

Energy Liberalisation and EC Competition Law

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I. The role of EC Antitrust Law

There have been 15 national and largely isolated electricity and gas markets in the European Union (EU) until recently. Other than for coal, petrol and nuclear energy these markets had not been made part of the European common market. This situation changed with the adoption of liberalisation directives for electricity¹ and gas² (the “Directives”) and their implementation in the year 1999 for electricity and 2000 for gas by almost all 15 Member States³. The Directives provide for the creation of Community-wide markets for electricity and gas as they exist already for other fuels and, indeed, almost all other goods and services. Monopoly rights at national level had to be abolished, a legal framework to allow new market entry as well as access to the networks had to be created and consumers had to be empowered to choose freely their suppliers throughout the EU. Energy liberalisation means thus to build single European electricity and gas markets out of 15 isolated national markets through the introduction of competition between energy suppliers for customers.

Expectations are that competitive European energy markets will increase the efficient allocation of resources and enhance consumer welfare. Distortions of competition between substituting fuels should come to an end. Competition between suppliers should lead to a downward convergence of prices in Europe. These expectations seem to be well founded in view of the positive developments for European consumers in the relatively short period of time since the Directives have been implemented. To mention are, in particular, positive price developments, which are up to now more pronounced for electricity than for gas. Whereas electricity prices for consumers have gone down in almost all Member States, gas prices remained heavily influenced by oil prices because of the gas price linkage to oil.⁴ Other positive developments are the emergence of new services and offerings (e.g. power exchange and gas spot markets). The almost parallel

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¹ European Parliament and Council Directive 96/92/EC (19 December 1996) OJ L27/20 (30.1.1997) (“Electricity Directive”)

² European Parliament and Council Directive 98/30/EC (22 June 1998) OJ L204/1 (21.7.1998) (“Gas Directive”)

³ France has not yet implemented the Gas Directive. For a short history of energy liberalisation see Levasseur in Faull/Nikpay, *The EC Law of Competition*, 1999, p. 735-737

See the Communication from the Commission to the Council and the European Parliament, *Completing the internal energy market*, COM (2001) 125 final, 13.3.2001 (“Communication”), p. 7-8, Commission Staff Working Papers, *Completing the internal energy market*, SEC (2001) 438, p. 18-26, 1st benchmarking report on the implementation of the implementation of the internal electricity and gas market SEC (2001) 1957, available at http://europa.eu.int/comm/energy/en/internal_market, Eurostat, Statistics in Focus, Environment and Energy, nr. X, “Electricity prices for EU industry on 1 January 2000: downward trend” and nr. Y, “Electricity prices for EU households on 1 January 2000: downward trend”

liberalisation of electricity and gas markets may mutually reinforce the respective processes. The availability of highly efficient and environmentally friendly gas-fired power stations is likely to facilitate new entry in electricity markets, whereas the accelerated growth of demand for gas may in turn create additional incentives for new entry in gas markets.

It is thus hoped that energy liberalisation will produce similar positive results as other previous liberalisation processes, like for instance in the telecommunication sector. The concrete result will of course be energy specific and this may mean that it will arguably only really become visible in the long run given that the electricity as well as the gas industry are characterised by large sunk costs and longer lead and construction times than industry average.⁵ It may also be that energy liberalisation will not be as appealing for European consumers as has been, for instance, telecom liberalisation through the competitive introduction of innovative and trendy products like, for instance, mobile telephony. But, of course, you never know.

Liberalisation is never launched in a “green field” situation. Electricity and gas liberalisation take place in industries which developed for decades along national lines. Moreover, the number of electricity and gas enterprises operating in each national market is very limited. Most of these operators enjoyed a monopoly before liberalisation and are now very often gatekeepers to the network and the customer base. The opening-up of markets for Community-wide competition will consequently lead to a transformation of the industry from a monopolistic towards a competitive structure. Given that electricity and gas have to be supplied through a network, which will remain a natural monopoly for most of its parts even after liberalisation⁶, the transformation forms a particular challenge for both industry and public authorities.

The European Community disposes of a variety of policy instruments to commence and govern the process of liberalisation.⁷ The application of these instruments taking into account the principle of subsidiarity requires the Commission, however, to establish a consensus among all major political powers of the Community. Each liberalisation process is unique in this regard and is built upon a specific policy mix. For the full liberalisation of the energy markets it was clear from the start that the opening-up of national markets has to be accompanied by harmonisation measures to be effective.⁸ The legal basis for the Directives of 1996 and 1998 adopted by the European Parliament and the Council form thus internal market rules (Art. 95 ECT) and not competition rules (Art. 86 ECT). The same holds for the new “Acceleration Directive” proposed by the Commission in March 2001, which has the objective to open up fully the electricity and gas markets.⁹ This current orientation does, however, in principle not exclude for the future the adoption of directives and decisions on the basis of Art.86 (3) ECT by the

⁵ International Energy Agency (IEA), *Competition in Electricity Markets*, 2001, p. 17-19.

⁶ IEA (footnote 5) p. 19-20 for electricity.

⁷ Ritter, *EC Antitrust Law and Energy* in: Fordham Corporate Law Institute 1994, p. 131-137.

⁸ Ritter (footnote 7) p. 137-142.

⁹ See Proposal for a Directive of the European Parliament and of the Council amending Directives 96/92/EC and 98/30/EC concerning common Rules for the Internal Market in Electricity and Natural Gas (“*Acceleration Directive*”), available at http://europa.eu.int/comm/energy/en/internal_market; Commission press release “*Towards a single energy market in 2005*”, IP/01/356 of 13.3.2001: All non-domestic electricity and gas customers shall already enjoy free-supplier choice by 2003 and 2004 respectively. All domestic gas consumers of electricity and gas shall freely chose suppliers by 2005.

Commission with the aim to push the transformation of the industries forward or to resolve quickly specific issues which come up in the process.¹⁰

Community competition policy forms a cornerstone for full and comprehensive energy liberalisation, even if the key legislative measures are instituted by internal market directives. This will be demonstrated in the following discussion of the three essential prerequisites for effective competition in network industries.

The three prerequisites are,

- free consumer choice of suppliers,
- free supply competition, and
- open access to networks.

Community competition policy disposes of four main instruments in order to contribute to the realisation of these prerequisites: classical antitrust (prohibition of cartels and abuses of dominant positions), merger control, supervision of enterprises entrusted with special or exclusive rights and state-aid control.¹¹ Energy liberalisation requires the comprehensive use of all four instruments in order to bring about and ensure genuine competition on the European electricity and gas markets. It seems that energy liberalisation is also unique in this regard.¹²

The close link between internal market and competition policy in the liberalisation process means that both have to be seen together. The emphasis in the following discussion will, however, be on Community competition policy and its four instruments.

II. Free consumer choice of suppliers

The first essential prerequisite for the creation of competitive Community-wide electricity and gas markets is to empower individual consumers to freely choose their energy provider throughout the EU. The new European framework provides for full competition with all the risks and chances for market participants engaged in the supply of commodity products. It is not limited to periodic auctions for the supply of consumers in a given area, even under the option of the “single buyer” procedure as foreseen in the Electricity Directive.¹³

1. Gradual and uneven market opening

The Directives allowed Member States, however, to opt for the gradual opening-up of their markets. The Community legislator followed in this regard the British example of electricity liberalisation.¹⁴ Not all consumers had to be given the right of free supplier choice at once. Member States could institute a phased process in which case they had to respect minimum opening levels for the liberalisation of demand.¹⁵ In spite of this rather

¹⁰ See Commission press release “*Commission confirms need to tackle cross-border investment restrictions and energy market distortions*”, IP/01/872

¹¹ Ritter p. 132-137.

¹² For telecom liberalisation see Ungerer, *Use of EC Competition Rules in the Liberalisation of the European Union's Telecommunications Sector*, available at <http://europa.eu.int/comm/competition/publications>

¹³ Art. 18 Electricity Directive; IEA (footnote 5) p. 58 for description of procurement model.

¹⁴ Ritter p. 142.

See Art. 19(1) Electricity Directive & Art. 18(2) Gas Directive: Regarding electricity, Member States had to open 28% of demand in 1999, and 35% by 2003, regarding gas, Member States had to open a minimum of 20% of demand in 2000, and 28% by 2003.

careful approach to market opening, the Community legislator was not able to fix a definitive date for the complete opening of electricity and gas markets in all 15 countries. The Directives only announce further measures to be considered after 2007 for electricity and after 2008 in respect of gas.¹⁶

Before this background it came as a pleasant surprise that only a minority of Member States opted for the “*minimalist*” approach of the Directives.¹⁷ Most Member States obviously wished to quickly reap the benefits of liberalisation and opened up their markets fully. Some did so immediately, others will do it over a relatively short period of time. The result was that around 66% of European electricity demand and 79% of total European gas demand are now legally completely open to Community-wide competition.¹⁸ This development encouraged the Commission to propose the so-called Acceleration Directive suggesting full market opening until 2005.¹⁹

The gradual market opening as foreseen in the Directives creates the critical mass for initiating the transformation of the industries from monopolistic to competitive markets. The fact that large and mostly professional energy consumers become eligible first to select freely their suppliers creates economic incentives for the latter to compete for contracts. It sets also in motion the difficult process to develop functioning transmission markets which did previously not exist in almost all Member States. The gradual approach takes finally the fact into account that market participants need time to adapt to the new framework and to develop the tools and instruments for the proper functioning of competitive markets.

The policy choice made by the European legislator also entails risks, however. Notably the risk of a lengthy transition period with imperfect competition even in the opened market segments. It seems already apparent that full market opening from the beginning serves consumers better also in terms of price competition than phased introduction of competition.²⁰ Of paramount importance, however, has become the risk of “imbalance” because of the uneven opening of 15 national markets. While in most countries suppliers are submitted to competition with their whole customer base, in a minority of countries suppliers are still partially protected against competition. Uneven market opening creates thus competitive advantages for some and disadvantages for others. Cross-subsidisation from the captive to the competitive customer groups is only one example for a competitive advantage. The possibility to cross-subsidize affects the ability of suppliers to win customers in other geographic markets or, worse, to defend historic market positions against new entrants.

These imbalances cannot effectively be contained by sector-specific or competition law. It is true that the liberalisation directives provide for a so-called reciprocity rule. This rule enables a Member State with 100% market opening to block certain exports from a country with only a minimal market opening²¹. However, the reciprocity rule only deals with cross-border trade. It does not deal with all other economic consequences of uneven market opening²². In particular, it does not address the issue of cross-border acquisitions

¹⁶ See Art. 26 Electricity Directive & Art. 28 Gas Directive.

¹⁷ France, however, has to date not implemented the Gas Directive in national law.

¹⁸ Details on the market opening of each Member State can be found in the Annex to this paper.

¹⁹ See footnote 9

²⁰ See Communication (footnote 4) p. 7.

²¹ See Art. 19(5) Electricity Directive & Art. 19(1) Gas Directive.

²² It may not even deal with the reciprocal trade issues effectively, see Communication (footnote 4) p. 5.

and mergers²³. This led to what one might call the “*EDF experience*”. The French power supplier EDF belongs to the group of European companies pursuing an active acquisition strategy throughout the Community. This raised concerns for two reasons: Firstly, EDF originates from a Member State with a minimalist approach to liberalisation. The company seems to take advantage of its protected home market in order to acquire competitors active in countries with a market opening of 100% and with a more pluralistic supply structure. Secondly, EDF is a state-owned company which may benefit from the fact that its shareholder does not expect as high returns on investments as private shareholders would.

The whole liberalisation process was put at peril in 2001, when two Member States made moves to freeze the voting rights in two power suppliers EDF was about to take over in the respective countries. The Commission reacted by proposing to accelerate market opening and to quickly fix a date for full liberalisation. Only a rapid and complete opening-up of energy markets for competition will effectively eliminate imbalances. To simply enlarge the reciprocity rule and include cross-border mergers and acquisitions as it has been advanced, would miss the point. Reciprocity rules neither deal with the real cause of the imbalances, nor do they remedy the competition issue. Besides, reciprocity rules are also hardly compatible with existing Community law and, more precisely, with the rules on freedom of establishment.

2. Locking-in of customers

The consumers having legally been empowered to freely choose their supplier in the Community²⁴ can be impeded in their freedom through private barriers erected by incumbent operators. It has always been a principal task of Community competition policy to deal with private barriers where State barriers have been successfully abolished through internal market policy. The process of European market integration is thus supported by the enforcement of the competition rules.

The traditional practice of electricity and gas suppliers to conclude exclusive long-term contracts with their customers can have the effect of a private barrier to the free choice of consumers.²⁵ Exclusive purchasing agreements on a long-term basis may violate the competition rules in particular, if the supplier enjoys market power. A dominant supplier has a special responsibility not to impair emerging competition.²⁶ If a dominant firm obliges customers to purchase exclusively on a long-term basis from it, competition from actual and potential competitors is impeded. This commercial practice constitutes an abuse of a dominant position within the meaning of Art. 82 ECT, if it ties a substantial proportion of demand, unless the dominant firm can objectively justify such practice.²⁷ Ties constitute an abuse irrespective of whether exclusivity is stipulated without further

²³ The most prominent case for a company with an active Europe-wide acquisition strategy in this regard is EDF, a state-owned company originating from a Member State with a minimalist approach to liberalisation. A list with its recent acquisitions in Europe can be found in EDF/EnBW (7.2.2001) para.85 (Comm’n), available at <http://europa.eu.int/comm/competition/mergers/cases/>.

²⁴ Directives define these consumers as «eligible customers», Art. 19 Electricity Directive & Art. 18 Gas Directive.

²⁵ See Exxon/Mobil (29.9.1999) paras. 59, 95 (Comm’n), available at <http://europa.eu.int/comm/competition/mergers/cases/>.

²⁶ Case 322/81, Michelin v. Commission, (1983) E.C.R. 3461 para. 57

²⁷ Commission, Guidelines on Vertical Restraints, OJ C291/1 (13.10.2000) (“VRG”), para. 107; Case T-65/89, BPB v. Comm’n, (1993) E.C.R. II-389 para. 68

qualification or whether it is undertaken in consideration of the grant of a rebate.²⁸ Since exclusive long-term contracts are rather the exception than the rule on competitive markets with sufficient liquidity as can already be observed on effectively liberalised markets, this commercial practice is *prima facie* not objectively justified. It is therefore one of the priorities of Community competition policy to pursue such exclusionary conduct of former monopolists on liberalised markets. This can be demonstrated by the example of the Gas Natural/Endesa case.

The former Spanish gas monopolist Gas Natural concluded a long-term gas supply contract with the leading Spanish electricity generator Endesa which covered basically all its gas requirements for the foreseeable future and thereafter in accordance with its perceived share of Spanish power production. Potential entrants to the Spanish gas market were thereby losing an attractive client, as electricity generators belong to the large volume consumers of gas. After the parties had been informed of the Commission's competition concerns, they modified their contract in terms of volume and duration. The volume purchased was reduced to the extent necessary to ensure, on the one hand, that Endesa would remain an attractive client in volume terms for new market entrants. On the other hand, Endesa's minimum requirements for the supply of the new power stations it intended to build were respected. The duration of the contract was substantially shortened thereby taking into account that Endesa would still have to build the power stations for which it purchases the gas.²⁹

It should be underlined that the Commission vigorously pursues exclusionary conduct towards all eligible customers within the meaning of the Directives whenever it is brought to its attention. This includes industrial consumers like power generators, traders where they are admitted as well as distributors.³⁰ Otherwise their legal empowerment remains without practical effect and they cannot benefit from liberalisation. Community competition policy contributes thus to ensure free consumer choice on electricity and gas markets which forms one of the three prerequisites for effective competition.

III. Free supply competition

The second essential prerequisite is free supply competition. The Directives provide in this regard a general obligation for Member States to create a new legal framework for the electricity and gas markets with "*a view to achieving a competitive market*"³¹. This lead in practice to the abolition of monopoly rights, in particular monopoly import and export rights. The 15 national electricity and gas markets are now open for trade. In addition, special or exclusive rights of incumbent energy suppliers had either to be lifted or modified by Member States in order to allow for competition. The grant of special or exclusive rights is closely linked to the provision of public services, e.g. the right of final consumers to be connected to and supplied by the grid. Since the issue of public service

²⁸ Case 85/76, *Hoffmann-La Roche v. Comm'n*, (1979) E.C.R. 461, para. 89. The use of an English clause or of fidelity rebates constitutes a *per se* violation for dominant firms, VRG (footnote 28) para. 152.

²⁹ See Annual Reports: Comm'n, XXXth Report on Competition Policy, p.154-155 (2000) and press release "*Commission closes investigation on Spanish gas company Gas Natural*", IP/00/297 of 27.3.2001; see also M. Fernandez Salas, *Long-term supply agreements in the context of gas market liberalisation: Commission closes investigation of Gas Natural*, Competition Newsletter 2000, issue 2, p. 55 et seq.

³⁰ Member States are entitled to exclude electricity traders from authorisation on their territory, Art. 17(1) Electricity Directive. Distributors are at least eligible customers themselves insofar as they supply eligible customers; see Art. 19(3) Electricity Directive & Art. 18(8) Gas Directive.

³¹ See Art. 3(1) Electricity & Gas Directives.

obligations does not only concern suppliers but also network operators, it will be discussed separately below.³²

The Directives deal with the issue of supply competition not only in a general clause but also through the explicit regulation of new market entry. They stipulate that new entry must be permitted under the transparent, objective and non-discriminatory terms of an authorisation procedure.³³ The Directives create thus the fundamental conditions for supply-side competition between incumbent operators as well as between incumbents and new market entrants. However, electricity and gas liberalisation have not been launched in a “green field” situation. The existing monopolistic supply situation does not evolve overnight into a competitive market structure.

1. Electricity

Many electricity markets in the 15 Member States have been dominated by a generation monopoly before liberalisation. Almost all national markets have been characterised by monopolistic supply areas.

The majority of suppliers active on the various national markets are vertically integrated transmission system operators and control thus the access to their traditional supply area. New market entry through the construction of power plants is generally facilitated by new production technology³⁴ and the parallel liberalisation of gas markets. These positive factors have to be balanced against the slow growth of consumption, existing overcapacity of generation in many Member States and the persisting market dominance of the former legal monopolists which probably discourage new entry. Import competition would thus seem to be the most promising source of supply competition at least in the shorter term. The sometimes very different price levels of the various national markets, which are among other things being caused by the different fuel mix of generators, create a powerful incentive for trade. However, the grids of only a few Member States are sufficiently interconnected to allow for the rapid development of real cross-border markets or, at least, for substantial trade flows with an impact on the market conduct of incumbent suppliers.³⁵

In view of this situation, which is not conducive to effective supply competition, many Member States have not only implemented the provisions of the Directive but engaged in the further re-organisation of their domestic markets. Two approaches have become apparent. Some countries have been splitting up their power generation monopoly into several independent entities (mostly Member States with large domestic markets and state-owned generation) and have organised market places for the wholesale of electricity, for instance, through the creation of pools.³⁶ Other Member States opted for a “*market expansion approach*”³⁷ and created jointly through regulation larger

³² See V. below

³³ See Art. 4 (generation) Electricity Directive & Art. 4 (gas supply) Gas Directive. As regards electricity Member States also could opt in favour of a tendering procedure instead of authorisation. However, only one Member State did. The draft Acceleration Directive (footnote 9) proposes to render the authorisation procedure obligatory (new Art. 5)

³⁴ IEA (footnote 5) p. 19.

³⁵ See IV.2. below

³⁶ See CEPR, *A European Market for Electricity?* 1999, for the description of the UK (p. 89-115) and Spanish (p. 164-180) markets.

³⁷ CEPR (footnote 36) p. 229.

geographical markets and thus increased the number of suppliers³⁸. Most Member States, however, rely on market forces and the emergence of the internal Community market to develop genuine competition among electricity suppliers (among these are many countries with small domestic markets).

Although Community competition law does not allow the Commission to break-up generation and supply monopolies without these violating a competition rule, it can contribute to the amelioration of supply competition and the enlargement of markets.

For example, there exist generators which were forced before liberalisation to sell all their electricity to the operator entrusted with statutory monopoly rights. These generators are very often still linked to former monopolists through long-term contracts, even after they have become competitors through liberalisation. The former French legal monopoly EDF entertained such a relationship with Compagnie Nationale du Rhône (CNR). This company is a significant French producer of hydropower which remained economically independent after the nationalisation of the French power industry some 50 years ago. The Commission took the case up and succeeded in cutting the contractual links so that CNR is required to gradually assume the sales function itself and enter into actual competition with EDF for customers.³⁹

Community competition law comes also into play in the re-structuration process of the European power industry through mergers, acquisitions and the formation of joint ventures. Many of these transactions are pro-competitive when they lead, for example, to new entry in product or geographic markets.⁴⁰ Whenever a transaction has an impact on the market position of a former statutory monopolist, however, the competition effects have to be assessed very carefully. The Commission has then to examine the concrete state of development of the liberalised supply and transmission markets as well as the possibilities and likelihood of new market entry. In doing so the Commission applies a dynamic approach. Foreseeable and imminent improvements of the conditions for competition as well as substantial remedies offered by the merger parties in order to either eliminate or compensate for negative competition effects are considered and may lead to the approval of an operation which would have been prohibited under a static view of existing market conditions and positions. This can be illustrated with the examples of the VEBA/VIAG and EDF/EnBW cases.

The first case, VEBA/VIAG, concerns the merger of two leading energy companies active on the already concentrated German power market with 8 generators holding a combined market share of 90%.⁴¹ The Commission regarded in its competition assessment the entire territory of Germany as the relevant market, although many suppliers still largely limit their activities to their previously protected monopoly supply areas. The Commission took a dynamic view of market development because the essential requirement for the nation-wide sale of electricity, the ground rules for third-party-access to all networks, albeit still imperfect, had been adopted.⁴²

³⁸ CEPR (footnote 36) p. 116-196 (Scandinavian countries).

³⁹ The case began as an antitrust procedure but was concluded in the merger procedure EDF/EnBW, see below.

⁴⁰ See, for example, Commission decisions on EDF/London Electricity (4.12.1998), Endesa/CDF/Snet (9.3.2001), RWE/Kärntener Energie Holding (2.7.2001) available at <http://europa.eu.int/comm/competition/mergers/cases/>

⁴¹ See Comm'n decision of 13 June 2000, OJ L 188/1 (10.7.2001)

⁴² See Comm'n (footnote 41) page 5-7 paras. 32-46

The Commission established that the consolidation would significantly increase concentration and create a dominant duopoly of two generators controlling 68% of supplies. Underlying market conditions such as the homogeneity of the product, the transparency of the market and the limited growth in demand would favour parallel behaviour of the two members of the duopoly. Of particular relevance were the numerous corporate links between them and with other competitors. In addition, the Commission found that the German system of negotiated third-party-access to the grid gave the duopoly members competitive advantages over competitors.⁴³

In order to avoid a prohibition of their envisaged transaction, the parties offered to the Commission a number of commitments with the aim to remedy the established competition problems. Firstly, the companies undertook to reduce the corporate interrelationships between them. This undertaking eliminated the grounds for a common interest of the market leaders in peaceful parallel behaviour and removed a tool for privileged access to information about the corporate strategy of the other member of the duopoly. At the same time these divestitures would have the positive effect to render a joint venture called VEAG, which would otherwise been jointly controlled by the duopolists, a new independent competitor with significant competitive potential. Apart from these undertakings, the enterprises committed themselves also to less conventional remedies and undertook, for instance, to drop the t-component surcharge for certain power transmissions within Germany which adversely affected competition from traders and smaller generators.⁴⁴ Another example for an unusual commitment is the undertaking of the merger partners to issue in future separate bills for network charges and energy prices in order to increase price transparency for their customers and to inhibit any cross-subsidisation by the network monopoly in favour of the power sales department being under competitive pressure.⁴⁵ The Commission regarded these commitments altogether as sufficient to remove the competition concerns arising out of the envisaged consolidation and allowed it consequently to go ahead.

The second case, EDF/EnBW, concerned the acquisition of a potential competitor from another Member State by a former national monopolist. EDF, the leading electricity generator in France, intended to acquire EnBW, a member of the group of the four largest German generators which had been formed after the already mentioned VEBA/VIAG merger.⁴⁶ The Commission found that the target company, which has its historic supply area adjacent to the French-German border, was one of the few potential entrants particularly well placed to enter the French market. EnBW had an incentive to enter at a significant scale and, indeed, the company had already participated in tenders launched by French eligible customers, also through a Swiss generation subsidiary.⁴⁷ It was furthermore established that EDF would become in general less exposed to competition in France after the acquisition. It would be in a position to use its presence in Germany to deter its rivals from pursuing aggressive competition in the French market. Moreover, it would control a large part of the Swiss generation and supply of peak load the access of which is not only important for EDF itself, but also for its competitors on the French market. Finally, EDF would through the entry into the German market further strengthen

⁴³ See Comm'n (footnote 41) page 11-26

⁴⁴ See for more details IV.1. below

⁴⁵ See Comm'n (footnote 42) page 38-41

⁴⁶ See Comm'n decision of 7.2.2001 – EDF/EnBW available at <http://europa.eu.int/comm/competition/mergers/cases/>

⁴⁷ Approximately 30% of French consumption or 1206 company sites are open for competition, see Comm'n (footnote 46) para.14.

its already outstanding position as a pan-European supplier of large business customers with production sites all over Europe.

The Commission only approved the envisaged transaction after EDF had made several major commitments. Of particular interest is the innovative commitment to make available to its competitors via auctions access to generation capacities located in France which amount to 30-32% of the national market for eligible customers. It was the prognosis of the Commission that access to virtual power plants in France will facilitate foreign suppliers to become active on the French market and improve their possibilities to conclude pan-European supply contracts. Especially German suppliers will be in a position to gain a foothold and will thus be able to cope with EDF's increased retaliation potential after the acquisition. Of interest is finally that EDF will divest the Swiss generation subsidiary of the target company in order to avoid any improvement of EDF's access to Swiss peak supplies. The EDF/EnBW case demonstrates that even a former monopolist can expand through acquisitions and thus try to make good on other markets any losses of revenues in the traditional sales area.

The Commission is not only concerned about the elimination of new entry by competitors from neighbouring markets. It aims also at protecting *ex novo* entry through new power generation. Gas is one of the energy sources from which electricity will increasingly be produced in the future because of its economic and environmental advantages. It is expected that the growth of the gas market in the next decade will to a considerable extent be driven by the use of gas as a fuel for electricity generation⁴⁸. A merger between the dominant electricity supplier and the dominant gas wholesaler, both of which active on the same geographic market, may thus allow the electricity supplier to gain control over one of the most important sources of competition for the electricity supply market. The Commission has already intervened twice against transactions threatening to foreclose access of new entrants to the gas market.⁴⁹

Other competitive advantages which a dominant supplier endeavours to obtain through a merger may also raise the Commission's attention. For example, the leading French supplier EDF envisaged to form a joint venture for the trade of electricity and other forms of energy with a well established trading company. France had not implemented the liberalisation directive at the time of the formal notification of the joint venture. The conditions and terms of third-party-access to the French electricity grid as well as the identity of eligible customers in France were not known. EDF would not only have been the sole electricity generator but also the only energy trader in France until the effective opening up of the French market. The company would thus have been able to gain a significant first mover advantage over its competitors which were still barred from entry. In order to avoid a prohibition decision EDF had to concede to the Commission that it would only offer energy trading services in France after the market has really been opened up for competitors⁵⁰.

⁴⁸ 1999 *Energy in Europe*, Special Issue December, Economic Foundations for Energy Policy, p.27, 98 (ed. European Commission)

⁴⁹ See Commission decisions 1.9.1994 - Tractebel/Distrigaz (II) para.47-49 and 2.6.1998 - Neste/IVO para.47-61, available at <http://europa.eu.int/comm/competition/mergers/cases/>. An additional ground for the intervention was in these cases that the dominant electricity producer would be able to influence the choice of industrial consumers whether to engage in own-production of electricity or to continue purchasing from the incumbent.

⁵⁰ Commission decision 28.9.1999 – EDF/Dreyfus, available at <http://europa.eu.int/comm/competition/mergers/cases/>

This case shows that even a dynamic approach which takes into account all short term improvements of the current market situation reaches its limits under EC merger control where the date for the entry into force of the new legal framework is not known.

Finally, the emergence of supply competition on electricity can also be impeded by the grant of state-aid. The control of financial aid given to enterprises by Member States is therefore another important instrument of Community competition policy in the liberalisation context. A particular issue is the grant of state-aid to compensate companies for so-called “stranded costs”.⁵¹ Prior to market opening some electricity undertakings invested, at times under the direction of the state, in assets or entered into contracts, which may prove to be unprofitable. However, the existence of a fixed tariff established by the state gave them the assurance that these investments or contracts would be in any event financed by their customers. Following the opening of the electricity sector for competition and the drop in electricity prices, some of these investments and contractual commitments may lose all prospect to be recovered – they become “stranded”.

The Commission currently investigates a series of cases where Member States set up aid schemes for electricity suppliers.⁵² It acknowledges in principle that stranded costs may appreciably affect the competitiveness of companies and considers that state-aid which merely compensates stranded costs for a certain period of time may be authorised under the EC Treaty (Article 87) in circumstances where such aid favours the transition of its beneficiary to competitive markets. However, it must be assured that the financial support really is limited to what is necessary to compensate for stranded investments. Otherwise the distortion of competition would not be acceptable. In addition, the methods of financing aid intended to offset stranded costs chosen by Member States must not have the effect of deterring new market entry. For instance, aid should not be recouped from levies on cross-border transmissions of electricity. This would only have the detrimental effect to create another hurdle for import competition. A methodology for the analysis of the compatibility of such state-aid has been elaborated by the Commission in cooperation with the Member States and was recently adopted.⁵³ It will guide Member States when adopting aid schemes and allow the Commission to coherently analyse the cases already under investigation.

The control of public support schemes always requires the qualification of the support as state-aid within the meaning of the EC Treaty. Recently the European Court of Justice had to deal with this problem in the context of a certain German act, the so-called „Stromeinspeisungsgesetz“⁵⁴. This law foresaw that energy companies – irrespective of whether they are private or public – had to buy „green electricity“ at fixed prices exceeding market prices. The financial assistance was thus not handed out by the state but by companies. The Court ruled that the scheme did not comprise state-aid as long as

⁵¹ The Electricity Directive provides also for transitional measures, if a Member State sees difficulties to arise for its electricity industry in the timely implementation of all obligations for market opening, see Art. 24.

⁵² The Commission is analysing cases related to Belgium, Denmark, Germany, Greece, Italy and the United Kingdom. The Austrian, Dutch, Spanish and British cases have recently been concluded. The decisions are available at [http:// europa.eu.int/comm/secretariat general/sgb/state aids/industry](http://europa.eu.int/comm/secretariat_general/sgb/state_aids/industry). See also the Commission press release “*Commission gives green light to ‘stranded costs’ compensation by Spain, Austria and The Netherlands*”, IP/01/1079, 25.7.2001.

⁵³ See Commission press release, “*Commission adopts document on methodology for state-aid linked to ‘stranded costs’ in the electricity sector*”, IP/01/1077, 25.7.2001.

⁵⁴ Case C-379/98, *PreussenElektra*, judgment of 13.3.2001, not yet published in ECR.

the company obliged to buy green electricity is a private one, which was the case in the matter to be decided by the Court. The Commission is at present examining the precise consequences of this decision for its state-aid policy.

The issue of stranded costs shows that the Commission actively and comprehensively applies all instruments of Community competition policy in order to improve the conditions for free supply competition on European electricity markets.

2. Gas

The pre-liberalisation situation for supply competition on gas markets in the 15 Member States is in many respects very similar to that of electricity. Gas is, however, a natural resource not found in every Member State. The European Union as a whole is a net importer of gas.⁵⁵ Since almost all Member States import gas, gas production markets have therefore always had a wider than a national dimension.

Gas fields are mostly developed jointly by several companies. Joint development is very often coupled with joint selling. Some gas exporting countries favour the joint selling of all gas produced on their territory.

Producers form the top of the “*gas column*”.⁵⁶ They sell traditionally to one importer or import organisation per Member State. Importers are regularly vertically integrated transmission companies and take also care of transport of the purchased gas over long distances through high-pressure pipelines, at least once it has reached the border of a Member State.⁵⁷ There, importers sell the gas on to power generators, regional and local distributors as well as industrial customers. Distributors are, again, vertically integrated with a distribution network operator, which transmits the gas to final consumers. Distributors may be separate and independent from importers. They are, however, as the other members of the vertical chain, closely linked to importers through long-term supply contracts. There existed little, if any “*gas-to-gas*” competition within the vertical chain lead by an importer. Indeed, like in the electricity sector most gas companies enjoyed a monopoly in their historical supply area. Each vertical chain operated in isolation from parallel chains in other Member States before liberalisation.⁵⁸ The isolation of the national supply chains forms a stark contrast to the fact that approximately 50% of all gas consumed in the EU crosses at least one border. After liberalisation, new entry is attracted by the high growth potential of gas consumption and significant possibilities for price arbitrage, but impeded by the insufficient liquidity of the downstream supply markets and the long-standing supply relationships between producers and importers upstream.

Member States are generally taking to a lesser degree measures to improve the conditions for competition on gas supply markets than they have been engaged in the organisation of electricity markets. Some have introduced gas release programmes, i.e. gas purchased under long-term contracts from producers is transferred to interested wholesalers, capped the market-share of the incumbent importer, or have done both. Most Member States

See Commission, Green Paper : *Towards a European Strategy for the Security of Energy Supply*, 2001, p.41

⁵⁶ See Exxon/Mobil (Footnote 25) paras. 48-51 (Comm’n)

⁵⁷ Some importers are also vertically integrated gas producers.

⁵⁸ The gas market is not equally developed in all countries. In Greece and Portugal, for instance, a natural gas industry is only emerging. This explains why these countries have been given special derogations from the obligations of the Directive, see Art. 26(2).

rely, as for electricity, on market forces and the internal Community market to bring about effective competition.

Community competition policy contributes to the development of gas-to-gas competition at a Community-wide scale through a review of the contractual arrangements at all levels of the supply chain.

One particular focus of enforcement activity are the joint selling agreements between gas producers. Technical and commercial constraints do not seem *prima facie* to require joint selling. Import monopolies are no longer justified, if they were ever a valid justification under the competition rules.

The Commission did therefore have serious doubts whether to exempt from the prohibition of Art. 81 (1) ECT the envisaged collaboration of owners of a newly discovered gas field west of Ireland in the Atlantic. The parties decided subsequently to withdraw the notification of their intended joint selling agreement and declared that they would market their gas separately.⁵⁹ Furthermore, the Commission initiated formal proceedings against the participants of the Norwegian Gas Negotiation Committee, called GFU. The organisation was created in the early 1980ies and was in charge of negotiating all contracts with European importers for the supply of gas produced by some 20 companies on the Norwegian Continental Shelf. It was the GFU which decided who could buy Norwegian gas and at which conditions. The Commission considers GFU to be a cartel falling under the prohibition of Art. 81 (1) ECT. It is true that the Norwegian State was closely involved in the organisation of Norwegian gas exploration and production. The State was aware of the existence of GFU and supported it to a certain degree. It remains to be seen, however, whether and to which extent the involvement of the State and the State interest in the management of natural resources contravenes or mitigates the Commission's initial assessment of GFU falling under the cartel prohibition as claimed by Norwegian gas producers.

The Commission commenced formal proceedings even after the Norwegian government had already announced that GFU would be abolished. The abolishment of GFU may have a very positive effect on gas-to-gas competition among producers for future sales. However, the activity of the GFU in the past, however, probably has a long-lasting adverse effect well into the future which may have to be addressed as well.⁶⁰

The aim of the on-going Commission review of horizontal arrangements among gas producers clearly is to put an end to the tradition to artificially reduce the number of independent players through joint selling arrangements. Price fixing is considered to be one of the most harmful restrictions of competition under Community competition law and is therefore almost always prohibited.⁶¹

Another focus of enforcement activity concerns arrangements which restrict cross-border competition between the members of the vertical gas supply chain existing in each Member State.

⁵⁹ See Commission press release "Enterprise Oil, Statoil and Marathon to market Irish Corrib gas separately", IP/01/578, 20.4. 2001

⁶⁰ See Commission press release "Commission objects to GFU joint gas sales in Norway" IP/01/830, 13.6.2001.

⁶¹ See Commission Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements, OJ C 3/2, 6.1.2001, para. 25.

A series of pending cases deals with direct territorial sales restrictions. These restrictions have been found in long-term supply contracts between producers and European importers. A so-called destination clause prevents the importer to resell the purchased gas outside his traditional supply area being normally the Member State in which he is located. Its main purpose seems to be to protect the pricing formula for gas called “market value principle”. According to this principle the gas is priced differently depending on the alternative energy sources available to gas buyers in each individual Member State.⁶² Since producers accept to discount from the market value price the costs of bringing their gas to the country of consumption (net-back)⁶³, they have an own interest in maintaining the clause.

The clause is directly opposed to the internal market goal of the Community and is considered to be a “hard core” restriction of competition.⁶⁴ The measure has the object and effect to segregate the 15 national markets and to maintain prevailing price differences. There is no doubt, the destination clause is void under Art. 81 ECT and its observance may be pursued with fines (Art. 15 Reg. 17). Given the absolute incompatibility of territorial sales restrictions with the internal market goal the Commission will of course also have to pursue all indirect measures aimed at inducing a gas purchaser not to re-sell to customers outside his traditional supply territory such as refusal or reduction of bonuses or discounts.⁶⁵

The Commission is aware of other restrictions of effective gas-to-gas competition within the vertical supply chain. It may have to tackle these one by one in collaboration with national competition authorities in order to bring about a change to what seems to be the commercial traditions of the sector.

Another example for the limitation of supply competition are use restrictions. It was established that a dominant gas importer imposed use restrictions in a sales contract with an electricity generator. The generator was only allowed to use the purchased gas for power production. He was neither permitted to sell the gas to final consumers through his own gas distribution network, nor was he allowed to sell it to other industrial consumers. The Commission intervened against the use restriction. It considered the restraint to constitute an abuse of a dominant position because it enables the supplier to practice price discrimination in accordance with the demand flexibility of his various customer groups. Moreover, use restrictions artificially reduce market liquidity when a generator does not require all gas purchased for power production. The restraint forms thus an obstacle to the development of gas spot markets.⁶⁶

The emergence of effective gas-to-gas competition can finally be hampered by mergers and acquisitions. The Commission took therefore care that the take-over of Mobil by Exxon did not produce negative competition effects. The transaction mainly had an impact on the global oil and gas sector, of course. However, it also affected the downstream gas markets of the Netherlands and Germany. Both markets are characterised by a supply structure which was not very favourable for competition even before the intended operation. The Dutch wholesale market was dominated by a single

⁶² See Exxon/Mobil (footnote 25) paras.52, 62

⁶³ See Exxon/Mobil (footnote 25) para.101

⁶⁴ See VRG (footnote 27) para.49

⁶⁵ See VRG (footnote 27) para.49; see also: CFI 6.7.2000, case T-62/98, ECR II-2707 - Volkswagen/Commission; Commission decision 8.5.2001 – Glaxo Wellcome, OJ L 302, 17.11.2001, p. 25-31

⁶⁶ See Commission (footnote 29)

company, whereas the German market was controlled by a narrow oligopoly. Exxon was indirectly active on both markets through major equity stakes in the market leaders. In contrast, Mobil belonged to the few outsiders with a certain competition potential because of its own gas production and not yet fully committed reserves. The take-over would have diminished, if not completely eliminated the competition potential of Mobil and thus resulted in the strengthening of the dominant incumbents to which Exxon belonged.⁶⁷ The merger parties agreed therefore with the Commission to re-establish the *status quo ante* on the Dutch market and sell Mobil's Dutch gas business to an interested third party. The remedy for the competition problem on the German market consisted in the divestiture of one of Exxon's stake-holdings in a German wholesaler which compensated for the loss of competition through the integration of Mobil's gas business.⁶⁸

In the case of the gas supply markets, at present the transition from monopoly to competition is mainly accompanied by the two instruments EC antitrust rules and merger control. The success of the transition seems to depend to a significant extent on the successful transformation of the *gas column* into a supply chain where each member is free to compete with each other member at all levels and throughout the Community. Free supply competition (the second prerequisite for effective competition on the European electricity and gas markets) is obviously much more difficult to accomplish than the first (free consumer choice of suppliers).

III. Open access to networks

The third prerequisite for effective competition concerns a particular feature of the electricity and gas sector: the network. Deliveries of electricity and gas are effectuated through an energy-transmitting network connecting suppliers with their customers. Most components of the electricity grid and gas pipeline systems constitute natural monopolies because their duplication would be inefficient due to the large fixed costs of the investment.⁶⁹ Open access to the network for suppliers and consumers is thus essential for free supply competition and free consumer choice of suppliers. Similarly, exporters and their customers must have open access to the lines connecting distinct networks of different Member States.⁷⁰

The Directives oblige Member States accordingly to open up all existing networks for suppliers and eligible customers located "*either inside or outside the territory covered by the interconnected system*".⁷¹ Most countries created a regulated system of access procedure (so-called regulated third-party access, TPA). Under this system users have a right of network access on the basis of published tariffs approved by a regulatory authority.⁷² However, in almost all Member States network operators are vertically integrated with electricity or gas supply businesses. The opening of networks for all

⁶⁷ See Exxon/Mobil (footnote 25) paras.205-223 and 230-258

⁶⁸ See Exxon/Mobil (footnote 25) paras. 828-829 and 830-834

⁶⁹ IEA (footnote 5) p. 19-20

⁷⁰ For electricity these cross-border lines are called interconnectors, see Art. 2 No 10 Electricity Directive.

⁷¹ See Art. 15, 16 Gas Directive & Art. 17 Electricity Directive.

⁷² See Art. 17(4) Electricity Directive & Art. 16 Gas Directive. Some Member States opted for the alternative system of negotiated third-party access also permitted by the Directives. This trend was more pronounced for gas than for electricity, see Art. 17(1) Electricity Directive & Art. 15 Gas Directive. The Commission proposes in the Acceleration Directive to admit in future reg. TPA only, see Proposal (footnote 9) new Art.16.

interested users means thus that operators have not only to give access to their network but *de facto* also to their traditional customer base for the supply of electricity or gas. This creates a risk of discrimination in favour of the own supply interests whenever an operator receives an access request.

The Community legislator was aware of the discrimination risk and obliged vertically integrated electricity and gas enterprises therefore to “unbundle” their network from supply interests. Unbundling means separation of accounts⁷³, creation of “Chinese Walls” to preserve the confidentiality of commercially sensitive information of network users⁷⁴ and, for electricity networks the separation of management through designation of a system operator who acts independently from supply interests.⁷⁵

The Directives obviously fall short of ordering ownership unbundling of the network. Instead network operators are obliged not to discriminate in favour of their or their shareholders’ supply interests when dealing with third-party access requests.⁷⁶ The observance of this non-discrimination obligation is monitored by a competent and independent “dispute settlement” authority established in each Member State.⁷⁷

Most Member States have gone in practice further than the Directives and required legal or ownership separation.⁷⁸ From a competition policy point of view further unbundling than foreseen by the Directives would seem to be not only appropriate but necessary. Behavioural obligations and regulatory supervision arguably are always second best to structural separation in order to effectively eliminate economic incentives for discrimination. Stricter unbundling appears all the more reasonable, if it is true that the loss of economies of vertical integration is small in the electricity and gas industry.⁷⁹ The Commission has recently proposed to go one step further and make the legal separation of network and supply interests compulsory.⁸⁰ It acknowledges that ownership separation would lead to “*a more rapid and equitable development of an effective internal market*”. The Commission intends however to further monitor whether “*effective and non-discriminatory access develops*” under legal unbundling before it will consider complete unbundling.⁸¹

1. Development of transmission tariffs

Community competition policy applies its legal instruments to effectively ensure open access to networks for suppliers and consumers in practice. In particular, the EC antitrust rules are enforced to deal with the two principal issues of exploitative conduct of network monopolies and discriminatory practices of vertically integrated network operators.

One of the major issues has been the development of fair tariffs for the provision of transmission services to third parties. Before liberalisation transmission was in almost all Member States an internal transaction within the same firm or was not even regarded to

⁷³ See Art. 14 Electricity Directive & Art. 13 Gas Directive

⁷⁴ See Art. 9, 12 Electricity Directive & Art. 8, 11 Gas Directive

⁷⁵ See Art. 7, 10 Electricity Directive

⁷⁶ See Art. 7(5), 11(2) Electricity Directive & Art. 7(2), 10(2) Gas Directive

⁷⁷ See Art. 20 Electricity Directive & Art. 21 Gas Directive

⁷⁸ This has been more pronounced in electricity than in gas.

⁷⁹ IEA (footnote 5) p. 25-26.

⁸⁰ See Commission Proposal (footnote 9) for a new Art. 10 (4).

⁸¹ See Commission Proposal (footnote 9) p. 6, there explicitly only expressed for gas, but applies to electricity networks, too.

be an activity separate from energy supply. To establish a price and terms for the use of networks has therefore been a principal task of paramount importance for the introduction of supply competition. The Commission has contributed to the tariff development through the creation of regulatory fora where national regulatory authorities, industry and other interested parties are discussing methods to calculate appropriate tariffs and measures to organise the cross-border transmission of electricity and gas.⁸² When necessary the Commission has also intervened on the basis of competition law against tariffication systems which are discriminatory or not cost-reflective or both.

The German network operators, for example, decided to introduce a tariff for electricity transmissions which was among other factors based on the distance between the feed-in point of the generator and the off-take point of his customer.⁸³ The Commission objected against the so-called distance component of the German tariff because the path for the physical delivery of electrons in densely meshed networks is not determined by the individual contract path between the generator and his customer. In this regard electrons are not comparable to other goods. They do not travel like, for instance, coal but obey the “law of the least resistance”. A dominant network operator charging a tariff on the basis of an erroneous parallel to other goods is committing an abuse within the meaning of Art. 82 ECT because his tariff charge is not related to the actual cost incurred. Moreover, the distance component discriminates in favour of generators in the vicinity of consumers. The Commission had therefore serious doubts whether the German tariff was compatible with the Community competition rules.⁸⁴

German network operators decided subsequently to abolish the distance component and introduced a non-transaction-based tariff. The price for transmissions depended now on the consumption of each individual consumer. This held at least for transmissions within a newly created Northern and Southern zone in Germany. Exports and imports as well as domestic transmissions from one zone into another, however, were charged an additional price, called “t-component”. The Commission objected again because of the discrimination of exports and imports as well as certain domestic long-distance transmissions. It regarded the t-component as arbitrary and therefore not cost-reflective as required for dominant firms in accordance with Art. 82 ECT.⁸⁵

It is not the aim of the Commission to require a uniform tariff without any locational component for all electricity transmissions within Europe. However, tariffs of dominant network operators for the transport of electricity should be in line with the laws of physics and, accordingly, the actual cost incurred in the network that is used for transmission. The Commission is therefore of the opinion that tariffication systems should not be based on the individual commercial transaction between a supplier and his customer. Instead of being “transaction-based” charges should relate to the connection or network access. Furthermore, for cross-border transmissions “pancaking” should be avoided. Pancaking occurs, if each country located between a supplier and his customer

⁸² See Communication (footnote 4) p. 10 for the fora of Florence and Madrid.

⁸³ Germany is the only Member State with a negotiated third-party access system for electricity transmissions. Industry associations have therefore been negotiating tariffs and terms electricity transmissions. The so-called association agreement is, however, not compulsory for individual network operators.

⁸⁴ See Annual Reports : Comm’n, XXVII. Report on Competition Policy, p.156-159 (1998) ; Levasseur, *Développements les plus récents*, Competition Policy Newsletter 1998 No.3 p.43-46

⁸⁵ The t-component was later dropped for inter-zonal transmissions as condition for the approval of the VEBA/VIAG merger (footnote 41).

imposes a charge for the transmission through its grid. This would seriously impede trade between Member States. The Commission is therefore opposed to any additional charge for exports or imports of electricity. It favours a system where network operators compensate each other for the cost of transmissions in their networks. The compensation mechanism should be based on the actual net physical flow of electricity between networks within a certain period of time. The network hosting such flows should be remunerated by the network causing such flows.⁸⁶ The users of the network causing the flows should indirectly, but ultimately have to bear the cost for cross-border transmissions. Competition policy could not introduce such a system. However, it should be considered whether it could be created by internal market policy.⁸⁷

2. Dealing with congestion

The other major network issue of EC competition policy apart from tariffication has been congestion management.

Electricity networks have been built in the past to serve a national, not a European market. Before liberalisation almost all of the electricity produced in the 15 Member States was also consumed in each of these countries. Only approximately 8% of total Community production has been traded between Member States.⁸⁸ This situation changes through market opening. The existing significant price differences between national markets provide a strong incentive for cross-border trade. It has already been pointed out how important import competition is for the improvement of the prevailing supply structure in many Member States.⁸⁹

The European network infrastructure has, however, to be substantially improved to allow trade to grow and import competition have a substantial impact on the market conduct of incumbent suppliers. Many lines connecting the distinct grids of Member States have quickly become congested after market opening. Transmission system operators are introducing special procedures for the allocation of bottleneck capacity because demand for cross-border transmissions has become constantly higher than supply. The procedures most frequently applied are auctions, pro-rata rationing and “first come, first served”.⁹⁰

Auctions have been criticized because they allow network operators to gain windfall profits on top of their regular transmission income. The additional revenue for the use of the bottleneck facility tends to equal the difference between the average prices for electricity in the exporting and importing Member State. Import competition is thus

⁸⁶ Communication (footnote 3) p. 11.

⁸⁷ See Proposal for a Regulation of the European Parliament and of the Council on Conditions for Access to the Network for Cross-border Exchanges in Electricity, COM(2001)125/4 and the conclusions of the 7th Forum of Electricity Regulators at Florence in February 2002, available at http://europa.eu.int/comm/energy/en/internal_market

⁸⁸ Communication (footnote 3) p. 9.

⁸⁹ See III.1. *supra*

⁹⁰ The Scandinavian Member States organised an electricity market which encompasses all their previously national markets and introduced a market splitting mechanism. This means that as a reaction to the occurrence of a congestion, there will be different market prices on either side of the bottleneck. Thus, electricity in the area which is oversupplied becomes cheaper than electricity in the undersupplied area. Consequently less market participants are interested to purchase from the area which becomes more expensive and resulting flow over the bottleneck is reduced. See Commission Second Report to the Council and the European Parliament on Harmonisation Requirements, COM (1999) 164 final, p.37

likely to be deprived of most of its pro-competitive impact on high-price markets. A vertically integrated supplier and network operator may thus benefit not only from his dominant position on the national supply market, but also from his auction income which is likely to be influenced by the national price level mainly determined mainly by him. Auctioning of bottleneck capacity has therefore been criticized as an abuse of a dominant position.

It is true that pro-rata rationing of transmission requests and the allocation of capacity in accordance with the timely order in which requests arrive keep the price for transmission lower and allow imports to exercise a stronger constraint on electricity prices in the import market. Both allocation methods suffer, however, also from certain weaknesses. Pro-rata rationing does not function effectively when demand massively surpasses supply. The capacity attributed to each individual request may become so small that it is no longer commercially interesting. The allocation of capacity on the basis of “first come, first served” lacks transparency and increases significantly the risk of discrimination, if the allocating network operator has himself export interests.

In contrast, the auctioning of scarce transmission capacity is a transparent allocation method, operational under all demand conditions. It provides price signals to market participants and should permit the lowest cost supplier to obtain transmission rights. Auctioning constitutes thus not by itself an abuse of the dominant position of the interconnector operator. Regular auctions generate, however, additional income for the operator. Collecting the additional income as a profit may therefore be abusive, if proceeds are not used to reinforce the transmission capacity of a constantly congested bottleneck facility, or to reduce the cost of cross-border transmissions for exporters.⁹¹

Congestion is at some borders further aggravated by the transmission capacity permanently reserved for large import contracts which have been concluded before liberalisation. These long-term contracts reduce the technically already limited capacity even further which is available for new entrants. The Commission is investigating the import contracts and capacity reservations which incumbent operators enjoy at the most congested borders between Member States. To grant priority rights to transmissions of former monopolists may constitute a discrimination and thus be an abuse of the dominant position of the allocating interconnector operator. The Commission will, of course, consider objective justifications for alleged priority rights, in particular if the parties to an import contract have made investments in order to execute their agreement which have not yet been amortised.

Some import contracts pre-dating liberalisation have already been modified by the parties while the Commission was investigating them. A long-term contract for the transmission of electricity between Norway and Germany via Denmark has, for instance, been changed to the effect that the full capacity of the line is now open for third parties.⁹² Similarly, the interconnector between France and the UK has been made available for all market participants because the parties previously using the full transmission capacity of the submarine cable decided not to prolong their existing reservation contract.⁹³

⁹¹ See above III.1. *supra*

⁹² See Annual Reports: Comm'n, XXXth Report on Competition Policy, p.155-156 (2000) and press release “*Increased scope for electricity import competition in Northern Europe – a step forward towards an internal market for electricity*” IP/01/30, 11.1.2001

⁹³ See Commission press release “*UK/France interconnector opens up, increasing scope for competition*”, IP/01/341, 12.3.2001

All measures taken to make the best use of the existing cross-border transmission capacity, however, cannot hide the fact that significant investments are necessary to adapt the European network infrastructure to the requirements of competitive, Community-wide supply markets. 15 national network systems have to be transformed into a Trans-European network⁹⁴. To increase the capacity of an existing interconnector or to build a new link between networks which have been operating in isolation from each other in the past will therefore normally be pro-competitive. The Commission encourages such investments. Competition problems may, however, arise, if third parties are restricted in the use of new transmission capacity.

The Commission intervened in the case of a new interconnector where the network operator originally granted a power supplier priority rights for up to 100% of the available transmission capacity for 15 years. The reservation had been concluded some years before the adoption of the Electricity Directive and had therefore not been awarded in an open and transparent procedure. The network operator, who is solely responsible for the construction of the new link between previously not interconnected grids, received funds from the European Community for the project. The Commission regarded the long-term reservation as excessive in terms both of capacity utilization and duration even when considering that it concerned a new submarine cable. After discussions with the competent national regulatory authority the parties informed the Commission of modifications of their agreement reducing the reserved capacity utilization to 50% for the duration of less than 6 years. This enabled the Commission to approve the modified agreement.

Even the long-term reservation of the full capacity of a new line for the constructing parties may however be compatible with Community competition law, where the already existing interconnector capacity satisfies market demand for transmissions for the foreseeable future.⁹⁵

3. Cooperation with national regulators

The creation of an open access regime for networks forms also a very good example for the close cooperation of the Commission with sector-specific regulatory authorities which most Member States specifically set up for the liberalised electricity and gas markets. The collaboration within the regulatory fora of Florence and Madrid where Community and national authorities meet to discuss cross-border transmission issues have already been mentioned. Another area of cooperation concerns the treatment of individual network access cases. The Directives provide that Member States empower their energy regulators with an authority to deal expeditiously with disputes concerning third-party access.⁹⁶ Community competition law and sector-specific regulation⁹⁷ will therefore very often apply in parallel in access cases, in particular if they concern access to cross-border lines. Multiple proceedings might, however, lead to unnecessary duplication of investigative efforts by the Commission and national authorities. In order to avoid such duplication the Commission and national competition authorities developed certain principles for the allocation of cases. It has been agreed, for instance, that the Commission concentrates its enforcement efforts on cases having a particular political

See the Communication from the Commission to the European Parliament and the Council on *European energy infrastructure* COM(2001) 775 final, 20.12.2001, p. 4-7, available at http://europa.eu.int/comm/energy/internal_market

⁹⁵ See Art. 19(3) publication of the Viking cable project, OJ C247/11, 5.9.2001

⁹⁶ See Art. 20 Electricity Directive & Art. 21 Gas Directive

⁹⁷ In some Member States national competition law may apply instead of sector-specific regulation.

economic or legal significance for the Community.⁹⁸ It would seem to be appropriate that this general principle applies also to the energy sector as it does with regard to other liberalised sectors.⁹⁹ Moreover, it has to be taken into account that national authorities have been especially called upon by the Community legislator to deal with access disputes. It would therefore also appear to be reasonable that the Commission does not tackle access disputes with priority while there are related actions before a relevant national authority or court.¹⁰⁰ This would seem to be all the more justified in view of the duty of national authorities not to approve any practice or agreement contrary to Community competition law.¹⁰¹ This obligation has explicitly been confirmed for the electricity and gas sector by the Directives.¹⁰² The Commission does thus not have to intervene itself in every case in order to ensure the Community rule of law and a level playing field in the European electricity and gas markets. At the same time, case allocation and close cooperation between the Community and national instances should lead to a mutual reinforcement of both sets of rules through the close cooperation of all authorities involved.

It depends very much on the development of functioning transmission markets whether consumers can actually switch suppliers and whether suppliers can genuinely compete against each other. The Commission as well as national authorities make a combined effort to support the development of cost-reflective tariffs and proper congestion management on the basis of the Community competition rules and sector-specific regulation. It appears however that additional legislative measures as proposed by the Commission in the draft Acceleration Directive and Regulation on access conditions for electricity networks are indispensable to succeed in effectively open up networks.

IV. Public service obligations and competitive energy markets

The provision of public services has always been a characteristic feature of the European electricity and gas industry. In order to ensure that the supply of electricity and gas responds best to the needs of consumers at large Member States traditionally impose obligations on suppliers to that effect. Such obligations can be grouped in mainly three categories: security of supply, protection of the environment and maintenance of service standards.

Before liberalisation the provision of public services had been ensured through state ownership of energy enterprises or via sector-specific regulation. The opening of the electricity and gas markets for Community-wide competition created many concerns, mainly on the side of the beneficiaries of the previous market organisation, as to the future of these services and their quality. Potential entrants in the liberalised markets, on the other hand, fear that enterprises entrusted with public service obligations will be granted special rights or public funds which give them an unfair advantage in the competition for customers.

The liberalisation of energy markets and the provision of public services neither exclude each other, nor are both objectives necessarily in conflict with each other. The Directives

⁹⁸ See Commission Notice on cooperation between national competition authorities and the Commission, OJ C 313, 15.10.1997, p. 3.

⁹⁹ See Commission, Notice on the application of the competition rules to access agreements in the telecommunications sector, OJ C 265/2, 22.8.1998 (Access notice), paras 18 & 6.

¹⁰⁰ See also Access notice (footnote 99) para 28.

¹⁰¹ Case 66/86, Ahmed Saeed 1989 ECR 838.

¹⁰² See Art. 22 Electricity & Gas Directive

are a clear demonstration of this. They require Member States to open up their markets for all European competitors and, at the same time, confirm the existence of public services.¹⁰³ They leave the freedom of Member States to introduce public services untouched and intact. Some public services typical for both energy sectors are even mentioned in the Directives, e.g. the obligation of distributors to connect and supply all consumers in a given area,¹⁰⁴ or the duty of network operators to give priority to environmentally friendly or indigenous fuel-using power installations when dispatching generating installations.¹⁰⁵

The Directives rule also how the competition and public service objectives can co-exist with each other. Both refer in this regard to the EC Treaty and in particular Art. 86(2). This means mainly that, if Member States wish to maintain or create new public services, they have to define and explicitly entrust enterprises with such a mission. It does not longer suffice to instruct state-owned companies to perform public services. Furthermore, any restriction of competition introduced by a Member State in order to support the performance of a public service must not exceed what is necessary to guarantee effective fulfilment of the mission.¹⁰⁶ The grant of special or exclusive rights to one or a limited number of enterprises has to be proportionate to the public service mission with which they have been entrusted. A Member State having the intention to uphold any of the existing monopoly rights in the electricity or gas sector and thus not implementing all of the key requirements for the creation of competitive Community-wide markets has to notify this plan to the Commission.¹⁰⁷ The fact that to date no Member State has found it necessary to derogate from any of these key requirements after liberalisation¹⁰⁸ demonstrates in practice that in the electricity and gas sector competition and public services are compatible with each other.

This will not change when liberalisation progresses and all consumers including all households can freely chose among suppliers. The Commission itself proposes in the draft Acceleration Directive to combine full market opening with the compulsory introduction of a number of public service obligations in the interest of final consumers. Among these are transparency requirements and low-cost dispute settlement mechanisms.¹⁰⁹ Additional minimum service standards as well as other public services can be secured through sector-specific regulation the observation of which is monitored by regulatory authorities. Even the obligation to supply electricity at affordable and reasonable prices to final consumers,¹¹⁰ can be guaranteed without maintaining existing supply monopolies. The total exclusion of competition in order to guarantee low prices for a particular group of consumers would seem to be disproportionate and not compatible with Art. 86(2) ECT. Instead of maintaining monopolies it could be considered to involve energy suppliers in financing the net extra cost of the universal service through a system of additional charges or a public service fund. Alternatively,

¹⁰³ See Art. 3(2) Electricity & Gas Directive.

¹⁰⁴ See Art. 10(1) Electricity Directive & Art. 9(2) Gas Directive.

¹⁰⁵ See Art. 8(3) (4) Electricity Directive

¹⁰⁶ See Commission, Communication on services of general interest, OJ C17, 19.1.2001, p. 8 paras 22, 23. The term services of general interest covers market and non-market services which the public authorities class as being of general interest and object to specific public service obligations, see Communication from the Commission on Services of general interest in Europe, OJ C17/4, 19.1.2001, p. 23, Annex II

¹⁰⁷ See Art. 3 Electricity & Gas Directive.

¹⁰⁸ Communication (footnote 4) p. 19.

¹⁰⁹ Proposal (footnote 9) new Art. 3(3) and Annex to Electricity and Gas Directive.

¹¹⁰ As being proposed by the Commission in the draft Acceleration Directive, see Proposal (footnote 9) new Art. 3(3) Electricity Directive.

state-aid could cover the cost of the public service.¹¹¹ Prices represent, however, one of the principal areas upon which electricity suppliers compete, as the example of some fully liberalised markets shows. The introduction of genuine EC-wide competition may thus indeed be the best mechanism to improve the quality of services also for final consumers.¹¹²

V. Conclusion

The European Union has successfully launched the liberalisation of the electricity and gas markets. The creation of an internal energy market forms an important part of the Lisbon strategy for economic reform of the European Council.¹¹³ A new legal framework for a new competition-oriented market order is now in place. The economic transition process of the electricity and gas industries from monopoly to competition has begun in all 15 Member States and is already irreversible. We are already in the third year of electricity liberalisation and the second year of gas liberalisation.

It is also true, however, that the difficulties of the transition become more visible the more the process advances. Transmission markets are beginning to work but only imperfectly. Competition between suppliers is emerging but hampered by the many advantages of incumbents, in particular those owning a network. Some new entrants are already withdrawing from the newly opened markets. Prices show a tendency to increase again after a period of price reductions. The “*Californian experience*” or, “*the accident which was waiting to happen*” (Paul Joskow), raised concerns about the new regulatory environment. Moreover, the political climate appears to be no longer as favourable for liberalisation after the failure of the European Council in Stockholm in March 2001 to agree on a definite date for full market opening.¹¹⁴ The continuing imbalances in market opening and the public perception that some state-owned companies take advantage of the uneven liberalisation further contributed to the negative development of the political climate.

The difficulties of the transition process must be taken seriously, but can be overcome. The Acceleration Directive proposed by the Commission already deals with the imperfections of the first Directives. It suggests apart from rapid and full market opening additional qualitative measures like further unbundling of networks and the compulsory introduction of regulated third-party access in order to create a more level playing field for all market participants. Furthermore, Community competition policy will continue to support the liberalisation process with all its instruments. The Commission will continue to enforce the competition rules against restrictive practices, market power increasing mergers as well as distorting state-aid. It will act in close cooperation with the national competition and regulatory authorities in order to enhance the effectiveness of the competition as well as the new sector-specific rules.

Moreover, it should be noted that the European Council is still fully committed to the objective of market opening. The Council failed in Stockholm to agree on a date for full market opening but did not fail to underline once again the importance of the contribution of energy liberalisation for the modernisation of European industry.

¹¹¹ Communication (footnote 4) paras 15, 26.

¹¹² Communication on services of general interest (footnote 106) p. 22, Annex I.

¹¹³ See Presidency Conclusions of Lisbon European Council (23&24 March 2000), EU Bull., no.3, para.17 (2000)

¹¹⁴ See Presidency Conclusions of Stockholm European Council (23&24 March 2001), EU Bull. No.3 para.17 (2001)

Furthermore, the governments of the 15 Member States expressed their full support for the vigorous application of the competition rules against all obstacles to the internal energy market.¹¹⁵

Finally and most importantly, European consumers will continue to press for further liberalisation. Even the only emerging competition on European electricity and gas markets has already demonstrated to their satisfaction that consumer choice significantly increases and supply offerings substantially improve through competition and the creation of Community-wide markets. After all, it should be the consumer that counts, shouldn't it?

¹¹⁵ See Presidency Conclusions (footnote 114)

ANNEX

(Extract from Commission Staff Working Paper, *Completing the internal energy market*, SEC(2001)438)

EU Electricity Market Opening

	2000	2003	Later
Austria	32%	100% (2001)	100%
Belgium	35%	50%	100% (2007)
Denmark	90%	100%	100%
Finland	100%	100%	100%
France	30%	35%	n.a.
Germany	100%	100%	100%
Greece	30%	35%	n.a.
Ireland	30%	40%	100% (2005)
Italy	35%	70%	70%
Luxembourg	40%	+56%	75% (2005)
Netherlands	33%	100%	100%
Portugal	30%	35%	n.a.
Spain	54%	100%	100%
Sweden	100%	100%	100%
United Kingdom	100%	100%	100%
EU – average	66%	75%	83%

EU Gas Market Opening

	2000	2008
Austria	49%	100%
Belgium	58,7%	100%
Denmark	30%	43%
Finland	90%	90%
France	20%	33%
Germany	100%	100%
Greece	0%	33%
Ireland	75%	100%
Italy	96%	100%
Luxembourg	51,1%	83,4%
Netherlands	45%	100%
Portugal	0%	33%
Spain	72%	100%
Sweden	47%	100%
United Kingdom	100%	100%
EU – average	78,9%	91,5%