

MLex Ab Extra:

Refilling the pipeline

Lars Kjølbye of Covington & Burling examines how EU gas and power markets have met with increased competition scrutiny in the past five years



Lars Kjølbye

Lars Kjølbye is a partner in the Brussels office of Covington & Burling, with broad experience in EU competition law. His practice focuses on complex cases in the areas of abuse of dominance, restrictive practices and merger control. Lars spent 10 years at the European Commission's Competition Directorate General, including heading the energy and environment antitrust unit from 2006 to 2008.

MLex's online market intelligence services have become indispensable primary resources for anyone requiring reliable, comprehensive, real-time intelligence, commentary and analysis about the impact of European regulation on businesses around the world.

REFILLING THE PIPELINE

Lars Kjølbye examines how EU gas and power markets have met with increased competition scrutiny in the past five years

Introduction

Over the past five years EU gas and electricity markets have seen an unprecedented level of intervention by competition authorities, in particular the European Commission. Using an energy sector inquiry to spearhead change, DG Competition and DG Energy worked closely together to make a decisive push towards achieving the common goal of creating integrated and competitive gas and electricity markets in the European Union. The results are well-known. The EU adopted the Third Package in 2009, containing far-reaching regulatory reform, and the commission pursued a number of high-profile antitrust cases addressing the main concerns identified in its energy sector inquiry. These antitrust cases have now been concluded, raising the question of where antitrust enforcement in the energy sector will go from here. Will it remain aggressive, will the focus change, and will it continue to push the boundaries of the law?

There is little doubt that the energy sector will remain high on the commission's agenda. The European Council has continuously stressed the importance of creating a truly competitive, interconnected and single Europe-wide internal energy market and in its November 2010 Energy 2020 Communication, the commission stressed that active competition policy enforcement at European and national level remains indispensable to foster competition and guarantee that consumers have access to energy at affordable prices.¹

However, it is also clear that the dynamics are changing. DG Energy is now focusing on the implementation of the Third Package, and some of its new policy initiatives – such as the proposed regulation on energy market integrity and transparency – may sit uneasily with DG Competition's general concern about transparency in concentrated markets. Moreover, climate change objectives put traditional market

mechanisms under pressure. Renewable energy sources are still not price-competitive, but account for an increasing share of output which is supplied outside the reach of the very market mechanisms that DG Competition is tasked with protecting. Hence, the clear mandate for strong antitrust enforcement that the commission established with the sector inquiry and the Third Package proposals may be under pressure. This article takes stock of the past and current policy context, and discusses likely developments in light of recent investigations launched by the commission.

The Enforcement Mandate created by the Third Package and the sector inquiry

Against the background of insufficient progress in creating integrated and competitive gas and electricity markets in the EU, in 2005 the commission launched a large-scale energy sector inquiry to identify why past market liberalisation efforts

had not had the desired effect. Markets remained national in scope and dominated by incumbent operators. In parallel, the commission developed what became the Third Package. DG Competition and DG Energy worked hand-in-hand throughout the process, united by a common set of objectives and principles. These objectives and principles were enshrined in the commission's 10 January 2007 Communication on an Energy Policy

for Europe, which was adopted on the same day as the final report on the energy sector inquiry.²

In this Communication, the commission stressed that a real internal energy market is essential to meeting all of Europe's key energy challenges, namely (a) competitiveness – a competitive market cuts costs for citizens and companies and stimulates energy efficiency and investment; (b) sustainability – a competitive market allows for the effective application of economic instruments including the emissions trading

The European Council stresses the importance of a competitive and interconnected Europe-wide internal energy market

mechanism to work properly; and (c) security of supply. These objectives were subsequently sanctioned by the Heads of State in the European Council.

Thus, the commission had a broad mandate to make a decisive push to create competitive energy markets, and DG Competition was ready to pursue a significant number of cases that reflected in particular the broad concern that vertical integration of network operations and supply led to disincentives to make efficient use of existing cross-border capacity and to invest in new capacity. There was broad commission support for launching antitrust investigations that would address these key concerns, even if it meant taking the EU competition rules into untested territory. The ground had been well prepared by the energy sector inquiry that had identified the following key areas of concern:³

Concentration: The inquiry found that wholesale gas and electricity markets had been slow to develop and that the incumbents remained dominant on their traditional markets, preventing the internal market from delivering cost-reflective prices to consumers. The concern that high concentration levels enabled incumbents to manipulate markets and charge higher prices to consumers is also reflected in the Third Package, which requires producers to store production data such that allegations of manipulation can be verified by regulators.

Vertical foreclosure: The inquiry found that new entrants lacked effective access to networks despite existing unbundling requirements. Vertically integrated network operators were suspected of favouring their own affiliates (discrimination). According to the commission, vertical integration had led to a situation where operational and investment decisions were not taken in the interest of network/infrastructure operations, but on the basis of the supply interests of the integrated company. These concerns featured prominently in the commission's Third Package proposals. Ineffective unbundling, inadequate investments in new transmission capacity and ineffective third party access to existing capacity were key concerns that the commission wanted to address.

Market integration: According to the sector inquiry, new gas entrants were unable to secure transit capacity on key routes or entry capacity into new markets. It was found that very often incumbents controlled capacity on transit pipelines and had little incentive to expand capacity to serve the needs of new entrants. Expansions were generally tailored to the needs of the incumbents' own supply businesses. In electricity markets, integration was said to be hampered by insufficient interconnector capacity and a lack of adequate incentives to

invest in additional capacity to eliminate long-established bottlenecks. These concerns are also mirrored in the Third Package.

Downstream contracts: The Energy Sector Inquiry also focused on customer foreclosure due to long-term supply contracts, and found problems in certain Member States. Again, there was a close link to the commission's market-liberalisation efforts. Enabling consumers to freely choose their supplier formed an important part of the Second Package, and without such freedom the Third Package would not be effective in opening up markets.

The commission's use of its Enforcement Mandate

The strong mandate for action adopted by the commission and supported by Member States paved the way for an unprecedented number of enforcement actions in a single sector of the economy. Some of these actions are briefly described here to underscore the almost perfect fit between the commission's broader policy objectives and its competition policy, both in terms of its focus and the remedies that the commission achieved.

Incumbents often controlled capacity on transit pipelines and had little incentive to expand capacity to serve the needs of new entrants

In the *German Electricity Wholesale Market* case, the commission intervened against alleged market manipulation by an incumbent generator. The commission considered that the generator in question had significantly increased prices by withholding generation capacity that it would

have been profitable (but not profit-maximising) to run. The commission closed the case by accepting a commitment to divest significant generation capacity.

In the *RWE Gas foreclosure* and *ENI* cases, the commission intervened against capacity hoarding and so-called strategic underinvestment in gas pipelines. The underlying idea is that the owner of a bottleneck infrastructure abuses its dominant position if it fails to invest in new capacity despite clear third-party demand. The vertically integrated network operator should gauge whether an investment would be commercially attractive from the perspective of network operations, and not stand idle due to affiliated supply interests. The case takes the so-called essential facility doctrine into new territory. Owners of an essential facility may be required to give third parties access to their facility, but the doctrine had never before been used as a basis for requiring facility owners to add new capacity. The commission closed the case by accepting commitments to divest transmission pipelines, i.e. ownership unbundling which was its preferred option in the Third Package.

In the *GDF* and *E.ON gas foreclosure* cases, the vertically

integrated incumbents had booked on a long-term basis most of the entry capacity into their respective national markets. The reservations were backed by long-term upstream supply contracts with gas producers. As a result of the capacity reservations, third parties had only limited scope for importing gas into France and Germany. The commission took the view that the long-term reservation of capacity in what it deemed to be an essential facility was abusive, since it led to long-term market foreclosure.

The commission closed the case by accepting commitments to release a significant amount of capacity. These cases are further examples of the commission's expansionist application of the essential facility doctrine, in that it considers it abusive for a vertically integrated firm to reserve its own capacity for itself. The vertically integrated company was actually using its capacity; there was no capacity hoarding.

The competition concerns relating to long-term contracts with industrial users were addressed by the commission in the *Distrigas* and *Long-term electricity contracts France* cases, in which the commission accepted commitments whereby the incumbent undertook to reduce the share of the market covered by such contracts and to limit their duration.

Is the commission's mandate intact?

In the course of 2010, the commission concluded the last of the cases that it had launched under the mandate created by the combined strength of the sector inquiry and the Third Package proposals. While there is little doubt that the energy sector remains a priority for the commission and that it is seeking to refill the pipeline with new case investigations that seek to address further obstacles to the creation of open, integrated and competitive energy markets in the EU, the dynamics are likely to change, for several reasons.

First, the EU energy agenda has moved on to issues on which the alignment with competition policy is less clear. The unbundling battle is over (at least for the time being). The commission is focusing on climate change, development of market codes and rules, cross-border co-operation between regulators and network operators, the development of investment programmes, market transparency etc. As a result, the strong alignment that existed between DG Energy and DG Competition at the time of the inquiry and the Third Package proposals is no longer required. Moreover, the regulatory and competition agendas may even diverge in certain areas. For example, in December 2010 the commission adopted a proposal for a regulation on energy market integrity and transparency (Remit), which imposes on

market operators to disclose *inter alia* production data.⁴ At the same time the commission adopted new antitrust guidelines on horizontal co-operation agreements that for the first time contain a chapter on information exchange, identifying concerns about *inter alia* certain exchanges of production data. There is a potential conflict between the belief commonly held by regulators that transparency is virtually always good and the belief commonly held by antitrust enforcers that transparency may be problematic.

Second, the commission's enforcement agenda is moving on. Being responsible for developing EU competition policy, the commission has a special responsibility to address new issues. This is particularly so in relation to markets such as energy, which have been and still are considered predominantly national in scope. National competition authorities are well-placed to deal with competition issues in their respective markets, unless that cases raise issues of general EU interest that should be dealt with by the commission in "leading cases." The commission has dealt extensively with issues relating to network access, and therefore needs to develop new legs to stand on. This does not mean that network-related cases will no longer be a priority, but it is highly likely that it will be merely one priority among others and not the core focus. The commission is looking beyond the priorities that followed from the sector inquiry and the Third Package. As a result, it is likely to take action in areas that have a less direct link with broader EU policy objectives.

A new enforcement agenda

Looking ahead, two areas seem particularly attractive as a basis for establishing a new enforcement agenda: (i) attempts to prevent new market entry and (ii) co-operation arrangements between competitors.

Preventing new entry

In many Member States, generation assets are ageing and need to be replaced. If they are not, there is a risk of a significant generation gap. Given these broader concerns at EU level, it is attractive for EU competition policy to play its part by intervening against mergers and conduct that prevent or delay new entry. There are clear signs that this is indeed a significant priority for the commission. For example, in the recent *EDF/SPE* merger case, the commission obtained commitments aiming at ensuring that investment projects, which were planned pre-merger, would be implemented post-merger.

Moreover, the commission is currently investigating whether an incumbent has sought to exclude new entry by reserving

The commission is investigating whether an incumbent has sought to exclude new entry by reserving more grid capacity than it needs

more grid capacity than it needs for its own plants and projects. Access to grid capacity is a prerequisite for building new generation capacity, and energy companies may therefore be able to prevent new generation projects by reserving more grid capacity than they need. At first sight, this case might seem similar to those brought by the commission in the wake of the sector inquiry, since grid capacity is a key feature. However, the current investigation does not raise any issue of vertical integration. The commission has moved on and is now focusing on whether non-integrated energy companies are engaging in conduct that prevents new entry. Moreover, its recent decision to open a formal investigation against Areva and Siemens regarding nuclear technology shows that the commission is not only targeting energy supplies; it is also taking a close look at technology providers to verify whether they have engaged in conduct that prevents new entry and thereby the availability of alternative technologies or sources of supply.

Co-operation arrangements

For quite some time the commission has watched consolidation in the gas and electricity sectors with some unease. It is concerned that by the time that it achieves its goal of creating integrated EU energy markets, they will no longer be competitive. The fear is that markets will be dominated by a limited number of pan-European operators that are linked by a web of co-operation agreements. As a result, the commission is likely to increasingly look at the ways in which large energy companies co-operate as buyers, producers and sellers.

The commission has held the view for quite some time that networks of co-operation agreements may give rise to competition concerns. However, there are no clear principles giving guidance as to when such concerns are likely to arise. The commission is therefore faced with a difficult task, but in a couple of areas it is able to rely on what are now established principles.

The first area is the recognition that energy companies are able to achieve significant price increases by limiting output. This is particularly true in electricity markets, due to inelastic demand and inability to store the product. Hence, when power companies jointly construct and operate power plants, they may be able to influence the prices through their joint output decisions. This concern is illustrated by the *EDF/British Energy* merger. The

parties had a combined market share not exceeding 30 percent, and faced no fewer than eight competitors (each holding shares of five to 15 percent). The commission nevertheless feared that the combination of British Energy's baseload nuclear capacity with EDF's flexible coal and gas capacity would allow the merged entity to withhold capacity, thereby raising market prices. To address the commission's concerns, the parties divested a coal-fired plant and a gas-fired plant.

The second area is information exchange, which is emerging as an area of significant focus by competition authorities throughout the EU. There are several reasons for this development. First, the EU Court of Justice has recently held that certain information exchanges have the objective to restrict competition, and therefore may be prohibited without showing any likely effects on the market. This makes life easier for enforcers, since such effects are difficult to show. Second, the commission has recently published new guidelines on information exchange, clarifying its approach. Third, information exchanges are attractive to challenge because it can often be done without putting into question any commercial co-operation between the parties, which may be beneficial. Hence, energy companies are well-advised to think carefully about the information that they exchange.

Conclusion

The past five years have seen an unprecedented level of antitrust enforcement activity in the EU electricity and gas sectors. This activity has been driven by a strong mandate to create open, integrated and competitive energy markets in Europe. Energy remains a high priority and the enforcement focus is likely to remain strong. However, the commission's attention is likely to shift to new areas such as co-operation arrangements and a broader range of market foreclosure issues. By so doing, enforcement will be more closely aligned with the commission's focus in other sectors. We are likely to see fewer cases that push EU competition law into new areas to achieve broader policy objectives. The common platform that made this possible is now less pronounced. ■

Lars Kjolbye is a partner in the EU Competition Practice of Covington & Burling. The views expressed in this article are personal to the author and do not reflect the view of Covington or any of its clients.

Footnotes

- 1 Commission Communication of 10.11.2010, Energy 2020 – A strategy for competitive, sustainable and secure energy, COM(2010) 639 Final, p.14.
- 2 Commission's Communication on an Energy Policy for Europe, COM (2007) 1 Final, 10.1.2007.
- 3 Commission Communication on the Energy Sector Inquiry, COM (2006) 851 Final.
- 4 Commission proposal for a regulation on energy market integrity and transparency (Remit), COM(2010) 726 Final.