

Single Electricity Market

TSO Certification under Article 10 of Directive 2009/72/EC

Application in respect of EirGrid Preliminary Decision

Qualified Approval of Application

February, 2013

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1 Executive Summary

- (1) The 3rd Internal Markets in Electricity Directive (Directive 2009/72/EC) requires that Transmission System Operators (TSOs) are unbundled from generation and supply interests. The Directive provides for three models of unbundling; Full ownership unbundling (FOU), Independent System Operator (ISO) and Independent Transmission Operator (ITO). The ISO and ITO models only apply to transmission systems owned by vertically integrated utilities (VIUs) on 3rd September 2009. In addition where the existing arrangements provide for greater independence than the ITO model the Member State is not required to establish the FOU, ISO or ITO models (Article 9(9)).
- (2) ESB have applied for certification of EirGrid as the TSO under the provisions of Article 9(9) in compliance with a decision¹ by the Irish Government (set out in SI 570 of 2011)
- (3) The Commission for Energy Regulation (the “CER”) has previously advised the Government, in 2000 and 2007, that in its view a fully ownership unbundled TSO would be the optimal unbundling model for Ireland. The current process (‘TSO Certification’) however does not concern the optimal model; rather it is an assessment of TSO independence under the current arrangements relative to the ITO model as required under Article 9(9) of the Directive.
- (4) Under the current arrangements EirGrid, a fully independent state owned company, is the licensed TSO. EirGrid TSO functions are defined in Irish legislation, and match those listed in Article 12 of the Directive, albeit with reliance on ESB for discharge of elements of the TSO function. EirGrid is also responsible for the market operation of the SEM. EirGrid also owns and operates the East West Interconnector (“EWIC”), a direct current interconnector between Ireland and Great Britain. SEMO (the Single Electricity Market Operator) is a joint venture between EirGrid and SONI (the Northern Ireland TSO). SONI is also owned by EirGrid.
- (5) ESB, the VIU, owns the transmission system and is the licensed Transmission System Owner (or “Transmission Asset Owner”, “TAO”), it also owns the distribution system and is the licensed Distribution System Owner (or “Distribution Asset Owner”, “DAO”). The TAO and DAO businesses are managed by ESB Networks Limited, a legally separate company owned by ESB, which is the licensed DSO. ESB Networks (a ring-fenced business unit of ESB) discharges the duties of the networks business under the management of ESB Networks Limited. The TAO functions are to carry out the maintenance and development of the transmission system and associated works in accordance with EirGrid’s Development Plan. ESB is prohibited from issuing any instructions or directions to EirGrid. EirGrid is responsible for these functions, ESB carries them out. This relationship is set out in detail in the Infrastructure Agreement. Both parties are required by law to enter into and comply with the Infrastructure Agreement, which is approved by, and subject to review by, the CER.

¹ [Government Press Release](#), “Government Decision on Electricity Transmission Assets in the context of EU 3rd Package on Energy”, Dublin, 27 July 2011

- (6) It is noted that ownership of and funding of new transmission development is not a TSO function under Article 12. In relation to maintaining and developing the transmission system both EirGrid and ESB have a role. EirGrid is exclusively *responsible* under legislation for these activities. However their freedom to discharge this responsibility is fettered by the obligation under legislation to exclusively use ESB to *undertake* the actual maintenance and construction. If this obligation was not there EirGrid could choose to undertake these activities with internal staff or external contractors. ESB as the monopoly provider of maintenance and construction services to EirGrid must carry out the required maintenance and construction in accordance with EirGrid's plan, the delivery of which is the sole responsibility of EirGrid. EirGrid's ability to discharge all of its statutory responsibilities is copper-fastened by certain provisions of the 1999 Act and SI 445 of 2000, the TAO licence and the Infrastructure Agreement, which have the aim of putting EirGrid in a similar position to the one it would be in if it contracted for the services provided by ESB through an open process. In other words, a similar position to ensure that it can effectively deliver all of those areas for which it has statutory responsibility.
- (7) In the Irish context the ITO model would involve ESB establishing a wholly owned subsidiary company. "ESB ITO" would consist of EirGrid (including or excluding SONI, EWIC and/or SEMO), ESB Networks and the transmission assets (possibly the distribution assets too). Essentially the 9(9) test is whether the current arrangements would provide for a more independent TSO than the alternative ITO arrangement.
- (8) Therefore, these arrangements must be compared against an ITO model, in this case a model that would likely see ESB take ownership of EirGrid (the TSO business at least) and incorporated into an ESB ITO.
- (9) ESB applied for certification under Article 9(9) and sets out four key arguments to support its application i) structural separation of EirGrid; ii) the role of ESB is limited in scope; iii) ESB's role is subject to regulatory and statutory controls; and iv) transparent transmission arrangements.
- (10) EirGrid as a relevant transmission company were invited to make a submission on ESB's application. EirGrid do not believe that the Article 9(9) test has been met.
- (11) In assessing ESB's application the SEM Committee has taken a purposive approach to its analysis. Article 9(9) is distinct from the other unbundling models in that there are no specific provisions to be met, it is by definition different from, and so will not comply with, the ITO provisions of Chapter V with which it must be compared. In order to provide a robust assessment, the SEM Committee analysed the existing arrangements relative to the ITO against core areas of independence, the Directive's aims of unbundling, the pillars of an effective ITO in addition to a 'line-by-line' comparison with Chapter V. The SEM Committee has also taken the European Commission's decision on the Scottish Arrangements (the only other 9(9) certification to date) into account.
- (12) In order to ensure a full and robust analysis, the SEM Committee has carried out a detailed review through a sub-committee of SEM Committee members as well as the executive teams of the CER and the Utility Regulator (the "UR"). In addition to the ESB application and the EirGrid submission, the SEM Committee has also made four information requests to ESB and two to EirGrid as well as an information request to the

Minister for Communications, Energy and Natural Resources. A full review of the Irish arrangements against the requirements of the ITO model has been carried out and a review against the arrangements in Scotland and the European Commission's decision on these arrangements has also been completed.

- (13) From this analysis the SEM Committee considers that the role of EirGrid, as a structurally separate independent company with responsibility for all of the TSO tasks under Article 12, albeit with reliance on ESB for construction and maintenance activities, and its decision-making and oversight roles in relation to the TAO tasks (maintenance and construction of the network) provides a significant level of independence. While the role of ESB is limited, it is not insignificant and the SEM Committee has considered in detail the governance and funding implications of the structure of the TAO. In particular that it is ESB, not ESB Networks Ltd., that owns the assets and holds the TAO licence notwithstanding the role of ESB Networks Ltd. in managing the TAO business and the restrictions and obligations placed on the TAO under statute and reflected throughout the agreements underpinning the Existing Arrangements.
- (14) The SEM Committee concludes that the existing arrangements have provided more effective independence of the Transmission System Operator than the provisions of Chapter V of the Directive and, with the improvements proposed, would clearly guarantee this into the future. On this basis the decision of the SEM Committee is to grant the application for certification of EirGrid, subject to the implementation of the proposed improvements and to the decision of the Commission under Article 9(10) of the Directive.
- (15) The application before the Committee was submitted by ESB as transmission asset owner in Ireland for the certification of EirGrid. This is the only application that the SEM Committee has received for the transmission system in Ireland. In reaching its decision, the Committee is conscious that EirGrid relies on ESB to discharge some of its TSO functions and therefore ESB could be considered to exercise some of the functions of a transmission system operator in Ireland within the meaning of article 2(4).

2 Introduction

2.1 Background

- (16) Under Directive 2009/72/EC (the “Directive”), transposed in Ireland by S.I. No. 570 of 2011², National Regulatory Authorities (NRAs) are required to certify the unbundling arrangements of Transmission System Operators (TSOs) in each Member State in a form consistent with the Directive. Unbundling refers to effective separation of networks from activities of generation and supply.³ There are three available models described in the Directive: full ownership unbundling (FOU); independent system operator (ISO); independent transmission operator (ITO); while Article 9(9) of the Directive allows for a derogation from these models provided that the existing transmission arrangements can be shown to guarantee more effective independence for the TSO than would be possible under the ITO model (“9(9) certification”). The procedure for this certification process is further outlined in Regulation 714/2009 (the “Regulation”).
- (17) The SEM Committee published a guidance paper (SEM-12-005) outlining the process for application for certification in Ireland on 6th February 2012. This paper set a deadline of 2nd April 2012 for applications for certification. On 2nd April ESB (Electricity Supply Board)⁴ made an application for certification under Article 9(9) of the Directive. This application argues that the current transmission arrangements in Ireland, EirGrid as TSO and ESB as transmission system owner (TAO) operating under a contractually defined relationship through the Infrastructure Agreement, guarantee more effective independence for EirGrid as TSO than the ITO model would.⁵ For clarity, ESB’s application has applied for EirGrid to be the certified TSO in Ireland. Under the SEM Committee’s process, EirGrid was offered the opportunity to make a submission in relation to the application which they did on 27th April 2012. EirGrid do not agree that the test for 9(9) certification is met in relation to the Irish transmission arrangements.
- (18) The SEM Committee would like to acknowledge that the various submissions from both parties were comprehensive and detailed. It is evident that a significant amount of time, effort and thought went into their preparation. In addition both parties have engaged willingly and constructively with the SEM Committee’s process.
- (19) The CER on behalf of the SEM Committee conducted the initial review of the ESB application and the EirGrid submission and requested further information from the parties on the 22nd May 2012 and 13th June 2012 respectively. To ensure a fully transparent process all⁶ relevant correspondence between the parties was shared with both parties. The CER also made a further information request to EirGrid on 9th November 2012 and three further information requests to ESB on 21st August, 1st

² Other aspects of the Directive were transposed by SI 630 of 2011. SI 570 of 2011 refers only to TSO certification in electricity.

³ Directive 2009/72/EC Recital (9).

⁴ General Information on ESB activities is available on the ESB website - <http://www.esb.ie/main/home/index.jsp>

⁵ It should be noted that the ESB application and this preliminary decision applies to the transmission system as defined in the Act with the exception of the East-West Interconnector which is otherwise considered part of the transmission system.

⁶ This excludes the parties’ respective legal advices shared in confidence with the SEM Committee and a small number of documents considered by the SEM Committee to be justifiably confidential.

October, and 9th November, 2012. In addition a request for information was sent to the Minister of Communications, Energy and Natural Resources was made on 12th November, 2012.

- (20) The Directive and Regulation stipulate that where an application is made for a 9(9) certification the European Commission shall make the decision as to whether the arrangements guarantee more effective independence than the ITO model. Therefore this paper represents the SEM Committee's preliminary decision and is submitted to the European Commission to aid their review of the application and their making of a decision. Once notified of the European Commission's decision the SEM Committee and the CER (as the National Regulatory Authority) will comply with this decision.
- (21) It is noted that SI No. 570 of 2011 does not stipulate under which model an application should be made for the TSO to be certified. However the legislation underlying the transmission arrangements in Ireland (outlined in more detail below), provides for ESB's ownership of the transmission system, thereby ruling out FOU, ISO and ITO as applicable models. In this context the Government's decision⁷ that ESB should retain ownership of the transmission assets has been noted. While the EirGrid submission did make some reference to its previous arguments on this issue, namely the net benefits that EirGrid considers would accrue from their ownership of the assets, EirGrid has confirmed that it fully accepts the Government's decision on the matter of the ownership of the assets. It should also be acknowledged that the most appropriate owner of the assets is not relevant to the subject of this preliminary decision. The SEM Committee's role is not to determine the best model of TSO independence, it is to apply the test as set out in the Directive. The Directive requires that this preliminary decision assesses whether the existing transmission arrangements in place in Ireland guarantee more independence for the TSO than an ITO model would, were such a model to be in place. Put differently does EirGrid's existence in its current form guarantee greater independence for EirGrid to deliver the responsibilities of the TSO than if "ESB ITO" were to undertake all transmission functions under the ITO model.
- (22) Please note that any reference in this paper to the "Commission", the term used in Irish legislation, is a reference to the CER. The European Commission is referred to as the "European Commission".

2.2 Related Documents

- Directive 2009/72/EC
- Regulation 714/2009
- S.I. No. 570 of 2011
- Commission Staff Working Paper: The Unbundling Regime (22/01/10)
- Commission Staff Working Paper SEC (2011) 1095
- TSO Certification Ireland: Guidance Paper SEM-12-005
- The ESB application, annexes and appendices (confidential)
- The EirGrid submission, annexes and references (confidential)

⁷ [Government Press Release](#), "Government Decision on Electricity Transmission Assets in the context of EU 3rd Package on Energy", Dublin, 27 July 2011

- The ESB responses and appendices to the requests for information (confidential); and
 - The EirGrid responses to the requests for information (confidential)
- (23) All information received by the SEM Committee and the CER on its behalf has been sent with this preliminary decision, to the European Commission. However, given the commercially sensitive nature of the documents they have not been published.

2.3 Legislative Background

- (24) The Directive requires that all TSOs are certified in accordance with the Directive and the procedures set out in the Regulation. In Ireland the Directive has been transposed by S.I. No. 570 of 2011 which requires the CER to establish and carry out a certification process. SEM-12-005 establishes this process.
- (25) The SEM Committee has determined that TSO Certification is a SEM matter⁸ and accordingly this process has been carried out by the CER on behalf of the SEM Committee.
- (26) Under the Electricity Regulation Act, 1999 as amended by the Electricity Regulation (Amendment) (SEM) Act 2007 any decision as to the exercise of a relevant function of the CER in relation to a SEM matter shall be taken on behalf of the CER by the SEM Committee. A matter is a SEM matter, within the meaning of the legislation, if the SEM Committee determines that the exercise of a relevant function of the CER in relation to that matter materially affects, or is likely to materially affect, the Single Electricity Market.
- (27) Given that the assessment of this application for certification must be made within the context of the overall electricity industry structure in Ireland, a large amount of legislation applies and is directly relevant to this preliminary decision. Much of the relevant legislation has been provided by ESB as part of its application. While the ESB was established by the Electricity Supply Act, 1927 which although substantially amended still remains in force, the current industry arrangements are provided for, in the main, by the Electricity Regulation Act, 1999, as amended (the “Act”). The Act, and supporting secondary legislation, establishes the current regulatory regime, the powers and duties of the CER, the licensing regime and, inter alia, the functions of the TSO and TAO respectively. The Act gives the CER various powers of direction, the power to issue licences and to modify those licences as the CER considers necessary. There is also a substantial body of secondary legislation in place, the most relevant to this process of which are SI 445 of 2000 and SI 60 of 2005.

2.4 Structure of the Paper

- (28) **Section one** of this paper contains the executive summary. This section, **section two**, sets out the background to the issue and the relevant legislation. **Section three** provides an overview of the existing arrangements, market structure and the SEM Committee’s approach to assessing the application. **Sections four and five** outline ESB and EirGrid’s arguments respectively. The SEM Committee’s analysis of the application and

⁸ Refer to the Minutes of [SEM Committee meeting 47](#) (29th November 2011)

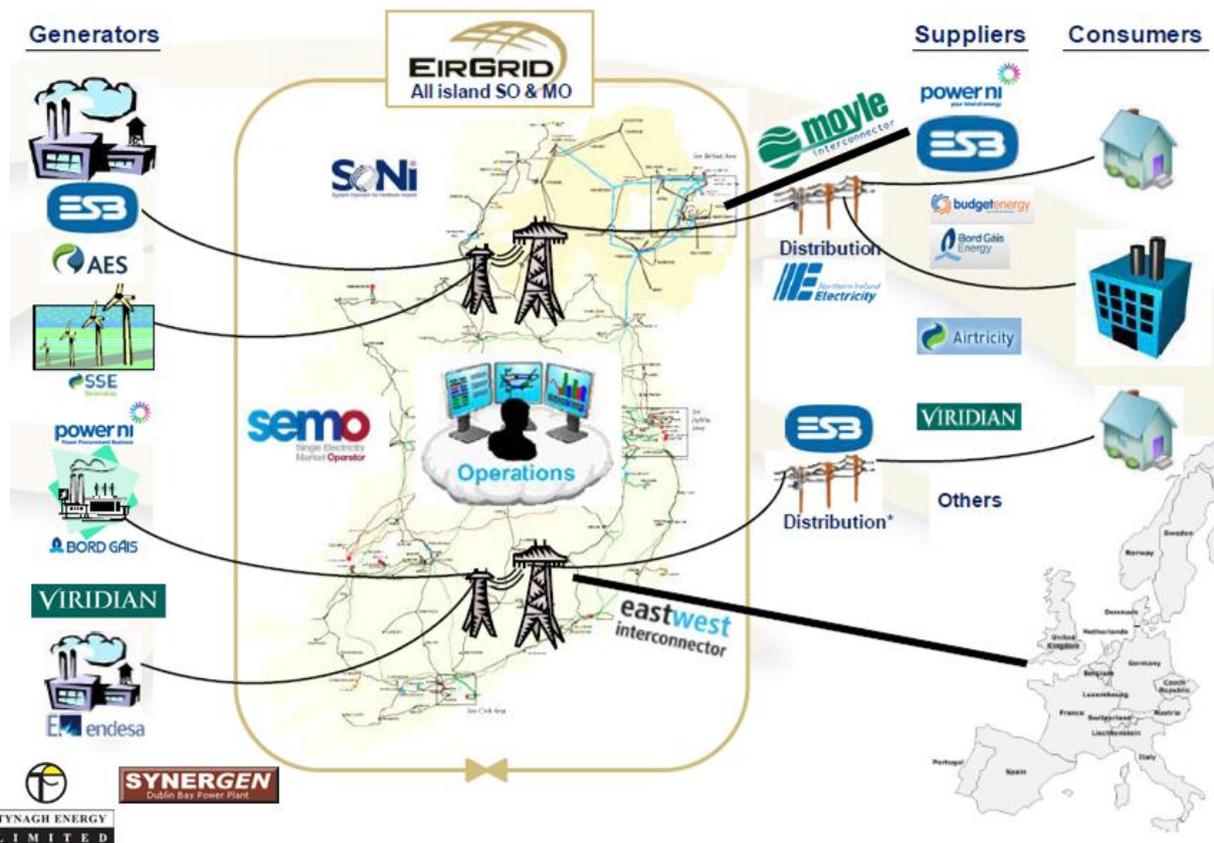
relevant material is set out in **Section six**. **Section seven** discusses areas the SEM Committee wishes to consider further and specific actions it proposes to take arising from its analysis. **Section eight** then provides the concluding summary and next steps.

2.5 Further Information

- (29) Please contact Robert O'Rourke (rorourke@cer.ie) at the CER for any queries in relation to this paper.

3 Existing Arrangements and the Certification Process

3.1 Irish Arrangements



Source: EirGrid

3.1.1 Wholesale and Retail Market Arrangements

- (30) To assess the transmission arrangements in Ireland in the context of the Directive and the certification process, it is useful to consider the wider industry context in which they sit. Therefore this section will give a brief overview of the structure of the Irish Electricity Market⁹.
- (31) The wholesale market, the Single Electricity Market (the SEM), is a mandatory gross pool market for the island of Ireland (i.e. a single market including Ireland and Northern Ireland). This market is operated by an independent entity licensed by both Regulators as the Market Operator, known as SEMO (the Single Electricity Market Operator).

⁹ Please note this section provides a highly simplified explanation of the SEM which is relatively complex market. For further information the CER has published several [factsheets](#) on the Irish market and it is also noted the ESB has addressed this issue in Section 4 of its application.

SEMO is a joint venture between the two licensed TSOs – EirGrid for Ireland and SONI¹⁰ for Northern Ireland. EirGrid and SONI are both part of the EirGrid Group.

- (32) The SEM is designed¹¹ to, inter alia, produce the most efficient wholesale market price in each half hour and eliminate the exercise and potential for market power by generators. The Bidding Code of Practice prescribes the calculation generators use in offering their bids into the SEM. Each generator bids in its short run marginal cost and a merit order based on market bids is established for each half hour of the trading day. The SEM operates under centralised dispatch. The Market Operator schedules generators in order of lowest to highest marginal cost, and the SEM's market price (the "SMP") is the marginal cost of the marginal generator in that half-hour required to meet demand. Therefore the marginal unit earns an inframarginal rent of zero while all other scheduled plant earns an inframarginal rent of the SMP minus their short run marginal cost. Generators with a short run marginal cost above that of the marginal plant required to meet demand are not run (though in practice "out-of-merit" units can be run for system security reasons e.g. for reserve purposes or due to transmission system constraints although do not receive inframarginal rent).¹² Therefore it can be seen that generators are incentivised to increase their efficiency in order to run more often and have no power to artificially raise the wholesale price of electricity. All electricity suppliers are obliged to buy their power from the SEM at the SMP.
- (33) Outside of the market suppliers and generators may enter into contracts to hedge against the potential price volatility of the SMP. ESB Power Generation (ESB PG) due to its potential spot market power is required to issue Directed Contracts¹³ the prices and volume of which are determined by the SEM Committee. It should also be noted that some of ESB's generation assets were sold in 2008 in order to further mitigate their potential market power. The Irish Government has also recently announced its intention to sell off some of ESB's non-strategic power generation assets.¹⁴
- (34) The retail market in Ireland has been fully open to competition since 2005 for electricity. In recent years there has been a significant increase in the level of customer switching and supplier activity. Ireland has seen some of the highest customer switching rates in Europe and continues to see significant levels.¹⁵ The resulting fall in the market share of ESB Customer Supply (the incumbent) prompted the CER to fully de-regulate¹⁶ the electricity retail market and accordingly domestic tariffs are no longer set by the CER and instead are determined by the market and monitored by the CER. As part of its decision on de-regulation the CER required ESB Customer Supply to re-brand itself so as to remove "ESB" from its name. ESB's supply business is now called Electric Ireland.

¹⁰ SONI (System Operator for Northern Ireland), further information on SONI can be found on its website www.soni.ltd.uk

¹¹ SEM High Level Design Decision Paper ([AIP-SEM-42-05](#))

¹² For simplicity divergences between the market schedule and the dispatch schedule are not discussed in this paper.

¹³ More information can be found [here](#) on the SEM website.

¹⁴ Government [press release](#), "Government secures substantial reinvestment in economy from disposal of State assets", 22nd February, 2012

¹⁵ <http://www.cer.ie/en/electricity-retail-market-reports-and-publications.aspx>

¹⁶ The CER published its [road map for deregulation](#) in April 2010 and its [decision to deregulate the domestic market](#) in March 2011.

- (35) The majority of retail market processes are automated and are administered by a business unit of ESB Networks, Retail Market Development Services (RMDS). All changes to these processes are discussed with industry through the Industry Governance Group (IGG) which is chaired by the CER. It is ultimately a matter for the CER to approve any changes to the market systems, market processes and market messages discussed at the IGG. Meter reading and data aggregation services are carried out for all distribution connections by a ring fenced business unit within ESB Networks, the Meter Registration System Operator (MRSO).

3.1.2 Role of the National Regulatory Authority and the SEM Committee

- (36) In relation to all SEM matters decisions are taken by the SEM Committee. The CER, the Utility Regulator (the “UR”) and an independent member¹⁷ (with a deputy) make up the SEM Committee. CER, UR and the independent member each have one vote. The chair of the SEM Committee rotates every six months.
- (37) Generally speaking, all wholesale market issues relating to the SEM are “SEM matters” but there is also an increasing number of transmission issues which are being addressed on an all-island basis (in the absence of a single all island transmission system) and as such can be considered SEM matters. Examples include the treatment of transmission loss factors, generator TUoS¹⁸ charging, Harmonised Ancillary Services and Other System Charges (HAS & OSC) and this Certification procedure itself.
- (38) Irish regulatory issues which are not SEM matters are determined solely by the CER. These issues include licensing of energy undertakings, matters relating to security of supply and emergencies, retail market issues, distribution matters, connection policy and the regulation of EirGrid and ESB Networks under five year revenue control mechanisms.
- (39) The current five year revenue controls for EirGrid and ESB Networks run from 2011 to 2015. These controls set out the allowed levels of operational expenditure, capital expenditure, expected efficiency gains and overall levels of revenue to be recovered over the course of the five year control period. In addition, as part of its five year revenue decision, the CER sets out the allowed Weighted Average Cost of Capital (WACC) for EirGrid and ESB Networks. The cost of capital for ESB Networks is determined for the networks business only not for the ESB Group as a whole. Therefore if ESB is unable to secure financing at a rate comparable to the level an efficient network-only company (by virtue of being a VIU or otherwise) they will be unable to recover those costs through their regulated revenue. A full explanation of how the CER sets the WACC is contained in the Cost of Capital Report, included as an annex to this paper.
- (40) The powers and duties of the CER are set out in various pieces of legislation, the most important being the Act,¹⁹ the Gas (Interim)(Regulation) Act, 2002, the Energy (Miscellaneous Provisions) Act, 2006 and the Petroleum (Exploration and Extraction)

¹⁷ The independent member may not have any interests in the Irish or Northern Irish energy industries.

¹⁸ Transmission Use of System (TUoS)

¹⁹ Section 9 in particular.

Safety Act 2010. It should be noted that the CER has a strong degree of independence relative to some other European regulators and has extensive powers of direction under legislation in addition to its licensing powers. The CER may modify a licence where it considers it appropriate,²⁰ subject to a consultative process set out in legislation. The CER's decisions and directions are not subject to review or oversight by any other authority except through formal legal procedure (the courts).

- (41) Therefore it can be considered that the totality of the arrangements in place under current legislation (including those which are the subject of this paper) falls within the regulatory oversight of the CER and is subject to modification where the CER (or the SEM Committee in relation to SEM matters) is of the view that the requirements of the legislation could be better met through such modification.

3.1.3 Transmission arrangements

- (42) The arrangements currently in place substantively have their origin in those arrangements established in 2000 (SI 445 of 2000), albeit with material modifications through legislation and regulatory decisions over the last decade. The ESB National Grid business was ring-fenced from ESB. The legal separation of ESB National Grid was subsequently completed and EirGrid formally became TSO in July 2006. The Infrastructure Agreement came into force at this time and defines the relationship between EirGrid as TSO and ESB as TAO and the requirements on each organisation under this agreement.
- (43) The Infrastructure Agreement ([CER/11/084](#)) has been in place since March 2006. Under its TAO licence ESB is required to enter into, and comply with, the Infrastructure Agreement “...for the purpose of enabling the Transmission System Operator to discharge its functions under the Act, the Regulations and the Transmission System Operator’s licence”.²¹ This sets out the relationship between EirGrid as TSO and ESB as TAO. The Infrastructure Agreement details the manner in which ESB will fulfil its functions on which EirGrid depend and vice versa. The nature of the interactions between the companies, their obligations to one another and the escalation procedures that apply in the event of a dispute (the matter may ultimately be referred to the CER if a resolution cannot be reached) are all set out in detail in the Infrastructure Agreement and are binding on the parties. It is also noted that the Infrastructure Agreement cannot be amended without the approval of the CER.
- (44) EirGrid is a separate independent legal entity, fully unbundled from any interest in generation or supply and is licensed as the TSO (legally the only entity who may hold this licence). EirGrid also owns and operates the East West Interconnector which is a DC interconnector with Great Britain. The SEM Market Operator (SEMO) is a joint venture between EirGrid and SONI (the Northern Ireland TSO), also owned by EirGrid.

²⁰ “Where the Commission is of the opinion that a licence or an authorisation should be amended it may do so with or without the consent of the holder of the licence or the authorisation, as the case may be.” Section 19(2) of the Act.

²¹ Condition 2(1) of the TAO licence. The equivalent Condition of the TSO licence, also condition 2(1), reads “The Licensee shall at all times have in force and comply with the Infrastructure Agreement.”

- (45) ESB (the incumbent state electricity company) owns the transmission and distribution networks ESB holds the Distribution Asset Owner licence and the Transmission Asset Owner (TAO) licence. Legally it is the only entity who may hold these licences. The DSO licence is held by ESB Networks Limited, a legally separate company wholly owned by ESB. ESB Networks (the business unit of ESB and legally part of ESB not of ESB Networks Ltd.) carries out the DSO functions under the management of ESB Networks Limited in addition to the transmission and distribution functions associated with the DAO and TAO licences. ESB Networks (the business unit) is required by licence to operate as a separate ring-fenced business from the rest of ESB. Although the ESB's distribution and transmission licences require each to be operated as a separate business the CER has previously given approval for both distribution and transmission businesses to be operated jointly by a single business (ring-fenced from the rest of ESB). This is due to the nature of the Irish system, the cost and duplication of resources that a separation of the transmission and distribution businesses would entail and that it is not contrary to the objectives of business separation given the ring-fencing from the competitive businesses.²²
- (46) The respective functions of the TSO and TAO under statute and licence are discussed in detail in Section 3.1.4.
- (47) ESB's supply business is Electric Ireland. Electric Ireland (formerly ESB Customer Supply and ESB Independent Energy), is also ring-fenced, as a licence requirement, from the rest of ESB. Electric Ireland holds the Public Electricity Supplier licence which places several additional responsibilities on it not required of independent suppliers such as a duty to supply. It also acts as Supplier of Last Resort, this role was offered to the market but no supplier expressed interest. The CER no longer regulates Electric Ireland's tariffs as the market has been deregulated to the domestic level since April 2011. Removal of "ESB" from its branding was one of the conditions of deregulation. The CER monitors the market and all suppliers' behaviour. ESB Independent Energy operated as an independent supplier in the commercial sectors of the market and was also ring-fenced. As part of the process of deregulation the CER has permitted the horizontal integration of ESB's supply businesses under the Electric Ireland brand.
- (48) With regard to the situation on 3rd September 2009, ESB's generation businesses were ESB Power Generation (ESB PG) and Synergen. Synergen operated under a similar licence to independent generators but was required to be ring-fenced from the rest of ESB and may not use "ESB" in its branding and communications. ESB PG may brand itself as an ESB company and is more heavily regulated, being required to offer directed contracts to the market for example. As discussed above several steps have been implemented in the wider design of the SEM and in regulatory decisions specific to Ireland to limit the market power of ESB Power Generation. In this context it should be noted that the various businesses of the VIU are ring-fenced from each other and prohibited from any form of cross-subsidy. ESB PG was also required to dispose of several of its generation assets to reduce its overall share of the market. In 2008 Endesa purchased²³ generation assets representing just over 1,000MW.²⁴ As part of the

²² See Appendix A(5) of ESB application, letter from CER dated 8th November, 2001

²³ CER [press release](#) July 2008

deregulation process the CER has permitted the horizontal integration of ESB's generation businesses.

- (49) The regulation of the ESB group and the market arrangements seek to limit its market power as both a provider of electricity in the wholesale and retail markets and as a buyer of power in the wholesale market.
- (50) ESB International (ESBI) is an ESB business that operates generation businesses outside Ireland in addition to an engineering contracting business both in Ireland and internationally. ESBI's dealings with other ESB businesses are permitted but must be on an arm's length basis and comply with relevant procurement legislation.²⁵

3.1.4 The TSO & TAO Tasks in the Context of Article 12

- (51) Article 12 of the Directive sets out the tasks of a TSO. It is noted that ownership of the transmission assets is not required by Article 12 but is a feature of the unbundling models. Given that both EirGrid and ESB have transmission roles, this section explains the nature of these roles and how they relate to the TSO tasks in Article 12.
- (52) EirGrid has *responsibility* for all of the TSO tasks listed in Article 12. These responsibilities are provided for under Regulation 8 of SI 445 of 2000, as amended. This regulation sets out the functions of the TSO in Ireland.
- (53) Regulation 8(1)(a) states ["...the transmission system operator shall have the following exclusive functions..."]:

(a) to operate and ensure the maintenance of and, if necessary, develop a safe, secure, reliable, economical and efficient electricity transmission system, and to explore and develop opportunities for interconnection of its system with other systems, in all cases with a view to ensuring that all reasonable demands for electricity are met and having due regard for the environment;

- (54) Regulation 8(1)(c) and 8(1)(ca) states:

(c) to plan the long term ability of the transmission system to meet reasonable demands for the transmission of electricity;

(ca) to contribute to security of supply through adequate planning and operation of transmission capacity and system reliability;

- (55) Therefore it can be seen that EirGrid as TSO has exclusive responsibility for the tasks of Article 12, including 12(a). While, EirGrid is reliant on ESB, the TAO, to discharge this function as it relates to construction and maintenance this does not absolve it of its functions under Regulation 8. EirGrid may not procure maintenance and construction services from a provider other than the TAO (i.e. ESB). The TAO functions are set out in

²⁴ These assets have subsequently been sold to Scottish and Southern Energy which is active in the wholesale and retail markets on the island of Ireland.

²⁵ Conditions 4(4) and 4(5) of the TAO licence

this context, that is, EirGrid has responsibility for the functions as set out above and ESB has a duty to discharge its TAO functions in accordance with EirGrid instructions.

(56) However as noted previously, the TAO does also have a role and its functions are set out in Regulation 19 (Functions of a transmission system owner) of the same Regulations.

(57) This TAO role manifests itself in relation to Article 12(a). Parts (b) to (h) of Article 12 are solely TSO (i.e. EirGrid) functions under Irish legislation. Article 12(a) states:

ensuring the long-term ability of the system to meet reasonable demands for the transmission of electricity, operating, maintaining and developing under economic conditions secure, reliable and efficient transmission systems with due regard to the environment;

(58) The TAO functions are set out in Regulation 19 (functions of transmission system owner). It states:

The transmission system owner shall-

(a) as asset owner, maintain the transmission system and carry out construction work in accordance with the transmission system operator's development plan, subject to the provisions of Regulation 18(3)²⁶,

(b) in accordance with the infrastructure agreement with the transmission system operator under Regulation 18 implement any other works required under the development plan, and carry out any other requirement applicable to it under these Regulations, having due regard for the environment,

(c) provide to the transmission system operator such information as the transmission system operator requires to ensure the secure and efficient operation, development and maintenance of the transmission system or otherwise in order to discharge its functions under these Regulations,

(d) have a duty to indicate to the transmission system operator and the Commission,²⁷ within such period as shall be specified by direction of the Commission, the measures which it proposes to take to implement the development plan in accordance with the infrastructure agreement,

(e) have a duty not to dispose of any assets constituting part of the transmission system or to create any encumbrance over the transmission system without prior notification, in writing, to the transmission system operator and the Commission.

(f) have a duty not to dispose of to an extent considered material by the Commission, any assets constituting part of the transmission system or

²⁶ Requires the TAO to use its own resources or outsource from a list of providers approved by EirGrid.

²⁷ i.e. the CER

create to an extent considered material by the Commission, any encumbrance over the transmission system, without the prior written consent of the transmission system operator and the Commission,

(g) comply with any regulations or directions applicable to it made by the Commission under these Regulations or under the Act of 1999, and

(h) otherwise comply with the licence issued under section 14(1)(f) of the Act of 1999.

- (59) Therefore it can be seen that the TAO functions are defined as functions which are carried out in accordance with the TSO's decisions regarding what construction and maintenance should be carried out. Regulation 19 does not confer responsibility for Article 12(a) on ESB nor does it in any way remove the responsibilities placed on EirGrid under Regulation 8. The independence of the TSO is further enforced through Regulation 9 which states:

(1) The transmission system owner shall neither direct nor give any instructions to the transmission system operator in relation to any of the functions conferred on the transmission system operator by these Regulations.

(2) (a) The transmission system owner shall, within such period as shall be specified by direction of the Commission, comply with any requirements considered necessary by the transmission system operator to enable the latter to discharge its functions under these Regulations.

(b) The requirements considered necessary by the transmission system operator in subparagraph (a) may include matters which relate to minimum standards for the maintenance and development of the transmission system, including interconnection capacity.

(3) (a) Subject to paragraph (4), the infrastructure agreement made under Regulation 18 shall be the basis of the relationship between the transmission system operator and the transmission system owner.

(b) The transmission system owner shall not exercise its property rights in a manner which would interfere with the obligations on the transmission system operator to operate the transmission system and to the extent that it is possible to do so, the infrastructure agreement shall set out the respective rights of the transmission system owner and the transmission system operator in that regard.

(4) Nothing in paragraph (3) shall be construed as affecting-

(a) any licence conditions in the licences issued to the transmission system operator and the transmission system owner,

(b) the transfer scheme, or

(c) any connection agreements.

(5) For the purposes of this Regulation, the Commission shall decide on any difference or dispute between the transmission system operator and the transmission system owner and the Commission shall issue a direction regarding its decision, as it sees fit, regarding the matter in dispute and the transmission system operator and the transmission system owner shall comply with such direction.

- (60) The Infrastructure Agreement sets out in detail how this relationship and in particular how the TSO can effectively ensure it discharges its responsibilities under Regulation 8 despite its reliance on the TAO for those functions set out in Regulation 19. Regulation 18 provides for the Infrastructure Agreement and while the entire Regulation is relevant of particular interest is 18(2) which states:

The Commission shall, in particular, ensure that the infrastructure agreement incorporates terms and conditions which, in the opinion of the Commission-

(a) enables the transmission system operator fully and effectively to discharge its functions under these Regulations, and

(b) ensures that the transmission system owner will facilitate the discharge by the transmission system operator of its functions and ensure the performance of the transmission system owner's own obligations, in accordance with its own duties.

- (61) Therefore it can be seen that firstly it is a legislative requirement that the TSO and TAO agree to an Infrastructure Agreement that reflects the functions set out in the legislation and that secondly, the CER itself has a responsibility to ensure the Infrastructure Agreement and the detailed processes contained within it enables the TSO to “fully and effectively” discharge its functions (i.e. Regulation 8 which includes those set out in Article 12 of the Directive). There are also other powers, such as its rapid step in rights, bestowed on the TSO to ensure it can effectively discharge its functions even where the TAO is failing in its duties.

- (62) This relationship between the TSO and TAO is therefore central to the certification process and the independence of EirGrid as TSO. This paper explores this issue and assesses whether these arrangements provide a greater guarantee of TSO independence than would be provided by an ESB ITO.

3.2 Existing Ring fencing provisions within the TAO

- (63) The following is a summary of the key arrangements in place through which ESB Networks (as managed by ESNB Limited) is ring-fenced from the generation and supply businesses of ESB. It is noted that the TSO, EirGrid, is a structurally separate company and so there is no ring fencing requirement for those functions. It is only the functions of ESB under statute and licence (as outlined in Section 3.1 above) performed by ESB Networks where there is a potential for VIU interference and where there must be strong ring-fencing arrangements in place. The ring-fencing provisions applying to the TAO must be considered in light of the role of the TAO and also the TSO's role in relation to those TAO functions. In this regard it is noted that the European Commission expressed

the view that due to the limited (but more extensive than ESB Networks) role of the Scottish Transmission Companies the specific ring-fencing requirements of Chapter V were not necessarily required. In reviewing the ringfencing arrangements in place between ESB Networks and ESB VIU for those transmission functions carried out by ESB Networks, the SEM Committee has borne this in mind. In addition EirGrid's oversight role as the body responsible for the delivery of the transmission tasks is noted.

3.2.1 ESB Ring-Fencing Provisions

- (64) There are no personnel within ESB Networks that also have a role in generation and/or supply business units and/or that have regular contact with personnel in the supply and/or generation units other than interaction in the normal course of business as with any market participant. The Memorandum of Understanding between ESB and ESB Networks Limited (the "MOU"),²⁸ which with the Asset Management Agreement defines the relationship between the companies, explicitly prohibits the appointment to ESB Networks Limited's board of any executive director or any other person who participates, directly or indirectly, in the day-to-day operation of any of ESB's generation or supply businesses:

*ESB shall not appoint to the Board of the Company and Executive Director or any other person who participates, directly or indirectly, in the day-to-day operation of the businesses of ESB relating to supply or generation of electricity.*²⁹

- (65) The MOU further explicitly prohibits performance targets of ESB Networks Limited senior management to be linked to the performance of ESB's generation and supply businesses.³⁰
- (66) Pursuant to the MOU and, in the case of ESB, to its TAO licence, each of ESB Networks and ESB have (and did have on 3 September 2009) in place a compliance code of conduct. These codes must be approved by the CER and are subject to amendment by the CER as required. The compliance codes of conduct include requirements in relation to the transfer and/or movement of ESB Networks staff between ESB Networks or ESB Networks Limited and ESB's other businesses, which:³¹
- (a) include restrictions on the transfer of confidential information, e.g. where an officer or employee of ESB Networks has received confidential information of ESB Networks and transfers to a different business unit of ESB where such confidential information is not required for the performance of the DAO or TAO functions, the officer or employee concerned cannot bring the confidential information with them and will continue to adhere to the terms of confidentiality

²⁸ Memorandum of Understanding between ESB and ESB Networks Limited (See ESB Application, Appendix B.15)

²⁹ Clause 19, MOU.

³⁰ Clause 44, MOU

³¹ Clause 10.2.5, Asset Management Agreement; Paragraph 3.4 ESB Networks Limited Staff Compliance Code of Conduct, (ESB Application, Appendix A.11); ESB Staff Compliance Code of Conduct (Confidentiality and Non-discrimination for ESB Networks Activities), (ESB Application, Appendix A.13). See also Clause 9 of the Networks Management Personnel Agreement (ESB Application, Appendix B.16).

- under which the confidential information was provided to them by not disclosing the confidential information;
- (b) provide for quarantine periods between transfers if considered necessary by the Compliance Officer; and
 - (c) require that upon transfer, the staff member's IT access is revised as well as access to certain premises;
- (67) Further to the provisions in the codes of conduct referred to above, ESB also has in place a Protocol for the Disclosure of Commercially Sensitive Information³². This protocol was in place on 3 September 2009 and continues to be in place today. The protocol relates in particular to how confidential information required by ESB Corporate Centre for its corporate governance role is protected and not disclosed to other business units. It also requires that ESB have in place necessary ring-fencing and business separation requirements approved by the CER, including arrangements in respect of accounting separation, complete and effective management separation, premises separation, a code of conduct for the transfer of staff, IT and systems access separation, communication of licence obligations to staff, protection of commercially sensitive information and the requirement for specific trust and confidence agreements where appropriate.
- (68) ESB Networks' annual budget, once agreed upon with ESB (through ESB Networks Limited), cannot be altered and must be ring-fenced from ESB's other business units' budgets.³³ ESB Networks Limited and ESB's accounts must at all times be kept separate.³⁴ The separation of the accounts (including financial accounting system ledgers and bank accounts) of ESB Networks Limited was completed in early 2009.³⁵
- (69) ESB Networks and ESB Networks Limited do not share any facilities (including physical premises) or IT systems³⁶ with the other ESB entities. With the exception of a public business and call centre (which were shared in 2009 with the consent of the CER), ESB Networks and ESB Networks Limited did not share any facilities with other ESB business units as at 3rd September 2009. This public business and call centre has since been separated.
- (70) There exists a firewall between the ESB Group legal team and the legal team of ESB Networks.
- (71) ESB Networks has its own Compliance Officer (exclusive to the networks business unit of ESB) who reports to the CER separately. The compliance officer ensures the compliance programme is implemented and adhered to at all times by requiring the manager of each area within ESB Networks to report to him on an annual basis in relation to compliance with all areas of the compliance programme, by briefing all staff

³² ESB Protocol for the Disclosure of Commercially Sensitive Information (See ESB Application, Appendix A.14)

³³ Clause 35, MOU.

³⁴ Regulation 27, 2000 Regulations.

³⁵ See also, DSO Compliance Report to CER, dated 31 March 2010 (Appendix A.15).

³⁶ ESB Networks and other ESB Group production Software Applications (i.e. the live systems used to support ESB operations and the market) are on physically separate servers and although these systems still share other IT related infrastructure (including LV power supply, disk storage and telecommunications systems) ESB Networks and ESB Group services are logically separated. This means that ESB Networks systems cannot "see" or access data on non-ESB Networks systems, other than Group Finance, (or vice versa).

and senior management on the compliance programme requirements, and by reviewing the compliance programme when required.³⁷ A compliance report is submitted to the CER annually.

- (72) Separate platforms have been established for commercially sensitive information (such as customer facing and strategic information).³⁸ ESB Networks' corporate functions (such as Legal) report into the ESB Group's corporate functions at a high level only and in adherence with the Protocol for the Disclosure of Commercially Sensitive Information and the ESB Networks Staff Compliance Code of Conduct referred to above.
- (73) Since 2011, ESB Networks has separate branding from ESB's supply business (which is now known as Electric Ireland).
- (74) Staff performance and evaluation in each business unit is set purely on that individual's performance, related to the objectives of that business unit and not to the overall ESB Group. The MOU explicitly prohibits the performance targets of the ESB Networks Limited directors or senior management being linked to the performance of the ESB Group.³⁹ In addition, given the current economic climate no bonuses are currently being paid to staff.

3.2.2 Areas of ESB Involvement

- (75) There are a limited number of areas of activity where, notwithstanding the ring-fencing arrangements, ESB still retains some operational responsibilities in relation to ESB Networks. Given the various protocols or procedures in place, as well as the significant scope for regulatory oversight (as envisaged in Condition 13 of the TAO licence)⁴⁰, ESB state that they do not believe that these give rise to any concern or weaken the independence of ESB Networks.

3.2.2.1 Financing and Remuneration:

- (76) Pursuant to the MOU, ESB Networks Limited must prepare an annual financial plan which includes a budget for the next five years and a proposed annual management fee payable by ESB to ESB Networks Limited for ESB Networks Limited's distribution and transmission responsibilities.⁴¹ This must relate to the budgetary requirements of ESB Networks Limited both as manager of ESB Networks (including ESB's delegated TAO responsibilities) and as DSO. The annual financial plan must be recommended by the

³⁷ See, e.g. DSO Compliance Report 2009, 31 March 2010.

³⁸ See in particular, Protocol for Disclosure of Commercially Sensitive Information, paragraphs 1 – 5.

³⁹ MOU Clause 44

⁴⁰ As described in above, the TAO licence in particular provides for an obligation on ESB as licensee (i) to comply with any requirement or direction as may be made by the CER from time to time for the purposes of the ringfencing condition; (ii) to require that the managing director of the TAO business report to the CER on the implementation of any ring-fencing measures which ESB is required to undertake; and (iii) to appoint a compliance officer who is responsible, inter alia, for ensuring compliance of the TAO business with the licence condition on ring-fencing.

⁴¹ The management fee is a percentage of the combined income due to ESB in its capacities as DAO and TAO, in each calendar year under regulatory price controls, and agreed between ESB and ESNB Limited. The management fee must be sufficient to cover ESNB Limited's costs of discharging its obligations and include a reasonable margin for ESNB Limited in accordance with normal commercial practice (subject to the achievement by ESNB Limited of performance targets specified in the annual financial plan). (Clause 7.1.1 – 7.1.2, Asset Management Agreement.)

board of ESB Networks Limited for approval by the board of ESB as shareholder. ESB determines whether or not to approve the draft annual financial plan or to require amendments or the preparation of a new draft.⁴²

- (77) If ESB and ESB Networks Limited are unable to agree on the annual financial plan 20 business days after entering into discussions in an attempt to agree on a revised financial plan, both ESB and ESB Networks Limited must enter into an agreed dispute resolution procedure, as set out in the MOU. This procedure requires that a senior representative from each company enter into bona fide discussions in an attempt to resolve the dispute. Both the Operating Agreement and the Asset Management Agreement set out dispute resolution mechanisms. The Operating Agreement refers to a CER determination (see Clause 21.3). The Asset Management Agreement refers to arbitration (Clause 14.3).
- (78) In the event of unforeseen circumstances that will cause ESB Networks Limited to incur significant additional costs in the discharge of its obligations, it may apply to ESB to have the management fee for that year adjusted to permit the recovery of the unforeseen costs. ESB cannot unreasonably withhold consent to such an application.⁴³
- (79) Once ESB Network's annual budget has been agreed by ESB (through agreement with ESB Networks Limited), it must be ring-fenced from other budgetary arrangements within ESB. The financial viability of another entity within ESB Group cannot be a basis for revising ESB Network's budget, except where circumstances have changed so substantially that such revision is deemed by the board of ESB to be necessary to protect the overall financial viability of the ESB Group.⁴⁴ ESB have argued that this is a very narrow and limited exception and it is difficult to envisage circumstances where this would arise. It is noted that this has never been invoked.
- (80) The above safeguards ensure that ESB does not have the ultimate say in terms of the financing of ESB Networks and cannot withdraw funds from ESB Networks once they have been agreed. Therefore, ESB is not in a position, through its financing role, to compel ESB Networks to act contrary to the interests of the transmission and distribution businesses. In comparison the Supervisory Body, acting in the interests of the ITO's shareholders, has overall control over the financing of the ITO, in addition to the potential to influence the preparation of the Development Plan that such an approval role entails.

3.2.2.2 Employees:

- (81) The MOU prescribes that ESB's board nominates all of ESB Networks Limited's board and has the right to remove any or all of ESB Networks Limited's directors (subject, in each case, to the approval and consent of the Minister for Communication Energy and Natural Resources and the Minister for Finance)⁴⁵ and determines the terms on which the directors hold office. These terms must be in accordance with the Code of Practice

⁴² Clauses 26 to 30, MOU.

⁴³ Clause 7.1.3, Asset Management Agreement.

⁴⁴ Clause 35, MOU.

⁴⁵ Clause 16, MOU.

for Governance of State Bodies. Further, the Managing Director of ESB Networks Limited is required to report to the Chief Executive of ESB in respect of all matters relating to compliance by the subsidiary with ESB's policies and procedures and in relation to the protection of ESB's financial interest in the subsidiary.

- (82) ESB Networks staff that transfer to other ESB Group business units must comply with the Staff Compliance Code of Conduct which prohibits staff from disclosing confidential ESB Networks information.⁴⁶
- (83) There is currently an Executive Director Team ("EDT") which is a team formed of the directors of ESB's businesses including the networks, generation and supply businesses and which meets as advisers to the Chief Executive approximately every month. The EDT reviews at a high level the policies and plans that are being implemented within the ESB Group and the structure, position, and prospects of ESB in the markets in which it is active. However, a protocol has been prepared in relation to these meetings to ensure that the discussions do not result in a breach of the ring-fencing obligations of the various ESB entities (e.g. to supervise compliance with these obligations all proposed agendas and all minutes of EDT meetings are copied to the Group Compliance Manager for review). No day-to-day operation matters are discussed in this forum.

3.2.2.3 Legal Proceedings

- (84) ESB Networks, through ESB Networks Limited, must obtain ESB's prior approval before it can initiate any legal proceedings in relation to the operation, maintenance, and development of the distribution and transmission systems which may affect the reputation or financial position of ESB or ESB Networks Limited.⁴⁷

3.3 **Scope of Certification of the Irish Arrangements**

- (85) The energy industry is a complex and continually evolving industry. The changes that have taken place over the last decade in Ireland and in Europe in the context of market liberalisation, structural change and unbundling have been significant. This has changed the way customers interact with energy companies and changed the nature of the supply chain from typical vertical integration to a transparent system with clear separation of roles and responsibilities. This pace of change will if anything increase over the course of the current decade as Europe moves towards a more integrated single market and the generation mix shifts substantially towards renewable generation in order to meet national and European-wide 2020 targets. It is also highly unlikely that post 2020 the pace of change will abate, the European Commission's [2050 Roadmap](#) illustrates some of the challenges and opportunities ahead. The impact of European developments is particularly acute in Ireland where for example the EU Target Model will require major changes to the operation of SEM⁴⁸. Additionally the levels of non-synchronous

⁴⁶ In addition, in respect of ESB board members, ESB's internal Code of Business Conduct for ESB Board Members (See ESB application, Appendix D.4) states that ESB board members should "*conform with procedures laid down by the board in relation to conflict of interest situations, including in regard to acceptance of positions following membership of the board which may give rise to the potential for conflicts of interest and to confidentiality concerns.*"

⁴⁷ Clause 59, MOU.

⁴⁸ Recent SEM papers relating to European Market Integration can be found [here](#).

generation (mainly wind) required to meet the 2020 targets on a relatively small system is a major technical and to a lesser extent regulatory challenge without global precedent⁴⁹.

- (86) Within this context it is likely that structural and regulatory changes will be necessary across the industry including many areas which could generally be termed as transmission related. Therefore it is necessary to clarify which elements of the arrangements are fundamental to the structure of the Irish transmission arrangements and which elements, while important, sit within these arrangements and are subject to change as required.
- (87) The elements that the SEM Committee considers integral to the Existing Arrangements, and accordingly collectively constitute the Irish Arrangements which must be certified, are as follows:
- the licensed TSO, EirGrid is a legally and structurally separate entity;
 - the functions of the licensed TAO, ESB are carried out by a ring fenced business (ESB Networks) of the VIU;
 - the TAO is obligated under statute and licence to assist the TSO;
 - the relationship between the TSO and TAO is clearly set out in a legal agreement and legally enforceable;
 - the regulator has the ability to modify the licences as it deems appropriate; and
 - the regulator has regulatory oversight and legally enforceable powers of direction over the companies, their duties, their contractual relationship and interactions.
- (88) Changes that occur within this framework are not considered a change to the certified arrangements, should such certification be granted. Changes requiring legislation could be considered outside the arrangements but licence modifications, non-material adjustments to the Infrastructure Agreement or alterations to codes and other documents that sit under either the licences or statute which are within the power of the CER to approve, upon a request or on its own initiative, can be considered to reside within the certified arrangements, should such certification be granted.
- (89) The SEM Committee considers this a pragmatic and appropriate interpretation of the Directive and of the boundaries of the transmission arrangements. To take the opposite view – that arrangements within the CER’s power to change must remain fixed once a decision on certification has been made – would have the effect of sterilising the transmission related elements of the industry to any further change, development, or improvement. This indeed would restrain the CER’s ability and responsibility under statute to make changes and improvements to aspects of the transmission arrangements as it sees fit, based on its experience in monitoring compliance with the

⁴⁹ EirGrid is currently undertaking a major project, [DS3 \(Delivering a Secure, Sustainable Electricity System\)](#), to allow the island system to operate at up to 75% simultaneous non-synchronous penetration (SNSP).

transmission licences and the efficient operation of the transmission arrangements. This would needlessly obstruct and frustrate EU and government policy to the detriment of the industry.

3.4 Purposive Approach

- (90) The SEM Committee considers that a purposive approach is the most appropriate means of assessing an application for an Article 9(9) certification. The purposive approach involves assessing whether the transmission arrangements in place meet or exceed the intent of the unbundling provisions of the Directive, in particular by guaranteeing greater independence than the ITO model. The SEM Committee considers the intent or purpose of the Directive to be broadly summarised by Recital 12 of the Directive:

The national arrangements for unbundling should be effective in removing any conflict of interests between producers, suppliers and transmission system operators, in order to create incentives for the necessary investments and guarantee the access of new market entrants under a transparent and efficient regulatory regime⁵⁰.

- (91) The Directive does not provide any detailed guidance in relation to assessing applications or structural arrangements under Article 9(9) but in not doing so and by setting it apart from the other three models, the Directive acknowledges that it will not fit precisely with the FOU, ISO, or ITO models (by definition, arrangements to be certified under Article 9(9) are different from the three other models). The inclusion of Article 9(9) makes clear that the arrangements envisaged by this Article would not be certifiable if tested strictly against the ISO or ITO provisions. If it were the intention that such existing arrangements should meet each of the provisions of Chapter V (i.e. the ITO model) purely on a “line-by-line” analysis, then the inclusion of Article 9(9) would be superfluous (a straightforward certification under one of the three existing models would suffice). The SEM Committee considers that the assumption of the Directive containing a superfluous certification model would be an incorrect interpretation of the Directive.
- (92) Therefore it can be seen that relying solely on a direct line-by-line comparison with Chapter V of the Directive would be a wholly insufficient approach to assessing an application for 9(9) certification. A direct comparison to the ITO model must be combined with an assessment of how the existing arrangements deliver the aims of unbundling – does it meet the purpose for which the unbundling provisions were included in the Directive? In taking a purposive approach then, the SEM Committee considers that it is necessary to weigh the areas of strength in the applications against areas of weakness in coming to an overall position on whether the arrangements are certifiable or not.
- (93) In adopting a purposive approach the SEM Committee has been cognisant of the aim of the unbundling rules of the Directive (taking particular account of the recitals) and of the roles and tasks of the TSO set out in the Directive. In this context it is noted that the European Commission made particular reference to Recitals 12 and 19 and to Article 12

⁵⁰ Directive 2009/72/EC – Recital 12

in its decision on the Scottish Arrangements⁵¹. The SEM Committee has also considered areas that are, in its view, core to the independence of the TSO.

(94) Accordingly the SEM Committee has assessed the Existing Arrangements relative to the ITO against the following criteria:

- Core issues of independence (SEM Committee Guidance paper and additional considerations);
- Aims of effective unbundling (Recital 12); and
- Pillars of effective unbundling through an ITO (Recital 19).

These analyses were also informed by a line-by-line comparison of the Existing Arrangements with Chapter V (the ITO model).

(95) In its Guidance Note SEM-12-005 the SEM Committee highlighted four areas of being of particular importance when considering a 9(9) application. These areas are:

- Resources;
- Organisation, governance and incentives;
- Information; and
- Regulation.

Additional issues considered: market operation, system operation, access and connection to the system, system charging, and system planning.

(96) With regard to the aims of unbundling, the Existing Arrangements relative to the ITO have been assessed taking the following into consideration:

Any system of unbundling should remove conflicts of interest and ensure:

- fair competition;⁵²
- sufficient investment;
- access for new entrants;
- integration of electricity markets; and
- should not create an overly onerous regulatory regime for national regulatory authorities.

⁵¹ Commission Decision of 14.5.2012 C(2012) 3284

⁵² Not included in Recital 12 but noted in Recital 19 in the context of the other aims of unbundling and so is assessed here along with the aims cited in Recital 12.

(97) When comparing the existing arrangements against the requirements for an ITO the following pillars of the ITO model have been considered:

- organisational measures and measures relating to the governance of transmission system operators;
- measures relating to investment, connecting new production capacities to the network and market integration through regional cooperation; and
- inter alia, certain 'cooling-off' periods during which no management or other relevant activity giving access to the same information as could have been obtained in a managerial position is exercised in the vertically integrated undertaking.

4 ESB's Four Key Arguments

(98) In its application the ESB presented four key reasons why the existing arrangements guarantee more effective independence of the transmission system operator than the ITO model:

1. Structural separation of EirGrid;
2. Role of ESB is limited in scope;
3. ESB's limited role is subject to regulatory and statutory controls; and
4. Transparent transmission arrangements.

4.1 Structural Separation of EirGrid

(99) ESB argues in its submission that EirGrid is exclusively responsible for the discharge of all the TSO functions in Ireland. This provides the Irish arrangements with a greater degree of independence than would be the case under the ITO model; in other words the fact that EirGrid is legally and structurally separate from the VIU provides greater independence than would be possible if the transmission functions were the responsibility of an ITO company, ring-fenced from the remainder of the VIU. ESB notes that EirGrid is structurally independent from all participants in the market place and has all the resources necessary to meet its obligations. ESB argues that in comparison, the ITO model, by nature of the retention of the TSO within the VIU, retains a degree of risk that simply does not exist in the Existing Arrangements in Ireland.

(100) EirGrid does not accept this first argument on the basis that the definition of TSO tasks used is incorrect, as ESB carries out some of those tasks, while EirGrid is dependent on ESB in order to deliver some of its tasks. EirGrid also note ESB's role in financing transmission infrastructure.

(101) Regarding EirGrid's rebuttal of the argument, as discussed in Section 6.1 the SEM Committee considers that the existing model where two separate businesses have roles in the transmission function does not by itself impact on the greater independence ensured by the structural separation of EirGrid. The impact on TSO independence of the respective TSO and TAO tasks is discussed further in sections 5 & 6. The impact on TSO independence of the funding arrangements is discussed in section 6.4.

(102) The SEM Committee considers that EirGrid's separation from ESB and indeed from all other participants in the industry provides a greater guarantee to the independent discharge of its duties than relying on ring-fencing alone as would be the case for the ITO. However, the SEM Committee does consider that the ring-fencing between ESB Networks and ESB could be improved to guarantee TSO independence into the future, this is discussed in section 7. A further consideration is the lack of complete legal separation between ESB and ESB Networks, this is discussed in section 6.

(103) In addition to the fact that EirGrid itself is structurally separate, the SEM Committee puts considerable weight on the fact that EirGrid has the sole decision-making responsibility with regard to all of the TSO tasks set out in Article 12. The SEM Committee takes the

view that while EirGrid may require the input or be reliant⁵³ upon ESB to deliver some of these tasks, EirGrid has sole responsibility for the discharge of these functions. This responsibility provides it with the authority to act independently in order to ensure delivery of each of these functions while the structural separation ensures no conflict of interest in the exercise of this authority. It is noted however that the role of the TAO is also a consideration this is discussed further in the sections below and in section 6.

4.2 Role of ESB is Limited in Scope

- (104) The ESB's second argument centres on the limited role of the TAO as set out in legislation and its licence. They note that the TAO's role is subordinate to the role of the TSO, which has the exclusive function and the autonomy⁵⁴ to take all decisions affecting the development, operation and maintenance of the transmission system. ESB's role as TAO is to carry out maintenance and construction work on the transmission system (using its own resources or by outsourcing to contractors⁵⁵) in accordance with a Development Plan which has been independently determined by EirGrid and approved by the CER. ESB also draws a distinction between EirGrid's *responsibility* for all TSO tasks and the TAO functions which are to *carry out* maintenance and construction work on the transmission system. ESB further argues that it has no role in relation to market sensitive functions, in particular planning and development of the system, connection and access to the transmission system (including tariffs), or system/market operations, and is prohibited by law from directing or giving any instructions to the TSO.
- (105) EirGrid argues that ESB's role is in fact significant, covering key TSO tasks. EirGrid further notes that ESB is the exclusive provider of services to EirGrid which are essential to the discharge of its transmission functions. This position of exclusivity means that ESB does not operate as a conventional "service provider" to EirGrid. EirGrid also asserts that ESB's role provides them the scope to prioritise connections relating to its generation business ahead of other connections on the basis that ESB has the ability to manage resource availability and project delivery on transmission projects.
- (106) EirGrid's first point regarding the respective transmission functions is discussed in section 6. With regard to the scope for ESB to prioritise their own connections the SEM Committee consider while this may in theory be a possibility it is noted that there is significant oversight by CER (and indeed by EirGrid) of the TAO's performance in this regard in addition to the fact that the transmission connection offer programme is run entirely by EirGrid.⁵⁶ It is also noted that to date this has not been raised by industry. Firstly there are the statutory and regulatory duties on ESB to perform in a non-discriminatory manner and ESB is required to report on its licence compliance to the CER annually or indeed as requested. Secondly, there is the oversight of EirGrid in monitoring the plans and project delivery in addition to its "on the ground" client engineer role. It is noted by the SEM Committee that this element of "on the ground" monitoring

⁵³ It is noted that on Direction from the CER EirGrid has rapid step-in rights in the event of default or delay by ESB.

⁵⁴ Subject to regulatory oversight

⁵⁵ Contractors who may be used are subject to EirGrid approval

⁵⁶ The CER's Gate 3 Direction ([CER/08/260](#)) sets out the criteria to determine which generators should receive an offer. EirGrid reviews connection applications in this context and issues all offers, the TAO does not have a role with regard to the Offer Programme.

by a third party is absent from the ITO model. Thirdly any generator who has, or claims to have, a right to a connection offer may bring a dispute to the CER in relation to any aspect of their connection (which would include its delivery, cost, etc). If a developer suspects that ESB is acting in any way in a discriminatory manner, that developer can refer a dispute to the CER. It is also noted that the right to bring disputes under legislation⁵⁷ is very broad and is not restricted to connection issues. The CER's determination of such disputes is binding on the parties. Fourthly, the ESB as TAO is subject to the regulatory oversight of the CER in relation to the delivery of construction and maintenance projects. Capital expenditure and project delivery for construction of new infrastructure is reported to the CER quarterly against forecast timelines and expenditures. The CER reviews these reports and meets with both ESB and EirGrid to discuss progress, delays and any issues which have arisen. The transmission maintenance plan is monitored by EirGrid who may escalate any issues to the CER as they consider appropriate. It is noted that EirGrid has availed of this option in relation to issues with the 2011 plan which have been raised by EirGrid with the CER and are being examined.

- (107) The SEM Committee considers that the role of the TAO under the existing arrangements is indeed limited and that for those roles that it carries out there is significant oversight. The involvement of EirGrid in the SEM Committee's opinion, adds a significant element of independence that would not exist under the ITO model in respect of both those tasks solely undertaken by EirGrid and also those roles carried out by the TAO. The SEM Committee places considerable weight on the fact that EirGrid, as TSO, has under legislation and licence the responsibility and decision making power in relation to all the TSO tasks listed under Article 12. Furthermore where a generator feels unfairly treated, inter alia, in relation to any actions taken by the TAO a dispute may be raised with the CER. There are also escalation procedures under the Infrastructure Agreement in relation to any disputes between the TSO and TAO which may ultimately be brought to the CER.
- (108) However, notwithstanding the SEM Committee's position outlined above it is acknowledged that while limited, the TAO's role is potentially significant, and the fact that the TAO is not a legally separate entity from the VIU raises concerns with regard to the discharge of that limited role. The SEM Committee does not consider the role to be as simple as a client – service provider relationship, as suggested by ESB. Rather since EirGrid does not have the option of contracting with alternative “service providers” (in relation to TAO functions), then in the absence of any regulatory or legal oversights, ESB would be able to use its position to its own advantage, or at the very least to frustrate EirGrid's plan. However, the strong regulatory and legal controls in place (described above), ensure that ESB is not in a position to do so. In addition and with regard to the significance of the TAO role, the SEM Committee has given consideration to the ring-fencing arrangements between ESB and ESB Networks, the arrangements pertaining to the approval of funds for transmission infrastructure, the legal identity of the TAO and the legally separate independence of EirGrid in its oversight role. These issues are discussed elsewhere in this paper (sections 5 and 6).

⁵⁷ Section 34 of the Act, as amended.

4.3 ESB's Limited Role is Subject to Regulatory and Statutory Controls

- (109) Further to the matters discussed in the above section ESB consider that the limited role it does have in relation to transmission is subject to extensive controls. ESB argues that the division of responsibilities between EirGrid and ESB is governed by a combination of legislation, regulation, and contractual arrangements.⁵⁸ These mechanisms ensure that EirGrid is fully empowered to secure the operation, maintenance and development of the transmission system in whatever manner it sees fit (in line with its legislative and licence obligations as TSO). Any perception that could give rise to a belief that ESB has a degree of indirect control or influence over the activities of EirGrid is countered by the fact that even if ESB were motivated to act inappropriately and try to exert control over the activities of EirGrid as TSO, it has no actual ability to do so.
- (110) EirGrid, however, argues in its submission that the controls in place are insufficient. In particular EirGrid singles out the ring-fencing arrangements between ESB and ESB Networks as being inadequate and inferior to that which would exist under an ITO.
- (111) The SEM Committee considers that the statutory controls on the TAO are considerable. It must discharge its TAO functions in such a manner that ensures that it does not discriminate against users of the system, and such that EirGrid can fully fulfil its obligations. In addition it is obliged to fund, construct, and maintain the network in accordance with EirGrid's development and maintenance plans (Regulation 19 of Statutory Instrument 445 of 2000). The TSO also, under legislation, has rapid step-in rights in the event that the TAO delays or defaults in its obligations. These rights provide not only considerable power to the TSO, but more critically a significant threat that the TSO can credibly take action in the event that the TAO is not discharging its obligations to the TSO appropriately. That the TSO has not used these step-in rights to date is important; nonetheless the existence of such an option helps to ensure confidence in the transmission arrangements.
- (112) It is noted that as part of this process, EirGrid has raised an issue with the legislative basis of Regulation 18⁵⁹ of Statutory Instrument 445 of 2000. To the extent that EirGrid's concerns are founded and there is in fact some ambiguity in the legislation or its implementation the CER will bring this to the attention of the DCENR as a matter of urgency. To the knowledge of the CER this issue has not been raised since the enactment of the legislation nor during the agreement of the Infrastructure Agreement (which sets out the process to be followed). However, the intent of the legislation is clear; EirGrid is to have rapid step in rights where ESB defaults or delays. Regulation 18(6) does not seek to restrict EirGrid's ability to exercise step in rights where approved by the CER.
- (113) The regulatory controls, primarily through licence conditions, are also considerable and subject to change on the initiative of the CER should the CER consider it appropriate within the context of the functions of the CER, the TAO or the TSO under the legislation. However, the SEM Committee considers that there may be scope for improvement in

⁵⁸ Principally the Act, the Regulations, TAO licence and the Infrastructure Agreement

⁵⁹ EirGrid response to CER request for information, dated 19th November, 2012

relation to the contents of the TAO licence and some of the codes that sit under it (also subject to CER approval from time to time). The SEM Committee's views on the adequacy of the ring-fencing arrangements are discussed in further detail in section 5.3 (EirGrid's Key Arguments), section 6 (SEM Committee Analysis) and section 7 (Proposed Improvements to the Irish Arrangements). The SEM Committee's view on the impact of legal identities of the TSO and TAO is discussed further in section 6.4.

- (114) The discharge of ESB's functions is further controlled by the Infrastructure Agreement and associated documents which establish the contractual relationship with EirGrid. Accordingly all interactions and dependencies between the TSO and TAO are clearly defined and subject to review and approval by the CER. This provides considerable control over the TAO's role because where the interaction between the companies or the conduct of one of the companies is resulting in an undesirable outcome in practice, it is within the powers of the CER to direct a change to that process. Such a direction is binding on both parties.
- (115) Therefore the SEM Committee concurs with ESB's assessment that its role is subject to considerable statutory, regulatory and contractual controls but also acknowledges that some of the concerns raised by EirGrid have merit in terms of the implementation and day-to-day operation of those controls to date. In this context it is considered that additional ring fencing measures should be imposed on the TAO to ensure the arrangements continue to guarantee greater independence.

4.4 Transparent Transmission Arrangements

- (116) ESB's fourth argument is that the nature of the Existing Arrangements, that is the structural separation of the TSO and the TAO, the legislative and contractual relationship between them and the regulatory oversight of their respective duties and interactions, provide greater transparency and compliance with the regulatory and legislative requirements than would be possible under an ITO within a VIU. ESB argues that under the ITO model all of the transmission tasks would be carried out within the one company whereas the joint functions of the Irish Arrangements ensure that there is third party oversight of the activities of the TAO. Through this separation the CER gains greater visibility into the workings of the arrangements, the natural tension created by the interaction of two separate organisations drives efficiencies and self-regulation, and the defined relationship between TSO and TAO through the Infrastructure Agreement provides the CER with an instrument of regulation and control that would not be present in the ITO model.
- (117) EirGrid does not accept ESB's argument on the basis that the arrangements *within ESB* are not transparent and that the "split accountability model"⁶⁰ produces inefficiency. EirGrid focused on the adequacy of internal ESB ring-fencing and the suggested improved efficiency of an end-to-end process residing within one company as opposed to the transparency created by the separation of ESB and EirGrid.

⁶⁰ Term used by EirGrid

- (118) The SEM Committee considers that the “split” in functions between TAO and TSO, with the TSO being nonetheless responsible for all TSO tasks, does provide an additional level of transparency to the discharge of the transmission functions that would not exist were they all to be carried out within the internal structures of an ESB ITO. Under an ITO model, the CER would have to rely on ring-fencing provisions and a significantly increased regulatory burden to achieve an equivalent, although likely lesser, oversight of the operational discharge of the transmission functions. Instead an independent company (EirGrid) is responsible in law for the TSO functions (Article 12 tasks) and is required under its licence to carry out the functions of a TSO in a transparent and non-discriminatory manner. The role EirGrid plays in directing and monitoring the activities of the TAO is also important as there is a direct incentive on EirGrid to ensure that the TAO fulfils its role under the Infrastructure Agreement. It would be very difficult for the CER to replicate this oversight within the ITO model, while there is no doubt that EirGrid’s expertise and knowledge as TSO means that it is well placed to carry out this oversight of TAO delivery and transparency. Additionally the existence of the Infrastructure Agreement provides the CER with a means to monitor and direct changes to the transmission arrangements at a procedural level. The oversight of an ITO would have to rely on the ring-fencing arrangements and incentive structures put in place by the CER. In such arrangements it is likely that specific inefficiencies would be brought to the CER’s attention less frequently than is the case when a third party, who is responsible and faces incentives for the overall function, is overseeing the process.
- (119) The SEM Committee notes EirGrid’s point that the *internal* transparency would be increased as all functions would reside within the one company. While this is true, the increase in transparency internal to the ITO would result in a loss of *external* transparency between the market, the CER and the transmission activities.
- (120) Regarding EirGrid’s argument that a single entity may be more efficient and easier to incentivise, this is considered to be a valid point with regard to the FOU model which the European Commission has identified as the preferred transmission model. However it is not considered by the SEM Committee that this position has been proven in relation to the ITO model which is the alternative model under the 9(9) test. However, as noted by EirGrid, the efficiency of the arrangements are not directly relevant to the 9(9) test. Notwithstanding this it is the SEM Committee’s view that there is scope for improvement in the efficient conduct of the TSO and TAO tasks relating to the delivery of infrastructure projects. Therefore the CER will place further, more effective penalties and incentives on both parties to incentivise the TSO and TAO towards greater co-operation and ultimately the timely and efficient completion of infrastructure projects.
- (121) The SEM Committee also notes that this TSO Certification process has, in itself been quite divisive, exploring as it has areas of fundamental difference of opinion between TSO and TAO. This in itself is regrettable, if somewhat unavoidable given the positions which have been adopted. Upon the conclusion of this process and depending on its outcome, following an appropriate period of reflection on the decision, the CER intends to bring both parties together to discuss mechanisms to improve efficiency of delivery, with the emphasis being on the responsibility of both parties to deliver their roles more effectively to the benefit of customers.

4.5 Conclusion

- (122) In summary the SEM Committee considers that there is merit in the four arguments presented by ESB. However, it is the SEM Committee's opinion that a focus solely on the issues raised by these four arguments would not provide the holistic and robust assessment required by a purposive assessment of the 9(9) test.
- (123) Section 6 provides the SEM Committee's assessment of the arrangements taking into account the four arguments outlined above as well as the substantial amount of additional information contained in ESB's application, EirGrid's submission and the responses to the SEM Committee's requests for information.
- (124) Section 7 discusses those areas, some of which were referred to in this section, which may benefit from adjustment and improvement.

5 EirGrid's Key Arguments

- (125) EirGrid's submission argues that the Irish Arrangements do not meet the 9(9) test on the grounds that EirGrid does not carry out all of the TSO tasks listed in Article 12, EirGrid is reliant on ESB for the delivery of certain tasks and notwithstanding this, the existing arrangements do not guarantee more independence than an ITO. EirGrid suggests that the FOU or ISO models would be preferable to the ITO model. EirGrid states that it fully accepts the government's decision (i.e. that ESB should retain ownership of the assets).
- (126) The SEM Committee notes EirGrid's position with regard to the ITO model⁶¹ relative to the existing arrangements and its preference for FOU or ISO. However the SEM Committee wishes to point out that the Article 9(9) test is exclusively focused on whether the transmission arrangements presented provide for more effective independence of the TSO than the ITO arrangements. Therefore it is with reference to the ITO arrangements that the SEM Committee has carried out its analysis (see section 3.3). An analysis to determine the effectiveness of the existing arrangements against FOU or ISO models is outside the scope of this process and the 9(9) test.
- (127) EirGrid sets out a number of issues with the ESB application in addition to addressing the ESB's four key arguments.
1. A purposive approach is neither appropriate nor sufficient
 2. The relationship of ESB to EirGrid is not one of a contractor
 3. The ring-fencing within ESB is inadequate
 4. ESB's role in investment decisions can constrain funding for transmission
 5. ESB's application, via NIE, to be certified TSO in Northern Ireland is relevant

5.1 A purposive approach is neither appropriate nor sufficient

- (128) EirGrid argues in its submission that a purposive approach is neither appropriate nor sufficient. To support this position EirGrid refers to the EC Guidance Paper,⁶² some published opinions on ITO certification applications elsewhere in Europe,⁶³ and the SEM Committee's Guidance Paper (SEM-12-005). EirGrid goes on to argue that the ESB application does not actually contain a purposive approach on the basis that there is at no point any reference to the specific provisions of Chapter V and as such there is no analysis of how the existing provisions serve to guarantee more effective independence than those provisions. Accordingly EirGrid's position is that the Irish Arrangements should be assessed against each Article of Chapter V and that the 9(9) test is only met where all of the requirements in these Articles are exceeded.

⁶¹ See EirGrid response of 6th July 2012, questions 1, 39 and page 7 of annex III (presentation to DCENR)

⁶² European Commission, "Interpretive Note on Directive 2009/72/EC concerning common rules for the Internal Market in Electricity and Directive 2009/73/EC concerning common rules for the Internal Market in Natural Gas the Unbundling Regime", 22 Jan 2010

⁶³ Specifically the European Commission Opinion's of 25th November, 2011 regarding RTE (France) and TIGF (France).

- (129) The SEM Committee's rationale for adopting a purposive approach is outlined in section 3.3 of this paper. It is noted that the SEM Committee's Guidance Paper states that the SEM Committee will have regard to not only Chapter V but also of the aim of the Directive as expressed in the Recitals when assessing the independence guaranteed by the Irish Arrangements. It is also noted that the European Commission's Interpretive Note, while not providing detailed guidance on the 9(9) test, explicitly states that a 9(9) Certification provides an exception to the Directive's requirement that elements of the different models cannot be mixed in order to create a new TSO model not provided for in the Directive. This would appear to be a clear acknowledgement of the fact that those applying for a 9(9) Certification will have existing arrangements that are different from the models provided for in the Directive.
- (130) With regard to the European Commission's opinions on ITO applications to date, the SEM Committee would consider it unusual for the European Commission to take any approach other than that set out in Chapter V when assessing an application to be certified as an ITO, not least because it was for this purpose that Chapter V was written. Indeed by definition the fact these applications have been made for certification under Chapter V, means that these applications have not been subject to the Article 9(9) test for "greater independence" and accordingly have not been assessed in such a manner.
- (131) Finally with regard to whether ESB's application presented a purposive approach, it is the view of the SEM Committee that it is the SEM Committee's review of the application and submissions that should take the purposive approach. It is up to ESB and to EirGrid separately to set out their arguments in the manner they choose fit, bearing the SEM Committee's guidance note in mind. The SEM Committee is satisfied that it has taken a purposive approach to the analysis.

5.2 The relationship of ESB to EirGrid is not one of a contractor

- (132) EirGrid states in its submission that ESB and EirGrid do not have the relationship of a contractor and employer. This is on the basis that ESB carries out several transmission tasks that are tasks of the TSO, EirGrid is dependent on ESB for several of its own tasks with no alternative to ESB for these services and EirGrid has no effective control over ESB's performance. EirGrid also notes that ESB has previously stated that it is not a contractor to EirGrid, but is now making an argument to be considered as a contractor.
- (133) To address the last point first, it is noted that ESB's application while comparing their role to that of a contractor they did not say that they were EirGrid's contractor but that their role was analogous to that of a contractor. ESB clarified this further in its response to the SEM Committee's request for information. The SEM Committee tends to agree with EirGrid in that the contractor analogy is not directly applicable given that EirGrid does not have scope to use an alternative contractor or to negotiate different terms with ESB for each piece of work. The analogy is applicable in the sense that it is EirGrid who remain responsible for the work (albeit that EirGrid does not have the option to use an alternative "contractor") and the TAO must act on EirGrid's direction. However the critical question is whether the TAO's defined role under the legislation allows ESB (as VIU) to influence or undertake any decision making roles in relation to transmission functions, or

otherwise has an impact on the independence of the TSO. This core issue is addressed elsewhere in this paper. It is noted that EirGrid proposed⁶⁴ that transmission works be made contestable, allowing EirGrid choose a contractor other than ESB to carry out maintenance and construction. While the SEM Committee considers this proposal may improve the efficiency of the arrangements it is noted that a legislative change would be required and is therefore outside the power of the CER to implement.

- (134) On the issue of ESB, in its capacity as TAO, carrying out tasks that are the tasks of the TSO, this is dealt with in section 6.1. EirGrid, as licensed TSO, has the responsibility for all of the tasks of a TSO as set out in Article 12. The fact that the TAO (or indeed any other body) carries out some of these tasks is not viewed by the SEM Committee as necessarily problematic in the context of the 9(9) Certification, provided the arrangements governing the VIU's role in these tasks does not have an undue impact on the independence of the TSO.
- (135) Regarding EirGrid's concern that it is dependent on ESB to deliver several of its own tasks with no alternative to ESB for these services, it is noted that the tasks (and the manner in which they are to be carried out) for which EirGrid is dependent on ESB are defined through the Infrastructure Agreement. Their delivery and the manner in which this is achieved is subject to regulatory oversight through the TAO licence in addition to the statutory duties imposed under legislation. Therefore it is possible that there are greater levels of oversight and greater controls in place than would exist were a normal client-contractor arrangement in place. Given the level of regulatory oversight and the fact that the decision making power in relation to these tasks rests with EirGrid, the SEM Committee does not consider that the TSO's independence is negatively impacted. Whether this arrangement is efficient or not, is not a core matter for the 9(9) test.
- (136) It is further noted that where ESB does not discharge its duties satisfactorily there are dispute mechanisms under the Infrastructure Agreement and ultimately disputes may be raised with the CER for determination. Further given the complexity and interdependency that exists in the energy industry, in addition to the scale of the challenges and changes over the next ten years it would be of significant concern for the SEM Committee if the TSO were not capable of managing projects, activities and risks that involve third parties. It is the SEM Committee's view that EirGrid has responsibility (under legislation and licence) for all TSO tasks and has been provided with sufficient powers and resources to deliver these tasks. Indeed EirGrid's performance in many areas (e.g. system minutes lost, system frequency, development of Grid25 plan)⁶⁵ has shown that it has the capacity and capability to operate as a strong and effective TSO. The fact that EirGrid must cooperate with ESB in order to effectively deliver certain tasks should not in itself impact on either the independence or the effectiveness of the TSO, EirGrid.
- (137) EirGrid further argues that it has no effective control over ESB's performance. In this regard the SEM Committee notes its comments above; there are statutory obligations on ESB, licence obligations, regulatory oversight, and a contractually defined relationship

⁶⁴ EirGrid letter of 19th November, 2012

⁶⁵ Please see EirGrid's dedicated website for projects (www.eirgridprojects.com) or its main website (www.eirgrid.com) for further information.

through the Infrastructure Agreement. Within the relationship between EirGrid and ESB, it is EirGrid that has the decision making powers in relation to ESB Networks functions and ESB must implement those decisions. The carrying out of the tasks is also monitored and ultimately approved by EirGrid. Where EirGrid is of the view that ESB is not discharging its duties under the Infrastructure Agreement it may refer the matter to the CER who may issue a legally binding direction to ESB to take the necessary action (or cease taking action as the case may be).

(138) The SEM Committee further notes that under licence both EirGrid and ESB are required to review the effectiveness of the Infrastructure Agreement and to propose any modifications to the CER for approval. While no such proposals have been made to date (which may in itself indicate that there are no issues with the application of the arrangements through the Infrastructure Agreement) the SEM Committee notes that the CER would welcome discussions in this regard particularly given the concerns expressed by EirGrid in this process.

5.3 The ring-fencing within ESB is inadequate

(139) EirGrid are of the view that the ring-fencing arrangements within ESB between the VIU and the TAO are inadequate. EirGrid highlights the following areas:

- Staff movements;
- Day-to-day management interaction;
- Financial rewards based on the performance of the ESB Group;
- The use of shared services; and
- The Asset Management Agreement regarding DSO and TSO separation requirements

5.3.1 Staff Movements

(140) EirGrid notes that Recital 19 of the Directive refers to the importance of 'cooling-off' periods and that Article 19 has particular requirements on the movement of staff. EirGrid argues that such restrictions are absent from the arrangements within ESB and cites several examples of transfers of senior staff between the corporate or commercial businesses and ESB Networks.

(141) The SEM Committee, having reviewed the ESB application, finds merit in EirGrid's underlying concern in this regard and considers that, as proposed in Section 7, that a strengthening of the ring-fencing arrangements, including those relating to staff transfers would ensure that the arrangements continue to guarantee the TSO's independence.

(142) The SEM Committee however notes that the issues raised by EirGrid are somewhat mitigated by the nature of the Irish arrangements. Firstly, the role of the TAO itself is limited with no ability to influence TSO decisions. Secondly, full compliance with the ITO provisions are not necessarily required, the key is that on balance more effective independence of the TSO can be shown. Thirdly, notwithstanding the SEM Committee's

concerns in this regard, EirGrid is incorrect in its assertion that staff have full fluidity and movement between ESB Networks and all other parts of ESB.

- (143) The TAO licence places a requirement on ESB to put in place a code of conduct on the transfer and/or movement of staff which is subject to CER approval. It is also noted that internal HR procedures require all transfers from ESB Networks be reviewed against compliance obligations before taking effect. The CER has required “gardening leave” (or “cooling off” periods) in relation to some senior staff transfers. It is within the power of the CER to formalise this case-by-case approach, which the CER intends to do.
- (144) Therefore, while the SEM Committee is of the view that there is potential for improvements to the arrangements regarding staff transfers, it is considered that independence is guaranteed by the nature of the Irish arrangements themselves in addition to the fact that within these arrangements the CER may impose further restrictions on the movement of staff within ESB – with which ESB must comply. The CER considers that such restrictions should be imposed to ensure the continuing independence of the Existing Arrangements.

5.3.2 Day-to-day management interaction

- (145) EirGrid concludes that there is commonality on a day-to-day basis of personnel of both the ESB Networks business division and other members of the ESB management team at both the executive and board level. EirGrid bases this conclusion on the holding of the Executive Director Team (“EDT”) meetings, the inclusion of the ESB Group Company Secretary and the ESB Group Finance Director on the ESB Networks Ltd. board and that the Memorandum of Understanding between ESB and ESB Networks Ltd. falls short of the full managerial independence required by Chapter V of the Directive.
- (146) Regarding the EDT meetings the SEM Committee shares some of EirGrid’s concerns. The SEM Committee however does not consider that the EDT meeting structures constitutes a day-to-day management interaction that impinges on the independence of the TSO. The EDT is conducted within written guidelines (provided as part of this certification process) which note the regulatory requirements relating to ESB Networks’ DSO and TAO licences and it is not a decision making body. However, the SEM Committee does consider that the workings of the EDT may potentially be a cause for future concern. Further information regarding the EDT to that provided in the ESB application was requested and duly received. While the SEM Committee and the CER have no evidence or reason to believe (either from review of the documents received or from previous experience) that ESB has ever violated its DSO or TAO licences as a result of the EDT meetings, there is the possibility and potential that such a violation could be facilitated by the existence of regular meetings of this nature. Therefore the CER will engage with ESB with a view to ending ESB Networks’ involvement in the EDT meetings in their current form. This is discussed further in section 7.
- (147) Regarding ESB (the VIU) staff sitting on the ESB Networks Ltd. board (two out of the five members), the SEM Committee does not consider that this necessarily negatively impacts the independence of the TSO. In comparison the ITO’s Supervisory Body has a minority of independent members. It is noted that the ITO’s Supervisory Body required by the Directive has the purpose of representing and protecting the financial interests of the VIU and may contain a majority of VIU staff; furthermore decisions relating to the

infrastructure that is required and the maintenance schedules are made by EirGrid. This separation (in the form of EirGrid) of the decision-making and planning functions in relation to the transmission system constrains the ability of the ESB Networks Ltd board (whatever its composition) to influence the day-to-day operations of ESB Networks in a manner contrary to EirGrid's instructions. In implementing the Irish arrangements in accordance with the legislation, the CER has been cognisant of the need to balance the rights of the asset owner to protect its financial interests against the independent operation of the transmission system. To achieve this, it is necessary to permit the VIU some representation on the ESB Networks Ltd board. The SEM Committee does not consider that the ESB Networks Ltd board containing two members from the VIU results in an impediment to the discharge of ESB Networks Ltd's day-to-day duties in a non-discriminatory manner. Nonetheless checks and controls need to be in place with regard to the role of and activities of these board members, the limitations on ESB Networks Ltd, in terms of not being the legal owner of the assets is also noted.

- (148) As discussed elsewhere in this paper the SEM Committee does not consider that EirGrid's view, that each of the individual provisions of Chapter V must be met for a 9(9) certification, is a correct interpretation of the Directive. It is also noted that EirGrid did not have sight of the MoU when forming its initial view however subsequently received a copy upon request.
- (149) However, the SEM Committee is of the view that a review of the MoU between ESB and ESB Networks Ltd. by the CER would be timely and may be conducted upon the implementation of the measures to be implemented to ensure the arrangements continue to guarantee greater independence which are discussed in section 7. The relationship between ESB and ESB Networks Ltd is discussed in section 6.

5.3.3 Financial rewards based on the performance of the ESB Group

- (150) EirGrid argue that the Irish Arrangements are contrary to Article 19(5) of the Directive on the basis of the ESOP⁶⁶ scheme, pensions, and "cross Group cultural integration" such as newsletters, sporting activities and social events.
- (151) As discussed in this paper the SEM Committee is not of the view that compliance or non-compliance with a particular provision of Chapter V necessarily guarantees or rules out the granting of a 9(9) certification. Certification is based upon balancing all aspects of strength and weakness in the existing arrangements to determine whether the article 9(9) test is achieved.
- (152) The SEM Committee has reviewed the ESOP scheme, whereby ESB staff have a collective 5% holding in the company, and have concluded that the financial incentives are immaterial in the context of providing any motivation for a member of staff to take any discriminatory action to the benefit of a competitive business of ESB. There are also a small number of EirGrid staff who are still in the ESOP scheme. The SEM Committee does not consider this a concern given the immaterial nature of the financial incentive

⁶⁶ Employee Share Ownership Plan

itself, the small number of EirGrid staff concerned, and the fact that the situation will not persist indefinitely.

- (153) It is noted that the European Commission in its decision on the Scottish Arrangements concluded that the group wide share ownership and bonus schemes were relatively insignificant. The Scottish schemes are significantly larger in monetary terms than the ESOP dividend. Similarly with regard to pensions, while the continued financial health of the ESB Group is necessary for the continuation of the pension scheme, the connection between an individual's actions and the eventual payment of that individual's pension is so weak as to be an irrelevant consideration. Given the long timeframes involved for the individual, the probability that many staff will move to or from another company over the course of their career, and the relative inconsequentiality of any potential discriminatory action on the overall long-term performance of the pension fund lead the SEM Committee to dismiss this concern. It is also noted that a requirement to maintain a separate pension fund for ESB Networks may impact on the long-term performance of the pension funds.
- (154) The SEM Committee does not wish to restrict the social activities of ESB staff, even where those events are organised by ESB. Provided the content of newsletters and conduct at sporting and social events do not contravene the respective statutory and licence obligations, the SEM Committee does not consider that such occasions pose a risk to the independence of EirGrid as TSO or to the transmission arrangements more generally. That said, there is a strong onus on ESB to ensure that all its staff are educated with regard to their responsibilities under the relevant ring-fencing arrangements and to continue to identify and manage potential risks and concerns in co-operation with the CER.

5.3.4 The use of shared services

- (155) EirGrid raises concerns that the use of shared services across the ESB group are contrary to Article 17(2)(h). EirGrid also raises particular concerns regarding ESB International (ESBI).
- (156) Notwithstanding the SEM Committee's position outlined in this paper regarding compliance with specific provisions of Chapter V, the SEM Committee does have concerns regarding the use of shared services. While these services comply with existing ring-fencing requirements, do not include market sensitive activities, and have not lead to any suspected discriminatory behaviour to date, the SEM Committee considers that further limitations on shared services be should placed on the TAO in order to ensure that this remains the case. The measures proposed in Section 7 will limit the use of shared services with a view to their eventual phasing out within a defined period of time.
- (157) In examining the role of ESBI further, the SEM Committee requested further information from ESB, which was duly provided. Having reviewed the additional information in conjunction with the information contained in the application and EirGrid's submissions, the SEM Committee is satisfied that ESBI's role is appropriate and operates on a commercial arms-length basis. The SEM Committee also notes that EirGrid is free to contract or not contract with ESBI as it considers appropriate. Furthermore should EirGrid consider it appropriate, it could prevent ESB Networks contracting with ESBI.

Also EirGrid's role in approving the contractors that the TAO may procure from, adds to the independence of the TAO in the discharge of its duties.

5.3.5 The Asset Management Agreement regarding DSO and TSO separation requirements

(158) EirGrid argues that the Irish Arrangements as regards the distribution system does not comply with the Directive (Article 26). They also note that they were not provided with a copy of the Asset Management Agreement prior to CER approval for the DSO arrangements. EirGrid further argues that ESB does not comply with Article 9(1), Articles 13 and 14 or Chapter V of the Directive.

(159) The matter of the distribution arrangements is discussed in section 6.2. The SEM Committee considers that the arrangements for distribution are in accordance with the Directive.

(160) The SEM Committee notes that the approval, or otherwise, of documents such as the Asset Management Agreement is a matter for the CER, EirGrid's involvement is not necessary unless required by the CER. It is also noted that the DSO arrangements were the subject of public consultation.

(161) The SEM Committee notes that Article 9(9) is a derogation from the requirement to comply with the unbundling models of the Directive (FOU, ISO or ITO) so that, if certified, the arrangements represent an appropriate unbundling model and are therefore compatible with the Directive in so far as the distribution and transmission functions are combined within ESB Networks.

5.4 ESB's role in investment decisions can constrain funding for transmission

(162) EirGrid argue that ESB is solely responsible for those TSO tasks which relate to financing new investments in infrastructure. Furthermore the central funding model, in EirGrid's view, raises the possibility that the VIU may refuse to approve the funds in the annual budget or even subsequently revoke or restrict funds previously approved should the financial viability of the ESB group be at risk. EirGrid also argues that this model fails to meet the independence tests under Chapter V. EirGrid also note that they have no visibility of the internal arrangements within ESB. The ESB submission makes reference to EirGrid's ability to raise money and obtain resources independently which EirGrid argues is irrelevant given ESB's role in funding transmission infrastructure.

(163) The SEM Committee has given considerable consideration to the implications of the central funding by ESB of the transmission network. This issue is discussed in section 6. However, the SEM Committee notes that the funding arrangements failing to meet the specific criteria that pertain to the ITO is not necessarily a concern but rather the issue is how the funding arrangements sit within the Irish arrangements and to what degree they contribute, or otherwise, to the independence of the TSO in that context.

(164) Regarding EirGrid's visibility of the internal ESB arrangements, the SEM Committee notes EirGrid's position but also notes that this increase in internal transparency for "ESB ITO" comes at the expense of external transparency in terms of the transmission activities, particularly when compared to the third party visibility that would exist under

the ITO model. It is also noted that this increased transparency under the Existing Arrangements could be considered to come at the expense of the efficiency of one company carrying out all work. It could be considered that the key issue for EirGrid is whether ESB provide the funding or not, as opposed to ESB's internal processes for "sign-off" of this funding. It is noted that the CER has regulatory oversight of these matters and there are legal requirements on ESB to provide the necessary funding. Given that EirGrid decides what infrastructure is required, provided ESB grants that funding, EirGrid's involvement in ESB's internal approvals process would not add any efficiency or further independence to the process. If funding were to be withheld (i.e. in violation of the law) this would be a serious matter necessitating the CER's involvement. EirGrid would also be independently obliged to raise this issue with the CER. Therefore EirGrid's visibility of the process is less important than the decision making powers in terms of what is required to be funded. In this regard EirGrid, subject to CER oversight, has exclusive power to decide what infrastructure is required. It is important that the necessary funding is provided and it is this that the SEM Committee considers in section 6.

(165) The SEM Committee agrees with EirGrid's point that EirGrid's ability to raise money and obtain resources is not directly relevant to the issue of infrastructure funding. However, it is relevant more generally. It shows that EirGrid has a considerable level of independence and capability distinct from the VIU. This provides more weight to EirGrid's functions and powers under statute including its rapid step-in rights where ESB defaults or delays in its duties. The relevance of EirGrid's step-in rights are discussed further in section 6.

5.5 ESB's application, via NIE, to be certified TSO in Northern Ireland is relevant

(166) EirGrid argues that NIE's application for 9(9) certification in Northern Ireland is relevant to ESB's application in Ireland and that, if approved, would give ESB access to TSO information and potentially see it involved in the drafting of the European Network Codes. EirGrid also asserts that the ring-fencing at NIE is inadequate and appended the SONI submission to the NIE application in support of this.

(167) The NIE application is a separate application and has been considered by the SEM Committee separately on its merits. EirGrid's argument rests on the premise that the NIE ring-fencing arrangements are inadequate and contrary to the Directive. If the European Commission concurs with this assessment then the Northern Ireland Arrangements will not be certified, and EirGrid's concern will not materialise. If on the other hand the Northern Ireland Arrangements are certified by the European Commission then it is the case that the ring-fencing arrangements have been assessed and found to be adequate, and EirGrid's concern will be without foundation. Therefore regardless of the outcome of the NIE application it is immaterial to the ESB application.

(168) The SEM Committee considers the NIE application to be irrelevant to the ESB application.

6 SEM Committee Analysis

(169) This section sets out the SEM Committee analysis of the Irish Arrangements. The first subsections deal with issues of particular importance that while featuring in the purposive analysis warranted analysis as individual issues.

(170) This section addresses:

- The Compatibility of the existing arrangements with the Directive;
- The Distribution Arrangements;
- Common State Ownership;
- The Legal Identity of the Companies and Ownership of the Assets;
- EirGrid's Step In Rights; and
- The Purposive Analysis
 - Core areas of independence;
 - The aims of the Directive; and
 - The pillars of an effective ITO.

6.1 Compatibility of the existing arrangements with the Directive

(171) The SEM Committee considers that the Existing Arrangements in operation in Ireland - that is a separately licensed TSO and a separately licensed TAO - is compatible with the Directive. Notwithstanding the assessment of the arrangements as set out below, the respective statutory functions of the TSO and TAO do not in themselves prevent a 9(9) certification. Essentially the separation sees EirGrid, as TSO, responsible for the operation and planning (including the scheduling of maintenance) of the transmission system while ESB, as TAO, carries out the construction and maintenance of the system in accordance with the TSO's instructions. The TSO is *responsible* for all transmission tasks, even those *carried out* by the TAO. The SEM Committee considers this model to be *joint accountability* in that both TSO and TAO *are accountable to the CER* for compliance with their respective licences, which outline their roles, duties and obligations with regard to the transmission function in Ireland.

(172) The key piece of legislation here is SI 445 of 2000 European Communities (Internal Market in Electricity) Regulations, 2000, as amended by SI 60 of 2005 European Communities (Internal Market in Electricity) Regulations. These Regulations set out the respective roles of the TSO and TAO, provides for the Infrastructure Agreement and empowers the CER with oversight of these arrangements including powers of approval, direction and to determine a dispute in relation to these Regulations. Part 3 Transmission System Operator (Regulations 8-18) and Part 4 Transmission System Owner (Regulations 19-21) are of particular relevance. SI 445 of 2000 and its key sections have been explored in detail in Section 3.1.4.

(173) Regulation 8 sets out the functions of the TSO and it is noted that the TSO has a statutory function for all of the tasks set out in Article 12 of the Directive. ESB functions, granted under various electricity legislation enacted between 1925 and 1945, are regarded as a function of the TSO in so far as it is necessary for the discharge of its functions under SI 445 of 2000. Regulation 8 also provides that any difference or dispute in this regard shall be decided upon by the CER.

- (174) The TAO is expressly prohibited from directing or giving any instructions to the TSO in relation to any of the TSO functions or to exercise its property rights so as to interfere with the TSO's functions. The TAO must also comply with "any requirements considered necessary"⁶⁷ by the TSO to enable the TSO to discharge its functions.
- (175) SI 445 of 2000 places an explicit duty of non-discrimination on both the TSO and TAO.
- (176) Regulation 19 of the same Instrument sets out the functions of the TAO which are limited in scope and must be carried out in accordance with the TSO's development plan and with the Infrastructure Agreement.
- (177) The TSO and TAO are required to enter into an agreement defining their relationship - the Infrastructure Agreement. This Infrastructure Agreement is subject to the approval and ongoing monitoring of the CER. The CER has powers of direction where it is of the opinion that either party is systematically failing to comply with the terms of the Infrastructure Agreement or in the event of a material breach of the agreement.
- (178) The Regulations further provide the TSO with "rapid step-in rights" on direction by the CER in the case of delay or default by the TAO.
- (179) The SEM Committee is of the opinion that the statutory basis for the joint accountability model is fully compatible with the Directive. It is explicit in providing for the TSO to be responsible for functions which include those set out in Article 12; it explicitly requires the TAO to carry out its functions in accordance with the TSO's development plans and to assist the TSO in the discharge of its functions. Any dispute in relation to their respective functions may be brought to the CER for determination. Furthermore the Regulations provides for the detailed procedures which operate within this relationship to be set out in the Infrastructure Agreement which is subject to regulatory oversight and approval. The TSO additionally has, in legislation, the right to rapid step-in rights where the TAO delays in the carrying out of its TAO functions.
- (180) Beginning from the premise that the TAO has ownership of and carries out the construction and maintenance of the assets it is difficult to see what further legislative powers could be given to the TSO and/or the CER to ensure greater TSO independence. It is noted⁶⁸ EirGrid suggested the introduction of contestability for all transmission works (i.e. allowing persons other than the TAO carry out maintenance and construction works). While the SEM Committee is not necessarily opposed to this proposal it cannot be implemented within the current legislation and so is outside the scope of this process. It is therefore the SEM Committee's opinion that within a model where ESB retains ownership of the assets (including a maintenance and contraction role) and is required to follow EirGrid's instructions, EirGrid has sufficient powers to ensure that ESB delivers upon its instructions.
- (181) The SEM Committee also notes that the European Commission in its decision on the Scottish Arrangements has found a split in transmission functions compatible with the Directive. It is further noted that under the Scottish Arrangements, the transmission

⁶⁷ Regulation 9(2) SI 445 of 2000

⁶⁸ EirGrid letter of 19th November 2012

subsidiaries of the VIUs retain responsibility, and hence a greater degree of autonomy, for the tasks they carry out.

(182) Accordingly the SEM Committee considers that the joint accountability model is compatible with the Directive in that it requires that the functions of a TSO sit with EirGrid and requires that the TAO in carrying out its functions assist the TSO in meeting its obligations. The Regulations also provide for a considerable level of control to sit with EirGrid and notwithstanding the regulatory oversight prescribed, in the event of a dispute the TSO may refer the matter to the CER for a determination which is binding on the TAO.

6.2 Distribution Arrangements

(183) ESB Networks undertakes the functions of distribution asset owner and distribution system operator⁶⁹ in addition to its TAO role. While it is a requirement of each of its licences to operate a separate business ring-fenced from the rest of the business, the CER has previously decided⁷⁰ that the distribution and transmission businesses need not be separate from each other. ESB Networks is required to be ring-fenced from the competitive businesses.

(184) It is also noted that Article 29 permits the combined operator model provided that the operator meets the unbundling requirements of Article 9. Given that Article 9(9) is a derogation from the Directive's unbundling requirements and that therefore, if certified, the Irish Arrangements provide an unbundling model equivalent to the FOU, ISO and ITO models, it is considered that Article 29 applies in the case of the Irish Arrangements. Notwithstanding this, it is noted for clarity that the TSO is structurally separate and the DSO is legally separate from the VIU. However TAO, DSO and DAO functions are discharged by the same ring-fenced business of the VIU.

(185) The CER's original reasoning for permitting the combining of distribution and transmission functions is still applicable. Given the nature of the Irish system which is a relatively small island system with a relatively large number of rural demand customers and a high number of distribution connected generators, it is more efficient and economic to combine the maintenance and construction functions for distribution and transmission. The purpose of ring-fencing is to ensure the VIU has no competitive advantage arising from its network activities. The ring-fencing from the retail and generation businesses achieves this aim. It is difficult to see any benefit to the consumer from separation of distribution and transmission. Therefore on the basis that requiring a separation of distribution and transmission functions would increase the costs faced by consumers, result in less efficient network service and would not deliver any benefits to consumers by way of mitigating market power (in supply or generation) or otherwise, the CER remains of the view that the current situation is in the best interests of the consumer.

(186) The SEM Committee concurs with this view.

⁶⁹ Under direction of the licensed DSO, ESB Networks Limited

⁷⁰ The relevant approval has been included in ESB's application

6.3 Common State Ownership

- (187) Both ESB and EirGrid are state owned companies. 85% of the shares of ESB are held by the Minister for Public Expenditure and Reform, 10% are held by the Minister for Communications, Energy and Natural Resources, and the remaining 5% are held by staff through the ESOP scheme. 99% of EirGrid's shares are owned by the Minister for Public Expenditure and Reform with the Minister for Communications, Energy, and Natural Resources (CENR) holding one share. The Minister for CENR principally manages the shareholder relationship, being the Minister responsible for energy policy. Further information is contained in Annex 1 of the ESB application, the SEM Committee also sought further information in relation to this matter from both ESB and EirGrid.
- (188) The SEM Committee does not consider that the common state ownership reduces the independence of EirGrid or indeed of ESB Networks for several reasons. Firstly the government established EirGrid expressly to provide a TSO independent of ESB and the Ministers are cognisant of this in the discharge of their responsibilities as shareholders and policy makers. Secondly both companies have their own boards and well established governance structures to manage their day-to-day operations and Ministers are not involved in the day-to-day operations of either company. It is also noted that ESB Networks Limited has its own board. Thirdly the ownership structure is such that a number of functions require more than one Minister's approval, reducing the ability of a single Minister to unilaterally discharge the shareholder function in a manner likely to impinge on TSO independence. Fourthly the role of the CER is clearly set out in legislation and has legally enforceable powers to ensure that the legislative provisions relating to TSO independence are adhered to. The powers of the Minister to make policy directions to the CER are subject to public consultation and also cannot relate to individual licensees or energy undertakings. Lastly the ownership structure of an ITO would similarly involve state ownership but the structural separation of the shareholdings at Ministerial level that currently exists would not exist.
- (189) The SEM Committee requested information from the Minister for Communications, Energy and Natural Resources with regard to the State's shareholder role. It is the DCENR's view that the Existing Arrangements provide for greater independence than the ITO model. A copy of this response is submitted along with this paper.
- (190) Therefore given the structural separation of both companies, the context in which Ministers discharge their functions as shareholders and the regulatory framework in place the SEM Committee is of the view that the current arrangements in relation to state ownership guarantees greater independence and will continue to do so with the proposed improvements, than would be the case under an ITO.

6.4 Legal Identity of the Companies, Ownership of the Assets

- (191) As discussed in Section 3 the TSO, EirGrid, is a fully unbundled company and the TAO functions are under the management of ESB Networks Ltd (a legally separate subsidiary of the VIU). However, ESB is the licensed TAO, owns the network assets and is responsible for approving the ESB Networks budget. The TAO business is managed by a separate legal company, ESB Networks Limited. It is noted that legal separation is a feature of each of the unbundling models and as such should be considered an issue in its own right outside the purposive analysis.

(192) The rationale for considering legal separation is that firstly it is a requirement of each of the three unbundling models, secondly its purpose is to promote the independence of the management of the network company, and thirdly it ensures that the network is appropriately maintained and developed. Essentially the purpose of legal separation is to reduce the conflict of interest inherent in a VIU.

6.4.1 Legal Separation as an Unbundling Requirement

(193) While legal separation is a requirement for the FOU, ISO, and ITO models there is no such requirement under Article 9(9). Therefore the presence of legal separation under the ITO and the incomplete legal separation of the TAO, bearing in mind the full legal separation of the TSO (EirGrid) under the Irish Arrangements must be considered in terms of the relative impact on TSO independence not as an absolute requirement. The SEM Committee notes that it has taken legal advice which confirms this reading of the Directive.

(194) Notwithstanding this, the SEM Committee notes that there is a clear rationale for its inclusion. Having a distinct legal identity and all that it entails under law, facilitates a distinct separation, in practical terms as well as legal terms between the networks business and the competitive business. This in turn reduces the conflicts of interest of the staff, management and board of the networks company relative to the interests of the VIU. In the case of Ireland, EirGrid the legally separate company has full responsibility for all of the Article 12 tasks of the TSO, while ESB Networks carries out certain functions in line with its legal obligations. A full explanation of these legal obligations is contained in Section 3.

(195) However the SEM Committee notes that legal separation is not a panacea and cannot by itself be considered to guarantee the independence of the relevant company, particularly where that company remains under the umbrella of the VIU as in the case of the ITO. The separation is not complete: the director of a subsidiary will still have some regard to the interests of the parent and its shareholders. In this regard the Sector Review carried out by DG Competition⁷¹ is noted with its conclusion that full ownership unbundling was required to ensure the independence of TSO's (legally unbundled as per the second package). The Third Package by placing additional requirements on unbundling (and the preference for ownership unbundling in particular) therefore acknowledges the limitation of legal unbundling absent additional separation or regulatory controls. The extent of the separation of the TSO from the VIU (whether it is completely separate as in the case of EirGrid, or legally separate as in the case of an ITO) must be a relevant consideration in the Article 9(9) independence test.

(196) Accordingly the SEM Committee considers below the role legal separation plays in ensuring the independence of the ITO and the incomplete legal separation in the Irish Arrangements (i.e. the impact on the arrangements resulting from the staff, TAO licence and assets sitting legally within the VIU – the management of the TAO being legally separate).

⁷¹ The [final report](#) was published in 2007

6.4.2 Independence: Governance & Management

- (197) The ESB Networks Board owe its fiduciary responsibility to ESB Networks Ltd. The Managing Director and senior management are all employed by the legally separate ESB Networks Ltd. Therefore to the extent that legal separation promotes an independent-minded management team the Irish Arrangements provide this. The limitations on the role of ESB Networks Ltd. are discussed below in this subsection. The substantive issue as to whether the Irish Arrangements provide greater independence relative to the ITO in the discharge of those TAO tasks are discussed in the sections below covering the purposive analysis.
- (198) The Management of the ITO consists of a Supervisory Body and senior management. The role of the Supervisory Body is to take decisions which may have a significant impact on the value of the shareholders' assets. This includes the approval of annual and long term financial plans, the level of indebtedness of the ITO and the dividends to be distributed. It is also noted that the arrangements establishing an ITO may require the Supervisory Body to seek the approval of the shareholders for certain significant decisions, a "double majority".⁷² Senior management are responsible for the day-to-day operation of the ITO (from which the Supervisory Body is to be excluded) in particular the preparation of the Development Plan.
- (199) The Supervisory Body is composed of representatives of the VIU, third party shareholders and, where relevant staff representatives.⁷³ A majority (half plus one) of the members of the Supervisory Body are appointed by the VIU under terms determined by the VIU, the NRA may not object to the appointment of any of these members. A minority (half less one), also appointed by the VIU, must be independent of the VIU's other commercial interests and their terms of office must be notified to the NRA. The NRA may object to these appointments if doubts arise as to their professional independence. The management of the ITO are appointed by the Supervisory Body the majority of which must have not worked in the VIU for three years prior to the ITO appointment, the rest are subject to a cooling off period of six months.
- (200) ESB holds the TAO licence. The licence requires that the TAO business functions as a "separate business". Accordingly the TAO business is managed by ESB Networks Ltd, a wholly owned legal subsidiary of ESB. The relationship between ESB, ESB Networks and ESB Networks Ltd is set out in the Asset Management Agreement and the Memorandum of Understanding between the companies. These agreements oblige ESB to provide ESB Networks Ltd. with all resources necessary for the discharge of its duties; reflecting the obligations in law on ESB. The ESB Networks Ltd. board is made up of five members, two ESB members (who may not have an involvement in the day-to-day operations of the supply or generation businesses), two independent members, and the Managing Director of ESB Networks Ltd. Operational decisions are made by the ESB Networks Ltd board and approval for annual financial plans are proposed by ESB

⁷² Taking the RTE opinion as an example, the double majority of both the members of the Supervisory Body and the members of the General Assembly of shareholders is required in relation to purchase or sales of assets above €5m and the establishment of securities and guarantees. It is noted the European Commission's concern focused on the level of the threshold not on the requirement of a double majority itself.

⁷³ Other interested parties, such as employee representative, if provided for in Member State legislation.

Networks Ltd and approved by the ESB board. All finance is raised centrally at Group level. However, it must be noted that such decisions are constrained in that the decision of what works must be carried out (maintenance and construction) is imposed on the TAO by EirGrid, neither ESB Networks Ltd nor ESB has any discretion to refuse to implement the plan in full or in part. The staff of the TAO business is part of ESB Networks; this is a ring-fenced business unit of ESB managed by ESB Networks Ltd. They are employed by ESB but are subject to ring-fencing and the management of ESB Networks Ltd. As noted in Section 7 it is proposed to ensure that the ESB Networks Ltd board will contain a majority of independent members.

- (201) In considering the issue of legal identity in the context of the independence of the governance and management of the transmission companies, the SEM Committee has considered the following: the fiduciary duty; decision making; operational, day-to-day discharge of tasks; ensuring the adequate resources for its functions; ability to enter into contracts with third parties; transparency; and favouring the VIU's other businesses.
- (202) As regards fiduciary duty, the Supervisory Body of the ITO will have a duty to the subsidiary (i.e. the ITO) but will also, as required by the Directive, have a duty to the financial interests of the shareholders (i.e. the VIU, by whom they are appointed) regarding decisions relating to the transmission business.⁷⁴ The VIU, where its approval is required under double majority rules, will have a responsibility to the wider Group. Under the Existing Arrangements the members of the board of ESB Networks Ltd will have a fiduciary duty to the ESB Networks business while the ESB Board will have a duty to the wider Group (subject to its legal obligations).
- (203) Therefore there is some equivalency between the fiduciary duties of the ITO's board and that of ESB Networks Ltd. Similarly with the duties of the VIU in both cases. However, the ownership of the assets sit with the ITO on one hand and the VIU on the other; therefore the fiduciary duty of the networks company covers the assets in the ITO's case but not in the Existing Arrangements' case. A further difference is that the decision making powers of the ITO and its parent are not constrained (subject to its general duties under the legislation) whereas the discretion of ESB Networks Ltd and ESB more so, is limited. The ITO is solely responsible for TSO related decisions including whether to finance infrastructure⁷⁵ or the appropriate prioritisation. Under the Existing Arrangements the TSO, EirGrid, has the decision making power in relation to all TSO tasks, including maintenance and development plans and the prioritisation of those works. ESB does not have the ability legally, to refuse ESB Networks Ltd. the resources it requires to implement EirGrid's development plan. This obligation is further reinforced contractually through the Infrastructure Agreement with EirGrid. It is noted that in practice should it refuse the budget in full or in part, the board of ESB Networks Ltd would have a duty to dispute the decision and separately EirGrid would quickly become aware of a problem if the maintenance and construction works were not proceeding. This would then trigger regulatory and legal action.

⁷⁴ It is noted that the European Commission have expressed concerns regarding the role of the Supervisory Body. Various [ITO opinions](#) refer; RTE (France); TIGF (France); GRTgaz (France); MAVIR (Hungary); Plinovodi, d.o.o. (Slovenia); Amprion GmbH (Germany); terranets bw GmbH (Germany).

⁷⁵ The Directive provides for regulatory intervention in the event the ITO refuses to make the necessary investments, which were to be executed in the following three years, in line with the most recent Development Plan

- (204) Related to this is the next issue, legal separation as a means of reducing the conflict of interest in the decision making process. As noted above the decisions which can be made by the ITO are much greater in scope and discretion than the existing TAO. However, it is noted that under the ITO model it is largely the Supervisory Body or the management who take decisions with the VIU only having a role in specific circumstances. Whereas the ESB board has a greater role in relation to those financial decisions that are made by the ESB Networks Ltd board pursuant to its obligations.
- (205) The inherent conflict of interest is mitigated differently by both models. Under the ITO it is the legal separation of the ITO coupled with an exclusion of the Supervisory Body on operational matters. Under the Existing Arrangements it is the discharge of the TAO licence by a legally separate company coupled with a strictly limited scope of responsibility and the imposition of decisions upon it by the independent TSO.
- (206) Turning to the operational or day-to-day activities, both the Existing Arrangements and the ITO model seek to exclude the VIU and mitigate conflicts of interest in this regard. Under the ITO model in the first instance there is the legal separation of the ITO itself from the VIU and then secondly in order to mitigate the conflict of interest within the ITO there is the requirement for the Supervisory Body to exclude itself from decisions relating to operational matters and the development plan's preparation. Under the Existing Arrangements there is firstly a structural separation with EirGrid carrying out all transmission activities such as system and market operation etc but excluding maintenance and construction for which it is responsible and is carried out by ESB Networks Ltd. Secondly in relation to the TAO tasks the VIU is excluded through the legal separation existing between ESB and ESB Networks Ltd. in addition to ring-fencing requirements. The conflicts of interest are further mitigated by the role of EirGrid in the TAO tasks (approval of contractors, scheduling of works, on-site client engineer etc) as detailed in the Infrastructure Agreement.
- (207) Compliance with the measures to mitigate conflicts of interest in operational matters is ensured through regulatory oversight under the ITO model in relation to all transmission activity and under the Existing Arrangements through TSO oversight and regulatory intervention in relation to TAO tasks. It is considered that the conflicts of interest are removed in relation to EirGrid's TSO tasks by virtue of its ownership separation from the VIU.
- (208) Ensuring that the networks business has adequate resources to carry out its tasks is a concern of both the ITO model and the Existing Arrangements. Under the ITO model the ITO owns the assets, must be responsible for the collection of network charges, is obliged to ensure it has adequate resources and should not be reliant on the VIU to perform its functions. Under the Existing Arrangements the TSO, EirGrid, collects all revenues and is responsible for determining, subject to regulatory approval, the needs of the transmission system both in terms of the TSO functions and the TAO functions. Based on the requirements imposed on ESB Networks by EirGrid, the annual budget and staffing required to deliver this is prepared and submitted to the ESB board for approval. Under the legislation, licence and Infrastructure Agreement ESB must provide the necessary resources – there is no legal provision for the ESB board to refuse to provide the necessary resources. There are some shared services between ESB and ESB Networks, which comply with existing ring fencing requirements. As noted earlier in

this paper, the issue of shared services is a concern for the SEM Committee and this matter is discussed further in sections 6.6, 6.7, 6.8 and 7.

- (209) Under the ITO model, compliance with its obligations in relation to resources is ensured through regulatory oversight. Under the existing arrangements it is ensured through the TSO's decision making role, its oversight role and through regulatory oversight.
- (210) The ability to enter into contracts with third parties can be considered to be a key element of a company's ability to act independently. A legal identity makes this possible. The ITO, having a legal identity and responsibility for all transmission tasks, may enter into agreements with third parties with relatively few possible restrictions placed on this ability by its VIU. EirGrid, as TSO, may enter into agreements with third parties as required by the discharge of its duties. ESB Networks Ltd, as a legal entity, may also enter into agreements with third parties; however its ability to do this freely is constrained on two counts. Firstly there is the role of EirGrid, who has an approval role in relation to procurement of goods and services including the contractors that may be used and the design of the equipment to be procured. ESB Networks Ltd also may not enter into a contractual relationship with generators, the contractual relationship is between EirGrid and the generator with the Infrastructure Agreement determining the interface between EirGrid and ESB Networks Ltd. or ESB as the case may be. Secondly it is constrained by ESB's legal position as the TAO and the terms of the agreements between ESB and ESB Networks Ltd. This restricts its ability to independently take legal action against third parties and obliges ESB Networks Ltd not to take any action which would put ESB, as TAO, in violation of its obligations to EirGrid under the Infrastructure Agreement or associated legislation.
- (211) A subsidiary's legal identity adds an element of transparency in that the employees of the subsidiary are clearly employees of the subsidiary and not of the VIU additionally the relationship between the parent and subsidiary must be clearly set out in agreements between the two companies. In the ITO model the Directive includes a number of requirements including legal separation to achieve transparency regarding the dealings and interactions between the VIU and ITO. Under the Existing Arrangements transparency is achieved through the separation of the TSO and TAO roles under a clearly defined legal relationship in the Infrastructure Agreement. This provides transparency in relation to the day-to-day activities of the TAO. Within the TAO only the board and management are legally separate from the VIU. ESB Networks Ltd. does have a clearly defined relationship, set out in agreements, with the VIU which govern the interactions between the companies. While the ESB Networks (the business unit) staff are managed by ESB Networks Ltd. they are ultimately employed by the VIU, albeit subject to ring-fencing requirements.
- (212) A crucial aim of ensuring independent management of a network company is that it will not benefit its subsidiaries or affiliated companies in their competitive businesses. This issue is dealt with in more detail below in relation to system operation, market operation, connections and access to the system but is discussed here briefly. The ITO has responsibility for all transmission activities, including generator dispatch, operation, connections and access. Under the Existing Arrangements this is the role of EirGrid, who has no generation or supply interests. In relation to the tasks of the TAO, the actual works, (not the scheduling or prioritisation of them) non-discriminatory behaviour is

prevented through EirGrid's oversight which includes a general monitoring role of the progress of works in addition to on-the-ground oversight through the client engineer. In this context, it is noted that EirGrid's auditors have stated that EirGrid's access to the transmission assets is working well. Under the ITO model, given that all the functions sit within the ITO, there are requirements to exclude the Supervisory Body from operational decisions including those related to issuing connection offers.

6.4.3 Independence: Infrastructure & Financing

- (213) A key aim of unbundling is that the transmission network should be planned, developed and maintained in an optimal and non-discriminatory manner. Therefore ensuring development plans are prepared independently and do not favour the commercial interests of the VIU is important. Additionally the decisions in relation to which lines get financed and which are maintained are almost as important. In this context legal separation seeks to mitigate the conflict of interest that may exist where a subsidiary carries out transmission tasks. In considering the issue of legal identity and its impact on the provision of infrastructure, the SEM Committee has considered the conflicts of interest in the planning construction and maintenance of the networks; the allocation of resources within the VIU; cross subsidisation from the networks business; and in the event of a financial crisis.
- (214) The planning of construction and maintenance is carried out by EirGrid under the Existing Arrangements, ESB (either as VIU or TAO) has no input into this process. Although the TAO does have a duty to undertake the actual construction and maintenance works it does so in accordance with the TSO's Development Plan and under TSO oversight (including the TSO's on-site presence). Under the ITO model the conflict of interest is managed through the exclusion, through internal ring-fencing, of the Supervisory Body from the preparation of the development plan. Thus the VIU has no input. The management of the ITO is therefore solely responsible although it is noted that the European Commission has stated some concerns regarding the role of management under certain ITO arrangements.⁷⁶
- (215) The allocation of resources is another potential area for conflicts of interest to materialise. Under the ITO model this is mitigated firstly as discussed above by improving the independence of the network planning process. Secondly failure to execute investments for more than three years may trigger regulatory intervention. Thirdly the ITO, a separate legal entity, can raise finance independently if the VIU refuses to provide the necessary finance. And lastly the general separation of the ITO from the rest of the VIU including the requirement for a minority of the members of the Supervisory body to be subject to stricter requirements, although still representing the VIU. Essentially the ITO model seeks to achieve an optimal investment in the network through promoting an environment where the ITO will naturally take its decisions without regard to the interests of the VIU. Under the Existing Arrangements by contrast the conflict of interest is dealt with through legal obligation reinforced through structural and procedural measures. EirGrid in setting out the Development Plan is a separate company. Funding for the Plan is raised centrally by ESB, as ESB Networks Ltd does

⁷⁶ See [TIGF \(France\) opinion](#)

not own the assets raising finance independently would be problematic. However the funding requirements are imposed on ESB (what must be funded and when) by EirGrid. There is a legal obligation on ESB to provide this funding, the obligation is absolute. It is noted that this is not an abstract condition in legalisation; this obligation is reflected throughout the Existing Arrangements, in licence and the Infrastructure Agreement.

(216) It is worth considering the case where the ITO or TAO were to act in the interests of the VIU. Under an ITO, the main means the VIU has of exerting influence is through the Supervisory Body who represents it and whom it appoints on the VIU's terms. The Supervisory Body is responsible for financial matters within the ITO and so could refuse or limit finance for the annual budget or for specific projects (it is also noted that depending on the way the ITO is set up the VIU may also exercise some control in specific circumstances e.g. the "double majority"). Where specific infrastructure was not invested in, the Regulator would become aware and after a period of time could take action.⁷⁷ Where the limitation was a more general one and did not manifest itself in the failure of any one infrastructure project the Regulator would be reliant on the ITO to report a lack of funding as the cause of a more general drop in performance. The possibility of the Supervisory Body having some indirect influence on the Development Plan can also not be ruled out. Under the Existing Arrangements any failure to deliver infrastructure or meet the needs of the maintenance schedule would be observed by EirGrid who are ultimately responsible for these tasks. Under such a scenario EirGrid would have recourse first to the escalation procedures in the Infrastructure Agreement, then to the CER and ultimately would be free to avail of their rapid step-in rights. It is also noted that such persistent disregard for its statutory and licence obligations would leave ESB open to legal action by the CER.

(217) The ITO's separate legal identity and ownership of the assets mitigates the possibility of the transmission business cross subsidising the other businesses of the VIU. The Directive requires that all loans from the VIU are on a commercial basis and the ITO's ability to seek independent finance means that it may operate independently, in a financial sense, from the VIU. Although it is noted that the financial arrangements of a subsidiary are unlikely to be entirely separate from that pertaining to its parent e.g. the influence on its credit rating etc. The ESB's central financing model raises the issue of whether the competitive businesses receive an indirect cross subsidy arising from the ownership of the assets at Group level. It is noted that direct cross subsidisation is prohibited and monitored by the CER. In examining the bond yields for European utilities which are network only companies does not provide any evidence that network only companies have access to cheaper finance. This seems somewhat counter-intuitive given the lower risk profile of a networks business but it would appear that other factors and market conditions play a greater role masking any "network only" effect that may exist. Especially noticeable is the impact of the yields on sovereign debt (i.e. those companies based in countries facing financial difficulty see high rates).

(218) Notwithstanding this it is noted that the cost of capital determined under the ESB Networks Revenue Review is set with regard to an efficient networks business not the

⁷⁷ The ability of the regulator to intervene does not apply where the ITO has been unable to execute the investment due to reasons beyond its control.

cost faced, or expected to be faced, by ESB or a VIU. Therefore the TUoS⁷⁸ customer is not required to pay a higher cost of capital due to ESB being a VIU.

(219) The impact of a financial crisis within the VIU is not clear under either model and would to a large extent depend on the specific arrangements of the ITO-VIU relationship and the circumstances themselves. Therefore having considered this issue the SEM Committee does not see a particular advantage in either the ITO or the Existing Arrangements under the circumstances of the VIU facing financial crisis. Notwithstanding this the SEM Committee considers that measures may be taken to ensure that the Irish Arrangements can guarantee transmission infrastructure will continue to be funded under extreme circumstances. These measures are set out in Section 7.

6.5 EirGrid's Rapid Step In Rights

(220) The TAO is required under statute and licence to fund the TSO's development plan. This requirement is absolute, meaning that ESB must in all circumstances provide the required resources to EirGrid to deliver the development plan. Where it does not, for whatever reason, it is in direct contravention of the law. The SEM Committee through its information requests to ESB has sought assurances with regard to the absolute delivery of this legal requirement, even in the case where the VIU was experiencing an extreme and prolonged financial crisis. In response to an information request ESB provided further detail on their ability to meet their obligations from internal cash-flow (i.e. where it was not possible to access external finance).⁷⁹ They stated:

ESB has a large capital investment programme of typically c. €1Bn p.a. This is typically financed c. 50% by borrowings and c. 50% from internally generated cashflows. These proportions can vary year to year but the ratio generally holds through over the long run. ESB typically has standby liquidity in the form of its Bank Revolving Credit Facility which allows flexibility between years such that the capex funding requirement does not have to be matched exactly by new funding each year. In a period where external funding is not available, ESB will adjust its capex programme to operate within available liquidity. Given that Transmission investment takes priority in ESB's capex programmes (as outlined in Q10 above), any rationing of capex due to funding constraints is not likely to impact on transmission investment. In the period 2010 to 2012, ESB internally generated cashflow available for investment (cash generated less interest, tax and dividend) will average c. €640m p.a. In the same period, Transmission capital investment will average c. €180m p.a. Therefore, the current level of internally generated cashflow available for investment is c. 3.5 times the level of transmission investment. This gives a very high level of resilience to any constraints on capex due to the lack of availability of external funding.

⁷⁸ Transmission Use of System

⁷⁹ Page 72, question 12, ESB response to CER request for information, 18th June 2012. See also ESB application, Annex 8 (part 1)

(221) As discussed above Regulation 18(6) of SI 445 of 2000 provides for EirGrid to undertake any works where the TAO has delayed or defaulted. It 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),⁸⁰ by direction of the Commission. The costs of such work to be undertaken shall be borne by the transmission system owner.

(222) The CER may issue a direction invoking EirGrid's step in rights with or without consulting ESB beforehand. It would be expected that such consultation would take place where the direction was not urgently required. As can be seen the legislation requires that where the step in rights are used by EirGrid, ESB as TAO is required to cover the costs of the works.

(223) Therefore where ESB has the capability to finance infrastructure and maintenance, either through its regular financing arrangements or indeed through cash-flow or the sale of a non transmission asset, EirGrid's step in rights ensures that all works required by EirGrid's Development Plan can be implemented even where the TAO fails to complete the works in a timely manner.

(224) In discussions with the European Commission the issue was raised as to how robust these step-in rights are in circumstances where ESB is unable to fund the infrastructure requiring EirGrid to raise the funds itself. Therefore this section considers such a scenario, bearing in mind its extreme nature and ESB's direct contravention of the law in this scenario.

(225) These circumstances would entail a prolonged period of financial distress for ESB exceeding two years. As is noted in the supporting material to this paper ESB's funding requirements are met for the following two years on an ongoing basis. It must also assume that during this period ESB has been unable raise the funds either through accessing the markets, diverting funds earmarked for its generation business or through the sale of its non-network assets. It is noted that Ireland is currently experiencing a financial crisis requiring international assistance and preventing the State from accessing the bond markets. This has somewhat impacted on the ability of all State owned companies to access the bond markets. It is noted that notwithstanding the financial crisis all infrastructure has been funded. Therefore a more extreme scenario than the financial crisis of 2008 must be considered.

(226) It is noted that EirGrid has the ability to raise its own funds. The CER could guarantee these funds with network charges (TUoS revenue) requiring the loans were financed ahead of other expenditure. The cost of the infrastructure would be underwritten by the Irish electricity consumer. It is considered that a guarantee of this nature to a stable, secure and predictable revenue stream would be sufficient to attract investment. This assumes however that the bond markets would still be open to Irish companies and as recent history demonstrates this would depend on the nature of the crisis. It is noted that

⁸⁰ That is the list of contractors ESB may use previously agreed by EirGrid

all TUoS revenue is collected by EirGrid in the first instance, EirGrid then passes on the appropriate revenues to ESB Networks.

(227) Comparing this to a similar situation under an ITO, where the VIU was in financial distress, it is not clear that the ITO would be in a better position than EirGrid to raise the necessary finances. Much would depend on the circumstances and the structure of the ITO itself and the actions of the Supervisory Body in taking decisions which have a significant impact on the value of the shareholder's assets. It is noted that ESB does not have any of the powers provided for through the Supervisory Body in the ITO model to limit the funding of infrastructure. The ability of the ITO to raise finance would likely be negatively impacted under circumstances where its parent was unable to access the markets analogous to the case of Ireland, where the financial difficulties being experienced by the State impacted on the ability of State owned companies such as ESB (not reliant on Exchequer financing) to raise finance on the bond markets. In this context it is also noted that there is no clear evidence that network only companies can raise finance any more cheaply than VIUs. Therefore it may be the case that the VIU and ITO, facing the same macroeconomic issues would have similar difficulties raising finance. Notwithstanding this, the absolute legal requirement on ESB to finance network development provides an extra protection which is not a feature of the ITO model. This requirement would see ESB being required to sell non-network assets in order to finance network development.

6.6 Core issues of independence

(228) This section addresses the SEM Committee's views on the Irish Arrangements in areas which it sees as being core to considering the independent discharge of transmission functions. Sections 6.7 and 6.8 follow on from the discussion in this section by discussing the Irish Arrangements in the context of the aims of the Directive. In its Guidance Note SEM-12-005 the SEM Committee highlighted four areas of being of particular importance when considering a 9(9) application. These areas are:

- Resources;
- Organisation, governance and incentives;
- Information; and
- Regulation.

Additional issues considered: market operation, system operation, access and connection to the system, system charging, and system planning.

The Irish Arrangements relative to the ITO are considered against each of these areas in turn below.

6.6.1 Resources

(229) Does the applicant have the necessary human, technical, financial and physical resources to carry out its tasks and functions?

- (230) Having reviewed the ESB application, EirGrid submission and the responses to the SEM Committee's requests for information, the SEM Committee is satisfied that the TSO and TAO have the necessary resources to satisfactorily discharge their duties under legislation and their licences.
- (231) ESB and EirGrid are subject to detailed five-year reviews of all of their activities, including costs, revenues, efficiency and delivery against plans. The CER carries out this review with the assistance of qualified independent consultants. A historical review of activity over the previous five year period is carried out while revenues and targets are set for the future five year period. Both organisations have the opportunity to make submissions to outline their needs for the five year period. The CER is satisfied that this five year revenue control mechanism allows for both TAO and TSO to have the necessary human, technical, financial and physical resources to carry out their tasks. Indeed an annual review is also carried out during each year of the control period, which allows for appropriate changes to revenues and resources to take account of additional tasks and challenges. Details of the CER's determination on the current five year control period (PR3) for 2011 – 2015 can be found on the CER's website.⁸¹
- (232) Under an ITO model a similar revenue review process would be carried out. However, all decisions regarding the level of resources required and what works needed to be delivered would be made in the first instance within the ITO before seeking regulatory approval. By contrast under the Irish Arrangements an independent third party (the TSO) decides what works need to be delivered and subject to the CER's approval this determines what resources the TAO must provide. However the ITO, as a legally separate entity owning the assets, could be considered to be in a better position to ensure its own resources.
- (233) In forming its view that the necessary human, technical, financial and physical resources are available to TSO and TAO, the SEM Committee has had specific regard to the tasks set out in Articles 12 and 22 and its analysis of the tasks required by those Articles. Regarding Article 22 (Network Development and powers to make investment decisions) in particular it is noted that EirGrid, as TSO, has exclusive responsibility to prepare and submit to the CER the Network Development Plan.⁸² This plan, once approved by the CER, is binding on the TAO. The TAO is required under licence and statute to develop the network in accordance with this plan. The TAO's functions in this regard are subject to the oversight of the TSO in addition to the role of the CER. The TAO is also obliged to make the necessary funding available to allow for this network development to take place.
- (234) ESB notes in its application that transmission funding is afforded priority when funds are approved annually at a corporate level. ESB has also cited the legal obligations which require them to make this funding available with the only circumstances under which funding could be withheld or withdrawn being if the viability of the ESB group itself were

⁸¹ <http://www.cer.ie/en/electricity-transmission-network-decision-documents.aspx?article=163210c1-f11f-4713-bfc9-d3b1c2fb4df3>

⁸² Currently a five-year plan as opposed to the ten-year plan required by the Directive, it is noted that practice will conform to the requirement in the Directive. The SEM Committee does not consider this divergence material.

in jeopardy. However the SEM Committee notes that in such a scenario transmission funding still has priority under the legislation.

- (235) The SEM Committee considers that the legal obligations on the ESB ensure that transmission infrastructure is indeed afforded priority within the ESB annual budget. This is supported by experience to date. It is especially noted that this is despite the last number of years being a particularly challenging time financially coinciding with a considerable level of infrastructure investment under the Grid25 programme. However the SEM Committee is of the view that this fact should be explicitly and definitively reflected in the TAO licence. Therefore the CER will review the TAO licence and insert such a condition to ensure the continued effectiveness of the arrangements.
- (236) ESB undertook some analysis of the difference in bond yields of Network-only companies compared with VIUs. The ESB's analysis and EirGrid's critique of it provides no clear evidence that either structure provides any systemic advantage over the other in this regard. It is noted that, perhaps counter-intuitively, other factors play a greater role than the perceived low-risk network-only business. The SEM Committee is of the view that based on the submissions, the Irish consumer is neither advantaged nor disadvantaged from a funding point of view by the current structure of the TAO (i.e. network only against VIU); that is there is no clear evidence that funding on a network-only basis would have any impact on the consumers in terms of higher or lower funding costs. It is noted that the WACC⁸³ is calculated based on the rate at which an efficient networks company facing the same conditions would be able to procure capital. Were it the case that ESB was unable to procure finance at this rate due to its non-network businesses it would not be compensated through regulated revenues.
- (237) It should also be noted that Ireland is currently going through an unprecedented financial crisis. ESB (and indeed EirGrid) by virtue of their status as semi-state companies may see higher debt costs in the medium term associated with a "sovereign risk". It would be a further unnecessary risk to the funding of the transmission network to require changes to the funding model at this point without any guaranteed benefits. It is also noted that ESB argue that extremely high costs would be incurred in the move to an ITO model.⁸⁴
- (238) The SEM Committee also notes that the approved EirGrid Network Development Plan has yet to be refused the necessary funds. The SEM Committee notes that several issues regarding the outage programme have been recently raised with the CER. The CER is currently examining this matter with EirGrid and ESB Networks. The SEM Committee does not consider that these issues point to a deficiency in the resourcing of the TSO or TAO and considers the fact that the issue has been escalated to the CER to be a sign that the existing arrangements and procedures to escalate issues work. It is unlikely that such an issue would be escalated to the CER under the ITO model and would have required the CER to initiate the investigation most likely at a later stage. EirGrid's argument that such issues would not arise were they responsible for carrying out the tasks currently carried out by ESB Networks is noted however the arrangements

⁸³ Weighted Cost of Capital

⁸⁴ See ESB response of 16th October, 2012

under the ITO would not provide a similar guarantee that such issues would be identified by the CER at an early stage.

6.6.2 Organisation, Governance and Incentives

(239) How effective are the arrangements in ensuring that TSO functions are performed independently of any VIU concerned? How effective are the arrangements in removing the incentive for the VIU concerned to discriminate against competitors as regards network access and investment?

(240) This criterion must be considered in several parts;

- the independent discharge of the TSO duties;
- the ability of the VIU to discriminate against competitors; and
- the VIU's incentives for so discriminating.

(241) As noted previously, EirGrid as TSO has responsibility for all TSO tasks as set out in the Directive. The TSO is fully separate from the VIU. Therefore in terms of the organisation, governance and incentives in place for EirGrid, the SEM Committee is satisfied that independence from the VIU is guaranteed and that the level of guarantee of effective independence is well in excess of that which would be provided by the ITO model and will continue to do so with the proposed improvements to clearly guarantee them into the future. It is noted that both ESB and EirGrid are in agreement on this point.

(242) EirGrid does however state that ESB carries out several TSO tasks and that EirGrid is dependent on ESB for some of its own tasks. This relates also to the second part of the criterion addressed in this section; the ability of the VIU to discriminate against competitors. As outlined in section 6.4 there is incomplete legal separation within ESB Networks and the SEM Committee has been cognisant of this fact when conducting its analysis.

(243) The tasks of the TAO,⁸⁵ in summary, are:

- to maintain the transmission system and carry out construction in accordance with the TSO's development plan;
- in accordance with the Infrastructure Agreement, implement any other works required under the TSO's development plan or the Regulations;
- to provide the TSO with such information as the TSO requires;
- to not dispose of any assets of the transmission system or create any encumbrance over the transmission system without prior notification to the TSO and the CER. Where considered material by the CER the consent of both the TSO and the CER is required prior to the disposal/encumbrance; and

⁸⁵ Regulation 19, SI 445 of 2000

- to comply with any CER directions or regulations and to comply with its licence.

(244) As can be seen from the TAO's tasks there is a limitation on the extent to which the TAO has the ability to discriminate as it is unable to take any action on its own initiative. Its activities must be in accordance with the TSO's development plan and the Infrastructure Agreement. Therefore the only scope for discriminatory behaviour could be in the carrying out of infrastructure works in such a way that adversely impacts connecting generators while benefiting the connection of generation assets associated with the VIU. In this regard it is noted that the TAO is ring-fenced from the rest of the VIU, all connection offers are issued by the TSO, the TSO has oversight of the TAO's activities in this regard, the TSO has rapid step-in rights, and that the legislation allows a generator to raise a dispute with the CER on very broad grounds.

(245) Given the above points the SEM Committee considers that the TAO has very limited ability to discriminate if it were so inclined. In particular where such discrimination were to arise, or thought to arise, the existing arrangements provide for the TSO and/or the affected party to take action and will continue to do so with the proposed improvements.

(246) Taking the final part of this section's criterion, the SEM Committee considers that there should be two main elements in the VIU having an incentive to act in a discriminatory manner. The first being the likelihood of such action being successful (i.e. remains undetected and there are no repercussions) and the second being the ability of the VIU to co-ordinate such activity (i.e. an absence of ring-fencing).

(247) As discussed above any discriminatory action taken would be unlikely to be successful given the role of the TSO (particularly in issuing connection offers under the GPA⁸⁶ process) and the ability of the generator to raise a dispute. The SEM Committee considers the transparency created by the TSO's role combined with, inter alia, the CER's dispute resolution powers provides a stronger guarantee against such action than would be the case under the ITO model.

(248) It is noted that the ITO model envisages stricter ring-fencing requirements than are in place in the TAO under the Existing Arrangements. For the purposes of the 9(9) test these requirements must be balanced against the extent to which such requirements are relevant given the other elements which are features of the Irish Arrangements. The adequacy of the ring-fencing within ESB compared to the ITO is discussed further in section 6.8 (ITO pillars) and issue of legal separation has been discussed in section 6.4.

(249) The adequacy of the ring-fencing within ESB and the legal identity of the TAO was given considerable attention by the SEM Committee and a significant amount of additional material was requested from ESB, which was provided. It is noted that no instances of a breach in the existing ring-fencing provisions have been previously brought to the attention of the CER by industry. Having reviewed ESB's submissions in addition to the fact that there is no evidence that ESB has ever violated its ring-fencing requirements or has acted in a discriminatory manner the SEM Committee considers that the

⁸⁶ [CER/08/260](#)

arrangements in place are sufficient to mitigate the possibility of such discriminatory behaviour and will continue to do so with the proposed improvements.

(250) The legislation places a requirement on the TAO not to act in a manner that unfairly discriminates against other parties, particularly in favour of the VIU's businesses. The TAO is separately licensed and as a condition of that licence the TAO must operate a separate business with adequate ring-fencing arrangements. These ring-fencing arrangements are subject to the approval of the CER and may be revised where the CER considers it necessary.

(251) Having reviewed the ring-fencing arrangements in place in the TAO, the SEM Committee is satisfied that the Irish arrangements have provided for sufficient ring-fencing to guarantee the effective independence of the TSO and will continue to do so with the proposed improvements. In terms of the implementation of the ring-fencing arrangements and guaranteeing independence is ensured in the future the SEM Committee considers that there is scope for improvement, in particular in relation to the attendance of ESB Networks at the ESB Executive Director Team meetings and a formalisation of the quarantine arrangements for transfers of senior staff. The CER will require changes to the Code of Conduct which sits under the TAO licence in addition to the MoU between ESB and ESB Networks Limited in this regard.

6.6.3 Information

(252) How effective are the arrangements in preventing the VIU concerned obtaining access to information relating to the performance of TSO functions?

(253) The TAO is obliged⁸⁷ to provide the TSO with any information the TSO requires for the discharge of its duties. The Infrastructure Agreement further sets out the procedures for all interactions between the companies. The Infrastructure Agreement is subject to the approval of the CER, while either party may raise issues regarding the effectiveness of the agreement with the CER. The CER has the power to make a determination in the event of a dispute.

(254) The TAO is further obliged⁸⁸ to preserve the confidentiality of commercially sensitive information. This obligation is further reinforced through the ring-fencing requirements.

(255) The SEM Committee is satisfied that the TSO has access to all of the necessary information required to fulfil its duties and will continue to have the necessary access with the proposed improvements. The TSO is a structurally separate and independent company with the power to raise a dispute with the CER should the TAO ever refuse to provide the necessary information and that the Infrastructure Agreement clearly formalises the process. These would not be features of the ITO model where the regulator would rely solely on internal ring-fencing arrangements creating sufficient independence that the TSO would assert its right to access information that the VIU was withholding.

⁸⁷ Regulation 19 of the SI 445 of 2000

⁸⁸ Regulation 21 of SI 445 of 2000

6.6.4 Regulation

- (256) How effective are the arrangements in terms of producing a regulatory regime which is transparent and efficient and not overly onerous for the National Regulatory Authority?
- (257) The CER regulates the industry through, inter alia, the powers of direction explicitly provided in legislation, licensing powers which include the power to make changes to licences without the licence holder's consent, and its dispute resolution powers. The key documents underpinning the regulation of the transmission arrangements consist of the TSO licence, TAO licence and the Infrastructure Agreement.
- (258) Under an ITO model the CER would only have to regulate the ITO and in doing so would rely on its compliance with its TSO licence. The CER would have no further insight into the internal ITO transmission arrangements than that which it observes as a result of compliance reporting and explicit requests for information. This would require greater regulatory oversight than the existing arrangements. It is noted that this view is consistent with the provisions of the Directive which require greater regulatory oversight to compensate for a lesser degree of structural separation of the TSO (i.e. comparing the FOU, ISO and ITO models).
- (259) The existing arrangements, through the Infrastructure Agreement, provide the CER with a regulatory instrument that allows the CER monitor the transmission arrangements at a procedural level without placing an onerous burden on the CER. The separation of the TSO and TAO itself, and the natural tension such a separation creates, ensures that issues are brought to the CER's attention at an earlier stage than would be possible under the ITO model. This is reflective of the fact that difficulties will become apparent at a working level well in advance of becoming apparent to an external observer thus prompting regulatory involvement. It is also noted, as discussed above, that the CER would not be able to replicate the on-the-ground oversight of infrastructure works that EirGrid currently carries out.
- (260) This structural separation also provides greater transparency in the event of a third party raising a dispute with the CER.

6.6.5 Other Issues

- (261) In addition to the areas raised in the SEM Committee's guidance note several other areas of relevance were considered by the SEM Committee in assessing the 9(9) application.

6.6.5.1 Market Operation

- (262) The Market Operator (SEMO) is a joint venture between the TSO in Northern Ireland and the TSO in Ireland, both part of the EirGrid group. Given the central role SEMO plays in the administration and operation of the market it is essential that SEMO be independent of any competitive or trading activity. It is also essential that the industry can trust that the market operator is truly impartial.
- (263) It is considered likely that the ITO model (were SEMO to be part of the ITO) would not provide a sufficient level of independence in this regard. EirGrid's concerns regarding

the legal implications of moving SEMO into the ITO are also noted in this regard. While it would be possible for SEMO to remain structurally separate were EirGrid's TSO functions transferred to ESB ITO and EirGrid were to remain outside ESB, this would create inefficiencies in terms of SEMO's access to system operator data. Furthermore this data would then be less independent, coming as it would from an ITO rather than from an independent TSO.

(264) It is also noted that while EirGrid is of the view that the ITO provides greater independence for the TSO than the existing arrangements, it believes that SEMO's independence is better guaranteed by the existing arrangements. EirGrid do not view the integration of SEMO into an ITO or its separation from the TSO as being beneficial to the industry or to its independence.

(265) The SEM Committee concurs with EirGrid's position regarding the market operator. Furthermore, the SEM Committee considers that the role of SEMO residing within a structurally separate TSO guarantees significantly more effective independence than would be the case under the ITO model.

6.6.5.2 System Operation

(266) EirGrid currently operates the Irish transmission system. The National Control Centre is run by and located in EirGrid. The back-up control centre is similarly run by EirGrid. The SEM Committee considers that the independent operation of the system including making decisions relating to the scheduling and dispatch of generators is a centrally important TSO task, where independence and impartiality is fundamental. A task of such central importance to the market should not be undertaken by an entity with commercial interests in generation and supply. As such the greater the degree of independence in this function provides a materially greater level of independence in the transmission arrangements in general.

(267) Ireland and Northern Ireland operate a central dispatch model as opposed to a self dispatch model in operation elsewhere in Europe. Therefore the decisions of the system operator have a material impact on the market and the payments received by generators.

(268) The SEM Committee considers that EirGrid undertaking the operation of the system guarantees significantly greater independence than would be the case were the National Control Centre to be located in and run by an ITO. The fact that EirGrid is independent and is seen to be independent in its operation of the system is critical to the confidence of market participants; it is the view of the SEM Committee that it is unlikely that the same level of confidence would exist under an ITO model.

6.6.5.3 Access and Connection to the System

(269) Connection to the transmission system is granted in accordance with the Group Processing Approach. This involves processing generators' applications for connection in a single group or "Gate". EirGrid processes transmission applications, ESB Networks Limited as DSO process distribution applications. The criteria for entry into the Gate are

set by the CER and then the System Operators issue connection offers to those generators who meet those criteria. The current connection process is Gate 3⁸⁹ while there is also provision to apply for connection outside the GPA process. Such “non-GPA”⁹⁰ applications are also processed by the System Operators in accordance with the criteria established by the CER.

- (270) As regards the transmission applications the process is conducted entirely by EirGrid. The offers are issued by EirGrid, the connection method is determined by EirGrid, the connection agreements with the customer are signed by EirGrid, all modelling to determine the levels and dates for firm access quantities are carried out by EirGrid. The TAO has no visibility of the planning or detail of transmission connection offers.
- (271) Therefore under the Irish arrangements connection access to the system is determined by EirGrid, who develop and issue connection offers in accordance with CER criteria. All interaction with the customer is conducted by EirGrid, while the TAO has no role. EirGrid argues in its submission that as the TAO carries out the works once construction begins EirGrid cannot guarantee non-discriminatory access to the system. This argument is not accepted by the SEM Committee. The SEM Committee considers that EirGrid has sufficient means at its disposal (in terms of resources, powers under legislation etc) in order to ensure non-discriminatory access.
- (272) Gaining access to the system can be seen in two parts; being granted access and being physically connected to the system. On the first part the TAO has no involvement. Once works commence (the second part), any delay or default on the part of the TAO allows the TSO to exercise their rapid step-in rights if they consider it appropriate. The generator in question may also raise a dispute with the CER regarding the actions of either the TAO or TSO. Therefore with these controls in place, the CER considers that EirGrid can guarantee non-discriminatory connection access to the system. Under the ITO model non-discriminatory access is guaranteed by the independence due to ring-fencing from the VIU as opposed to the structural separation of the TSO.
- (273) It is noted that real-time access to the system is determined by EirGrid, the TAO has no involvement.
- (274) The SEM Committee considers that EirGrid’s role in determining access to the transmission system guarantees greater independence than would be the case under the ITO model and will continue to do so with the proposed improvements in place.

6.6.5.4 System Charges

- (275) System charges are calculated and collected by EirGrid. The relevant charges are approved by the CER on an annual basis and are set at a level sufficient to cover the TSO’s and TAO’s efficiently incurred costs. The TAO’s costs form an input into the charges seen by the customer but the customer does not interact with TAO. The TAO’s costs are also subject to regulatory approval. Connection charges are similarly set and collected by EirGrid. These charges are also subject to CER approval.

⁸⁹ CER Direction on Criteria for Gate 3 and Related Matters ([CER/08/260](#))

⁹⁰ Decision Paper Treatment of Small, Renewable and Low Carbon Generators outside the GPA ([CER/09/099](#))

- (276) The existing arrangements differ from the charging arrangements that would occur under an ITO model in that the charges are proposed for CER's approval and collected by a structurally separate independent TSO as opposed to a ring-fenced TSO owned by the VIU. It is also noted that separate calculation of the TAO's costs could be considered to provide an additional level of transparency that would not exist within an ITO. As previously noted the TAO's costs are subject to a separate five year review carried out by the CER, as well as annual reviews during the five year control period. This allows for both additional transparency of TAO costs than would be possible under ITO, as well as allowing stakeholders an opportunity to comment separately on TSO and TAO costs during the consultation phase.
- (277) The SEM Committee considers that the TSO's role in relation to system charges and the separation between TAO and TSO, guarantees greater independence than would be the case under the ITO model and will continue to do so with the proposed improvements in place. Therefore as discussed in Section 7 the SEM Committee considers that measures should be implemented to ensure that this continues to be the case into the future.

6.6.5.5 System Planning and Development

- (278) EirGrid as TSO, has responsibility for system planning and the development of the network. EirGrid carries out all system planning itself and prepares a development plan. ESB, as TAO, is bound by that plan and must carry out the works and make the investment necessary to give effect to the plan. It is noted that the TAO has no involvement in the drafting of the development plan. The development plan is subject to the approval of the CER.
- (279) The separation of the system planning function from the ownership of the assets and the commercial interest in the outcome of the plan that ownership implies removes a potential conflict of interest that would occur under an ITO model. As the TSO does not own the assets it has no commercial incentive to seek to build more infrastructure than is necessary to develop the system in line with expected needs.
- (280) Under the ITO the development plan is central to ensuring the appropriate infrastructure is provided. Whether the ITO has adequately delivered infrastructure and whether regulatory intervention is required is determined in reference to the development plan. To ensure its independent preparation the Supervisory Body is expressly excluded. It is also noted that under the Scottish Arrangements, the only other 9(9) certification to date, the subsidiaries of the VIUs play a significant role in system planning. In Ireland system planning is the exclusively the function of the TSO, a fully independent party, which is binding on the TAO.
- (281) The SEM Committee considers that the TSO's role in relation to system planning and development in addition to the separate ownership of the assets guarantees significantly greater independence than would be the case under the ITO model and will continue to do so with the proposed improvements.

6.7 Assessment against Aims of Effective Unbundling

(282) The application has been assessed taking the following into consideration. Any system of unbundling should remove conflicts of interest and ensure:

- fair competition;
- sufficient investment;
- access for new entrants;
- integration of electricity markets; and
- should not create an overly onerous regulatory regime for national regulatory authorities.

(283) In relation to the aims cited above, the SEM Committee notes that while to the extent that the Existing Arrangements have delivered on these aims to date there is of course no guarantee that they will continue to do so into the future. Accordingly the SEM Committee has proposed changes to the arrangements set out in Section 7 to ensure the aims of the Directive continue to be met into the future.

6.7.1 Fair Competition⁹¹

(284) The Irish electricity retail market has been fully open to competition since 2005 and there has been full tariff deregulation since April 2011. There were seven active suppliers in 2011 and four new electricity supply licences were issued in 2011. Electric Ireland (formerly ESB Customer Supply) had a market share of 57% in the electricity market and 1.7% in the gas market. The switching rate was 11% in 2011 which is down from the rates seen in 2010 and 2009. However the 2009 and 2010 switching rates were very high by international standards and so the 2011 rate is still considered representative of a highly active market.

(285) The SEM Committee considers that the Irish retail market and the SEM exhibit fair competition particularly when the size of the market is taken into account. In addition, the transparency of the SEM and the simple nature of the retail-market switching process promotes further competition, new entry and makes it very difficult for any market participant to attempt to exercise market power. The current level of competition makes it evident that the existing arrangements are effectively delivering fair competition in the market or at the very least are not inhibiting competition.

(286) The SEM Committee considers that this aim of effective unbundling is met by the existing arrangements and will continue to do so with the proposed improvements. It is unlikely that an ITO model would promote competition as effectively as the existing arrangements due to the fact that the ITO remains a company of the VIU and would be seen to be less independent than the structurally independent EirGrid.

⁹¹ Not explicitly referenced in Recital 12 but is explicitly noted in Recital 19 in the context of the aims of unbundling and it is accordingly considered appropriate to address fair competition here.

6.7.2 Sufficient Investment

(287) Since 2000 there has been considerable investment in the transmission system relative to the preceding 20 years. This is particularly so in more recent years due to the 2020 renewables targets, the increasing penetration of wind as well as projected growth in electricity demand. The Grid 25 programme, which represents the projected infrastructure requirements for 2025, has an approximate value of €3.2bn⁹² comprising 2,200 km of upgrades and 1,150km of new build. Ireland currently has 6,750 km of high voltage network (i.e. the equivalent of almost half the existing high voltage network is covered by the programme).

(288) Given the consistent levels of investment in the transmission network over the last decade and substantially larger current and future investments under the Grid 25 programme, the SEM Committee considers that this aim of effective unbundling is met by the existing arrangements and will continue to do so with the proposed improvements. There have been no instances where required investment has not taken place.

6.7.3 Access for New Entrants

(289) Since 2000 installed capacity has increased from under 5GW to under 9GW on the Irish system⁹³. The current connection process, Gate 3, has seen almost 4GW receive connection offers. Based on current demand forecasts EirGrid estimates that approximately 30-40% of Gate 3 is required to connect in order to meet Ireland's 2020 target of 40% renewable electricity. There is also in excess of a further 20GW in the queue outside Gate 3. Peak demand in Ireland in 2011 was 4.64GW⁹⁴ and the total electricity requirement was 27GWh.

(290) Therefore it can be seen that there are high volumes of applicants seeking to connect to the Irish system, several times the amount that could be supported by current, or forecast, demand. There has also been a substantial amount of generation connected and an unprecedented volume of generation has been issued offers under Gate 3, with 1,280MW already accepted⁹⁵.

(291) Based on current connections, the volume of generation seeking connection offers and those expected to connect under Gate 3, the SEM Committee considers that this aim of effective unbundling is met by the existing arrangements and will continue to do so with the proposed improvements. Therefore improvements to guarantee this continues are discussed in Section 7. Furthermore, the fact that CER sets the connection policy (in line with SEM access rules) and monitors the implementation of this policy further ensures that the existing arrangements continue to deliver efficient access for new entrants. It is also noted that the Gate 3 project and associated issues are discussed with industry at

⁹² Revised down from an initial forecast of €4 billion

⁹³ Includes 7GW of dispatchable plant. Generation Capacity Statements available on [EirGrid's website](#)

⁹⁴ In 2010 it was 5.1GW due to an exceptionally cold winter.

⁹⁵ The Gate 3 process has not yet concluded in that all offers have not yet been accepted. However, this delay is due to the ongoing SEM Committee consultation process on Tie Breaks in Curtailment Situations [SEM-12-028](#) and is unrelated to the transmission arrangements themselves.

the bi-monthly *Gate 3 Liaison Group*⁹⁶ which is chaired by the CER and attended by representatives from the TSO, DSO, conventional generators and renewable generators.

(292) There is also provision to connect generation outside the current Gate 3 process under the CER's non-GPA policy (CER/09/099).

6.7.4 Integration of Electricity Markets

(293) As discussed in the introductory section of this paper, the SEM is an all-island market – an integrated wholesale electricity market for Ireland and Northern Ireland. It is noted that the level of integration currently achieved on the island is significant in terms of existing market integration across Europe.

(294) The SEM Committee is also currently undertaking a review of the SEM arrangements with regard to ensuring compliance with and implementation of the European target model in Ireland and Northern Ireland, including greater integration with neighbouring markets.⁹⁷

(295) EirGrid is a particularly active member of ENTSO-E, particularly relative to the size of the Irish system. ESB has no involvement in the development of Network Codes or any other ENSTO-E activity.

(296) Given the Irish market's high degree of integration with Northern Ireland and the current plans to further integrate with Great Britain and France, the SEM Committee considers that this aim of effective unbundling is met by the existing arrangements and will continue to do so with the proposed improvements.

6.7.5 Regulatory Burden

(297) The SEM Committee and the CER do not consider that the existing arrangements create overly burdensome regulatory responsibilities for the CER. It is noted that under an ITO model, given the increased reliance on ring-fencing to achieve TSO independence, the CER would be required to expend significantly more time and resources in regulating, monitoring and auditing the ITO than is currently required for the structurally separate TSO. It is also noted that the potential for the TSO, on its own initiative, to raise a dispute with the CER pursuant to action taken by the VIU would no longer be a possibility. Under the ITO model (unless a generator had been directly impacted) the CER would be the only party capable of initiating a similar process.

(298) Given that the ITO model would place a greater regulatory burden on the CER despite providing less robust regulatory oversight than is currently the case under the Existing Arrangements, the SEM Committee considers that this aim of effective unbundling is met more effectively by the existing arrangements, than would be the case under ITO.

⁹⁶ The Gate 3 Liaison Group was established under the Gate 3 direction (CER/08/260) more information on the Liaison Group is available [here](#) on the CER website.

⁹⁷ Recent SEM papers in relation to European market integration can be found [here](#).

6.8 Assessment against the Pillars of Effective Unbundling

(299) When comparing the existing arrangements against the requirements for an ITO the following pillars of an effective ITO model must be considered:

- a pillar of organisational measures and measures relating to the governance of transmission system operators;
- a pillar of measures relating to investment, connecting new production capacities to the network and market integration through regional cooperation; and
- inter alia, certain 'cooling-off' periods during which no management or other relevant activity giving access to the same information as could have been obtained in a managerial position is exercised in the vertically integrated undertaking.

6.8.1 Governance: Organisational Measures

(300) The ITO organisational measures essentially consists of separating the TSO from the VIU to a substantial degree while still permitting the VIU's ownership of the TSO and transmission system, protect its property rights and its return on investment. The inherent conflict between VIU control and TSO independence is managed through formal legal separation of the ITO, ring-fencing, strict regulatory oversight, a formalisation of the permitted interactions between the VIU and the ITO and of the interactions of the Supervisory Body and Management Board within the ITO.

(301) Comparing this to the Irish arrangements the SEM Committee has focused on these requirements in light of their aims.

(302) The key difference between the organisational measures under the Irish arrangements and those of the ITO is the separation of the TSO from the TAO. This results in all decision making functions relating to the transmission system being fully separate and removed from the control of the VIU. The structural separation of EirGrid ensures that the TSO is independent of the VIU and can act independently in the discharge of its functions. Therefore the SEM Committee is of the view that the current organisational measures exceed those of the ITO in respect of ensuring the TSO's independent decision making.

(303) However, the organisational measures of the ITO also seek to limit the control of the VIU over the transmission assets. This is achieved through the legal separation of the TSO, specific structural changes (such as a Supervisory Board and a Compliance Officer) and increased regulatory oversight. The organisational separation of the TAO from the VIU is not equivalent to the separation envisaged by the ITO. The TAO is not a legally separate entity. The TAO functions are discharged by a separate business unit ring-fenced from the rest of the organisation managed by a legally separate subsidiary and the approval of the VIU Board must be sought for the annual TAO budget. It is noted however that the VIU does not have the discretion to refuse to provide the resources (financial and human through ESB Networks) deemed necessary by the TSO's development plan as approved by the Regulator. Therefore the SEM Committee is of the view that the current organisational measures in this regard fall short of those of the ITO in respect of

ensuring the independence of the TAO, but not of the TSO. It is noted that further improvements to the Arrangements are proposed in Section 7 with a view to ensuring this concern does not materialise in the future.

- (304) The SEM Committee is of the view that the organisational pillar of the ITO is most important in terms of its seeking to ensure the independent decision making and removal of the VIU's influence in the discharge of the TSO functions. This is particularly clear as the organisational measures that relate to the TSO functions seek to isolate the ITO from the VIU while those relating to the assets allow for the involvement of the VIU, albeit through the Supervisory Body.⁹⁸ Therefore the SEM Committee puts greater weight on those organisational measures relating to the decision-making and day-to-day operational functions. Accordingly the structural separation of EirGrid coupled with its responsibilities and powers under legislation lend significantly greater organisational independence than would be the case under an ITO. Furthermore when viewed in the context of EirGrid's role as TSO, the organisational shortcomings of the TAO relative to the ITO are reduced in significance.
- (305) Therefore on balance, the SEM Committee considers that the existing arrangements currently provide greater independence through the current governance and organisational measures than those that would exist under an ITO by virtue of EirGrid's functions. The SEM Committee however considers that the TAO governance arrangements fall short of the ITO in the absence of the proposed improvements. There is scope to enhance and strengthen the current governance and organisational measures in the TAO, within the existing arrangements to ensure this greater independence is maintained in the future. These are discussion in section 7.

6.8.2 Investment, Connections, Regional Integration

- (306) Chapter V (the ITO) contains several measures relating to the second pillar of the ITO. Principally the ten-year network development plan provides the framework for infrastructure investment setting out the system needs, anticipated infrastructure and a timeframe for project deliveries. The plan must also take account of regional integration. It is notable that the Supervisory Body is explicitly excluded from decisions relating to the preparation of the ten-year development plan. There is also provision for regulatory intervention to ensure investments are made where the identified necessary investments are not executed by the ITO. The measures relating to connections require that the TSO establish transparent and efficient procedures for non-discriminatory access and strictly limits the TSO's ability to refuse connections.
- (307) Given the role and importance of the ten-year network development plan, the SEM Committee considers it and its independent preparation to be central to the full effectiveness of the second pillar. Under the ITO model, it is the plan that determines what investment is necessary and it is against the plan (or failure to deliver the plan) that the need for regulatory intervention is assessed. It is also noted that the level of regulatory intervention required under the ITO to ensure investments are carried out is not required by the ISO or FOU models.

⁹⁸ See for example Article 18(4) and Article 20(1) of the Directive

- (308) However, it is noted that finance is raised centrally by ESB, ESB Networks Ltd cannot raise finance independently and is reliant on ESB as TAO, for funds, albeit that ESB has no legal ability to refuse the necessary funds.
- (309) Under the existing arrangements the Development Plan is prepared by the TSO, EirGrid, and submitted to the CER for approval. The TAO is legally required (under statute, licence, and contractually through the Infrastructure Agreement) to fund and deliver the infrastructure required by the development plan. The TAO's duties are enforceable by Direction from the CER if required. The offer programme is entirely run by the TSO and offers are issued in accordance with the criteria set out by the CER. Furthermore the TAO has no role in promoting regional integration. SEMO, the licensed market operator of the SEM, is a joint venture between the TSO and SONI (the TSO in Northern Ireland also part of the EirGrid group). EirGrid is an active member of ENTSO-E; ESB has no involvement in this area. Therefore it can be seen that the TAO's and the VIU's involvement in matters relating to the second pillar of the ITO is minimal, relating solely to decisions made by EirGrid.
- (310) The SEM Committee gives particular weight to the preparation of the development plan by the TSO, an entity fully independent of ESB. Weight is also given to the fact that the TAO, who has no influence over the actual preparation of the development plan, is bound by the development plan. Therefore the needs of the system are independently assessed by the TSO and its physical delivery by the TAO is subject to oversight from the TSO in addition to the overall regulatory oversight of the CER.

6.8.3 Governance: Staff Ring-Fencing and Transfers

- (311) The final pillar of the ITO contains various measures to ensure the independence of the management of the TSO and in particular prevent information obtained in the ITO being used in the VIU. These measures are in addition to the organisational separation making up the first pillar. The measures require that the management of the ITO do not have interests or involvements with the VIU and that there be significant "cooling-off" periods before a member of the executive management team may have a professional involvement with the VIU.
- (312) The existing arrangements in Ireland have full separation regarding the functions undertaken by EirGrid. The TAO is required by licence to maintain a separate business to carry out the functions of the TAO. The TAO licence also requires ring-fencing measures to be implemented to ensure that no information contained in the TAO business is accessible or transferred (accidentally or purposively) to another business of the VIU – the competitive businesses in particular. Staff transfers are assessed by line managers and HR prior to the transfer taking effect to ensure compliance with ring-fencing requirements. Quarantine periods or "gardening leave" have been required by the CER for some transfers, depending upon seniority and level of access to information. The implementation of the ring-fencing requirements is set out in the ESB Code of Conduct which is subject to approval and modification by the CER. Accordingly substantive changes could be made to the practices without the need for a modification

to the TAO licence. Although it is noted that the CER may impose⁹⁹ such a licence change should it determine it appropriate.

(313) The SEM Committee considers that this pillar of the ITO is surpassed by the existing arrangements with respect to EirGrid but not with respect to ESB. On balance, when considering the third pillar of the ITO, the SEM Committee considers that the ring-fencing in place in the TAO should be improved. However, the SEM Committee is of the view that with the imposition of the measures proposed in Section 7 the potential risk to TSO independence in this regard will be removed.

6.9 Overall Assessment against the Purposive Criteria

(314) As discussed in the above sections, the SEM Committee considers that in many respects the existing arrangements surpass the independence that would be guaranteed by the ITO model and will continue to do so with the proposed improvements. i.e. the existing arrangements provide greater independence for the TSO than the provisions of Chapter V subject to the measures discussed in Section 7. However some concerns arising from the legal identity of the TAO weigh against the independence provided by the Irish Arrangements. To reiterate the criteria below were used to assess the existing arrangements relative to the ITO:

- Core issues of independence (SEM Committee Guidance paper and additional considerations);
- Aims of effective unbundling (Recital 12); and
- Pillars of effective unbundling through an ITO (Recital 19).

These analyses were also informed by a line-by-line comparison of the Existing Arrangements with Chapter V.

⁹⁹ The legislation provides for a consultative process but the consent of the licensee is not required for the CER to modify the licence

7 Additional Measures Proposed by the SEM Committee

(315) The SEM Committee concludes that the existing arrangements have provided more effective independence of the transmission system operator than the provisions of Chapter V of the Directive and with the improvements proposed in this section, would clearly guarantee this into the future. On this basis the opinion of the SEM Committee is that the European Commission should therefore grant the application by ESB for certification under Article 9(10) of the Directive of the present arrangements, subject to the implementation of the proposed improvements. It is noted that the improvements suggested in this section can be made by the CER within the existing legislative and regulatory framework.

7.1 General

(316) The efficiency of the working relationship between ESB Networks and EirGrid has emerged as an issue. This is a key concern for the CER as any difficulties in the functioning of this relationship ultimately impacts customers (both generators and demand customers). Therefore the CER will request formal submissions from EirGrid and ESB Networks in relation to the operation of the Infrastructure Agreement and will consider possible alterations once these submissions have been received.

(317) The CER will introduce incentives related to the operation of the Infrastructure Agreement to encourage EirGrid and ESB Networks to work in an efficient and co-operative manner.

7.2 ESB

(318) In addition to the above there are several issues the CER will address specifically with ESB. A key aim of these improvements is to deepen the existing separation between ESB Networks and ESB.

7.2.1 Financing:

(319) A condition will be inserted in the TAO licence explicitly reflecting the existing legal obligations to fund the Development Plan. The absolute nature of this obligation shall be explicitly reflected in the TAO licence. It is noted that the legal obligation is indeed absolute, potentially requiring ESB to sell non-network assets to meet its obligations.

(320) A condition will be inserted in the TAO licence requiring the licensee to maintain an investment grade credit rating, unless the TAO demonstrates to the satisfaction of the CER that it is not feasible to do so due to circumstances beyond its control. ESB will report annually to the CER on this.

(321) A condition will be inserted in the TAO licence requiring the licensee to certify to the CER on an annual basis that it has sufficient resources to finance the transmission capital development, including the evidence to substantiate this.

(322) A condition will be inserted in the TSO licence requiring the licensee to certify to the CER on an annual basis that the sufficient resources which it required to finance its Development Plan were provided to it.

- (323) ESB's current central funding model will remain. The CER will continue to set the allowed WACC in the 5 year networks price control on the basis of a stand-alone networks company and not on the basis of the ESB Group. This will continue to ensure that customers are protected in the financing of network build. In relation to all new debt raised, there should be a clear distinction provided by ESB to the CER, (for the purpose of regulatory transparency), to debt raised by ESB to fund network infrastructure and that required for the competitive businesses. The CER will implement this condition in a manner that does not impact any existing holders of ESB debt.
- (324) In relation to EirGrid exercising its rapid step in rights in circumstances where ESB is unable to finance the works the CER will formalise the arrangements for these circumstances by allowing such works to be guaranteed by TUoS revenue.
- (325) The CER will require that greater transparency with regard to ESB releasing funds to ESB Networks is developed. ESB Networks Limited request for funding and the ESB's approval of that request shall be provided to the CER in each case.

7.2.2 Ring-fencing:

- (326) The membership of the ESB Networks Limited Board will be increased by one independent member. The independent members should at all times comprise a majority of the total membership of the Board.
- (327) A further condition will be inserted requiring that all communications between ESB and ESB Networks Limited be in writing and copied to the Compliance Officer - for review by CER as required. The agenda and minutes of any meetings, where permitted by the CER, between ESB and ESB Networks Limited will be furnished to the Compliance Officer.
- (328) ESB Networks involvement in the monthly EDT meetings in their current form should cease. As the ITO and the certified Scottish arrangements allow for a coordinating mechanism, such a mechanism will be permitted to remain. The arrangements will be revised and will exclude any person with a direct involvement in the generation or supply businesses.
- (329) The appointment of the ESB Networks Compliance Officer will be subject to CER approval.
- (330) The use of shared services including IT, HR, procurement and legal is to be phased out; ESB Networks where appropriate should provide all of its own services. ESB will be required to submit a detailed plan setting out the implementation of this requirement. Alignment with Article 17(5) of the Directive will be considered in this context.

8 Conclusion

8.1 Summary of SEM Committee Position

(331) The SEM Committee concludes on the basis of the purposive analysis carried out, that the Existing Arrangements have provided more effective independence of the transmission system operator than the provisions of Chapter V of the Directive and with the improvements proposed, would clearly guarantee this into the future. On this basis the decision of the SEM Committee is to grant the application in respect of EirGrid for certification, subject to the implementation of the proposed improvements and to the decision of the Commission under Article 9(10) of the Directive.

(332) The application before the Committee was submitted by ESB as transmission asset owner in Ireland for the certification of EirGrid. This is the only application that the SEM Committee has received for the transmission system in Ireland. In reaching its decision, the Committee is conscious that EirGrid relies on ESB to discharge some of its TSO functions and therefore ESB could be considered to exercise some of the functions of a transmission system operator in Ireland within the meaning of article 2(4).

8.2 Next Steps

(333) The SEM Committee will engage with the European Commission, as required by the European Commission, to assist with their review of the application and associated material.

(334) It is anticipated that the European Commission's review will take between two to four months (it is open to the European Commission to request the view of ACER).

(335) Once the SEM Committee has received the European Commission's decision it shall implement that decision and publish the European Commission's decision.