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EU COMPETITION RULES IN THE ENERGY MARKETS

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I. MERGER CONTROL IN THE ENERGY MARKETS

The liberalization of European energy markets encouraged companies to restructure by means of mergers or acquisitions. In particular, the electricity industry has witnessed a wave of mergers and acquisitions following the liberalisation Directive[1]: during 1998 and 1999 there were no less than 20 major mergers and acquisitions in the electricity industry.[2] The merger of German utility giants Viag and Veba, for example, created Germany's largest electric utility.[3] Moreover, a considerable number of mergers and acquisitions have taken place in fully liberalised electricity market of the UK as well, although many of them were realised within the borders of the United States such as British Energy merging with Philadelphia Electric to form AmerGen.[4]

There are mainly two types of mergers involving the energy utilities: those driven by economies of scale and those driven by economies of scope. In the first type of mergers, companies attempt to extend their customer base by acquiring companies operating in a different geographical market, particularly ones that are highly concentrated.[5] Examples of these include the mergers of EdF and London Electricity[6], Preussen Elektra and Dutch Company EZH[7], and Vattenfall and HEW.[8] In the first type of mergers driven by economies

[1] The Electricity Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity, *OJ L 27, 30.01.1997*

[2] Townsend, D., *'Mergers and Acquisitions: Leading the Merger Pack'*, [2000] 34 Petroleum Economist

[3] Commission Decision, Case M 1673, 2000 *Veba/Viag*. In order to be approved by the Commission, Veba/Viag proposed to dispose of numerous holdings in other companies, and make improvements to the ground rules governing the market in electricity, and these commitments allowed the Commission to approve the merger of direct and leading competitors. See for more Schaub, A., *op. cit.*

[4] A limited partnership formed by PECO Energy Company and British Energy on August 18, 1997

[5] Cameron, P., *Competition in Energy Markets: Law and Regulations in the European Union*, Oxford University Press, 2002, p. 325

[6] Commission Decision, Case IV/M 1346, 1999 *EdF/London Electricity*

[7] Commission Decision, Case IV/M 1659, 1999 *Preussen Elektra/EZH*

[8] Commission Decision, Case IV/M 1842, 2000 *Vattenfall/Hamburgische Elektricitiatswerke AG*

of scope, the acquisition is directed at companies active in other energy markets. Examples of this type include the Exxon/Mobil[9] and Veba/Viag[10] in the gas and electricity sectors.

When assessing the compatibility of a merger with the competition rules, the main concern is whether the transaction gives rise to the creation or reinforcement of dominant position formerly held in the common market. The energy industry is not different from others in this respect, and the Commission, thus, applies the general rules applicable to mergers, which are, in particular, Articles 81 and 82 of the Treaty and the Merger Control Regulation.[11]

While these mergers in the energy industry may well have a pro-competitive character, leading to new entry in product or geographical markets, according to Cameron, the converse can also be true, since in the highly segregated energy markets of the EU, they could easily lead to the creation of reinforcement of a dominant position in the market.[12]

Crucial to assess the effects of a merger on competition is to define the relevant geographical and product[13] markets. This is a necessary prerequisite for the identification of other market characteristics, such as the calculation of market shares and the height of barriers to entry. The relevant geographical market is defined by taking into consideration the competitive conditions resulting from distances, transport costs, special or exclusive rights, local consumer preferences, and other relevant factors.[14] In determining the geographical market in the energy sector, the Commission mainly considers the seasonal variations in imports and exports, the existence of transmission bottlenecks, the cross-border transit fee, any differences in various regulatory conditions such as reserve capacity requirements, and other barriers to cross-border trade arising out of environmental policies.[15] The trend in the EU as regards the geographical energy markets is to expand to cover the markets of different Member States, despite the fact that the Commission generally adopts a narrow market definition. It is mainly due to opening up of European electricity and gas markets in the past decade. As the author of a recent book notes, since the European market becomes increasingly liberalised, geographic markets will continue to expand to more regularly cover regional markets that overlap national boundaries.[16]

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[9] Commission Decision, Case IV/M 1383, 1999 *Exxon/Mobil*

[10] Commission Decision, Case M 1673, 2000 *Veba/Viag*.

[11] Regulation No 4064/89, OJ 1989 L 395/1 amended by Regulation No 1310/97, *OJ 1997 L 180/1*

[12] Cameron, P., *op. cit.* at 325

[13] The term of 'product', for the purpose of this section of the study, refers to the service as well.

[14] See Commision Notice on the definition f relevant market for purposes of Community competition law, *OJ C 372/5 (1997)*; see also Article 9(7) of the Merger Regulation.

[15] Schaub, A., *op. cit.*

[16] *ibid.*

The relevant product market comprises all products that are regarded as substitutable by the consumer. In other words, capability for substitution in the specific circumstances constitutes the essential criterion to precise relevant product market. This general rule is also employed in merger cases in the energy sector. For instance, in a case involving the dominant Belgian electricity and gas companies, the Commission defined the gas and electricity markets as separate product markets *"because of very imperfect capability for substitution existing between these two sources of energy."* [17] Similarly, in a 1999 case involving the Berlin gas and district heating supplier, GASAG, and two other energy companies, Gaz de France and BEWAG, the Commission stated that the gas and district heating companies operate in different product markets, since the *"substitutability between gas and district heating is very limited."* [18]

In some other merger cases in the electricity sector, the Commission, by defining the relevant product market, made a distinction between exclusive uses of electricity, e.g. lighting, and certain chemical reactions, and non-exclusive uses for which there is potential substitutability, e.g. heating and traction.[19] However, even for the merger cases falling under latter category where there is a potential substitutability, the Commission has observed that *"substitutability could take place only over a long period of time because it involves different choices of equipment, according to the source of energy chosen."* [20]

A further assessment of the competitive effects of merger cases in the energy sector requires a threefold distinction. First category of mergers involves those between suppliers. Such mergers are rather pro-competitive, if they allow these companies to enter the new markets for trading at exchanges or network services, especially if these are highly concentrated.[21]

Second category relates to the mergers between former monopolists having become direct competitors through liberalization. In these cases, there is a risk that those companies consolidate their strong market position in their former exclusive supply area. The Commission has, in such circumstances, adopted a 'dynamic' approach, taking into account the actual and future conditions for supply competition.[22] According to this approach, conversely to the 'static' view, economical benefits offered by the merger, the degree of market opening, the economic dependence of Transmission System Operators, and the actual conditions for Third Party Access are also taken into account and may lead to approvals.[23]

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[17] Commission Decision, Case No IV/M.493, 1994, Distrigaz/Electrabel

[18] Commission Decision, Case No IV/M. 1402, 1999, Gaz de France/BEWAG/GASAG

[19] e.g. Commission Decision, Case No IV/M.931, 1998, Neste/IVO

[20] Schaub, A., *op. cit.*

[21] *ibid.*

[22] If the proposed merger makes it more difficult the entry into the supply area of former monopolists, it is unlikely to be approved by the Commission. See Cameron, P., *op. cit.* at 325

[23] Albers, M., *'Energy Liberalisation and EC Competition Law'*, Paper in Fordham 28th Annual Conference of Antitrust Law and Policy, October 2001, p. 3

And finally, there is a need to assess the competitive effects of mergers between suppliers of different energy sources, e.g. a merger between electricity and gas suppliers. Similarly to the first category mentioned above, these mergers may be pro-competitive, provided that they lead to new market entry.[24] Examples of this category include merger cases of Tractebel/Distrigaz[25] and Neste/IVO.[26]

II. COMPETITION ASSESSMENT OF LONG TERM ENERGY CONTRACTS

Long-term energy contracts are of considerable importance for the development of the European energy markets, as the demand for energy in the EU is mostly covered by such agreements.[27] They are generally used for gas supply transactions, and have two main types: depletion and supplies contracts: the former involves the purchase of the entire output from one gas field, while the latter provides for the supply of a fixed volume of gas over a number of years.[28]

Long-term contracts have certain benefits in many respects. Their essential benefit to the producers and purchasers is that they provide for the stability, which, as analysed earlier, is a key element in energy transactions. The energy production generally involves a threefold process: first, period of build-up, next the plateau period in referring to the production for a number of years at a constant rate, and lastly, a decline period. As a response against that instability arising from the nature of energy industries, long-term energy contracts, usually concluded for up to twenty-five years, ensure the purchaser a stable energy supply, and ensure the producer a guaranteed outlet for its production.[29]

Long-term energy contracts, however, may give rise to some negative effects, in particular, with respect to the competition in energy markets. Although they are not *per se* illegal under EC law, they might well restrict competition in terms of Article 81 of the EC Treaty.[30] The Commission analyses the compatibility of long-term contracts to the competition rules on a case-by-case basis. It usually states that two basic elements of such contracts restrict competition: first, the long duration of such contracts makes it difficult for third parties to enter the market. The Commission, therefore, generally limits the duration of contracts in order to remove or minimize their anti-competitive effects. In the *Electriadde de*

[24] Schaub, A., *op. cit.*

[25] Commission Decision, Case No IV/M.493, 1994 *Tractebel / Distrigaz, OJ C 249 07/09/1994 p. 3*

[26] Commission Decision, Case No IV/M.931, 1998 NESTE/IVO, *OJ C 218, 14/07/1998 p. 4*

[27] See Discussion Document on Long-term Contracts, Gas Release Programmes and the Availability of Multiple Gas Suppliers. Draft of 22 January 2002 For Discussion At The 5th Meeting Of The European Gas Regulatory Forum.

[28] Roggenkamp, M.M. (Ed.), *Energy Law in Europe: National, EU and International Law and Institutions*, Oxford University Press, 2001, p. 256

[29] Roggenkamp, M.M. (Ed.), *op. cit.* at p. 256

[30] Cameron, P., *op. cit.* at 119

Portugal/Pego[31] and *RENT/Turbogas*[32] cases, for instance, the Commission reduced the duration of contracts to 15 years. In the *ISAB Energy* case, similarly, the Commission held that the case should be re-examined after 15 years of operation.[33] Secondly, exclusive supply provisions may create negative effects, and have thus been examined by the Commission in a number of cases. In *Shotton*[34] and *Industrial Gases*[35], for example, the Commission found such exclusive supply contracts contrary to the competition rules. The ECJ, in the *Alamelo*[36] case, similarly to the Commission, held that the exclusive supply and purchase contracts concluded between the Dutch regional and local suppliers of electricity were contrary to both Articles 81 and 82.[37]

A further element of long-term contracts that the Commission opposes concerns the destination clause, inserted into supply contracts, which prevent the resale of gas from one EU Member State to another. These clauses are generally favored, in the gas supply transactions, by countries with the biggest reserves, such as Algeria and Russia. The Commission considers these clauses as infringing the EU single market rules, and thus opposes them. According to European competition commissioner Mario Monti's spokesperson Amelia Torres: *"The Commission has no problem with long-term gas supply contracts, we recognize the uses of this type of contract for necessary investments, which are very costly and assure security of supply, [...] but destination clauses are contrary to the single gas market"*[38]

As seen above, the Commission does not totally prohibit long-term energy contracts, but usually requires for reduction in their durations - generally to 15 years – and for amendments in their anti-competitive clauses. Because, although some elements of such contracts restrict competition, they ensure the Community's long-term security of supply at a time when it is clear that the Europe's external energy dependence will increase over coming decades. Consequently, it appears that the question of whether such long-term contracts can be approved for security or continuity of supply reasons have to be evaluated by taking into consideration their practical positive and negative effects on a case-by-case basis.

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[31] *Electriadde de Portugal/Pego* [1993] *OJ C 265/3*. The contract was originally concluded for 28 years.

[32] *RENT/Turbogas* [1996] *OJ C 118/7*

[33] *ISAB Energy* [1996] *OJ C 138/3*

[34] *Shotton* [1990] *OJ C 106/3*

[35] European Commission, XIXth Report on Competition Policy, p. 18

[36] [1994] ECR I-1477

[37] See for details Roggenkamp, M.M. (Ed.), *op. cit.* at p. 257

[38] Quest Economics Database, MEED Quarterly Report, *"Maghreb Gas Projects"*, July 11, 2002, available at Lexis.

III. STATE AIDS TO THE ENERGY SECTOR AND ARISING COMPETITION ISSUES

State aids involving energy industries are granted for almost all types of energy sources ranging from oil refineries[39] to nuclear plants to the supply of district heat[40], and in several forms. This has mainly been a result of the expansion of the State aid concept by the Commission and the ECJ.[41] The latter has consistently held that the concept of State aid is not limited to directly financial measures, such as the provisions of a capital subsidy[42], but includes any other intervention involving State resources that might produce an economic benefit for a particular undertaking.[43] In *Sloman Neptune*, for instance, the ECJ stated that any benefit granted directly or indirectly out of state resources must be considered as State aid.[44] The ECJ later held that, in determining whether a measure is to be regarded as State aid, 'no distinction should be drawn between cases where aid is granted directly by the State and cases where it is granted by public or private undertakings established or appointed by the State.'[45]

The Commission further expanded the concept of State aid so as to require notification by the Member States of measures that were not originally State aid but which have become aid due to the evolution of the market.[46] Consequently, as the author of a recent study wrote, a very broad range of benefits are covered by the scope of Article 87, including interest subsidies, grants, interest-free or low-interest loans, asset revaluations, compensation for government-imposed financial burdens, preferential terms, price reductions, reduction in social security charges, State guarantees, and tax exemptions.[47]

The legal basis for State aids under Community law is particularly Articles 87-88 (ex 92-93) of the EC Treaty. The general principle set forth in Article 87(1) is that any State aid which distorts or threatens to distort competition by favoring *certain* undertakings or the production of *certain* goods, is incompatible with the common market.[48] It thus appears that

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[39] e.g. Commission Decision 77/260/EEC of 22 March 1977 concerning aid planned by the Belgium Government towards the extension of capacity of an oil refinery at Antwerp, OJ 1977 L 80/23

[40] In particular for the coal industry

[41] See Hancher, L., Ottervanger, T., and Slot, P., EC State Aids, 1999; cited in Roggenkamp, M.M. (Ed.), *op. cit.* at p. 245

[42] e.g. Case 30/59 *De Gezamenlijke Steenkolenmijnen in Limburg v High Authority* 819619 ECR 1, 19

[43] Roggenkamp, M.M. (Ed.), *op. cit.* at p. 248

[44] Joined Cases C/72-91 and C/73/91 *Sloman Neptune* [1993] ECR I-887

[45] Case C-305/98 [1991] ECR I-1603

[46] See Council Regulation (EC) No 659/1999 of 22 March 1999

[47] Roggenkamp, M.M. (Ed.), *op. cit.* at p. 248

[48] Article 87(1) set fort that *'Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens*

the measures concerning State aids are twofold: general and specific measures. In other words, general measures favoring *all* undertakings within a Member State are outside the scope of Article 87(1), while specific provisions, which are envisaged at favoring certain undertakings or the production of certain goods, are incompatible with the common market. This distinction made between general and specific measures is also known as the selectivity principle. An example of this principle, in the energy sector, can be seen in a Commission Decision on a State aid granted by Italy.[49] That State aid envisaged at granting benefits to the energy utility sector has been considered as specific measure, since the eligibility for these benefits depended on the legal status of the undertakings and on the nature of shareholders.[50] Consequently, that measure has been held within the scope of Article 87(1) and incompatible with the common market.

Another main element of Article 87(1) relates to the effect on competition of the measure taken by a Member State. The measure must distort or threaten to distort competition in order to fall within the scope of Article 87(1). According to the ECJ's case law, whether or not the measure distorts or threatens to distort the competition in the market requires the examination of whether the measure strengthens the position of the beneficiary.

The final element of Artic le 87(1) concerns the effect of the measure on trade at Community level. The measure must affect trade between Member States in order to be considered as state aid for the purpose of Article 87.[51] The example of Italian State aid mentioned above also constitutes an example of the effect at Community level. Because, the benefits to local public undertakings might result in that these beneficiary undertakings bid at more competitive prices than national or foreign undertaking not benefiting from the aid, so making a negative impact on trade between Member States.[52]

Article 87(2) enumerates three exceptional types of State aid that are compatible with the common market:

(a) aid having a social character, granted to individual consumers[53];

(b) aid to make good the damage caused by natural disasters or exceptional occurrences; (c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, insofar as such aid is required in order to compensate for the economic disadvantages caused by that division.[54]

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to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market.'

[49] *OJ 1999 C 220/14*

[50] Roggenkamp, M.M. (Ed.), *op. cit.* at p. 247

[51] e.g. ECJ Case No. 248/84 *Germany v Commission* [1987] ECR 4013

[52] See Roggenkamp, M.M. (Ed.), *op. cit.* at pp. 250-251

[53] Provided that such aid is granted without discrimination related to the origin of the products concerned.

[54] After the German reunification in 1990, the Commission does no longer consider State aid in the former Federal Republic of Germany under Article 87(2)(c), but Article 87(3)(a),

Article 87(3) sets out five aid categories that may be exempted.[55] The difference between Article 87(2) and 87(3) is that the Commission has no discretion to decide whether the aids listed in Article 87(2) are compatible with the common market, while it is in the discretion of the Commission to grant exemption for five aid categories listed in Article 87(3). For instance, as the Commission stated, the schemes for energy saving and diversifying energy resources may be exempt as important projects of common interest.[56] Both the Commission[57] and the ECJ[58] have interpreted this discretion in a restrictive manner.

Pursuant to the provisions of Article 88 of the EC Treaty, the Commission must regularly reviews notifications of State aids granted by the Member States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the common market.[59] If, the Commission finds that aid granted by a State or through State resources is not compatible with the common market, or that such aid is being misused, by virtue of Article 88(2), it shall require from the State concerned to abolish or alter such aid.

The Commission, when assessing the compatibility of State aids with the common market, pays particular attention to a number of aspects, including the promotion of renewable energy sources and securing a level of security of energy supply. Concerning the latter, the Commission authorizes Member States to give priority to coal energy, to an extent not exceeding a fixed threshold based on their annual energy consumption, in order that they might meet a certain level of supply security. For this purpose, the Commission has recently adopted some Decisions authorizing some Member States to grant aid to the coal industry.

The Commission also gives particular emphasis to the assessment of State aids for environmental protection. It issued, in 1994, the Community guidelines on State aid for environmental protection[60], which expired on 31 December 1999. Although these guidelines

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which will later be dealt with. See the Commission's *'XXth Report on Competition Policy'*, paragraph 178.

[55]These categories are: *'a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment; b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State; c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest; d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest; and e) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.'*

[56] The Commission's VIIth Report on Competition Policy

[57] *ibid.*

[58] Bkz. ECJ Case No. 730/79 *Philip Morris Holland v. Commission* [1980] ECR 2690

[59] Article 88(1)

[60] *OJ C 72, 10.3.1994, p. 3*

have been reviewed in the light of market liberalization trends[61], the Commission extended the validity of the 1994 guidelines first on 22 December 1999 until 30 June 2000[62]; and then on 28 June 2000 until 31 December 2000[63]. In 2001, however, the Commission has adopted new guidelines with respect to State aids on environmental protection[64]. Under the new rules, governments can choose between several options for granting investment and operational aid, including covering the difference between production costs and market returns, and introducing green certificates.[65] These new guidelines will be effective until 31 December 2006.

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[61] See Roggenkamp, M.M. (Ed.), *op. cit.* at p. 247

[62] *OJ C 14, 19.1.2000, p. 8*

[63] *OJ C 184, 1.7.2000, p. 25*

[64] Community guidelines on State aid for environmental protection *OJ C 37 2001. p. 3*

[65] *'Energy State Aid Gets New Rules'*, Reed Business Information Ltd. Utility Europe, February 1, 2001, p. 7, available at Lexis.