

RENEWED REGULATION OF FINNISH ELECTRICITY DISTRIBUTION NETWORKS

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1. Introduction

The Finnish Parliament has adopted a legislative package concerning the electricity markets which is scheduled to enter into force on 1 September 2013. The purpose of the new legislation is to implement the EU's third energy package and to enhance the security of electricity supply in scarcely populated areas.

In the following, we discuss certain key features of the regulation of electricity distribution networks and the changes brought by the new legislation.

2. Licence

Operation of an electricity distribution network will continue to be a licenced activity. According to the new Electricity Market Act, a licence holder is required to have the technical, financial and organisational capabilities to carry out network activities. The licence may include conditions.

The licence is revoked if the licence holder no longer fulfils the requirements for obtaining the licence. In such an instance, the licence holder is required to transfer the network to the new operator. Unless the parties reach an agreement on the issue, the energy market authority (**EMA**) may decide on the transfer against full compensation.

The licence is not transferable. Licences typically do not include conditions concerning the identity of the owner of the distribution system operator (**DSO**). Therefore, a transfer of the shares of a DSO will not affect the validity of the licence as long as the DSO continues to have the required technical, financial and organisational capabilities to operate the network.

Under the new Electricity Market Act, all DSOs are required to apply for a new licence within three months from the entry into force of the Act.

3. Security of Supply

The so-called Tapani and Hannu storms in December 2011 resulted in outages affecting over 500,000 users of electricity, mainly in areas outside cities where networks consist largely of overhead power lines vulnerable to damage caused by snow and falling trees. In response to these failures, the new Act imposes on DSOs an obligation to maintain and develop the

No change of control provisions

New development obligations

network so as to, *inter alia*, ensure its secure functioning also when it is subjected to disturbances caused by weather or other outside factors which are normal and can be anticipated. In the case of failure to comply with this obligation, the EMA may order the DSO to undertake corrective measures and may impose a fine.

The new Act also imposes on DSOs an obligation to develop the network so that an outage caused by snow or storm does not last more than six hours in cities and 36 hours elsewhere. This development obligation means in practice that DSOs are obliged to switch overhead power lines to underground cables to a significant extent. The required investment is estimated at EUR 3.5 to 5.5 billion nationwide. In order to alleviate the financial burden and reduce the need to increase transmission fees, long transitory periods are granted requiring 50% of all end users (excluding vacation dwellings) to be within the scope of these time limits by the end of 2019, 75% (excluding vacation dwellings) by the end of 2023 and 100% by the end of 2028.

Fixed compensations to electricity users for interruption of power supply are also increased and will range from 10% to 200% of the end user's annual transmission service charge depending on the duration of the outage.

4. Separation Obligation

Larger DSOs are subject to a structural separation obligation. This means that, although the DSO may belong to a group of companies which is engaged in electricity generation and sales activities, it must be independent from those activities in terms of its judicial form, organisation and decision making. A DSO must also have its own brand name which is distinct from the brand names of the group's generation and sales businesses.

A board member or the managing director of a DSO which has more than 50,000 customers may not be in a corresponding position in a group company engaged in electricity generation or sales activities. The remuneration of the management of such a DSO may also not be influenced by the results of the group's electricity generation or sales activities

5. Pricing

Distribution networks are natural monopolies and pricing is therefore regulated. Price regulation is effected through control of the DSO's level of return rather than control of customer pricing. The EMA issues, for four-year periods, regulation methods for assessment of reasonableness of pricing. The currently effective regulation applies for the calendar years 2012–2015.

The rules concerning the permissible level of return remain largely unchanged in the new Act. The EMA is, however, expected to update certain features of the regulation methods to reflect changes required as a consequence of legal challenges against the calculation methods. The EMA's decision concerning determination of the permissible level of return will in the future be in force for two regulatory periods, *i.e.*, eight years, as opposed to the four-year period set out in the previous law. The EMA's decision determining the amount by which the DSO's actual adjusted return exceeds or falls below the permissible reasonable return will continue to be given after each four-year regulatory period.

Fixed capital structure

The permissible return of a DSO is calculated by means of a weighted average cost of capital model which uses a fixed capital structure with 70 % equity and 30 % interest-bearing debt. This model does not impose any obligations on a DSO concerning its actual capital structure but is used for calculation purposes, irrespective of the actual debt to equity ratio, in determining the permissible level of return.

The reasonable rate of return ($R_{k,post-tax}$) in euros in year i after corporation tax is calculated according to the following formula:

$$R_{k,post-tax} = \left(C_{E,i} \times \frac{70}{100} + C_{D,i} \times (1 - t_1) \times \frac{30}{100} \right) \times (D_i + E_i)$$

where:

$R_{k,post-tax}$	= reasonable rate of return after corporation tax in year i , euros
$C_{E,i}$	= real reasonable cost of equity in year i
$C_{D,i}$	= real reasonable cost of interest-bearing debt in year i
D_i	= adjusted amount of interest-bearing debt invested in the DSO's network operations at the end of year i
E_i	= adjusted amount of equity invested in the DSO's network operations at the end of year i
t_i	= corporation tax rate in year i

According to the calculation formulae presented in the regulation methods, the reasonable cost of equity ($C_{E,i}$) and the reasonable cost of interest-bearing debt ($C_{D,i}$) are tied to the average interest rate of the Finnish government 10-year bond in May of the previous year. As the Finnish government bond yield has decreased in the last years, the permitted reasonable rate of return for DSOs has also come down. While the Finnish 10-year government bond yield was 3.32% in May 2011, it was 1.82% in May 2012 and 1.76% in May 2013.

Reduction of permissible return

Corporation tax is currently 24.5% but is proposed to be lowered to 20% as from the beginning of 2014.

For 2012, the reasonable cost of equity ($C_{E,i}$) was 5.47% and the reasonable cost of interest-bearing debt ($C_{D,i}$) 3.32%. The reasonable rate of return ($R_{k,post-tax}$) for 2012 was consequently 4.58% for entities subject to corporation tax. Due to a decrease of the government bond yield, the reasonable rate of return has since decreased. For 2013, the reasonable cost of equity ($C_{E,i}$) is 3.97%, the reasonable cost of interest-bearing debt ($C_{D,i}$) 1.82% and the reasonable rate of return ($R_{k,post-tax}$) 3.19% for entities subject to corporation tax.

The regulation methods set out the manner for determining the amount of capital invested in the network operations and for dividing the capital into interest-bearing debt (D_i) and equity (E_i).

In addition, the regulation methods set out the way for determining the adjusted return from network operations. The regulation methods include various incentives aimed at encouraging the DSO to maintain and develop its network and operations. These are the investment incentive, quality incentive, efficiency incentive and innovation incentive. The DSO's performance relative to the pre-determined benchmarks under these incentives leads to a deduction (in the case of positive performance) or increase (negative performance) of the adjusted actual return, which is then compared to the permissible reasonable return.

Tariff adjustment during next regulatory period

The EMA prepares each year a non-binding calculation of the DSO's reasonable rate of return and actual adjusted return and notifies the DSO thereof. After the end of the four-year regulatory period, the EMA issues a formal decision determining the amount by which the DSO's actual adjusted return exceeds or falls below the permissible reasonable return during the period. In the case of excessive return, the EMA will require the DSO to lower its transmission tariffs during the following regulatory period by the excess amount, together with interest equalling the average reasonable cost of equity if the excess return is 5% or more. If the actual adjusted return is lower than the permissible reasonable return, the DSO is entitled to a corresponding increase of its tariffs during the following regulatory period.



Partner Juha-Pekka Mutanen heads D&I's Finance & Capital Markets practice.

Juha-Pekka Mutanen

[juha-](mailto:juha-pekka.mutanen@dittmar.fi)

pekka.mutanen@dittmar.fi

+ 358 9 6817 0112



Partner Robin Nordblad heads D&I's Energy, Infrastructure & Natural Resources practice.

Robin Nordblad

robin.nordblad@dittmar.fi

+ 358 9 6817 0150

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Dittmar & Indrenius, Pohjoisesplanadi 25 A, FI-00100 Helsinki, Finland

Tel: +358 9 681 700, Fax: +358 9 652 406

www.dittmar.fi