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ON THE ROAD TO PAN-EUROPEAN ENERGY MARKETS: SOME REMARKS ON THE APPLICATION OF EC COMPETITION LAW

By Werner Berg and Jan Lohrberg***

Europeanization of Energy Markets

For a long time, the European energy sector was considered to be outside the scope of the competition rules.[1] Many European Governments took the view that at least the transmission and retail of energy constituted natural monopolies which were to be operated by state-owned entities. Moreover, as security of supply was a matter of paramount concern, it was common practice for governments to assign the task of energy supply to vertically integrated corporations granted a monopoly in relation to a distinct area. Cross-border trade was marginal.[2] In addition to this, EU Member States generally have a different conception of their respective energy policy due to different natural resources and different geographical locations. Diverging emphasis on other relevant policies such as environmental protection or economic development further complicates the situation.[3]

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1. Further background information can be found in a speech delivered by Philip Lowe in November 2006, The Liberalization of EU Energy Markets, available at: http://ec.europa.eu/comm/competition/speeches/text/sp2006_017_en.pdf.

2. *Cf. Thomas von Danwitz*, Regulation and Liberalization of the European Electricity Market – A German View, Energy Law Journal, Volume 27, Number 2, 2006 p.423.

3. Röller/Delgado/Friederizick describe this situation as the "hold-up problem." *See Röller/Delgado/Friederizick,* Energy: Choices for Europe; p. 55; available at: http://www.esmt.org/fm/13/Energy_%20Choices%20for%20Europe.pdf.

Sector-Specific Regulation and Application of EC Competition Law

However, as the structure of European energy markets was perceived to be detrimental to consumer welfare, the European Commission (Commission) issued two key Directives, *inter alia* calling for the establishment of national sectoral regulators in order to foster competitive European electricity and gas markets.[4] In addition, to encourage market integration, the EC Regulation on cross-border trade in electricity[5] and the EC Regulation on conditions for access to the gas transmission networks[6] set rules for the transmission of electricity and gas between Member States. Based on these EC laws, national energy regulators now oversee many competitive aspects, particularly as to pricing and access to networks and information. Nevertheless, the rules on competition and in particular Articles 81 and 82 EC as primary EC law continue to apply alongside the sector-specific measures (*e.g.,* legal and operational unbundling, price regulation).

Sector Inquiry

When Neelie Kroes took office as European Commissioner for Competition Policy in 2004, European energy markets still lacked competitive features, and she announced that competition enforcement in the energy sector would be one of the key priorities for the new Commission. In order to identify any anticompetitive practices and possible market failures, the Commission launched a formal Sector Inquiry into the European energy markets in 2005 and adopted a final report on 10 January 2007.[7] The main problems identified are market concentration, vertical integration and a lack of cross-border market integration. According to the Commission, energy markets are still too highly concentrated in the hands of former national monopolists. To protect their market positions and profits, the inquiry found that incumbents continue to engage in practices that make it difficult for new entrants to enter and compete in the market. Moreover, as network operators and distributors enjoy market power they have the possibility of charging supra-competitive prices. Vertical integration is also considered to result in a lack of liquidity that prevents new entry. In particular, where network and supply companies are integrated, there are too few incentives to invest in networks - a major obstacle to new entry and a threat to security of supply. Finally, the Commission detected an absence of cross-border integration and cross-border competition. Markets and market players remain too national in their

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4. Electricity directive 2003/54/EC, *Official Journal L 176, 15 July.2003, p. 37–56*; Gas directive 2003/55/EC, *Official Journal L 176, 15 July.2003, p. 57–78.*

5. Regulation on cross-border trade in electricity 1228/2003/EEC, *Official Journal L 176, 15 July 2003, p. 1–10.*

6. Regulation on conditions for access to the gas transmission networks, *Official Journal L 289, 3 November 2005, p. 1–13.*

7. DG Competition, Final report on energy sector inquiry, SEC(2006)1724, 10 January 2007.

scope, and insufficient cross-border capacity and different market designs prevent newcomers from transporting energy throughout the European Union.[8]

Remedies

In order to address these issues and to reduce entry barriers, the Commission is determined to apply both competition and regulatory-based remedies rigorously. Immediate measures will include aiming for full ownership unbundling, regulatory improvements and vigorous competition law enforcement. According to the Commission, economic evidence shows that full ownership unbundling would be more effective in strengthening competition than an independent system operator approach as the latter would require more detailed and costly regulation. As national regulators are not well suited to deal with the issue of cross-border energy supply, the Commission is also looking to reinforce coordination among national energy regulators. In addition, the Commission calls for European Community oversight to ensure internal market interests. The Commission indicated that it is also determined to pursue infringements of Community competition law forcefully. It has emphasized that this includes increased scrutiny in merger control proceedings and the use of divestiture obligations or energy release programs to ensure that European markets will become or remain competitive.[9]

Vigorous Enforcement of EC Competition Law is Expected

EC competition law is primarily concerned with problems that occur where a company possesses a degree of market power. In order to determine whether a company has market power it is always necessary to identify the "relevant market."[10] Given the efforts of the Commission and national regulators, energy market structures are bound to be subject to rapid change and thus "the definition of the relevant product market(s) must take into account the existing degree of market opening thereof."[11] Especially as regards the geographical scope, it can be expected that energy markets, which are currently considered national or even regional in scope, will be defined more broadly in the future as cross-border market integration increases. Meanwhile companies run a considerably higher risk of being subject to a Commission investigation, as the Commission has announced that it will pursue forcefully infringements of EC competition law, particularly so as to reduce entry barriers for newcomers. To this

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8. DG Competition, Final report on energy sector inquiry, SEC(2006)1724, p. 6 *et seq.*

9. DG Competition, Final report on energy sector inquiry, SEC(2006)1724, p. 10.

10. As to the different markets in the energy sector see *Christopher W. Jones* (editor), EU Energy Law, Volume II, EU Competition Law and Energy Markets, chapter 2 *et seq.*; Commission notice on the definition of the relevant market for the purposes of Community competition law, Official Journal C 372, 9 December 1997, p. 5–13.

11. Cf. Commission Decision of 9 September 2004, COMP/M.3448, EDP/Hidroelectrica del Cantabrico, para. 9.

end the Commission works closely together with national authorities within the general procedural framework laid down in Article 11 of EC Regulation 1/2003.[12]

In the Area of Cartels

Hard-core cartels are one of the most serious violations of EC competition law. It is possible that market partitioning arrangements by territory or customer in the energy sector still take place in various forms. Such market or customer sharing arrangements in the form of a direct or indirect agreement or a concerted practice ("gentlemen's agreement") always infringe Article 81 EC.

Through an Increased Number of Dawn Raids

In May 2006, Commission officials carried out unannounced inspections at the premises of gas companies in Germany, Italy, France, Belgium and Austria.[13] In December 2006, Commission officials inspected the premises of electricity companies in Germany.[14] Based on the findings of the sector inquiry, further inspections might take place once the material obtained in the course of the dawn raids mentioned above has been properly analysed.[15]

By Imposing Higher Fines

Until recently the Commission focused on reaching settlements in order to create competitive energy markets. In the GFU case,[16] a committee negotiated natural gas sales contracts with a limited number of purchasers on behalf of all Norwegian gas producers and thus fixed the selling price, volumes and all other trading conditions. This agreement based on a Norwegian law was held to infringe Article 81(1) EC and could not be exempted under Article 81(3) EC. However, due to the fact that the energy markets were undergoing fundamental changes the Commission did not fine the participants, and instead accepted the commitment by the Norwegian gas producers that they would market their gas individually in future. With the Commission's determination to enforce

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12. Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, Official Journal L 1, 4 January 2003, p.1-25.

13. Commission, Commission has carried out inspections in the EU gas sector in five Member States, MEMO/06/205, 12 December 2006.

14. Commission, Commission has carried out inspections in the German electricity sector, MEMO/06/483, 12 December 2006.

15. In this context the Commission already initiated proceedings against E.ON and RWE; See case COMP/39.326, Notice on the initiation of proceedings, 2 October 2006.

16. Case COMP/36.072, GFU - Norwegian Gas Negotiation Committee, IP/02/1084, 17 July 2002; See also *Lindroos/Schnichels/Svane* "Liberalisation of European Gas Markets - Commission settles GFU case with Norwegian gas producers", Competition Policy Newsletter 2002 (3), p.51.

competition law in the energy sector it is likely that future infringements will be subject to substantial fines. Although not in the energy sector, the Commission just recently imposed a fine for participants of a cartel close to EUR 1 billion.[17] Since substantial fines are supposed to make up for the lack of criminal sanctions at EU level,[18] the Commission has issued new guidelines on fines which are designed to increase fines further so as to better deter offenders, and in particular repeat offenders who will now be subjected to a one hundred percent increase of the fine.[19]

In the Area of Distribution Agreements through Intensified Scrutiny

Energy is commonly supplied on the basis of exclusive long-term purchasing and supply agreements. Typical exclusivity arrangements include non-compete obligations and exclusive distribution agreements. The main concern arising from vertical restraints is market foreclosure.[20] Thus vertical agreements between energy providers and purchasers are likely to have a negative effect on competition only where the company imposing vertical restraints has some degree of market power.[21] This is also recognised in the vertical block-exemption regulation where vertical arrangements imposed by a supplier with a market share below thirty percent of the relevant market are exempted from Article 81(1) EC.[22] However, given the lack of cross-border trade, many markets remain still national in scope and thus, market shares of above thirty percent in the energy sector are not exceptional. For many companies, the risk of not being able to rely on their supply agreements poses a far greater threat than an administrative fine. If a contract does not comply with EC competition law some clauses or the whole contract might be null and void and thus unenforceable in national courts. For example, some gas producers that sell into the EU use a so-called "*destination clause*" in their long-term supply agreements. These clauses prevent a wholesaler from reselling outside the country where it is established. In the GDF case, the Commission considered that these territorial restrictions infringed Article 81 EC as they partitioned national markets and prevented consumers from be-

17. Cf. Commission, IP/07/209, 21 February 2007, Commission fines members of lifts and escalators cartels over € 990 million.

18. Cf. *Neelie Kroes*, Speech/06/494, 15 September 2006, Developments in anti-trust policy in the EU and the US, The C. Peter McColough Series on International Economics, The Council on Foreign Relations, New York, 15 September 2006.

19. Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003. Official Journal C 210, 1 September 2006, p. 2-5; See also *Wils Wouter P.J.*, "The European Commission's 2006 Guidelines on Antitrust Fines: A Legal and Economic Analysis", World Competition - Law and Economics Review, Vol. 30, No. 2, June 2007.

20. Cf. Commission notice - Guidelines on Vertical Restraints, Official Journal C 291, 13 October 2000, p. 1-44.

21. Guidelines on Vertical Restraints, s*upra*, footnote 20,, paragraph 6.

22. Art. 2(1) Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, Official Journal L 336, 29 December 1999, p. 21-25.

ing supplied by ENI and ENEL.[23] In line with this decision the Commission has been investigating territorial sales restrictions in supply contracts between gas producers and European wholesalers for some time.[24] Generally such provisions constitute a breach of European competition law and according to the Commission undermine the on-going creation of a truly European gas market.

Vertical agreements which are national in scope have also been held to infringe EC competition law. In January 2006, the German Federal Cartel Office (FCO) released a formal prohibition decision against E.ON Ruhrgas AG, Germany's largest gas supply company, stating that the exclusive long-term gas supply contracts with its regional and local distributors violated Articles 81 and 82 of the EC Treaty as well as Section 1 of the German Act Against Restraints of Competition (ARC). Following a landmark decision of the Higher Regional Court Düsseldorf, which confirmed the immediate effect of the FCO decision, E.ON had to adjust its contracts as from October 2006. In November 2006, the gas transmission companies Wingas, Gasunion and Saarferngas made binding commitments to the FCO to adapt their respective gas supply contracts accordingly. As a general rule, the FCO regards contracts as prohibitive under competition law when they cover more than eighty percent of the actual gas requirements of the purchaser and run for more than two years, or cover fifty percent or more and run for more than four years. Moreover, where there is a tacit renewal clause the FCO will consider the contract as having been concluded for an unlimited period of time. Finally, for the purpose of the competition analysis, multiple supply contracts between a gas supplier and the same local or regional distributor will be regarded as one individual contract. The FCO considers this rigid assessment of vertical supply agreements necessary to open up the gas market in Germany. In fact the policy allows local utilities to choose between suppliers more frequently although they seem to be hesitant to do so due to the importance of issues like planning reliability and long established relationships (including cross-holdings).

In the Law of Abusive Behaviour Through Enforcement on EU Level

Article 82 EC only applies if a dominant position is held in the EU or a substantial part thereof. In this regard, the ECJ has held that a dominant position covering a whole Member State constitutes a substantial part of the EU.[25] It is therefore likely that companies controlling high voltage grids or the gas transport network in one Member State will be regarded as dominant on the European level within the meaning of Arti-

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23. Case COMP/38.662, GDF/ENI/ENEL, IP/04/1310, 26 October 2004.

24. Cf. the Gazprom cases COMP/38.085 (Austria), IP/05/195, 17 February 2005; COMP/38.308 (Netherlands), IP/03/1345, 6 October 2003; COMP/38.307 (Germany), IP/05/710, 10 June 2005.

25. ECJ, Case 127/73, BRT/SABAM II, ECR 1974, p. 51; see also Commission decision, Irish Sugar, 1997 Official Journal L 258, p. 16.

cle 82 EC. Most likely operators of local distribution networks will not have a dominant position in a substantial part of the EU. Thus questions relating to excessive pricing in the end-customer segment will continue to be assessed under national law. In this context certain national legislative developments are underway with a view to targeting excessive pricing of energy suppliers.[26]

However, as energy companies are operating in increasingly integrated energy markets their behaviour has an effect on trade between Member States and so the Commission is more likely to intervene. This is particularly true if energy companies engage in activities which are intended to keep competitors out of their "traditional" markets. There are currently several complaints before the Commission based on Article 82 EC that concern cross-border network/information access or capacity reservations. However, against the background of the Commission's proposal calling for a European Regulator[27] it remains to be seen whether the Commission will take these cases forward.

And, in Merger Control Proceedings Through Increased Scrutiny

Mergers that would create or strengthen a dominant position in "small" national markets are often carried out with the aim of creating a pan-European energy company able to compete at a pan-European level.[28] The current merger decisions of the Commission in the energy sector seem not only to address competition concerns but sometimes seem rendered with a view to encouraging cross-border trade.[29] Nevertheless, at the same time, the Commission is keen to avoid fostering monopolisation of European energy markets through a lax application of the EC Merger Regulation (ECMR).[30] It can be expected that the Commission will continue to require the parties to concentrations for example to divest businesses or provide for gas release programmes.[31] On the other hand the Commission will continue to act against Member States that it perceives as attempting to protect their national incumbents.

After the Commission had cleared the acquisition of Endesa by E.ON without conditions the Spanish energy regulator (CNE) imposed

26. See for example the legislative project for specific law on unilateral conduct in Germany; draft available at: draft available at: http://www.bmwi.de/BMWi/Redaktion/PDF/Gesetz/entwurf-gesetzes-bekaempfung-von-preismissbrauch,property=pdf,bereich=bmwi,sprache=de,rwb=true.pdf.

27. *Supra* under "Remedies."

28. See for example Case COMP/M.4110, E.ON/ENDESA.

29. See *M. Piergiovanni* "EC Merger Control Regulation and the Energy Sector: An Analysis of the European Commission's Decisional Practice on Remedies," Journal of Network Industries, (2003) 4, p. 227.

30. Council Regulation (EC) No 139/2004 of 20 January 2005, Official Journal L 24 of 29 January 2004, p. 1.

31. See Commission Decisions of 8 October 2004, COMP/M.3410, Total/Gaz de France and of 6 June 2006, COMP/M.4141, Linde/BOC.

several conditions on the intended concentration.[32] CNE claimed that its decision was based on legitimate public interests and therefore was covered by Article 21(4) of the ECMR. The Commission disagreed and adopted a decision holding that Spain had violated Article 21 since (i) the CNE adopted the decision without prior communication with (and approval by) the Commission and (ii) the submission of E.ON's acquisition of control over Endesa was subject to a number of conditions that were contrary to the EC Treaty's rules on freedom of establishment (Art. 43 EC) and free movement of capital (Art. 56 EC).[33] It is obvious, especially based on the legitimate concern of ensuring security of supply that national interests still prevail among Member States.[34] In this context the Commission just recently revisited the E.ON/Ruhrgas merger in which the opposing decision by the FCO had subsequently been overruled by the German Ministry of Economics. Until a coherent European energy strategy is in place, Member State's initiatives to create "national champions" will continue to give rise to Commission action under EC competition law.

The Way Ahead

While vigorous competition law enforcement can make a significant contribution, it cannot be expected to open markets and resolve all the shortcomings identified by the Sector Inquiry. Consequently, following the adoption of the Green Paper calling for a European Strategy for Sustainable, Competitive and Secure Energy published in March 2006, the Commission recently issued a communication to the European Council and the European Parliament calling for a coherent energy policy for the EU that sets out the need for a coherent EU energy policy.[35] This communication introduces an action plan to combat climate change, limit the EU's external vulnerability to imported hydrocarbons, and promote jobs and growth, with a view to providing secure and affordable energy to customers. Key issues of this action plan include a commitment to further unbundling of networks, the establishment of a European regulatory body for the energy sector, the harmonization of technical standards, and the reduction of energy consumption and greenhouse gas emissions.

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32. Commission Decision of 25 April 2006, COMP/M.4110, E.ON/ENDESA; A similar example would be the acquisition by AEM and EDF of Edison, Commission Decision of 12 August 2005, COMP/M.3729, EDF/AEM/EDISON.

33. See Commission, IP/06/1426, Commission opens infringement procedure against Spain for not lifting unlawful conditions imposed by CNE on E.ON's bid for Endesa.

34. See *Francesco Maria Salerno*, Current Issues of EU Merger Control in the Energy Sector: A Proposed Framework to Foster the Dialogue, ECLR, 2007, p. 65.

35. Cf. Communication from the Commission to the European Council and the European Parliament: An energy policy for Europe, COM(2007) 1 final, 10 January 2007.

It remains to be seen whether the Commission's proposals will find their way through the legislative procedure.[36] In any event, European energy markets, especially in the electricity and gas sectors, have seen their traditional supply structures undergo significant change and this development is likely to accelerate in the future. Besides further regulatory measures (notably ownership unbundling), the possibility to impose far reaching structural remedies for infringements of EC competition law provided for by Article 7 (1) Reg. 1/2003 has explicitly been brought to the fore by the Commission. Measures are also being proposed at a national level.[37] Although it is yet to be seen which national legislative projects on energy regulation will ultimately enter into force, it is likely that national regulators and competition authorities as well as the Commission have a new impetus in their task of opening up energy markets in Europe. While international energy utilities are closely watching those developments and are preparing for market entry, local and national utilities (sometimes backed by their governments)[38] try to reinforce their own positions in order to be ready to meet the growth in competition.

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36. On 15 February 2007, the European ministers for energy indicated already that they are fiercely opposed to the full ownership unbundling suggested by the Commission. As a reaction, Andris Piebalgs, EU Commissioner for energy, admitted that Member States might force him to change his preferred option of full ownership unbundling. Cf. FT.com of 15 February 2007, available at: http://www.ft.com/cms/s/d73c5954-bd21-11db-b5bd-0000779e2340.html.

37. See for example the legislative project for specific law on unilateral conduct in Germany, draft available at: http://www.bmwi.de/BMWi/Redaktion/PDF/Gesetz/entwurf-gesetzes-bekaempfung-von-preismissbrauch,property=pdf,bereich=bmwi,sprache=de,rwb=true.pdf.

38. Cf. recent merger cases in Commission Decision of 25 April 2006, COMP/M.4110 -E.ON/ENDESA or Commission Decision of 14 November 2006, COMP/M.4180 Gaz de France/Suez.