Commission takes further action to speed up opening of energy markets

Riccardo Celli, Flavia Distefano and Christian Riis-Madsen
O'Melveny & Myers LLP

Since the beginning of the liberalisation process in the energy sector, EU energy markets have faced increasing scrutiny by the European Commission also under EC competition law. It is clear that the Commission was not satisfied with the progress in the opening of the gas and electricity markets and this concern culminated with the launch of a sector inquiry last year. Competition Commissioner Kroes has stated that what the Commission found "was rather worrying" and that its preliminary findings indicated "real market distorsions". Based on these preliminary findings it is no surprise that the Commission intends to step up the already active enforcement of competition rules in the energy sector. This has led to a number of investigations over the past couple of years and also resulted directly in a series of dawn raids this spring.

Structurally, the Commission has also tried to improve the transnational coordination of competition law enforcement in the energy sector. Under the European Competition Network (ECN), the Commission set up an energy subgroup in 2004, which aims to provide a forum to discuss key issues and develop a common approach in the application of EC competition rules in the energy markets.

Many energy companies in Europe have already felt the direct impact of the Commission's increased focus. In any event, energy companies in the EU are well advised to pay particular attention to competition law issues as the risk of future investigations is very high. Similarly, a disgruntled contract party may find it easier to use competition laws to escape from long-term take or pay obligations or similar obligations.

Sector inquiry's preliminary findings

In June 2005, the European Commission, in parallel with the EFTA Surveillance Authority, launched a sector inquiry into the supply of gas and electricity in the EU. The inquiry is based on article 17 of Regulation 1/2003 and comes as a reaction to the significant price increases in recent years and customer complaints that markets are foreclosed.[1]

In February 2006, the Commission published a preliminary report, where it confirmed its initial findings that the EU gas and electricity markets suffer from a number of serious "problems" or "malfunctions", as announced in an "Issues Paper" earlier in November 2005.[2] The preliminary report has been followed by a public hearing and the Commission is expected to draw up a final report with its recommendations by the end of 2006.

In this first phase of the inquiry, the Commission has identified five main impediments to competition in EU energy markets:

- **Market concentration:** Gas and electricity markets are still highly concentrated, in particular at wholesale level, mainly as a result of long-term downstream supply contracts and vertical integration. This high concentration allows incumbent operators to remain dominant in their traditional markets and to exercise market power, eg, by withdrawing capacity or raising prices.
- **Vertical foreclosure:** New energy suppliers are finding it difficult to have access to essential infrastructure and enter the wholesale markets, leading to less consumer choices. Dominant incumbents are usually vertically integrated, so that they have little or no incentive to give third parties access to infrastructure. In gas markets, lack of access also results from long-term downstream supply contracts, which 'lock' almost all of the available gas production. There is consensus that the existing EU rules on third-party access (TPA) and 'unbundling' between supply activities and infrastructure have proved insufficient to ensure effective access to networks.
- **Lack of market integration:** Despite the Community's efforts to create single EU markets for gas and electricity, markets are still largely national, with a low level of cross-border trade flows. Lack of integration results from limited access to or insufficient capacity of transmission systems (import pipelines and storage for gas, and interconnectors for electricity). Many interconnections in Europe are not adequate in size and are chronically congested by legacy contracts, which derogate from normal TPA rules and allow incumbents to control transmission capacity. Many respondents agreed on the need for additional capacity and better congestion management methods for access to interconnections.
- **Lack of transparency:** New market entrants complain of not being able to access key information, notably on access to transmission infrastructure and networks, which they need to compete effectively with incumbent operators.
- **Price setting mechanisms:** Prices are often not determined based on effective competition. Recent increases of fuel prices cannot fully explain the recent and significant increases in gas and electricity prices.

Although the Final Report will undoubtedly discuss possible remedies, based either on competition rules, regulatory action or structural measures, the Commission has already started its efforts to tackle the problems. In May 2006, the Commission carried out two waves of dawn raids in the largest gas companies in five EU countries and in the electricity incumbent in Hungary.[3] The gas companies are suspected to have both abused their dominant position, contrary to article 82 EC, by restricting access to pipelines and storage facilities, and to have put in place market-sharing practices in violation of article 81 EC. In Hungary, the Commission is investigating whether long-term purchase agreements in the wholesale electricity markets create anti-competitive effects. In a separate investigation, Belgian dominant gas company Distrigaz is suspected to have abused its dominant position by concluding long-term gas supply agreements with several industrial customers, with the effect of preventing new suppliers from entering the Belgian gas markets. Distrigaz received a statement of objections in May 2006.[4] This approach should come as no surprise. It is clear that such aggressive enforcement of the EC competition rules provides for the fastest means of intervening since it is not subject to a lengthy legislative procedure. At the presentation of the preliminary findings, Commissioner Kroes stated: "we are just at the beginning of a period of more intensive antitrust enforcement. I can only encourage everyone to take a closer look at their practices. Prevention is always better than cure". That warning should not be ignored.

Furthermore, antitrust enforcement was identified as one of three pillars of priority measures set out in the Commission's preliminary report. The main measures identified were:

- Competition enforcement measures, which include: effective action under EC merger control, which is key in addressing market concentration; a close review of the use of long-term downstream contracts allowing to address vertical foreclosure; an in-depth assessment of existing agreements on access to capacity on pipelines, gas storage and interconnectors, as well as of the use of market-partitioning clauses, which are crucial to achieving market integration. The Commission has also announced that it will look closely, in particular, at long-term downstream agreements and contracts restricting access to transport infrastructure and gas storage capacity.
- Regulatory actions, which include: strengthening transparency obligations; reviewing residual capacity rights stemming from pre-liberalisation monopoly contracts (ie, 'grandfathering rights'), which represent a serious barrier to market entry; and increasing the powers of certain national regulators (in particular, granting the power to review TPA conditions and prices).
- Structural measures: the Competition Directorate suggests introducing full 'structural unbundling' (ie, effective separation of supply and retail businesses from monopoly infrastructures, including not only legal, organisational and management unbundling but also ownership unbundling).

The last point was highlighted by Commissioner Kroes, who noted that "owners and operators of critical networks often compete with companies that need to have access to the same networks. Can we expect such integrated companies to treat competitors in a fully fair manner? Their own self-interest would suggest not."

In parallel with the sector inquiry, the Commission has also taken the opportunity to assess the effectiveness of the current legislative 'liberalisation' framework which, as the Commission has recently noted, has proven insufficient to ensure a competitive environment and market integration in the various gas and electricity markets in the EU. In particular, the Commission is reviewing implementation by EU member states of the Second Gas and Electricity Directives[5] and aims to submit proposals in this respect by the end of 2006. In the meantime, in April 2006, the Commission launched proceedings against 17 EU member states for not implementing the energy directives into national law within the required time frame.[6]

The Final Report of the Commission is expected by the end of 2006. This will mark the beginning of a much more stringent and focused enforcement of the competition rules in the energy sector.

Anti-competitive agreements and practices

The Commission has already been an active enforcer of competition rules in the energy sector for a number of years. The great majority of these cases concerned territorial restriction clauses in gas transportation contracts (eg, the decisions in *GDF/ENI* and *GDF/ENEL*, and the settlements in the 'Gazprom' and 'NLNG' cases), which the Commission considered contrary to article 81 EC. The Commission has also been increasingly scrutinising long-term gas supply agreements, which may infringe article 81 or article 82 EC when they have foreclosing effects on downstream markets. This issue is likely to become a more frequent element under scrutiny considering the Commission's preliminary conclusions in the sector inquiry. Other recent Commission cases include the settlements in *DUC/DONC* and *GFU*, concerning joint marketing of gas sales, which were based on relatively old legislative structures on the Danish and Norwegian continental shelf respectively.

Territorial restrictions cases in gas supply

In *GDF/ENI* and *GDF/ENEL*,[7] the Commission adopted two decisions prohibiting territorial restriction clauses contained in the gas supply contracts concluded in 1997 between Gaz de France (GDF) and, respectively, Italian gas company ENI and Italian electricity company ENEL. In particular, the contract with ENI concerned the transport of natural gas that ENI purchased in Northern Europe. The contract included a clause obliging ENI to market the gas only after leaving France ("downstream of the redelivery point"), whereas the contract with ENEL concerned swaps of liquefied natural gas purchased by ENEL in Nigeria and contained a clause requiring ENEL to use the gas only in Italy.

The Commission considered that these territorial restrictions infringed article 81 EC as, by restricting the territory in which the parties could use the gas, they partitioned national markets and prevented French consumers from being supplied by ENI and ENEL. These are the first formal antitrust decisions that the Commission has adopted in the energy sector since a decade which, after a number of cases concluded with a settlement (eg, the contracts with Nigerian NLNG in 2002 and the ENI/Gazprom contracts in 2003), confirm that territorial restriction clauses amount to anti-competitive practices.

The Commission has also recently settled almost all of the investigations it launched in 2001 into gas supply contracts between suppliers outside the EU (ie, Russian Gazprom, Algerian Sonatrach and Nigerian NLNG) and many of their European customers. The investigated territorial restrictions prevented wholesalers from exporting gas outside the countries in which they were traditionally established and limited their incentives to do so, thus undermining the ongoing creation of a European gas market.

The first case that Gazprom settled with the Commission, in 2003, concerned the territorial restrictions in the gas supply agreements with ENI.[8] The companies agreed to delete the restrictive clauses, so that ENI is now free to resell outside Italy the gas it buys from Gazprom. Similar to the Commission's settlement with Nigerian gas company NLNG in 2002,[9] the companies also agreed not to introduce such clauses or clauses with similar effects in new contracts, eg, 'use restrictions' preventing buyers from using gas for purposes other than those agreed and 'profit splitting mechanisms', whereby if gas is sold across borders or for uses other than those agreed upon, then the supplier receives a share of the profits. In addition to deletion of the objectionable clauses, the settlement with ENI and Gazprom contained various other elements aimed at increasing cross-border competition. For example, ENI agreed to offer significant gas volumes to customers outside Italy over a five year period, to increase capacity on the Trans Austria Gazleitung (TAG) pipeline transporting Russian gas to Italy through Austria and to offer an improved TPA access on the pipeline.

Later in 2005, the Commission closed its investigation into Gazprom's gas supply contracts with Austrian gas supplier OMV[10] and German E.ON Ruhrgas.[11] With regard to the contracts between Gazprom and OMV, the companies agreed to delete territorial sales restrictions from their existing contracts, thus allowing OMV to resell the gas outside Austria, and to remove a 'right of first refusal' that required Gazprom to offer any gas in Austria to OMV first, so that Gazprom is now free to sell to any Austrian customer. OMV also agreed to increase third-party access to the TAG pipeline in line with the commitments offered by ENI.

With regard to the contracts between Gazprom and E.ON Ruhrgas, the companies also agreed to remove destination clauses in their gas supply contracts and a 'most favored customer' clause, based on which Gazprom would not supply E.ON Ruhrgas's competitors on better terms than E.ON.

The Commission's investigations continue with regard to imports by Italian and Spanish operators of Algerian gas.

Long-term gas supply agreements

Historically, long-term supply contracts have been a key means for investors to share the inevitable risks linked to investing in energy networks or production. When the downstream counterparty had retail market power or a monopoly, the contracts also allowed the risks to be passed on to customers. The Commission has now clarified that long-term gas supply agreements between suppliers, on the one hand, and distribution companies and industrial and commercial users, on the other, may infringe article 81 or article 82 EC or both, in particular when they foreclose downstream markets, thus preventing customers from switching to alternative suppliers.

As mentioned above, the Commission is currently investigating Distrigaz's long-term supply agreements. Interestingly, the Commission is coordinating with national competition authorities within the ECN Energy subgroup on the application of EC competition rules to these contracts, which national authorities are increasingly scrutinising. For example, the Bundeskartellamt, after publishing a report on the anti-competitive effects of long-term contracts for gas supply to German local utilities (*Stadtwerke*), entered into negotiations with the 15 largest suppliers to introduce clear limits on the duration of the supply contracts. After these negotiations broke down in September 2005, the Bundeskartellamt announced that it would launch formal proceedings. In January 2006, it adopted a formal prohibition decision against E.ON Ruhrgas's existing long-term supply contracts with its regional and local gas distributors which cover more than 80 per cent of their actual gas requirements.[12] The Bundeskartellamt concluded that these contracts, combined with long-term purchase obligations, were contrary to EC and German competition law. Rejecting E.ON's offered commitments as insufficient, the Bundeskartellamt required the contracts' termination by 30 September 2006. With regard to new contracts, the Bundeskartellamt prohibited the conclusion of agreements that either have a duration of more than four years and cover more than 50 per cent of actual gas requirements, or last more than two years and cover more than 80 per cent of gas requirements.

Joint marketing cases

The Commission looked at the legality of joint marketing of gas sales in *GFU*[13] and, more recently, in *DONG/DUC*.[14] *GFU* concerned the joint marketing of Norwegian gas production through the Gas Negotiation Committee (GFU), composed of two permanent members, Statoil and Norsk Hydro, and occasionally including certain other Norwegian producers. The Commission settled the case after Statoil and Norsk Hydro agreed to negotiate their gas individually when contracts come up for review and to reserve certain gas volumes for new customers for four years. Similarly, in *DONG/DUC*, the investigation was closed with a settlement after the three Danish gas producer members of DUC (Shell, Maersk and ChevronTexaco) committed to sell their gas individually, to reserve significant gas volumes for new customers (in the past they had sold all their gas to Danish incumbent wholesaler DONG) and to remove some restrictive clauses in their contracts with DONG. These clauses included, in particular, an obligation on DONG to report to the DUC members of the volumes sold to certain categories of customers in order to obtain a discount or special prices. The Commission considered that this amounted to a 'use restriction', as DONG was not free to sell to a customer of its choice without risking losing the benefit of the specific price formula. Other restrictions included priority rights for DONG, obliging the DUC members to offer all their future gas finds to DONG first, and reduction clauses allowing the buyer to reduce the volumes bought from the seller if the latter started selling into the buyer's supply area.

Abusive conduct: refusal to grant access to essential infrastructure

After a long investigation, the Commission has now settled the five *Marathon* cases concerning refusal to grant third-party access to gas pipelines. US gas producer Marathon complained that five major European gas companies (German Thyssengas, BEB and Ruhrgas, Dutch Gasunie and French GDF), had jointly refused to give its Norwegian subsidiary access to their Continental European gas pipelines in the 1990s. The cases were settled after the companies gave a series of commitments aimed at facilitating third-party access to their pipelines, including balancing, transparency, trade in capacity rights, congestion management, handling of access requests and an 'entry–exit system' to deal with the 'fictitious' transport of gas (which enters the system but is not actually transported; other gas being taken off elsewhere to supply the order in question). The case was settled with Thyssengas in 2001,[15] with Gasunie[16] and BEB[17] in 2003, and more recently with Gaz de France and Ruhrgas in 2004.[18]

Merger control

As also confirmed in the sector inquiry's preliminary findings, EC merger control has a key role in addressing market concentration and dealing with those structural obstacles to competition that the energy Directives do not manage to remove. The EC Merger Regulation (ECMR) enables the Commission to require structural changes which may result in forcing market opening beyond the specific requirements of the Gas and Electricity Directives. In a number of recent merger cases in the energy sector, the application of remedies has led to further market opening than what was envisaged under legislation.

For example, in the recent *E.ON/MOL* decision,[19] which conditionally approved E.ON Ruhrgas's acquisition of control in two subsidiaries of incumbent Hungarian oil and gas company MOL (ie, MOL Storage and MOL WMT), the remedy package offered by the parties went beyond the requirements of the current regulatory framework. In particular, through MOL's divestiture of its remaining 25 per cent interest in MOL WMT and MOL Storage, the remedies achieved full ownership unbundling (ie, the structural separation in entirely unaffiliated companies) between the gas production and transmission activities retained by MOL and the gas wholesale and storage activities acquired by E.ON. Also, for the first time, a 'gas release programme' was part of a remedy package within EC merger control. Based on this programme, aimed at ensuring sufficient liquidity on the Hungarian wholesale market at non-discriminatory pricing, E.ON committed to release significant volumes of gas on the market at competitive conditions through eight annual auctions. E.ON also committed to divest half of its 10-year gas supply contract with MOL Exploration and Production. The two measures would release 16 billion cubic meters (bcm) until 2015 (up to 2 bcm per year), corresponding to 14 per cent of Hungarian consumption. This is the most significant gas release ever implemented in Europe, both in terms of volume and duration. Also, in *Total/Gaz de France*,[20] the Commission conditionally approved Total's acquisition of sole control over certain natural gas assets in France subject to a number of behavioural undertakings aimed at facilitating third-party access to Total's gas infrastructure (ie, transmission network and storage facilities), which go beyond the Gas Directive requirements.

The Commission is also increasingly reviewing proposals to integrate 'national champions' in gas and electricity in a number of member states. For example in *GDP/EDP/ENI*,[21] the most recent prohibition decision under the ECMR and the first one in the energy sector, the Commission prohibited the proposed acquisition of joint control over Gás de Portugal (GDP), the Portuguese incumbent gas

company, by Energias de Portugal (EDP), the dominant electricity operator in Portugal, and Italian energy company ENI.[22] After an in-depth investigation, the Commission considered that the transaction would have anti-competitive effects, as it would strengthen: (i) EDP's dominant position in wholesale and retail electricity markets in Portugal, mainly by removing the competitive pressure exercised by GDP as the most likely and significant potential entrant on these markets (horizontal effects) – notably because of its competitive access to gas resources and its advantage in power generation through gas-fired power plants – and by granting EDF the ability and incentive to foreclose its competitors' access to the Portuguese gas infrastructure (vertical effects); and (ii) GDP's dominant position in the various Portuguese gas markets. The Commission rejected the parties' extensive commitment package as insufficient to address the competition issues it raised on various electricity and gas markets.

Following EDP's appeal, in September 2005, the CFI rendered its judgment in a record seven-month 'fast track' procedure. The court upheld the Commission's conclusion that the transaction would have strengthened EDP's dominant position in a number of electricity markets and that the commitments offered by EDP would not have resolved the Commission's concerns. However, the court held that the Commission had erred in finding that the transaction was likely to strengthen GDP's dominant position on a number of gas markets in Portugal. The court considered that the gas sector in which GDP had a monopoly was still closed to competition because Portugal enjoyed a derogation from the obligation to liberalise. The court held that GDP's monopoly was the ultimate form of dominance and therefore could not be further strengthened, so that the first condition of the dominance test, ie, the creation or strengthening of a dominant position, could not be met in this case. The court also considered that the transaction, as modified by the offered commitments, would have accelerated the opening of the gas markets under review by some two to three years and would have immediately ensured third-party access to gas capacity. But the court considered that the Commission's wrong assessment of the effects of the deal on the Portuguese gas sector did not affect the correctness of the Commission's review in relation to the Portuguese electricity sector and was sufficient to justify the Commission's prohibition decision.

Also, the Commission is presently undertaking an in-depth investigation of the proposed acquisition of Suez by GDF.[23] But very often, transactions between national champions follow outside the scope of the ECMR, based on the requirement that EC merger control does not apply when companies achieve more than two-thirds of their EU revenues within one and the same member state (as recently highlighted in the *Endesa/Gas Natural* transaction in Spain and *E.ON/Ruhrgas* in Germany). Commissioner Kroes has recently brought this issue to public attention, together with the possible need to amend this provision.

Conclusion

As highlighted above, competition law enforcement in the EU energy sector has already been very active and, with the increased focus based on the sector inquiry findings, energy companies can expect more to come.

The Commission has also identified the high concentration in the energy markets as a problem which will likely lead to more in-depth reviews and even prohibitions under the EC Merger Regulation.

Energy companies should not expect a helping hand from the US in terms of the US antitrust agencies urging the Commission to reduce its enforcement efforts. Rather, to the contrary, the US agencies are already under significant pressure for not tackling the increasing energy prices in the US and they may end up being urged to follow the Commission's example.

All of this leads to a heightened focus on competition issues in the energy sector and it takes great care and strategic thinking for EU energy companies to carry out their business without incurring undue competition law risks.

Notes

1 IP/05/716, 13 June 2005.
2 IP/06/174, 16 February 2006; also, see I Osborne and A van Haasteren, 'European Energy Sector - Quo Vadis? First results of the Sector Inquiry', Competition Policy Newsletter, Number 1, Spring 2006, pp 12-17.
3 Eg, 'Dawn raids on energy groups in EU inquiry', *The Times*, 18 May 2006.
4 MEMO/06/197, 16 May 2006.
5 Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity (OJ L 176, 15.7.2003, p 37); and Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas (OJ L 176, 15.7.2003, p 57).
6 IP/06/430, 4 April 2006.
7 IP/04/1310 of 26 October 2004; see also C Cultrera, 'Les décisions GDF. La Commission est formelle: les clauses de restriction territoriale dans les contrats de gaz violent l'article 81', Competition Policy Newsletter, Number 1, Spring 2005, pp 45-48; and H Nyssens, C Cultrera and D Schnichels, 'The territorial restrictions case in the gas sector: a state of play', Competition Policy Newsletter, Number 1, Spring 2004, pp 48-51.
8 IP/03/1345, 6 October 2003.

O'Melveny & Myers LLP

Blue Tower
Avenue Louise 326
1050 Brussels, Belgium
Tel: + 32 2 642 4100
Fax: + 32 2 642 4190
E-mail: rcelli@omm.com
Web: www.omm.com

Contact: Riccardo Celli

O'Melveny & Myers has one of the world's pre-eminent Antitrust and Competition practices. Tim Muris, former chairman of the Federal Trade Commission, and Rich Parker, former director of the FTC Bureau of Competition, are co-heads of the practice group. With more than 80 experienced antitrust and competition lawyers based in our offices in the US (Washington DC, New York, Los Angeles and San Francisco), Asia (Tokyo, Beijing, Hong Kong and Shanghai) and Europe (Brussels), the firm's global strength enables it to represent clients in multi-jurisdictional proceedings with resource, efficiency and shared expertise. Few firms can match its consistent strength across the three major economic areas: the US, Europe and Asia. O'Melveny & Myers is recommended as a leading antitrust and competition law practice in the prestigious Global Competition Review 100 and several partners of this group are recognised as leading experts in competition law.

The Brussels office has a strong team of international lawyers with extensive experience advising on all aspects of EU competition as well as on competition laws of key European jurisdictions including EU, France, Germany, Italy, the UK, as well as Austria, Belgium and Denmark. This enables us to provide streamlined multi-jurisdictional competition law advice fully satisfying our clients' needs.

Riccardo Celli, who heads the Brussels office, is recognised by many specialised publications as one of the world's leading lawyer in the field of competition law, particularly in the energy sector.

9 IP/02/1869, 12 December 2002.
10 IP/05/195, 17 February 2005.
11 IP/05/710, 10 June 2005.
12 Bundeskartellamt's press release of 17 January 2006.
13 IP/02/1084, 17 July 2002.
14 IP/03/566, 24 April 2003.
15 IP/01/1641, 23 November 2001.
16 IP/03/547, 16 April 2003.
17 IP/03/1129, 27 September 2003.
18 IP/04/573, 30 April 2004.
19 IP/05/1658, 21 December 2005.
20 IP/04/1200, 11 October 2004.
21 IP/04/1455, 9 December 2004. See also, for example, the merger between E.ON and Ruhrgas in Germany; and the proposed merger between Endesa and Gas Natural in Spain, which the Spanish authorities conditionally approved in February 2006. Such mergers can reduce fuel-sourcing risk for gas-powered electricity generators and reduce volume risk for gas companies.
22 See G Conte, G Loriot, F-X Rouxel, W Tretton, 'EDP/ENI/GDP: the Commission prohibits a merger between gas and electricity national incumbents', in Competition Policy Newsletter, Number 1, Spring 2005, pp 84-87. The notified concentration was part of a wider operation including the transfer of the gas transmission network, owned by GDP, to REN, the Portuguese electricity grid operator within a given time frame. The transfer of the network constituted a different concentration, which fell under the competence of the Portuguese authorities.
23 IP/06/802, 19 June 2006, announcing the opening of an in-depth investigation in *GDF/Suez*.