5th Workshop on

EU Energy Law and Policy

in coordination with the
Florence School of Regulation

Mergers and Acquisitions in a Liberalising Energy Market: The EU Experience

Florence, 21-22 September 2006
Theatre – Badia Fiesolana

In association with
Arthur Cox; DeBrauw Blackstone Westbroek; Fiebinger, Polak, Leon & Partner; Linklaters Oppenhoff & Raedler; Pierce Atwood; Reti, Antall & Madl Landwell

Report on Proceedings

Peter D Cameron

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RSCAS European University Institute
Robert Schuman Centre for Advanced Studies

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1. Summary

Day One: Assessing Proposals for Mergers & Acquisitions in a Liberalising Market: the EU Experience

Session 1: What are the Issues in M & A arising from Market Restructuring?

- An overview of the key economic issues was presented by Professor David Newbery of the University of Cambridge (Electricity Policy Research Group).
- Among the issues he examines were the 'special' character of energy mergers, definitions of significant market power, collective dominance criteria, convergence mergers and the impact of the Emissions Trading System on gas pricing.
- He concluded that currently the incumbent suppliers control networks and balancing; some mergers can have low levels of damage; gas and electricity mergers were particularly harmful, and unbundling gas and electricity should have a high priority.

Session 2: Responses to Industry Reorganisation

The topic was addressed by various speakers from the Commission, and national competition and regulatory authorities. Among the points made were:

- The merger review process is linked to the degree of market liberalisation. It impacts on market definition; the assessment of dominance and the assessment of remedies in terms of their viability.
- A challenge in the short to medium term is how to assess mergers in non-liberalised markets.
- A source of constraint on the Commission is the case law (outside the energy sector) in which procedural requirements have been clarified. These ensure that the interests of parties affected by the proposed merger (for and against it) are taken into account.
- The impact of the Regional Markets Initiatives in electricity and gas on the definition of the relevant market may be considerable but it is too early to evaluate this.

Sessions 3 and 4: Case Studies from the Gas and Electricity Sectors

The experience of merger cases in both electricity and gas sectors was the subject of the afternoon sessions, examining particular cases such as the E.ON/MOL merger and the DONG/Elsam/E2 case. Overviews of mergers and acquisitions in the electricity sector in the EU and elsewhere were also presented by speakers from Eurelectric and the International Energy Agency.
Among the observations made were:

- In some Member States the government has the power to overrule a decision by a national competition authority and therefore there is concern about the limits imposed on the Commission's jurisdiction by the two thirds rule.
- The Hungarian experience in the E.ON/MOL case provided an illustration of the above point, and the Commission role was instrumental in the development of important and innovative remedies.
- The Commission's approach to market definition has evolved a lot from the early merger cases to the present ones, and continues to evolve (for example, with respect to interconnectors).
- The more that can be included in a regional markets initiative, the less needs to be included in new legislation.
- Key differences between US and EU approaches to M & A issues were noted by several speakers.

Day Two: Solutions – Short, Medium and Long Term

Keynote Speech: George Verberg, former CEO of Gasunie and chair of International Gas Union, currently on the board of several leading Dutch companies

- Mr Verberg delivered an overview of the international energy scene with the message that the world has changed since the internal energy market programme was conceived and the objectives should be adapted accordingly.
- In this new global energy context which he outlined in some detail, there are some aspects of EU regulation that should be re-thought in terms of the outcome that the EU is trying to achieve.
- On national champions he considered a key difference between such companies in the future and in the past was the lack of legal (and de facto) protection that they are likely to be given in their national markets.

Session 5: The Impact of the Sector Inquiry on Industry Restructuring

In this session five speakers provided brief assessments of the ongoing energy sector inquiry that is being carried out by the European Commission Competition Directorate. This included a status report on the Inquiry itself as well as assessments of the process so far and likely consequences. Among the points made were:

- The final report will include additional material on balancing of electricity and gas and also consideration of LNG issues.
- The sector inquiry has generated usable data to assess remedies in merger cases and has made the Commission familiar with the market situation.
- Already there is a noticeable increase in enforcement of the cross-border regulations by the TSOs and regulators, suggesting that its impacts may be felt before the final report (and the DG TREN benchmarking report)

Session 6: What are the Principal Remedies and How Effective are they?

Several speakers outlined and assessed the various remedies that have been accepted in merger cases. The Commission has accepted divestitures, unbundling, gas release and virtual power plants, and interconnection capacity as the main remedies. Among the observations made were:

- Without careful design and implementation VPPs and gas release programmes were unlikely to achieve the desired effects. In any case, auctions alone are unlikely to reverse anti-competitive effects of mergers involving already dominant players.
- The remedy of improved transmission access could be given greater weight even if there are legal considerations that make it difficult.
- There were mixed views in the discussion about the effectiveness of VPPs with some noting an improvement in their operation as a remedy over the years and others noting their limited impact.

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2. The Proceedings

2.1 Economic Overview: What are the Issues arising from Market Restructuring?

There are several issues that make energy mergers special and which suggest that sector-specific guidelines may be useful. Firstly, the significance of a merger between mainly domestic companies may extend beyond the Member State concerned and affect other Member States. This feature is not captured by the size test – the two thirds rule – in EC competition law. Several examples illustrate the odd results: the E.ON/Ruhrgas merger had external impacts beyond Germany; when Gas Natural tried to take over Endesa in Spain the European Commission lacked jurisdiction, but such a merger would have had impacts on Portugal. Another feature of energy mergers is that the definition of the market and of dominance may not be readily defined by the case law since electricity markets can be transient and small market shares may confer market power.

Moreover, collective dominance may arise if market characteristics are conducive to tacit coordination, and if tacit coordination is sustainable. The criteria for establishing collective dominance, such as low elasticity of demand, excess pricing, concentration of markets, are likely to be met in many EU electricity markets but are hard to prove.

Some mergers – such as vertical mergers - can be pro- or anti-competitive. Horizontal mergers across borders are by contrast likely to degrade information to regulatory authorities and may adversely affect domestic security. Mergers between gas and electricity companies are likely to be anti-competitive: examples are Ruhrgas and E.On and Gas Natural and Endesa. Since gas companies are the most likely entrants into the electricity supply industry, a merger will remove a potential entrant. The merged company will also benefit from raising the gas price to drive up the electricity price.

Another feature that is relevant here is the impact of the emissions trading scheme on gas pricing. It will provide an extra incentive to a merged gas-electricity company to raise the gas price.

So, while some mergers can have low levels of damage, gas-electricity (convergence) mergers are particularly harmful. In this context, unbundling of gas and electricity should have a high priority to make entry contestable.

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2.2 Global Overview: The Wider Context for Energy Market Reform

The global or external dimension to the EU internal energy market project was the object of an extended overview. In its preoccupation with liberalisation and regulation inside the EU, there is sometimes the risk of neglecting the many changes that are occurring outside but which are already impacting on the EU energy scene in fundamental ways.

Among the major changes – relevant to EU growing energy dependence - that have occurred in recent years are:

- Fossil fuel reserve replacement in relation to production is low;
- The cost of finding new reserves has increased significantly;
- Investment is falling due to a variety of factors – companies buying back shares, corruption in certain areas, difficulty in accessing reserves, etc.;
- Growth in national oil and gas companies' ownership of reserves;
- LNG growth changes the global gas markets but almost no cargoes available before 2012.

What are the implications for the EU? The market reform model adopted is flawed in three respects:

- its fundamentalist faith in markets, ignoring the continuing role of governments in the energy sector;
- its belief that a multiplicity of producers would emerge with plenty of supplies for the EU and
- its idea that gas and electricity can be regulated as if they are alike.

In fact, liberalisation has important implications for investment, increasing uncertainty and capital costs, and not helping a diversification of production capacity. There is now an important need for investment as the period of asset-sweating comes to an end.

There are consequences for the EU and its approach to regulation. These include the need to improve its investment climate but also the possibility that creating new national champions in the energy sector can create new dynamics in the energy sector over time. For example, the creation of Suez-GDF is the fastest way of privatising GDF to a large extent, and at the same time of making it a national champion on the EU scene, without the legal safeguards it enjoyed while in state ownership.

2.3 Responses to Industry Reorganisation (Session 2)

Each of the EU packages of Directives on electricity and gas market reform has been followed (or at least accompanied) by a merger wave. This is a curiosity of the EU scene since in the other continental market that has engaged in significant energy

reform, the USA, there has been no comparable development. This may be rooted in the different approaches of the EU and the Federal Energy Regulatory Commission to mergers in this sector or in the different strategies adopted with respect to market liberalisation: in the US, gas market reform preceded electricity, reform was enforced at the federal not national level and began with wholesale not retail markets (in the EU this was evident only in the second package).
In the EU setting, each wave of merger activity has led to questioning of the merger control rules, demands for stronger remedies in settlements and the balance of power between the Commission and the Member States/national competition authorities in dealing with merger cases. The current wave of mergers has provoked this set of responses. How do the authorities respond?

The Commission
Several features inform the Commission's approach to the current merger wave. As additional data has become available through the Sector Inquiry (and the DG TREN benchmarking reports), it has become more apparent how serious the remaining obstacles to competition are which remain. The intensity of scrutiny is therefore considerable. At the same time, the procedure adopted by the Commission with respect to mergers has become influenced by Court decisions on (non-energy) mergers that require it to be more methodical and thorough in its assessments.

In recent merger cases such as the EDP case, these features – intense scrutiny and the possibility of a legal challenge – have been evident. The case was appealed to the Court of First Instance but the Commission's decision was upheld. A feature of this case and others is the link drawn between the merger review and the degree of liberalisation. This has an influence on the market definition, assessment of dominance and the viability of specific remedies. The EDP case also raised the question of how to assess mergers in non-liberalised markets (gas) in which there are no immediate effects of dominance. If these are sufficiently foreseeable, the Commission can also assess future effects. Increasingly, derogation periods are going to phase out so this problem can be expected to disappear.

The National Competition Authorities
The increasing complexity of liberalising electricity (and gas) markets is becoming a challenge for the NCAs too. The Netherlands competition authority, the NMa, commissioned a study into mergers which was published in June 2006 (in English). The idea was to be prepared for possible merger proposals in the NW European markets. With respect to assessment of proposed mergers and remedies accepted, the various decisions on procedural matters taken by the Court have also been noted by the NCAs (GE/Honeywell, Impala and Sony Bertelsmann).

The Regulators – the Regional Energy Markets Initiative
The ERGEG has taken the lead in promoting Initiatives that are designed to encourage the development of an intermediate step between national markets and a single market: regional markets. This is being carried out with the cooperation of market participants, especially TSOs. This participation will be crucial in determining whether the concept works or not. Currently, the Initiatives are being driven by the

national regulatory authorities but increasingly they involve the competition authorities too. This attempt to change the geographic scope of markets has implications for the kind of issues raised by industry reorganisation and concentration: for example, will the growth of regional markets make the creation of large utilities through concentration of less concern; can the problems caused by the existence of large national champions be tackled by the creation of regional markets rather than competition remedies?

In the discussion several points emerged:

- There is considerable transparency in the Initiatives for electricity and gas. They are linked to the Florence and Madrid processes and so are institutionally tied in to the process of creating a single market. They are not therefore likely to lead to a crystallisation of regional markets.
- If the market were competitive, the appropriate bodies to monitor behaviour would be the competition authorities but in the current phase this role falls principally to the regulators.
- The regional geographic areas in the Initiatives are not set in stone

Discussion points

- Suggestions were made for sector specific guidelines on mergers and for an extension of the UK device of concurrent jurisdiction between regulators and national competition authorities in this area.
- Comparisons could fruitfully be made with practices in other markets in transition, such as health care and telecoms.
- The approach to competition law enforcement is sometimes ‘strange’: for example, the Commission only became involved in the EDP case because of ENI’s involvement (a very minor stake) and it is positive about the E.On bid for Endesa in spite of E.On’s track record and Endesa’s large market share in Spain. There was a sense that the 2/3 rule was not working well in the energy sector.
- A key question for governments is whether competitive markets will deliver security of supply in gas; the doubts about this have led some of them to intervene in their markets. This leads to political pressure behind mergers and increasingly on NCAs which may not be able to withstand it. Yet – ironically – many Member States are already dependent on others for their supply security.
- Another response to industrial concentration is the resort of competitor companies to litigation, which has been a minor feature of a number of merger cases so far.

2.4 Case Studies from the Gas and Electricity Sectors (Sessions 3 and 4)

The importance of decisions taken in specific cases in this area is self-evident. Whatever the Green Paper on Energy Policy or other policy documents may state, the decisions taken in specific cases provide indications of the real tests that will be applied to proposed mergers notified to the competition authorities. In the two afternoon sessions, speakers reviewed cases from the gas and electricity sectors.

Gas

In 2006 there have been more natural gas merger cases than ever before. Activity has been high however since liberalisation began. There has been a growth in absolute numbers and in relative importance. Until 1999 there had been a predominance of upstream mergers but since 2000 there has been a rapid growth of downstream mergers. Domestic as well as cross-border mergers have increased since the second gas directive. Among these gas to gas predominates but recent problematic cases contained a gas to power element. The number of problematic cases has grown in line with the overall growth in gas cases. Although there have been 11 problem cases so far, three in particular are recent and worth noting: E.ON/Mol; DONG/Elsam E2 and GdF/Suez.

- The E.ON/MOL case included elements of political pressure on the competition authority to approve the merger as originally proposed, but the case was taken over by the Commission. Remedies were required to address vertical concerns and the risks from E.On's ability to foreclose the wholesale market. The remedies included the most significant gas release ever implemented in the EU in terms of both volume and duration.

- The DONG/Elsam E2 case was a gas to electricity merger in Denmark. A novel element was the use of a swap auction which appeared justified in this case but may not be of wider application. As a remedy to the storage concern, a divestment was required, the first time unbundling was required that separated out ownership (in the E.ON/MOL case a different unbundling remedy was used).

- Finally, there is the GdF/Suez case. Although this is still pending, the parties have already accepted the need for remedies in their public statements.

In Austria too, there has been a sector inquiry but into gas, following simultaneous price increases of suppliers and complaints relating to import contracts by intermediary traders. The investigation into the gas sector is providing data that assist in the assessment of mergers.

Electricity

In the electricity sector there are some specific issues that need to be investigated in relation to the definition of product and geographic markets. With respect to the latter,

elements for a determination of the geographic wholesale market should include sufficient level of cross-border trading to induce convergence of prices between price areas, convergence of wholesale prices and harmonised market-based mechanisms for congestion management and balancing. Merger control could act as an important tool to support the integration of electricity markets but there needed to be consistent application of the competition law. In particular, the 2/3 rule should be re-examined, but even more so the issue of how to avoid an overruling of the decision-making power of the NCAs in such cases. There should also be distinctive remits between sector regulators and NCAs.

The very large amount of future investment that is required in EU electricity markets was emphasised; mergers that were anti-competitive including the establishment of national champions risked creating barriers to the making of these investments in the coming years.

The complexity of the electricity sector was stressed by several speakers. It needed to be understood if merger control was to be properly applied. Defining the 'relevant market' was very hard in practice for this sector. However, it was noted that the Commission (and some NCAs) had become considerably more sophisticated in its way of tackling this issue over the past few years.

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2.5 The Impact of the Sector Inquiry on Industry Restructuring (Session 5)

Although the Sector Inquiry has yet to reach its conclusion, this short session pulled together several different perspectives on its progress so far and on the likely impacts after it is concluded.

The final report was scheduled to be published in January 2007 and would include additional material on balancing of electricity and gas, on LNG issues, on downstream contracts in both electricity and gas (re-selling inhibitions, etc.), as well as a response to the many submissions that the Commission had received during its consultation period. The Commission was basing its analysis on data collected mostly in 2005 and had decided that this would not be updated, apart from a few areas concerning electricity.

For the Commission, the sector inquiry has generated usable data to assess remedies in merger cases and has made the Commission familiar with the market situation. For some sections of the energy industry, it has contributed to the climate of uncertainty that limits their willingness to invest. For others, the inquiry has contributed to pressing TSOs and regulators to anticipate the outcomes and act now. There is a noticeable increase in enforcement of the cross-border regulations by the TSOs and regulators, suggesting that its impacts may be felt before the final report (and the related DG TREN benchmarking report). This includes a push for greater transparency of transmission and demand data and generation data. There appears to be a new will to make intra-day and balancing markets work, which will lead to increased cross-border competition. There is also a greater focus on unbundling.

For others, these initial steps did not detract from the need, felt by some participants, for further legislation to supplement the 2003 package. Such legislation should include measures on unbundling, transparency and cross-border issues that concern regulators. Regulators need a common set of powers and duties that are set at a higher level than at present and provide more consistency on each side of the border: without this there are disincentives for investment.

2.6 What are the Principal Remedies and How Effective are they? (Session 6)

The principal remedies that were adopted in the first wave of merger cases had a mixed record but in more recent cases there is evidence that the competition authorities have learned from their past experiences. The gas release programme in the E.ON/MOL case is by far the most ambitious yet and ownership unbundling has also been tried, as have VPPs. It was emphasised in the discussion however that they require careful design at the outset and more careful implementation and monitoring if the desired effects are to be achieved. Auctions alone, without structural remedies,

were unlikely to reverse the anti-competitive effects of mergers involving already dominant players.

3. Conclusions – Solutions in the Short, Medium and Long Term

1. The main theme of the workshop was M & A in a liberalising energy market and particularly in the context of the EU. There are a number of problems that need to be addressed to ensure that M & A does not act as a 'show-stopper' in the liberalisation process: the growing intervention by Member State governments to assist in the creation of national champions is one example, but the lack of independence of some national competition authorities in merger cases is another. However, some of the problems are rooted in wider issues that the EU needs to address to ensure that the single market process remains on track. These include problems of regulatory powers, unbundling, enforcement, and transparency. Some of them require solutions in the short term, others require a medium or longer term perspective.

2. One of the solutions considered which is already being attempted is the change of strategy by regulators and by the Commission: the shift from an exclusive focus on the single market to a regional market one. This raises issues about geographic market definition. There was much support from industry and NCA participants for the Regional Energy Markets Initiative in electricity and gas, as an intermediate step between market reform at the national level and the establishment of a single energy market. However, this Initiative is still at an early stage and its potential can still only be guessed at. Moreover, it does not address the problems of a lack of implementation of the Directives and Regulations or the inadequate powers of the regulators at the present time. At the same time, it offers a framework in which to solve problems in the short to medium term which would take much longer to achieve by the legislative route.

3. Cooperation among regulatory and competition authorities was also noted as a problem. This arose at the EU-Member State level with respect to merger cases, and in the relations between NRAs and NCAs. While many voices were critical of the so-called 'two thirds' rule (on the allocation of cases between the Commission and the Member State authorities), there was a sense that Member States' self interest would prevent it from being revised. In any case, the real concern seemed to be less with *who* handled the case than with the independence of the competition authority responsible: a number of NCAs were vulnerable to pressure from their governments in this respect. This need for cooperation extends to the relations between the NRAs and the NCAs. In this context, the adoption of guidelines on concurrent jurisdiction by the NRAs and the NCAs might be a useful first step (as is operational in the UK). However, there are gaps in the legislation with respect to NRAs' powers that make it difficult to promote the increased level of cooperation that is required.

4. The problems created by the complexity of defining the relevant market in the electricity sector were emphasised by several speakers. In this respect, it was noted that the Commission in its merger decisions was clearly trying to advance its analysis to tackle this subject. This was evident with respect to its analysis of electricity product markets. It was also noted that NCAs were looking at this subject as well as NRAs. The role of economic analysis in making progress in this area is clear.

5. The problem of national champions as anti-competitive forces was considered in the context of market reform but also in the context of the external (non-EU) dimension of energy policy. Some participants saw them as vehicles for securing security of supply to mitigate uncertainty caused by market reform while others saw them as defenders of EU interests in the face of challenges from large non-EU suppliers. However, it was pointed out that energy inter-dependence of Member States is now quite advanced and a rational response to security of supply concerns is to recognise this and develop European solutions. However, as a counter to the idea that a national champion is a 'solution' rather than evidence of a problem, there was vigorous support for the use of unbundling and divestiture remedies in merger cases, and a more robust response from competition authorities generally.

6. Several speakers raised questions about the availability of solutions from other contexts, in particular from the USA. Some comparison with its approach to energy market reform was thought to be worthwhile, whether in terms of its approach to merger control and enforcement generally or more widely in terms of the strategy of introducing market reform. It was felt that this comparative dimension merited further investigation, perhaps at another workshop session.

7. Does the market deliver security of supply? Competition still on trial at present. Sense of being in transition from pre-liberalised markets to something else. The Emissions Trading Scheme is a complicating factor in this scenario, with potential for abuse by some market players.

8. The application of the competition law in a more robust fashion was mooted as a possible solution to M & A problems. However, it was noted that on several occasions companies had challenged decisions by the Commission in the Courts and that sometimes the Commission had lost. It was therefore important not to forget that a more aggressive response from incumbents in national or EU courts is likely in the future as the Commission steps up its enforcement activities.

9. The solutions offered by the various kinds of remedies used in energy merger cases had proved to be effective in some cases but too modest in others, and in still others they had failed entirely. Careful design and implementation were emphasised as essential for these solutions to counter anti-competitive effects.