated that CBLs at the time of conclusion were not in the interest of the Dutch people and that distribution companies conducted them for purely financial benefit. Accordingly, any negative consequences of industry restructuring with respect to CBLs would have to be borne by the distribution companies alone and would not carry weight in the industry structuring debate.

markets was implemented and strong regulation to ensure the independence of the network would be in place). Moreover, the head leases were not considered to be a change in ownership since control over the networks remained with the energy companies through the sublease.

It has been suggested that US tax authorities might engage in reassessing existing CBLs and in particular that any possible opportunity might be used to recapture the tax benefits that were granted in the past. Again, the soundness of such argumentation is difficult to assess and remains subject to discussion.

In the meantime, Dutch distribution companies NRE (see footnote 10) and Intergas have split-up voluntarily and their supply activities sold to E.ON Benelux and Dong (Denmark) respectively. Reportedly, the networks of both companies are subject to CBLs; however, this apparently has not been an impediment to the reorganisation and sale of the companies.