Working Party No. 2 on Competition and Regulation

VERTICAL SEPARATION IN REGULATED INDUSTRIES

-- Czech Republic --

This note is submitted by the Delegation of Czech Republic to the Working Party No. 2 FOR INFORMATION at its next meeting on 27 October 2000.
EXPERIENCE WITH VERTICAL SEPARATION IN REGULATED INDUSTRIES

The Czech Republic

I. Overall picture re separation/integration in regulated industries

Table: sectors involving both competitive and non-competitive activities, regulation/ownership of competitive and non-competitive activities

<table>
<thead>
<tr>
<th>Sector</th>
<th>Competitive activities</th>
<th>Non-competitive activities</th>
</tr>
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</table>
| Railway           | - there is no competition in the operation of the infrastructure and transport  
|                   | - the infrastructure and the rolling stock are practically fully owned by the state                                                                                                                                                                                                                                                                                               | - freight and bus transport are fully competitive                                                                                                                                                                         |
| Road transportation | - communications and infrastructure are fully owned by the state                                                                                                                                                                                                                                                                                                               | - other activities are fully competitive (including the delivery of consignments to trade customers "house-to-house" where such consignments are below 350 g)                                                                   |
| Postal services   | - delivery of consignments below 350 g (this activity is conditioned on the satisfaction of conditions currently complied with solely by the state-owned Česká pošta)                                                                                                                                                                                                 | - all services are fully competitive (starting from 2003, there will be free access to fixed telephone networks and transferability of numbers)                                                                                                               |
| Telecommunications | - competition is limited to a certain degree in the provision of universal service (this activity is conditioned on the satisfaction of conditions currently complied with solely by the state-controlled Český Telecom)                                                                                                                                  | - provision of content services is fully competitive                                                                                                                                                                     |
| Broadcasting      | - transmission of TV and radio signal is concentrated in a single entity controlled by the state, České radiokomunikace, a.s.  
|                   | - due to technical reasons, competition is not envisaged in this area                                                                                                                                                                                                                                                                                                          | - provision of content services is fully competitive                                                                                                                                                                     |
| Electrical energy | - transmission is performed by ČEPS, a.s. (ČEPS, a.s. is a separate accounting unit but is in fact interconnected with generation at ČEZ, a.s.; a separation is currently being prepared)  
|                   | - distribution (third party access to networks is being prepared)                                                                                                                                                                                                                                                                                                              | - generation is fully competitive (but restricted by the integration of generation and transmission)                                                                                                                             |
| Gas               | - transport is separated from distribution  
<p>|                   | - a state-owned company, Transgas, transports gas (competition is to be ensured in this area, the draft energy act provides for access by the state, as well as third parties)                                                                                                                                                                                                 |                                                                                                                                                                                                                           |</p>
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<td>Air services</td>
<td>- a state-owned company (Česká správa letišť) operates the airport in full</td>
<td>- other services are competitive and are separated from the other activities (there are only two cases of integration of services, i.e. airport operation and catering, and airport operation and air transport)</td>
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<td>- air traffic is managed by the state owned company Řízení letového provozu České republiky</td>
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<tr>
<td>Water management</td>
<td>- various infrastructure owners who enter into agreements on its operation; potable water supply, collection and treatment of waste water are local network monopolies, no competitors have access to the networks</td>
<td>- there is competition among operators in the conclusion of agreements with individual infrastructure owners</td>
</tr>
<tr>
<td>Waste management</td>
<td>- the operator for the collection of communal waste is appointed by the municipality - this is a local monopoly</td>
<td>- large scale collection of waste and refuse dump management are fully competitive</td>
</tr>
</tbody>
</table>

**Regulatory decisions**

1. In the above areas, no regulatory decision regarding vertical separation/integration by a regulator or the Office for the Protection of Economic Competition (the "Office") has been imposed thus far. Where vertical separation occurred, it was on the basis of a decision of the state as the owner, prior to the privatization of the companies involved. The separation of generation and distribution of electricity may be given as an example; the separation resulted in a dominant generator which has owned and does own the transmission grid, and 8 regional distribution companies. The state’s decision on privatization further led to the establishment of independent electricity generators; in the gas industry, transportation, storage and distribution of natural gas were separated.

2. The current approved energy policy of the state envisages the separation of power generation from its transmission by means of the high voltage grid (VVN), exclusion of the transmission grid from the ownership of the dominant power generator (ČEZ, a.s. which has a 70% share in the power generation market). The aforementioned process resulted from a decision made by the state which is a majority owner.

3. In water management, two different types of companies are found as a result of the privatization of the infrastructure. These are mostly companies with separate ownership and operation of the infrastructure of public water and sewage systems (the owner enters into lease agreements for the operation of the infrastructure). A few of the companies active in this segment both own and operate the infrastructure.

4. In waste management, the municipalities play the regulatory role. Pursuant to the laws currently in effect, the municipality is considered to be the owner of communal waste and as such is obliged to ensure its disposal. The municipality determines what collection company is to collect waste on its territory. The consumer has no say in this process and from the consumer’s perspective, the collection company enjoys a dominant position on the local market of the municipality.

**Allowing competition**

5. Competition between railway operators on rail/routes of a rival operator is currently not allowed (with the exception of two routes where competition currently is allowed).
6. Competition in the collection and transport of mail is currently not allowed, there is some degree of competition between forwarding companies and the state-owned company Česká pošta with respect to delivery of mail (in particular express mail).

7. Competition is allowed in power generation and independent power generators account for approximately 30% of the relevant market.

8. A great number of infrastructure owners (owners of the water supply and sewage systems) is characteristic of the potable water supply market consisting in the public water distribution system and the service market involving collection and treatment of waste water by means of the public sewage system; such owners enter into long-term agreements for the operation of the infrastructure with companies authorized to provide such services pursuant to special regulations. The operators obtain monopoly positions only in individual local markets because the consumer in the relevant territory is unable to obtain potable water supplies from any other undertaking (local network monopolies). In these markets, economic competition comes into play only at the moment of selection of the operator.

Separation of competitive and non-competitive activities

9. Railway, road transportation, telecommunications, broadcasting, power generation, gas and air transportation sectors have been or are being transformed and privatized. The main step is to separate non-competitive and competitive activities and subsequently privatize the companies so created by direct sale or coupon privatization. Non-competitive activities in these areas are owned by the state, and a number of competitive activities also continues to be owned or controlled by the state for the time being.

10. As regards water supply and distribution management, the water management assets and infrastructure have been privatized. Ownership and operation of infrastructure (water supply and sewage networks) is separated in most cases. Infrastructure owners enter into lease agreements for the operation of the networks. Only a few of the companies engage in both ownership and operation of infrastructure.

11. In waste management competitive and non-competitive activities are separated. High-volume waste management (e.g. management of waste produced by business activities) is fully competitive, whereby individual waste producers may select a collection company or a carrier who would ensure that the waste is collected and deposited in a waste dump. The price for waste collection is determined by agreement. Competitive areas include the operation of waste dumps, where only the establishment of dumps is regulated (the relevant body of state administration grants its consent to its operation), together with the economic efficiency of waste collection (i.e. the distance from a particular location within which waste must be collected is defined). In this area, frequently the owners (or operator of the waste dump) is integrated with the collection company which engages in the collection of communal and high-volume waste.

Activities being regulated by price-caps:

- provision of telecommunication services
- electricity and gas supply
- passenger train transport (substantive regulation is envisaged)
- television and radio broadcasting
- waste collection fee (the components of the fee are set as a fixed fee for a specific time period)
Activities subject to substantive regulation (the price must reflect justified cost and reasonable profit):

- heat supply
- postal services
- determination of water and sewage fees (stipulated by law)

II. Industries in which some form of separation/integration has been imposed

12. In the railway, road transportation, telecommunications, broadcasting, power generation, gas and air transportation sectors, accounting was separated during transformation when separate legal entities were created. As regards railway transport, the ownership of the infrastructure has yet to be separated from the rolling stock or from operating services, as the case may be; however, an accounting separation was performed. As regards generation and transmission of electricity, an accounting separation was carried out but ownership has not been separated as yet. Separate accounting (or rather, separate cost, income and revenue accounting) needs to be maintained for all price-regulated services, as well as in the operation of public telecommunication services, although this service is not price-regulated.

13. In water and waste management, the accounting separation of infrastructure from operation has been performed in most cases. In water management, such separation occurred as early as during privatization. The owner of water supply and sewage systems can at the same time operate the same. In waste management, a waste dump operator may also act as the collection company.

14. The law does not exclude an airline from owning the principal airport.

15. Cable TV distributors may own TV program providers.

16. Local telecommunication companies are not excluded from providing inter-city (long-distance) telephony.

17. A telecommunications company may also provide Internet services.

18. The current legislation does enable an electricity generator to own the transmission grid.

19. The aim of the separation was to privatize competitive activities, one of the reasons being the creation of a competitive environment. In the gas and electricity sectors, privatization is still in progress; however, the Office strives to prevent vertical integration of distribution and generation (in the case of gas, transport and storage). The Office further stresses that the ownership of the transmission grid needs to be separated from power generation. This is to be effected in the near future.

20. It is currently impossible to assess the effects of separations as the same have not been completed in the main industries (electrical energy, gas). The positive effect of competition in the forwarding sector (despite the postal privilege, i.e. the monopoly of Česká pošta for the delivery of correspondence) and road transportation were due to the introduction of competition or foreign entry into the market. As regards telecommunications, the operation of the fixed network will be separated from the operating services in 2003.
III. Decision on separation/integration resulting in structural changes

The Office has not adopted any such decision as yet.

IV. Summary

21. The Office commenced active advocacy of economic competition from the very beginning of its existence. It consistently promotes a pro-competitive approach to restructuring, in particular in the regulated sectors, where it aims to create conditions for the introduction of competition. In the annual report on the Office’s activities for 1996 which was submitted to the Czech government, the Office stated in connection with its advocacy of competition principles in the power industry that "in the long run, in addition to the liberalization of electricity prices and support to increased efficiency of electricity consumption, the provision for supply and demand for electricity will require a systems restructuring of the power generation system consisting of the separation of transmission from generation so as to enhance efficiency of this sector. Such separation would result in the creation of better conditions for regulation, as well as in the introduction of tenders for producers and other power providers to ensure the least costly long-term power supplies, and would have a positive effect on the consumer."

22. The Office supported the division of the original bus transport structure into smaller entities, and, so as to ensure greater degree of protection of the passengers’ interests, it proposed that bus terminals be managed by the individual municipalities. Reality showed this was correct as in places, where bus terminals were privatized, pressure being exercised by local monopoly operators on the carriers seems to persist. During the privatization of the petrochemical industry, the Office disapproved of the integration of the oil pipeline and product pipeline with the emerging holding company, as this could result in the restriction of entry by competitors into this system.

23. In 1995-1996, the Office had its representatives in management and supervisory boards of strategic companies, e.g., SPT Telecom, Česká dráha and Poštovní novinová služba. The participation of such representatives made it possible to participate in the privatization process as early as the stage of review of the proposal for the basic structural changes and privatization plans.

24. In 1996, the Office collaborated with the regulatory body in the rectification of the procedure for the collection of investment contributions from off-takers as a share in the supplier’s costs in the case of gas distribution companies, and initiated amendments in the administrative guidelines regarding the supplier’s costs related to the hook-up of the off-taker to the grid. In other cases, when the discussions regarding the correct approach for the regulation of natural monopolies in market liberalization and the actual solution thereof were at the initial stage, the Office, pursuant to its own analyses and experience from other countries, including OECD member states, submitted, at its own initiative, to the relevant ministries a specific proposal for an improvement of regulation in regulated sectors by establishing independent regulatory bodies. The Office further stressed its preparedness to participate in the creation of the requisite regulatory framework.

25. In the last three years, competition advocacy focused on 32 sectors, the greatest number of interventions having been in power generation, water management, sewage, telecommunications and transport. This fact is in harmony with the general trend of introduction of competition into the above sectors. These are sectors where any increase in the efficiency of regulation will result in great benefit to the final consumer. The degree of success of the most significant advocacy efforts of the Office in 1999 is 36%. This success rate is in line with the experience from and trends in other countries, as far as competition advocacy is concerned.
26. The high frequency of interventions in administrative proceedings or complaints of abuse of monopoly by local monopolies in regulated sectors often directly initiates competition advocacy in the promotion of liberalization of regulated sectors in favor of public interest. E.g., a high number of complaints referred to the Office and related to frequent increases of prices of cable TV services resulted in the initiation of negotiations regarding introduction of regulation in this area.

Examples of the Office’s advocacy:

27. Restructuring reform: The Office promoted the separation of power generation from the high voltage transmission grid and distribution networks, sought a consistent separation of the infrastructure from the transportation activities of the railway and the accounting and financial separation of other business activities from the operation of the railway and railway transport. Further, the Office requested with respect to the privatization of power companies that privatization is not initiated before the regulatory framework in energy sectors is created. The Office advised against a vertical integration of production, transmission (in the case of gas, transport and storage) and distribution of electricity and gas. As regards the draft telecommunications act, the Office proposed that an independent regulatory authority for this area be established.

28. Network infrastructure reform: In the selection of a third operator for the mobile telephony network, GSM 1800, the Office promoted the principle that the new operator would not be in any way interconnected with theretofore mobile telephony providers or the fixed network operator. The Office succeeded in introducing a provision into the new act on postal services whereby the monopoly of Česká pošta with respect to correspondence is limited by time. As regards the supply of water and collection and treatment of waste water, the Office initiated a change in the powers of the regulator who would define clear rules for the creation of funds for investment into infrastructure of public waterworks and sewage companies.