

## The effect of energy market liberalization on EU competition

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*A new entrant in a network industry faces a very difficult situation if it wishes to compete with a company already on the market. According to Bara (2006), competition is endangered by two factors: the state and the competitors themselves. However, such sectors exist where competition can not develop in a natural manner. Concerning the network industries and the competition policy guarding the newly formed/forming competitive energy markets, the challenge is especially the characteristic that the operation of the market, the opening itself, is not necessarily able to eliminate the monopoly structure. Thus the subject of our analysis is the effect of energy market liberalization, launched a decade ago in the European Union, on the competition in the sector. Has the European Union in reality reached the effect it planned or has the opposite occurred?*

*Keywords: liberalization, energy market, market concentration*

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### 1. Introduction

In the opinion of Bara (2006), competition is endangered within a sector by two factors: the state and the competitors themselves. However, such sectors exist where competition can not develop in a natural manner. *Concerning the network industries and the competition policy guarding the newly formed/forming competitive energy markets, the challenge is especially the characteristic that the operation of the market, the opening itself, is not necessarily able to eliminate the monopoly structure* (Kovács 2008). This can be explained by the fact that the entry to the market is not only incidental but can also be immensely costly and risky owing to the entry barriers demonstrated previously. A new entrant in a network industry faces a very difficult situation if it wishes to compete with a company already on the market (in position) (hereinafter: incumbent), since it is not enough to simply offer a better and/or cheaper product if the expectation of the consumer is that nobody would buy the product. The less compatible the new service is with the existing one, as well as the more committed the consumers are toward the incumbents, the greater this self-fulfilling expectation is (Kovács 2008). Thus, such markets (owing to some artificial, structural or strategic causes) are closed to the potential competitors, and their actors are called natural monopolies by the literature. Telecommunications, railway transport, gas and electricity service, basic public services (water, sewage,

waste transportation, public lighting, etc.), and postal services all belonged to this group, among others, until now. *“In these sectors problems of competition arise from the closed nature of the market, thus from the fact that in case of the state’s inaction (lack of state legislation) only the incumbent company, protected by the monopoly position, is able to reach the consumer”* (Bara 2006, p. 208.). Competition starts when these markets open, owing to the creation of the conditions for the wide availability of the indispensable instruments as was done during the liberalization initiated in 1998. In present article we forbear demonstration of the technical and regulatory side of market opening, thus here the requirements and consequences of competition law, with respect to liberalization, will be provided.

### *1.1. Changes in competition policy owing to liberalization*

Thanks to the EU legislation, *as a consequence of the sharpening competition*, the consumers – also thanks to their more and more conscious behaviour and quality expectations – *are theoretically able to use the public services in increasingly better quality*. Nevertheless, an insolvable *contradiction* seems to exist between *the securing of basic services, the increase of the level of services, as well as the narrowing resources, increase of efficiency and the interest in profit*. Development of the services, including liberalization, necessarily involved the development of competition policy since competition policy and competition regulation, as its practical manifestation almost everywhere, is one of, if not the most, efficient instruments (Motta 2007). Consumers had and have to be assured that the opening of newer and newer public service sectors for competition does not affect them disadvantageously. Competition policy tried to follow the changes occurring in the services market – the rearrangement of power in favour of the tertiary sector, as well as transnationalization. Thus in the life of the European communities the direction of competition policy occurring from the 1970s mostly in industry mirrors well the changes happening almost forty years later in the services market (Pelle 2009).

Three important processes can be seen lately in the competition policy of the EU. One is that the *sectoral legislation and the general competition legislation are becoming closer to each other (1)*. Earlier, the general notion was that the task of competition regulation is to keep well in hand the occurring market behaviours independently from the sector, without sector-specific analysis and legislation – the sectoral regulations fulfilled this task – while nowadays more and more regulators realize that the specific market and the currently existing, restricted or in some cases non-existing competition cannot be treated as totally independently from each other. Therefore market analyses have become the basic instrument of modern competition policy<sup>1</sup>, according to Motta (2007).

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<sup>1</sup> The analyses on liberalization beyond a certain depth required the comprehensive study of the concerned sectors, which has appeared as a new institution in the European economic integration. The Directorate General for Competition of the European Commission had been entrusted with the task of preparation of sectoral studies. With respect to the new scope of authority, those service sectors had

It is beneficial to make a short detour in order to define the difference between *general competition regulation and sectoral competition regulation*. In certain sectors of the sphere of public services, *regulation is twofold*, as in the sector of gas services. *One part of it covers all the public services and their common points; the other part is expressly sector-specific, and relates to its economics. In the case of the regulation of monopoly markets, competition regulation and sectoral regulation differ from each other.* Task of the latter in this case is to guarantee that even in the lack of competition, optimal conditions should be attained for the society. *Frontiers between competition and sectoral regulation fade away when in monopoly markets – in our case in the previously monopolized gas markets providing public services, as the effect of liberalization – competition occurs.* At this time “...*the regulator of the competition has to deal with the monopoly markets, while the regulator of the monopolistic sectoral markets has to deal with the competition markets.*” (Kiss 2008, p. 23.) Nevertheless, the newly liberalized markets still significantly differ from the operating oligopoly competitive markets. They still have the public service and sectoral characteristics, and to understand their operation and for effective regulation, being familiar with the specific market is essential. It is generally true that the general requirements of competition should be achieved grounded upon the peculiarities of the sector. In the viewpoint of the EU, competition policy in itself is not able to induce competition in all circumstances; for this, companies have to operate generally in such economic circumstances which stimulate competition. In an indirect way, synchronized with the adequate sectoral policy, this can contribute to the improvement of the competitiveness of the European Union.

The second phenomenon is that some *kind of convergence can be found in the regulation (2)*. Since the object of regulation is the same, competition, the applied instruments, that is market analyses, are also becoming closer and closer to each other, and thus clearly convergence also appears in the regulation (Pelle 2009). However, the synergy seems to be realized in the case of the EU, in spite of the fact that convergence, during which the regulatory tasks of the liberalized markets are transferred to the competition regulators, as well as the taking of public service and other sectoral elements into the functions of competition regulators, is still going on. Fitting to the general competition regulation, deadlines in the sectoral regulations for the new phases of market opening fell into the period between 2007 and 2009 (Valentiny 2008). Based on the previous experiences, sectoral regulations promised more frequent and often more radical changes when compared to competition regulation.

The third element is *deregulation (3)*. This is grounded upon the idea the aims are often more efficiently reached by operation of the market than by regulation. Thus, the primary goal of regulation should be the assurance of the operation of the

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been named which are under scrutiny. These are the following (DG Comp. EC 2008b): electricity and gas services, financial services, media, postal services (relevant case: COMP/36.915), telecommunications, and professional services.

market, which on the other hand can only be provided by the synchronized development of the sectoral and competition regulation (Pelle 2009). Naturally, this is true for the group of public services, especially for the energy market, only in a restricted way. The necessity of the regulation and its indispensable importance has been acknowledged since the market opening in the gas markets. Thus, in this sector we should not mention deregulation, but rather “re-regulation”.

Generally, the development of competition regulation looks similar irrespective of the sector. Usually a legal case calls attention to the deficiencies of the market. Subsequently a comprehensive, public, market analysing, sectoral inquiry takes place with the participation of different professional and social organizations. (In the case of the gas market this came about in 2005<sup>2</sup>.) Taking the consequences as a starting point, the Commission drafts proposals, and then the final outcome is embodied in the development of the applicable law (Pelle 2009). Thus it is well demonstrated that competition cases form a very important part of the European competition law, since the outcome of these competition cases affect the regulation of competition. Starting right from the cases appearing before of the Commission to the rendered decisions, as well as the new, more market-conformed and competition-strengthening behaviours displayed by the companies, the effects of the above-mentioned situation can be seen.

It is important to highlight that competition law – especially outside of Europe – does not stand by itself, and is only one of the integration policies. For this, the most spectacular and mostly cited example is the policy of the internal market ensuring the four freedoms, which is directed against the state measures which hinder integration, while competition regulation takes steps against those measures of the market actors which have the same direction. Hence this means that the barriers of trade eliminated gradually in the course of years are not allowed through the competition policy to be rebuilt by the companies. Thus thanks to the convergence in the market of public services, as well as in other sectors, the relevant EU and state competition regulation should be applied adequately owing to the compulsion originating from the market opening<sup>3</sup>. The basis of the competition regulation of the EU is provided in the Rome Treaty founding the European

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<sup>2</sup> The Commission was entrusted with the task of conducting a comprehensive inquiry (Energy Sector Inquiry) which took into account the competition aspects of the energy sector in 2005. More detailed information is available on the following website: <http://ec.europa.eu/competition/sectors/energy/inquiry/index.html>. The aim of the inquiry was to prepare an in-depth analysis for the exploration of the characteristics of operation, or rather, the causes of the inadequate operation. This is all for the improvement of the competitiveness of the whole European economy through bringing it to perfection. The above mentioned final report was prepared based on this comprehensive inquiry, and published in January, 2007.

<sup>3</sup> According to the economic idea behind the legislation, these are such public services which would not operate if the state did not provide them. The two main aspects are the operation of the service and its safety. The EU has started to examine whether these are really public services, and to what extent (the size of the part), and whether competition can be introduced to the market of these services (EC DG Comp. cited by Pelle 2009).

Economic Community and its amendments. Specifically, it is Articles 101 and 102, as well as 106 of the Treaty on the Functioning of the EU (TFEU) that regulate the behaviour of the companies, while Articles 107–108 contain the rules on state aid. Article 106 (2) of the TFEU states in this respect that undertakings entrusted with the operation of services of general economic interest are subject to the rules contained in the TFEU, in particular to the rules on competition<sup>4</sup>. As a new element, *liberalization* has occurred, it has become the frontier territory of the community competition policy.

## **2. Concentration in the energy sector**

According to Bara (2006), groups of competition problems relating to market opening are composed of such sector-specific questions like: which are these aspects, how can they be realized in the particular sector, and what, how, and when should they be (or should they not be) regulated? During the preparation for, establishment of, and finally execution of the market opening, the European Union might find itself opposing primarily the member states, and then the major actors if they do not or inadequately take into account the objectives of the creation of the competition and the aspects of the competition itself. The danger of this might be that in spite of the market opening, no efficient competition forms in the relevant sector. Furthermore, in the case of opening of the European gas market, this process can even demonstrate some opposing aspects. Thus, in the following we map whether the gas market liberalization – as well as including a few cases concerning the whole energy market – is able to create – if only a restricted – competitive market, or if we are just witnessing a concentration. Subsequently concentration is interpreted in accordance with these categories:

- As the consequence of the separation, *horizontal and vertical cartels* have formed in the gas market (or in the whole energy market) owing to different considerations (effectiveness, economies of scale, strategic considerations, etc.)

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<sup>4</sup> Art. 106 (2): “Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union.”

However, Article 106 (2) allows an exception from the rules contained in the Treaty, provided that a number of criteria are met. Firstly, there must be an act of entrustment, whereby the State confers responsibility for the execution of a certain task to an undertaking. Secondly, the entrustment must relate to a service of general economic interest. Thirdly, the exception (compensation) has to be necessary for the performance of the tasks assigned and proportional to that end (the necessity requirement). Finally, the development of trade must not be affected to such an extent as would be contrary to the interests of the EU.

- Owing to different reasons, but the *dominant position of national incumbents is increasing*
- Owing to different reasons, *takeovers and mergers* might take place more frequently in the gas market (energy market).

When observing this from an institutional point of view, instead of looking at the behaviour, the listing can be reversed. In the above-mentioned situation the actors are institutionally independent from each other and are not necessarily in a dominant position, they are “just” collaborating and cooperating. Competition policy has to deal with them in an ex post way. From this aspect it is worse if the structure is already established, for example by mergers and takeovers, or if owing to state aid monopolies can be created. In such cases there are grounds only for ex post de facto sectoral regulation, monitoring and competition authority.

### *2.1. Mergers and takeovers in the energy sector*

Energy sectors are characterized by the operation of relatively few undertakings, but at the same time ones of great size. Within this group of undertakings, mergers and takeovers frequently take place, which result in such a concentration of ownership that directly affects the structure of the market, and the intensity and conditions of the competition. It is becoming more and more obvious that the energy sector is traditionally the hunting grounds of the transnational companies, where lately, partially as a consequence of vertical separation conducted in accordance with liberalization, concentration has increased.

What can motivate the fusions that aim at convergence and/or concentration? The first reason for this can be that the *companies interested in the energy industry would rather spend their profit on takeovers* than additional investments in their own business policy. Secondly, although the aim or means of liberalization was the vertical separation of the supply chains, *for the energy generating undertakings a new vertical integration is more beneficial, owing to the possibility of reducing transactional costs, than the establishment of contractual relations substituting it.* With respect to passage through the sectors, the energy generating companies and the gas transmitting undertakings *mutually enjoy the above-mentioned advantages of the synergy.* A further advantage of the institutionalized convergence between the two sectors is that *the gas supplier company will be able to distribute electricity thanks to the fusion.* This is used in all of the households as long as the price of gas is lower. However, owing to this, the situation of the other competitors who wish to enter is, additionally, rendered more difficult. Further motivation between the two companies having different profiles can be the above-mentioned *existing relationship between the supplier/customer networks*, as well as the diminishing of transactional costs on account of this. Besides *the two activities complementing each other, the new company established as a result of the fusion might be able to create*

*the possibility of risk-reducing diversification. And last but not least, the market position, the infrastructure, the instruments, the information and the market knowledge is obtainable through the takeover* (Vince 2009).

### *2.1.1. Types of fusion based on the revealed reasons behind them*

The phenomenon observable in the market of the European Union is also supported by the experience of the American energy market, namely that not the emergence of new companies will be the ruling tendency, but rather the *establishment of vertically integrated companies interested in many sectors – such as electricity, gas, and maybe water – which are of a European scale*. In the past eight years on the territory of the Union 30 percent of the reported fusions contained trans-boundary elements, while, though at an increasing rate, an average of 50 percent of them contained a trans-sectoral element (Verde 2008).

It is typical that such fusions/takeovers realizing the convergence of the two sectors rather take place in those member states where liberalization is the most advanced, such as the United Kingdom, Germany, Italy or France<sup>5</sup>. However, these are all fusions within one state. Nevertheless, such fusions/takeovers assisting the convergence of the two sectors might have a trans-boundary characteristic. Typically in reality this happens with the mainly Western-European companies, who are capital intensive and in a good position with a strong national basis, standing alert, waiting for the time of the separation in Eastern Europe, and as soon as it became possible, they selected from the pieces of the separated gas supply chain. Such cases were the takeover of gas business unit of Hungarian oil company, MOL by E.On, a German company acting on the electricity market (COMP/M.3696), or the takeover of the Polish electricity generator company, ZEDO by the Spanish Endesa company (COMP/M.4060).

Although it might seem that reaching the aim of liberalization is rendered impossible by them, the fusions and takeovers are logical consequences of liberalization since the market actors try to answer the insecurity of demand and the fluctuation of prices by calling upon efficiency owing to economies of scale and economies of scope<sup>6</sup>. Furthermore, the essence of liberalization is to create a more and more widespread and at the same time a single energy market as the result of the cooperation of the Member States of the European Union. A bigger market is able to handle bigger undertakings, which are thus able to be more efficient and to establish economies of scale (Jacobsen et al 2006). So the pressure for fusions and takeovers is constantly strong. This phenomenon should not really be disapproved of on the

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<sup>5</sup> One of Europe's significantly grand electricity suppliers, the French EDF aims at reaching a level of 53 billion m<sup>3</sup> gas trade per year by 2015 (Zyuzev 2008).

<sup>6</sup> These takeovers have an obvious explanation if we know the relationship between the gas sector and electricity generation. Companies generating electricity hope to gain economic advantages and bigger safety of supply by the takeover of a gas company, while gas transmitters see a safe market when merging with an electricity generator company.

grounds of the market if these takeovers are conducted by such sectoral actors which are exclusively in private ownership and operate under the rules of the market.

Now we move on to the *other trend* that is traceable in the market, according to Verde (2008). On the international energy markets – since these are public services – it is not unusual that dominant companies, moreover with state share in ownership, are competing (Losoncz 2007)<sup>7</sup>. Thus when a company, with a state share and in accordance with it controlled under the existing governmental interests, takes steps in order to protect the market, as well as the national sector, this might inevitably entail the *creation of a “national champion”*. It’s just enough to mention the cases of Gaz de France/Suez (COMP/M.4180) or Gas Natural/Endesa (COMP/M.3986). A common feature of these fusions is that the concerned Member States had contributed to the success of the action directly and actively with a series of legislation created in an ad hoc way (Verde 2008). Instead of direct state aid, a more sophisticated version of active state action is the creation of market, as well as influencing the chances of the company in the acquisition and keeping of markets, briefly, the *creation of a “national champion”*.

Such national interests can lie behind this as the protection against friendly or hostile takeovers. An aspect of security policy also belongs to protection, namely that certain activities should anyhow be conducted by national undertakings. The official government policy with respect to the national champion of the energy market is primarily the safety of supply, since an occasional market competition “dictated from above”, from their point of view, might endanger the safety of the supply mainly on the smaller gas markets which do not have their own resources and depend on high imports of energy. Nevertheless, this does not mean that only countries having such characteristics maintain national champions<sup>8</sup>. This might signify a new form of protectionism if the national actors are not protected from the competition, but the national market and the benefits of the incumbents are protected from the entrants. Pursuit of both tendencies is some kind of preparation for leave of the competitive market at Union level. Let alone that the companies established this way are able to represent a significant negotiation position when dealing with a supplier.

Those *interests and motivations*, partially mentioned above, along which the fusions and takeovers of the energy market can be differentiated are summarized in Table 1, below. Some of these represent protectionist goals having an effect against liberalization, while others rather assist in preparation for the entry into the competitive market and rationalisation. But it is common among them that *all of*

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<sup>7</sup> The list of those companies interested in the energy sector which are a hundred percent or partially state owned is quite long. Those companies which have state ownership in their share capital are capable of operating under the rules of market economy, but it is more frequent that their management asserts other aspects of a not economic character: political pressure, etc. (Losoncz 2007).

<sup>8</sup> It’s just enough to mention the cases of Gaz de France/Suez or Gas Natural/Endesa.



them could/can develop as the consequence of the liberalization process of the Union.

Table 1. The revealed reasons behind the different types of fusions/takeovers in the energy market

	Sectoral and horizontal fusions/takeovers	Transsectorial and vertical fusions/takeovers
Fusions/takeovers within the national market*	<ul style="list-style-type: none"> <li>– Protection against (hostile) takeovers (<i>GdF/Suez (COMP/M.5092)</i>, <i>Helsingin/Vantaan/E.On Finland/Lahti/SEU (COMP/M.3507)</i>)<sup>9</sup></li> <li>– (re)gaining of activities into national hands</li> <li>– Establishment of such a national market actor who has a strong negotiation position and thus capable of successful action against/with suppliers and competitors – formation of economies of scale<sup>10</sup> (<i>DONG/Elsam/EnergiE2 (COMP/M.3868)</i>)</li> </ul>	<ul style="list-style-type: none"> <li>– A cost-reducing step fulfilled by the integration of the different levels of the supply chain</li> <li>– Establishment of a strong national champion of the energy industry with the fusion of the national gas- and electricity generating company (<i>E.On/Ruhrgas</i><sup>11</sup>)</li> </ul>
Trans-boundary fusions/takeovers	<ul style="list-style-type: none"> <li>– Expansion in a geographical sense of companies providing certain partial activities (<i>Enel/Slovenske Elektrarne (COMP/M.3665)</i>)</li> <li>– Acquiring a focal role at the European level before the end of the process of liberalization (<i>Tennet/E.On (COMP/M.5707)</i>)</li> </ul>	<ul style="list-style-type: none"> <li>– Companies generating electricity hope to gain economic advantages and bigger safety of supply by the takeover of a gas company (<i>E.On/MOL (COMP/M.3696)</i>, <i>Endesa/Zedo (COMP/M.4060)</i>)</li> <li>– Gas transmitters see a safe market when merging with an electricity generator company</li> </ul>

Note: \* If the EU case number is not provided after the name of the concerned companies, its explanation is that the effect of the fusion on the market was judged by the authority of the Member State.

Source: own construction on the basis of Jacobsen et al (2006), Verde (2008) and of the website of the European Commission

<sup>9</sup> One example of a hostile takeover can be the case of OMV-MOL, when MOL did not wish to get under the control of OMV. Finally OMV backed out of the situation owing to the expected condemning decision of the Commission and the enacting of a not definitely market-conform legal instrument, the Lex MOL, by the Hungarian Parliament.

<sup>10</sup> Earlier, in the course of Hungarian privatization, such a decision was rendered that the national gas producer and importer company (MOL Rt.) was not allowed to participate in the privatization of the gas transmitters covering big portion of the territory of the country (in order to avoid the establishment of vertical integration). Following the privatization, a few smaller gas transmitter companies were founded in some unsupplied parts of the country (the less inhabited and relatively underdeveloped territories). After a few years of operation it became clear that these companies could not develop owing to their poor state of capital, thus they intended to sell their market and activity. The only customer to come forward was MOL Rt. The transactions required authorization under the provisions of competition law. The Hungarian Competition Authority gave the permission for the fusion. The explanation in the decision was that since the price of natural gas is fixed there is no possibility to abuse it. (GVH 2000).

<sup>11</sup> This fusion can represent an example for the merger of gas supplier and electricity generator companies, as well as for the formation of multisectoral energy suppliers.

According to Valentiny (2008), it is not a negligible consequence of the appearance of the multi-sectoral service providers, that this way the traditional framework of regulation might be transformed. The yet separated regulatory institutions which operate on a sectoral basis are compelled to cooperation, and might even merge. With the proliferation of the transnational companies there is an increasing need for the establishment of inter-regional regulation. Already the Sapir Report of 2003 had considered the time ripe for the creation of a European-level regulatory institution (Sapir 2003). The regulatory tasks have long overstepped the level which is solvable within the national framework; however, the establishment of the European-level regulatory institution is yet to come.

### 2.1.2. EU-level monitoring of concentration on the energy market

In spite of all the positive consequences mentioned above, fusions and takeovers might result in anticompetition behaviour or outcomes, so in the European Union, the judgment of these is the task of the European Commission. Monitoring of fusions is the latest formed branch of competition law worldwide, but its role seems to be increasingly appreciated<sup>12</sup>. The reason for this might be that structural monitoring, as means to prevent the competition problem, can significantly reduce the need for an ex post intervention. The regulation of mergers in the European Union is the youngest branch of competition regulation of companies. Besides the national authorities, the Commission for a long time had dealt with concentrations under Articles 101 and 102 (previously Articles 81 and 82), although they had not been expressly designed for merger control; thus, it became necessary to separately regulate mergers. In contrast to the former, merger control does not mean the regulation of the behaviour, but the structure<sup>13</sup>. Previously in such cases, the national authorities rendered the decisions, which resulted in the situation that decisions of the cases were not based on the same standard. The first Regulation (EEC) No. 4046/1989 entered into force in 1990, the present one, 139/2004/EC Regulation has been in effect since 2004. The essence of the change was to place in the centre of the valuation the SLC-test<sup>14</sup>, also used in the United States, instead of the previously applied dominance test. The proposal had resulted in great disputes. Putting an end

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<sup>12</sup> Although the tendency is well-traceable, naturally there are schools disagreeing with this right to monitor, as it can be seen from the assessment of competition policy of the Chicago School.

<sup>13</sup> Under the provisions of the 139/2004/EC Regulation, a merger takes place when a concentration arises with the following conditions: "*the merger of two or more previously independent undertakings or parts of undertakings, or the acquisition, by one or more persons already controlling at least one undertaking, or by one or more undertakings, whether by purchase of securities or assets, by contract or by any other means, of direct or indirect control of the whole or parts of one or more other undertakings.*"

<sup>14</sup> The essence of the SLC-test ("Substantial Lessening of Competition" test) or often cited as significant lessening of competition test is that it is the task of the competition authority, during the merger control, is to decide whether the merger can result in significant lessening of the competition. This used to be called the SIEC-test in continental competition policy.

to these, according to the new merger regulation, which entered into force at the same time with the May 2004 enlargement of the EU, *granting of authorisation for a merger cannot be refused if it does not significantly impede effective competition* (Significantly Impede Effective Competition, the SIEC-test), especially if it does not result in the creation or strengthening of a dominant position. Otherwise, the merger has to be banned. With respect to merger control in the EU, *the objective of monitoring structural changes concerning a certain product or service is to hinder the creation or strengthening of a dominant position, which would significantly impede effective competition on significant parts of the common market.*

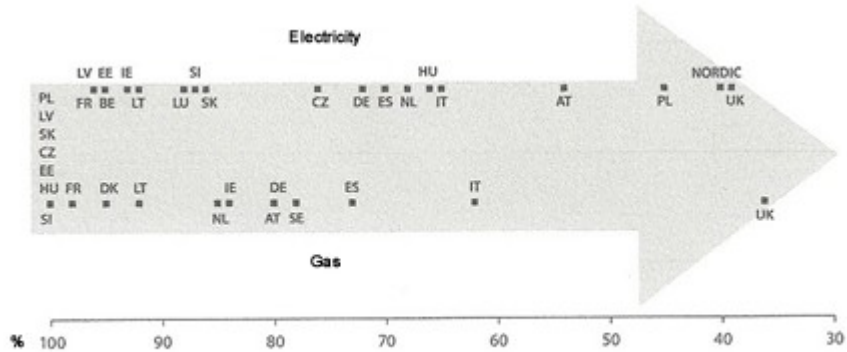
Another reason for the modification of the regulation was that it is disadvantageous for the operation of the economy when actions decided by the actors of the market are delayed, thus losing the power of surprise, and with governmental or other hostile instruments applied by other competitors they are placed in an impossible situation. Thus the pending legal situation existing until the end of the merger-authorization proceedings can have disadvantageous effects on market processes. Although these disadvantages are balanced by the protection of public interest relating to competition, it is reasonable that authorization proceedings should last for the shortest possible period of time – without neglecting the requirement of well-founded decision-making (Bodócsi 2004).

Concentrations creating dominant ownership shares, often not exempt from overlap of owners, are able to result in a more transparent situation with respect to the conditions of competition, as it has already been stated by Vince (2008) in relation to the Hungarian market. The group of owners, who has a share and influence in the undertakings of the energy market, might get narrower. In certain cases fewer owners control the actors of the market. Parallel with this, the separate groups of owners participate in the management of the companies not directly, but through their interests. On the other side of the scale we find that concentration in ownership might create the possibility of enforcement of the advantages stemming from dominance (Vince 2008). It is the task of the competition authorities to take into consideration this possibility by analysis of the horizontal, vertical and portfolio effects, and to reveal the concentrations which restrict competition.

## *2.2. Other possible competition consequences of the concentrations existing in the sector*

It can be stated concerning the effect of the already concluded vertical integration on competition that in most of the countries a very high level of organizational concentration has been formed (see the Figure 1). The weight of the three biggest gas transmitter companies exceeds 60 percent in all the countries except the United Kingdom. One of the benchmarks of competition at the national markets is the full market share of the three biggest generator (electricity) and wholesale transmitter (gas) companies (COM(2005) 568).

Figure 1. Capacity-share of the three biggest participants and generators of the wholesale market in the gas- and electricity markets



Note: Member states are indicated in percentage according to the capacity-share of the three biggest participants in their electricity (upper row) and gas (lower row) markets.

Source: Vince (2008) based on COM (2005) 568

If possibilities of ex ante regulation of competition are exhausted owing to the authorization of mergers and sectoral regulations, then the need might still occur for the control of behaviour of the companies created by concentration. This is the role of the other areas of EU competition law.

### 2.2.1. The liberalized gas market, dominance and questions of competition regulation related to it

Under the EU's competition rules – basically Article 102 of the TFEU – a dominant position is such that a firm (or group of firms) would be in a position to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers<sup>15</sup>. Such a position would usually arise when a firm or group of firms accounted for a large share of the supply in any given market, provided that other factors analysed in the assessment (such as entry barriers, customers' capacity to react, etc.) point in the same direction.

Concentration is not the sole way how dominant undertakings can be created in the energy market. During the privatization and liberalization of the network industries, despite all the efforts, the undertakings already in the market with a monopoly, thanks to formerly being a public service provider, had not lost much of their starting advantages, and according to the practice, they still have been

<sup>15</sup> This definition is given by the Court of Justice in its judgment of 13 February 1979 in Case 85/76, Hoffmann-La Roche [1979] ECR 461, and confirmed by the Court in subsequent judgments.

dominant, determinant actors of the market<sup>16</sup>. It is obvious that the service provider undertakings, as former monopoly actors on the market with state ownership, endeavour to still keep their role, and their significance after liberalization. Those markets can represent an exception where the former natural monopoly service provider undertakings were purchased during privatization fully or partially by capital intensive foreign companies. However, in this case it's only the ownership structure that has changed and not the position. *The position of the dominant participants of the market in the European Union* is further strengthened by the increasingly criticized special state shares called *golden shares* (Valentiny 2007). Furthermore there are markets where they have the same share level as prior to the opening of the market, and *thanks to the separation of properties executed with respect to the Union legislation, often they could even purchase in other markets, thus further increasing their market share at European level.*

It is important to highlight that the competition law of the European Union does not penalize dominance itself, but the abuse of it and the possible loss of the consumers. Its aim is not, or at least not primarily, to dismember such giant companies, but to provide an efficient and competition-based European energy market<sup>17</sup>. Also, an argument for keeping the dominant position is, according to Voszka (2009) and Jacobsen et al (2006), that the change of structure of the market under the aegis of liberalization might worsen the competitiveness of the whole sector, thus curtailment of the incumbent can be at least in the same way detrimental as the lack of competition.

The incumbent monopolist, competition distorting, strategic behaviour directed to the hindrance of entry can, for example, be below-cost pricing, confinement of the inputs necessary for production from the other competitors, price-discrimination, or tying, which are typical subjects of the competition investigations proceeded by the competition authorities. Generally it can be stated that competition authorities have to intervene in these cases if a monopoly impedes entry into the market with such behaviour which is profitable only owing to its capability of keeping the other competitors away. However, these behaviours and the actions against them belong to the sphere of Union and national competition law. Significant cases of the past years were for example: the proceedings against *E.ON*, *RWE* and *Gaz de France* for sharing of the French and German market (COMP/39388), while *Electrabel* (Belgian) and *EDF* (French) as two incumbent

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<sup>16</sup> The competition-distorting behaviour of such companies can be attained in many different ways, starting with the impediment of other competitors' access to the essential networks, the application of inadequate pricing techniques or, for example, cross-financing.

<sup>17</sup> An argument for keeping the dominant position might be the theory of Schumpeter, according to which imperfect competition or monopolistic power can be favourable for research because the accumulation of the profit of monopoly creates for the undertakings the financial sources for research and for coping with the instability of the results. Furthermore, the power of monopoly and impediment of the entry into the market makes it possible to prevent imitation and to sustain a high level of profitability.

undertakings had abused their dominance in their own national markets (COMP/38091)<sup>18</sup>. The European Commission had instituted anti-trust proceedings against RWE in May 2007 (COMP/39402), in the course of which Brussels endeavoured to prove its suspicion that the German energy company really provided *unnecessary barriers* in the regional gas market of North Rhein Westphalia for the entry into one of the most important *so-called "core markets"*. In 2006 the Commission initiated proceedings against an Italian energy provider undertaking called ENI for dominant market position (COMP/39315). The objective of ENI and its associates had been an alleged market foreclosure not only on their parts of the national markets, but also from the Austrian and German market interests. Judgment of this is a difficult question of jurisprudence since in the network industries frequently it has caused hardships to separate fair competitive behaviour from, for example, foreclosure strategy (Kovács 2008)<sup>19</sup>. However, this again proves the role and influence of the regulation of the European Union also in other areas. For the new entrants, the situation is even more aggravated in that most of the pipelines are overloaded owing to the long-term agreements, thus there's relatively little space left for the transmission of the free quantity of gas<sup>20</sup>. Until now this situation was

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<sup>18</sup> In 2006 the Commission initiated proceedings against an Italian energy provider undertaking called ENI for dominant market position (COMP/39315). The objective of ENI and its associates had been an alleged market foreclosure not only in their parts of the national markets, but also from the Austrian and German market interests. The behaviours distorting the market were *capacity hoarding and strategic underinvestment in development*. These activities were practiced by ENI S.p.A and its affiliates or partners (Trans Austria Gasleitung GmbH, Trans Europa Naturgas Pipeline GmbH & Co. KG, ENI Deutschland S.p.A. and Eni Gas Transport International SA) together. In the interpretation of Bökönyi (2005), this exhausts integration applied for securing market dominance. It has to be added that this investigation was not part of the competition-related inquiry of the sector.

<sup>19</sup> The basis of the proceeding was that according to the suspicion of the Commission, the instrument of this would have been the impediment of access to the gas transmitter network for the potential new service providers. As an effect of these, the RWE concern announced on June 2, 2008 that it would sell its gas pipeline network of 4100 kilometres. The German energy producer hoped that in exchange for this decision the Commission would end the proceedings against it for alleged abuse of dominant market position. This proceeding had not only threatened them with a grave fine, but would have also created the possibility for their business partners to sue them for great sums of compensatory claims. The Commission had welcomed the decision right then, however it was able to conduct the market test of the offer of the company group only on December 5, 2008. This test meant that the Commission had collected commentaries from all the concerned parties concerning whether the promises of the company were adequate for dismissal of the anxieties about the abuse of dominance. The concerned parties had a one-month deadline from the publication of the notice for sending their opinions to the Commission. Brussels declared in advance that if the test proved to be positive, the Commission would accept the commitments, thus making them legally binding. As the consequence of the outcome of the test, the Commission accepted the offer of RWE in March, 2009, because the result of the test was that sale of the gas pipeline network was necessary and proportionate in the opinion of the concerned parties.

<sup>20</sup> It has occurred several times that capacity had been reserved without actual transmission, thus impeding the entry of new competitors into the market. Later even a rule had to be provided for this, according to which in case somebody is not conducting actual transmission in the previously bought

perfectly adequate for the European energy giants, who, respectively, have not activated themselves for the development of the transmission infrastructure.

One of the possibilities of abuse of dominant position in the energy sector is the so-called “*English clause*” referring to which the company does not let the customers leave. The *English clause* prescribes for the customer the obligation of reporting all better offers provided for them, and that the customer can accept it only in the case if the original supplier does not offer the same, or in some cases, a more advantageous one. This obligation might have the same effect as the non-compete obligation, especially if the customer has to reveal the name of the company making the better offer. Besides, by increasing the transparency of the market, this might facilitate collusion between competing suppliers (2000/C 291/01)<sup>21</sup>. However, this issue has another side also, that is there might be other reasons for hampering the withdrawal from a contract. The service provider might make investments designed for personal needs, which it would not undertake without the insurance of long-term commitment. Thus, it is not worth it to expressly forbid the application of English clauses, since reduction of the costs of negotiation arising from this possibility can be in the interest of both parties (Antal–Pomázi 2009)<sup>22</sup>.

It is also part of the cases of dominance when the creation, maintenance, and protection of the above-mentioned and so-called “*national champions*” happens. This phenomenon partially belongs to the Union legislation of state aid. Frequently it is part of the maintenance that such supposedly strategic companies are artificially kept alive by not particularly EU-conforming means, such as market-seeking, state order, or consolidation (Voszka 2008). Nevertheless, some other objectives, such as motivation for innovation or European competitiveness in a wider sense, might be impaired by the lack of competition in the sector. Such, mainly not natural monopolies, further increase the need for regulation. National champion companies are not motivated in providing access for other service providers to the networks in their ownership (Röller et al 2007). In the light of this, some of the member states sacrifice domestic competition and support the horizontally and/or vertically integrated national giant energy companies in the interest of securing their already made investments and the access to the energy resources<sup>23</sup>.

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capacity, then the system manager can freely sell it for a third party, while also keeping the originally paid sum (Patkó 2009).

<sup>21</sup> Also in Hungary, in case of five energy supplier companies (DÉDÁSZ, ÉDÁSZ, ELMŰ, ÉMÁSZ and TITÁSZ) the question arose whether they were hindering their customers from entering into the free market by fixing the principle of “most favourable offer” in the contract. The principle was the Hungarian equivalent of the English clause, and in 2008 a decision had been delivered in the cases (Vj–108/2006/46., Vj–107/2006/76., Vj–104/2006/130., Vj–105/2006/66., Vj–109/2006/99.).

<sup>22</sup> The Hungarian Competition Authority took the case further and declared that the application of the principle is the safeguard for the preparation for the opening of the market by the incumbents, and thus the consumer can in reality gain advantages from the free market competition.

<sup>23</sup> Glachant and Finon (2004) similarly present the French electricity supplier market and its national champion, EDF, who stayed in state ownership thanks to a daring reform in 1999–2000 (Vogelsang 2004).

These cases prove that in spite of the competition policy being a horizontal policy and independently from the gravity of the country of seat of the concerned undertaking, anybody can be punished by the Directorate-General for Competition of the European Commission; however, efficient supervision of the competition is missing. This fact and the low level of investments in the sector together might result in such further cases with great likelihood (Dreyer et al 2010).

### 2.2.2. Cartels in the gas market

Legislation of the European Union with respect to the prohibition of cartels (Article 101 of the TFEU) *distinguishes three forms of collusion*. The *agreement*, which covers all such behaviours that express the parties common will to behave in a certain, defined way in the market. This can be informal, based on trust, and it can be created in any loose form. *Decisions of associations of undertakings* usually pertain to vocational organizations and sector unions. While *concerted practices* do not reach the level of agreement, they might serve as a wilful substitution of it. The *types of a cartel can be horizontal, vertical or conglomerate*. In the former case, the agreement is concluded between competitors of the same level. The vertical cartel is when the participants in it are companies on different levels of the production process. A conglomerate is when more than one, not vertically related markets stand behind the concerted practices.

Under the prohibition of restriction of competition, those agreements and concerted practices are forbidden which negatively affect economic competition. Most often these are price-fixing, sharing of the market, restriction or control of production processes, tying, discriminative behaviour against the different partners and other behaviours.

In the past years an energy cartel's case (COMP/C.39401) has set the record for penalties, where the Commission had fined both of the companies in the case, namely E.ON AG and GDF Suez SA for 533 million EUR, for the sharing of the German and French energy gas markets. The two gas supplier companies, according to the investigation, had agreed on the sharing of the market in 1975, under which they would not sell gas transmitted through the MEGAL-pipeline, constructed by them, in each others markets. They maintained their behaviour subsequent to the liberalization of the European gas market, this way depriving the German and French customers from the advantages of the competition in the gas market. The significance of the decision, apart from the sum of the penalty, is that this had been the first time when the Commission fined participants of the energy market (GVH 2009).

Nevertheless, collusion can also be in positive way, for example, if it is a cooperation for development which results in the growth of the welfare of



consumers and consequently of society. When somebody concludes cooperation<sup>24</sup>, it should be known that according to some economists, competition ends there, and it immediately becomes suspicious. In contrast to this, others state that these relations are absolutely normal forms of cooperation and creation of values. If the state does not intervene, then the *undertaking or groups of undertakings have a great role in economic governance* not only owing to the fact that they have all the means to restrict competition, for gaining a monopoly position and because they use this possibility, but *because often this is the luckiest and most effective form of cooperation*. If they hinder this in the name of competition, then in some cases its damages can be more than its profits<sup>25</sup>.

### 3. Conclusions

When liberalization guarantees conditions of competition and entry, then the next task is for the competition regulation to supervise the changes of structure as a result of the actions on the market, and to follow and control them. This is of high priority, especially because *many of the former vertically integrated incumbent companies have survived the liberalization*, instead of the many competitors intended to be created by the separation of ownership for the solution to market concentration. They could even get stronger as a result of the new possibilities arising from the separation. *Other European undertakings have weakened owing to the separation*, and through liberalization they have sacrificed their dependency for competition, thus becoming independent from the state *has made them more exposed* to the capital intensive and strategic-type foreign supplier companies (e.g. Gazprom, Sonatrach, and Statoil). We can find examples for any of the tendencies in all the member states.

Interests and motivation behind the concentrations experienced in the energy market can be very wide-ranging. Some of these represent protectionist objectives

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<sup>24</sup> For example, if the insurance company agrees with the service station that it would send all its insured cars there; or if the bank makes it difficult for the indebted to agree with another bank providing a better offer (for example it prescribes a high prepayment fee); or if a company buys one of its suppliers, or simply prescribes that it cannot supply other competitors, then the economist supporting competition calls upon the state, expecting the protection and enforcement of competition by the state.

<sup>25</sup> Recognition of this opportunity was exactly the reason why Oliver E. Williamson had been granted a Nobel Prize in 2009. According to him, it's not only the logic of competition that is hidden in the market, but also cooperation and collaboration. Production, and the creation of values often require cooperation. It's just enough to think about clusters, producer organizations, research centres, etc. It was the subject of his research to consider in what types this cooperation can be formed. His research thesis was exactly, starting from the work of Coase, to define when it is worthwhile to organize production by contracting and when inside the company, for example, by purchase of the supplier. The theory of transactional costs developed by the 1970s does not consider vertical integrations (or other atypical forms of contracts) as the means of cartelling, but one of the ways of saving on the costs of contracts.

having an effect against liberalization, while others rather assist in preparation for the entry into the competitive market and rationalisation. But it's common among them, that *all of them could/can develop as the consequence of the liberalization process of the Union*. The capital intensive companies operating in the Union or in countries outside of the European Union, while preparing for the full opening or already being well-prepared, can shape the markets in a direction advantageous for them at all times, in the existing (or non-existing) framework of competition law, taking the opportunities provided by liberalization – no matter whether it's about securing the service or elimination of other competitors.

Thus, it is obvious that although the aim of liberalization is/was the creation of competition and the increase of intensity of competition, the market tendencies do not point to that direction. In most of the markets it seems that after the initial flaring, owing to the compulsory opening and separation of the market, restoration takes place. Besides all the positive consequences of liberalization it has reserved possibilities not taken into consideration by all of the member states. If it was possible, seeing this tendency, it would be worthwhile to draw the balance of quantifiable profits and costs or losses gained by liberalization. These could not be estimated in advance; opinions can be formed only in retrospect.

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