This note is submitted by the Delegation of Netherlands to the Working Party No. 2 FOR INFORMATION at its next meeting on 27 October 2000.
1. Introduction

This memorandum is the Dutch response to the request of the OECD of 7 July to supply empirical evidence of vertical separation and integration in regulated industries. The main questions of the OECD were:

1. Considering industries in which there is a non-competitive regulated activity and a related competitive activity or activities, in which of these industries is there a decision to permit, allow or promote competition in the competitive activity or activities?

2. In which of these industries has the ownership, accounting or operation of the non-competitive activity been separated from the ownership, accounting or operation of the competitive activity?

3. In which of these industries has there been a decision, which has resulted in a structural change?

4. Does your agency have a policy regarding vertical separation in regulated industries?

2. Section 2 of this memorandum outlines the Dutch government’s vision regarding vertical separation and integration. Section 3 discusses the way in which vertical separation or integration in various network sectors is regulated in the Netherlands, what factors were taken into account at the time and what experience has been gained so far. The water supply, postal, public transport, energy, telecom and cable sectors are covered successively. Section 4 gives a summary of lessons learned during this short investigation.

3. Section 2 is based on the policy document "Public interests and market regulation: liberalisation and privatisation in network sectors", distributed by the OECD (DAFFE/CLP/WP2(2000)2/REV1/ANN2), and the Dutch response to the OECD memorandum ‘When should regulated companies be vertically separated network sectors?’ (DAFFE/CLP/WP2(2000)2/REV1/ANN1). Section 3 is based on relevant policy documents, legislation and research papers. In drafting the response the relevant ministries (Economic Affairs; Transport, Public Works and Water Management), and the involved regulatory authorities (NMa, DTE and the OPTA) co-operated.

2. View of the Netherlands

In the Netherlands we distinguish the following forms of vertical separation (from light to heavy):

- Accounting separation (allocating costs to the competitive and non-competitive activities);
- Organisational separation (classification under various organisational entities, such as business units);
• Legal separation (dividing an entity into separate legal bodies); and
• Separation of ownership (no cross-ownership)

5. We do not ex ante opt for one of these forms of separation. The pros and cons of applying each of them to a particular network sector should be assessed, after which a choice for a specific form of separation is made. The specific sectoral circumstances and characteristics influence the choice between various market modalities and separation variants. The main aim is to prevent the network owner from abusing his dominant position. Efforts are made to find the most suitable form of competition for the sector concerned. As a result, there are differences in the way in which vertical separation is regulated in the Dutch network sectors (see section 3).

6. The choice for a regime of vertical separation cannot be seen in isolation from the type of competition that is made possible in newly liberalised network sectors. In this regard four types of possible competition (so-called market modalities) can be distinguished, namely:

• Competition between infrastructures;
• Competition on the infrastructure;
• Competition for the market; and
• Yardstick competition and benchmarking.

7. The above summary of modalities is to some extent a descending list of preferences. The optimal form of competition is competition between infrastructures, combined with competition on the infrastructure. If this is not (yet) possible, a lighter form of competition can be considered, such as competition on the infrastructure. However, the proviso in that case is that access to the existing network must be given to third parties. In such a situation, the potentially competitive segments of the market tend to be separated from the non-competitive market segment. If it is technically impossible for several suppliers to use the network simultaneously, this right can periodically be put out to tender. This is referred to as competition for the market. Yardstick competition and benchmarking are the weakest forms of possible competition and can be applied in order to force (regional) monopolies to improve their efficiency.

8. Vertical separation is considered especially when the second market modality, competition on the infrastructure, is chosen. In such a case separation may be the solution for the relatively high risk of abuse of a dominant position of a (former) monopolist.

9. Vertical integration, however, is a normal economic phenomenon that can bring with it major economic benefits. Vertical integration can be a business strategy choice to improve the economic dynamism of a company. The development of a network and the development of services can thus presumably be better co-ordinated.
3 Experience in the Dutch network sectors

3.1 Water supply

Policy

10. In the Netherlands, there is currently no competition in the drinking water sector. The Dutch drinking water supply sector is characterised by vertically integrated regional monopolies. Production, distribution and supply are all managed by a single operator. There is currently no obligation to separate accounting between the activities in the various links in the chain. Operators other than water supply companies are prohibited from supplying drinking water to households. The Dutch government is currently working on a new act that will bring the supply of industrial water under direct competition and to introduce benchmarking for the supply of drinking water. However, the Dutch government believes that the water supply companies should remain vertically integrated and government-owned.

Considerations

11. Due to the specific characteristics of the drinking water supply sector, the Dutch government decided not to opt for competition on the infrastructure. For this reason, there are no rules enabling third party access to the network. One important argument for the choice of vertical integration is the need to guarantee water quality with a view to safeguarding public health. Guaranteeing both the quality of drinking water and its security of supply is crucial. By integrating ownership, management and operation of production and distribution of drinking water it is possible to ensure an integrated quality control system. One positive impact of vertical integration in the drinking water supply sector is the fact that it creates economies of scope.

Experiences

12. There is no experience with forms of vertical separation in the Dutch drinking water supply sector.

3.2 Postal sector

Policy

13. The Dutch postal sector is characterised by horizontal separation. Competition in the Netherlands is applied to postal deliveries of over 100 grams, direct mail and outgoing international mail. The non-competitive activities cover deliveries of below 100 grams. In the postal sector, the network is not by definition an essential facility. Distribution and sorting centres -owned by the (former) monopoly holder TNT Postal Group- do not prevent free access.

14. Various sub-sectors can be distinguished in the postal sector. The imposition of accounting separation on the monopoly-holder prevents cross-subsidisation from the monopoly market to neighbouring competitive markets. The table below gives a summary of the different market segments and the way in which they are structured:

4
Subsidiary sector

| Postal deliveries of less than 100 grams | Legally regulated monopoly via a license |
| Postal deliveries of between 100 grams and 10 kg. | Non-exclusive license for monopoly-holder and competition |
| Postal deliveries of more than 10 kg. | Free competition |

15. For postal deliveries of below 100 grams and a tariff that is less than or equal to NLG 2.40 (equal to three times the basic tariff for an ordinary letter) there is currently a legally regulated monopoly (through a concession) in order to ensure a universal service. Both the management of the network (consisting of the postal boxes, distribution and sorting centres) and the provision of the services are in the hands of a single private company. In addition to the exclusive concession for postal deliveries of up to 100 grams, this monopoly-holder also has a non-exclusive concession on postal packages of up to 10 kg. Competition between infrastructures occurs in this subsidiary sector and in the sub-sector consisting of items from 10 kg upwards. However, there is no shared use of the infrastructure. The concessions of the monopoly-holder arose from the privatisation of this former state-owned company and were not obtained via a call for tenders.

16. On the one hand, this company holds a monopoly, but it also operates on the free market. Initially, the aim was to liberalise the market for postal services in Europe eventually and this would overcome the risk of unfair competition for deliveries of items exceeding 100 grams. Whether, and if so when, full liberalisation will be achieved is unclear at present. For the time being, the new Dutch Postal Act has provided for accounting separation, which requires that specific non-confidential business information should be made public.

Considerations

17. Vertical separation does not apply to the Dutch postal sector, since there is no clear distinction between the competitive and non-competitive businesses. Research has shown that the only difficulty competitors find is in gaining access to the post boxes. The government has specified that the network operator must negotiate with potential competitors regarding this type of access. If the various players cannot reach an agreement, an appeal can be lodged with the network supervisor.

Experiences

18. It is not yet possible to outline the experiences gained with the system of (horizontal) accounting separation or the restriction of the monopoly, since the system was only introduced at the beginning of 2000.

3.3 Public transport by rail

Policy

19. The Dutch rail sector is characterised by vertical legal separation between the ownership and management of the network on the one hand and use of the network on the other. A public limited liability company owned by the Dutch State - “De Nederlandse Spoorwegen (NS)” - operates passenger services. Previously, the NS also owned the railway infrastructure. NS consists of a group of private limited liability companies. Among these companies, a distinction can be made between business units that operate on the
transport market and units which perform tasks of general interest for the government, such as maintenance and supervision of the infrastructure, allocation of capacity and transport management (so-called task organisations). These so-called task organisations are both administered and financed by the government. On 1 January 2001 the ownership of these organisations will be legally separated from railway operator, as a result of which they will fall directly under the jurisdiction of the government. Since a number of important facilities (including the stations) are still provisionally owned by the private company, specific temporary competition rules will presumably be relied upon in order to counteract any anticompetitive behaviour. Once this has been evaluated, the government will consider to what extent the sector can be further restructured.

20. Recently, the national rail transport license has been awarded for a 10 year term to “NS Reizigers” (NS Passenger services), a full subsidiary of NS. The remaining regional rail transport licenses will be put out to tender in a number of temporary concessions. Transport on the high-speed rail link (HSL-Zuid) will also be put out to tender as a temporary concession.

Considerations

21. The main consideration behind the separation of infrastructure ownership and the operation of services has been to create conditions to give rival transport companies access to the rail network. When opting for legal separation within the privatised state monopoly, the following criteria played a key role: financial cross-links between the business unit responsible for the infrastructure and other business units must be excluded (given that the government will in future be responsible for financing the infrastructure), the capital of the business unit responsible for the infrastructure must be separated from the other business units, and finally, objective capacity management must be guaranteed with a view to providing access to other users of the infrastructure.

Experiences

22. As yet, relatively little experience has been gained with competition in the railway sector. Until recently, a company held five small scale licenses for the provision of train services around Amsterdam. This transporter ceased its activities once it was clear that the government intended to allow no competition on the main rail network until 2010. At the moment, there is some competition in the award of regional concessions in certain parts of the Netherlands. The introduction of the License Act for Passenger Rail Transport will result in more experience being gained with the (public) award of tenders for regional rail services. In the near future, therefore, there will be either licenses or competition for the rail network, with the chief aim of improving transport performance. Until now, one regional license has been awarded via open tender in the north of the Netherlands and two privately. The tendering procedure for HSL transport is currently ongoing.

3.4 Energy

Policy

23. The energy sectors are characterised by vertical separation. The infrastructure for electricity is split in a national transport network and regional networks for distribution. The gas infrastructure is split up into a national high-pressure transport network and regional low-pressure distribution networks. The network management of the regional distribution networks for electricity and gas must be legally separated from other commercial activities, such as production en supply. Therefore the energy companies have to
form and formally appoint one or more public or private limited liability companies who will manage these networks. The Minister has to approve the appointment of independent network operators by the energy companies. Almost all the electricity network managers have already been appointed. This process still has to begin in the gas sector.

24. The owner of the high-pressure gas transport network (Gasunie) is obliged to hold separate accounts for transport and other activities. The national electricity transport network company (TenneT) is owned by the production companies, but is legally separated from their commercial activities.

25. All companies have to meet legal requirements on independence set in the Electricity Act and the Gas Act. Policy rules have been drafted setting out more detailed regulation for the electricity network managers. Similar policy rules will be drafted for the gas sector.

26. Most of the regional energy distribution companies are still owned by the provinces and local authorities. The privatisation of the energy distribution companies is possible under certain conditions, subject to the approval of Minister of Economic Affairs. However, apart from one company, none of these energy distribution companies has yet been privatised.

27. One important difference between the electricity and gas sector is the way in which access to the market is structured. In the electricity sector, a system of regulated access is used. The tariff structure, tariffs and conditions are fixed in advance by the government. In the gas sector a mixed system is applied. Access to the network is negotiated for non-bounded customers, while it is regulated for bounded customers. Thus, it is primarily the market that sets the tariffs and defines the limiting conditions. The supervisory authority settles disputes. In the Netherlands, supervision of the electricity sector is handled by (a separate sector-specific supervisor), the Office for Energy Regulation (DTte) (an agency of the Dutch Competition Authority, NMa). The supervisor for the implementation of the Gas Act is the NMa, which has transferred specific tasks (these can be compared with the activities relating to the Electricity Act) regarding the implementation and supervision of compliance with the Gas Act to the DTte.

28. The energy markets are being opened up for competition in line with the relevant EU Directives. At present, the energy sectors are only partly liberalised. It will however be gradually liberalised in order to ensure a smooth transition. Large industrial consumers have already been liberalised, and the medium-sized group and domestic consumers are to follow later. At the beginning of 2000, it was decided to accelerate the liberalisation of the energy market. The deadline for full liberalisation of the energy market was moved forward from 2007 to 2004, and will if possible be moved forward again to 2003. Efforts will be made to fully liberalise the market for ‘green’ (environmentally friendly) energy during 2001.

Considerations

29. The decision to legally separate the regional network and supply companies was prompted by the desire to ensure transparency for consumers and to guarantee non-discrimination. Separation is designed to prevent cross-subsidisation, ensure independent network management and limit the influence of the shareholders on the network (strategic and commercial interests should be separated from the natural monopoly). The (minor) differences between the way in which access to the electricity and gas sector networks are regulated can be explained by various factors. Unlike the electricity sector, for example, the gas sector market is already largely internationally liberalised.
Experiences

30. It is not yet possible to outline the effects of liberalisation and privatisation, or the associated requirements that must be made by the energy companies, since the process of liberalisation is still under way. However, the initial signs are already visible, and include lower prices, better service, improved insight into the cost structures and greater flexibility. Prior to the amendment of policy, the commercial effects were first assessed. However, these commercial effects were not quantified. Both the Electricity Act and the Gas Act will be evaluated in 2002.

31. Following the completion of a recent survey by the Dutch government and the gathering of experiences abroad, the terms of the liberalisation were reviewed again and it was decided to accelerate the liberalisation of the energy sector.

32. In 1999, the NMa has imposed a fine on the Association of Electricity Producers (SEP), the owner of the main transmission network for public power supplies, following their refusal to allow the electricity an independent producer had produced to be transported on the network of SEP.

3.5 Telecommunications and cable

Policy

33. The telecommunications sector is characterised by vertical separation in the form of accounting separation. Providers of fixed public telephone networks, fixed public telephone services and rental lines offering interconnections to other providers must apply an accounting separation between activities relating to interconnection and their other activities. KPN (the former monopolist) must give other telephone providers access to its network.

34. In the Dutch telecommunications sector, there is a high level of vertical integration of infrastructure and service supply. In order to boost competition within the sector, the government has opted for a model of separation of economic functions (functional separation), but not for a form of legal or economic vertical separation. This functional separation can be made more visible through an obligation to apply an accounting separation between activities relating to interconnection and their other activities, so that discriminatory behaviour by the supervisory authorities can be more easily established. The market players are also obliged to notify their conditions of access beforehand, both clearly and in a detailed way (reference tender).

35. Access by third parties to telecommunications networks under non-discriminatory and reasonable conditions is guaranteed on the basis of sector-specific competition rules that are based on the EU Directives, and on general competition rules. The basic principle that applies here is that only network owners with significant market power (this will probably be equated with a dominant market position following the review of the EU Telecoms Regulations) are (or can be) obliged to provide access to third parties under reasonable conditions and in a non-discriminatory way. The former state-owned monopolist must give other telephone providers access to its network.

36. Among the broadcasting companies, the structural (ownership) separation between the services to be supplied and the network management has now been abolished. Cable operators have been able to supply their own services since 1996. Moreover, they are recently also permitted to provide telecommunications services via the cables in addition to broadcast services. The cable companies are obliged to allow other providers to the network via negotiated access. With a view to open access, it is
mandatory to apply an accounting separation between the management of the access network and the supply of broadcast services.

Considerations

37. If dominant network managers integrate vertically, this could give rise to problems relating to competition for access to networks. These problems can be tackled using general and sector-specific competition rules or by imposing vertical separation. In the field of telecommunications, the government has opted for an approach based on prescriptions and behavioural corrections based on sector-specific and general competition rules.

38. The problem of potential discrimination in the provision of access to networks for third parties (favouring own service supply) is being tackled by means of the EU Directives (special access). Based on the sector-specific competition rules (Telecommunications Act), network owners with a significant market position are obliged to provide third parties with non-discriminatory access to the telecommunications networks under reasonable conditions. Consequently, a functional separation and behavioural prescriptions is regarded as adequate.

39. Vertical separation of the network management and the provision of services may well be easier in the case of a natural monopoly. There is little or no evidence of this in the telecommunications sector. Developments have shown that alternative networks (can) arise for existing networks. This makes separation less necessary. Competition (between networks) appears most difficult to get off the ground in the area of access to end-users.

40. In the Netherlands, the development of networks cannot adequately keep up with the rapidly rising demand for more capacity. Vertical separation of networks and services could have a negative influence on this development. The dominant network manager will be prepared to expand the capacity of his network but will, if there is not enough competition, have a tendency to realise the expansion in a conservative, risk-avoiding way in order to minimise the threat of undercapacity on his network. A vertically integrated company is confronted with competition for services. For the development and supply of new services, an improvement and expansion of the network will often be necessary (more connections, more capacity per connection). These incentives are lacking or are only present in limited form for separated network managers. The Dutch government is therefore trying to stimulate effective competition with regard to the telecommunications networks and with regard to services. A balance will in each case have to be found between (mandatory) on the one hand and the need to give network managers an incentive to expand capacity on the other hand.

41. In the case of cable companies, the transmission costs for distributive radio and television services should be made separately visible. This accounting separation will enable the supervisory authority to rapidly and effectively settle disputes. To date, the level of competition between infrastructures for broadcasting companies has been limited. At present, only the satellite is an alternative to the cable. Cable companies, however, do experience competition in the markets for non-broadcast services such as the Internet and telephony. The Dutch government has plans to stimulate the development of other infrastructures and to remove any obstacles. Disputes concerning access can be put before the supervisory authority (OPTA) and the NMa can take action against abuse (of a dominant position).
Experiences

42. It can be concluded that since the introduction of the Telecommunications Act (on 1 January 1998) there have been several providers on the market together with the development of new services. Following a lead-in period (with disputes), the access conditions for e.g. carrier (pre) selection, have now largely crystallised out. The disputes always concerned the fairness of the access conditions and only to a limited extent involved discrimination. The impression remains that the chosen access regime will work well over time, when there is clarity concerning the exact access conditions. Vertical separation would not have provided clarity concerning the access conditions any sooner. The possible advantages of vertical separation are in our view of limited impact and do not offset the disadvantages. These advantages cannot justify a far-reaching impact on the structure of companies in the form of mandatory vertical separation.

43. Since 1996, cable operators have been allowed to provide other services, in addition to transmitting broadcast signals. These include broadcast programmes, Internet services and cable telephony. This has not led in recent years to many conflicts between broadcast providers/service providers and cable operators concerning e.g. the access tariffs to be applied. OPTA and NMa have developed guidelines to provide clarity concerning competition rules governing broadcast access. These guidelines will soon be converted into a statutory regulation.

4. Lessons learned

44. The overview below summarises the way in which the Dutch network sectors are structured within the framework of competition:

<table>
<thead>
<tr>
<th>Network sector</th>
<th>Market modality</th>
<th>Vertical or horizontal separation</th>
<th>Form of separation</th>
<th>Regulation of tariffs for interconnection</th>
<th>Supervisor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drinking water</td>
<td>Benchmarking</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>NMa</td>
</tr>
<tr>
<td>Post</td>
<td>Competition between infrastructures</td>
<td>Horizontal</td>
<td>Accounting</td>
<td>No</td>
<td>NMa, OPTA</td>
</tr>
<tr>
<td>Public rail transport</td>
<td>Competition for the market</td>
<td>Vertical</td>
<td>Legal</td>
<td>No</td>
<td>NMa</td>
</tr>
<tr>
<td>Energy</td>
<td>Competition on the infrastructure</td>
<td>Vertical</td>
<td>Legal</td>
<td>Yes</td>
<td>NMa/DTE</td>
</tr>
<tr>
<td>Telecom/cable</td>
<td>Competition on the infrastructure</td>
<td>Vertical</td>
<td>Accounting</td>
<td>Yes</td>
<td>NMa, OPTA</td>
</tr>
</tbody>
</table>

45. This summary shows that the Dutch network sectors are characterised by vertical separation, whereby a choice is generally made for accounting or legal separation. In the drinking water supply sector there is full vertical integration. These differences can be accounted for by the choice of competition modality, market dynamics and the negotiating position of the users who are seeking access.

46. In general, vertical separation does not provide a guarantee for access to networks under reasonable conditions (excessive prices may be continued). Vertical separation does however provide a (limited) solution for non-discriminatory access. Disputes concerning the reasonableness of differences in access conditions (such as discount schemes) will remain.

47. The effectiveness of the approach of 'functional separation', such as applied in the Dutch telecom sector, and sector-specific and general competition rules for non-discriminatory access under reasonable conditions could be measured against the development of competition on the services markets due to the fact that third parties have gained access to networks. A comparison with a virtual situation of vertical separation of ownership, however, is difficult to make.
48. The various network sectors are currently in a state of flux. The liberalisation of the network sectors is still under development and in most cases, choices have been made recently. As a result, little experience is gained so far. The results of different forms of vertical separation in this paper are provisional.

49. It is often unclear whether developments in specific sectors can be linked to (the form of) vertical separation. In any event, accounting separation certainly leads to more insight in the cost components. Future evaluations may lead to changes in market modalities and forms of separation chosen by the Dutch authorities.
NOTES

1. Until 1 June 2000, there was a distinction between items above and below 500 grams. The lowering of the cut-off point has further restricted the monopoly position.

2. Regional public transport by bus is in the hands of a number of transport companies. These regional transport concessions will periodically be put out to public tender. Routes that use a special infrastructure such as bus lanes will remain state-owned.

3. The section on energy covers the electricity and gas sector, being the network sectors involved. These two sectors are discussed jointly in section 3.4, since the approach in both sectors is almost identical. The section examines the energy distribution companies. The energy production companies are not included in the discussion.

4. The competences of NMa are restricted in most network sectors by specific rules and measures, as described in the different paragraphs of chapter 3. In principle, however, the Competition Law is enforced in all sectors by the NMa.

5. Differences in structuring the gas sector and the electricity sector are elaborated in chapter 3.4.

6. Differences in structuring the telecom sector and the cable sector are elaborated in chapter 3.5.