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## RECENT EFFORTS TO ACCELERATE THE OPENING OF ELECTRICITY AND GAS MARKETS

### I. Liberalisation: Where Do We Stand?

The liberalisation of the electricity and gas sectors in the European Union has proceeded rapidly since the respective directives entered into force in February 1997 and August 1998.<sup>1</sup> The results have been positive in reducing end user prices and enhancing consumer choice, as well as for achieving such other Community objectives as improving public service standards, ensuring security of supply, and enhancing environmental protection. The principal problems that have arisen stem from two main sources:

- First, the varying pace of implementation among Member States, mainly due to the unexpected extent to which many Member States have voluntarily exceeded the requirements of the directives; and
- Second, the inadequacy of the physical infrastructure (principally inter-connection capacity) to handle intra-Community trade flows.

Uneven implementation has strained the internal EU market and created the potential for abuse by energy enterprises in

<sup>1</sup> OJ No. L 27/20 (30.1. 97) and OJ No L 204/1 (21.7.98) (the "Electricity Directive" and the "Gas Directive", respectively).

relatively protected home markets. It also denies clear benefits to consumers.

For example, electricity prices have declined an average of 25% for industrial consumers across the EU since the Electricity Directive was implemented. Household prices have also declined. The picture is more complex for gas, since gas prices are linked to recently increasing oil prices. Huge price disparities for gas still exist among Member States, mainly due to the later implementation of the Gas Directive. Even in electricity, there is enormous future potential in liberalisation. The cross-border trade in electricity stands at 8% of total electricity production, which is far lower than in other sectors of the internal market such as telecommunications, financial services, and industrial products. At the same time, an increasing number of consumers, including a majority in the U.K. and Sweden and as high as 20% in Finland, have changed suppliers, which must also be considered an indicator of success.

Based on these substantial benefits, there is a clear consensus that further rapid liberalisation of the energy sector is desirable. This EU Energy Law Update describes recent efforts in the areas of EU legislation, competition policy, and cross-border investment rules intended to speed liberalisation and reduce unwanted distortions in the internal market for energy.

## II. Proposed Legislative Package.

The European Commission has grown increasingly concerned about lagging and uneven implementation of the Electricity and Gas Directives. The Commission has sent “reasoned opinions” to Belgium (electricity), Germany (gas), and Luxembourg (gas) admonishing them to implement the measures into national law. France has even been taken to the European Court of Justice for failure to implement fully the terms of the Gas Directive.

The Commission has concluded, however, that additional EU legislation is required, and in March 2001 proposed a legislative package that would accelerate liberalisation substantially. The Commission has also suggested it may use its authority under Article 86(3) EC to apply these measures directly to the Member States without the participation of the Parliament and the Council of Ministers, if these bodies are unable to act with the necessary speed.<sup>2</sup>

The initial proposals were presented to the Parliament on 13 March 2001. There is no time limit for the first reading of the legislation in the Parliament. The first readings in the Parliament and the Council and subsequent communication of the Council’s position to the Parliament mark the beginning of the legislative timeline for adoption.<sup>3</sup> The earliest possibility for

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<sup>2</sup> See Art. 86(3) EC (granting the Commission authority to apply EC competition rules against undertakings that have been granted special or exclusive rights by Member States by “address[ing] appropriate directives or decisions to Member States”). The Commission exercised this authority in liberalising the EU telecommunications sector.

<sup>3</sup> Art. 251 EC.

adoption of the measures would be in the Council’s first reading. This is only possible if the Parliament has - in its first reading - not made any amendments to the proposals, or if the Council approves of all amendments made by the Parliament. Otherwise, the Parliament in its second reading must come to a decision within three months after receipt of the Council’s position.

The draft legislation consists of (i) proposed amendments to the Electricity and Gas Directives<sup>4</sup> and (ii) a proposed Regulation regarding access to networks for cross-border electricity exchanges.<sup>5</sup>

### *A. Proposed Amendments to the Electricity and Gas Directives.*

The Commission’s proposals to amend the Electricity and Gas Directives divide into three categories. First, so-called “quantitative proposals” address the need to progress rapidly to a position of completely open electricity and gas markets. Second, “qualitative proposals” set forth a far-reaching set of requirements regarding minimum obligations for access to the network, consumer protection, and the regulation and unbundling of the transmission and distribution functions in integrated gas and electricity companies. Third, additional measures relate to

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<sup>4</sup> 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 (13.3.01).

<sup>5</sup> 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 (13.3.01).

facilitating intra-Community energy trading and enhancing security of supply.

In the “quantitative” category, the amendments establish the following schedule for complete opening of the electricity and gas markets:

- by 2003 all non-domestic (non-household) customers should be free to choose their electricity supplier;
- by 2004 all non-domestic customers should be free to choose their gas supplier; and
- by 2005 all customers should be free to choose their gas and electricity suppliers.

This schedule substantially accelerates the original schedules in the Directives. In electricity, the market opening was to be 35% of total use by 2003, with no provision for 100% market opening. In gas, the market opening was to be only 28% by 2003, and 100% only in 2008.

In the “qualitative” category, the Commission’s proposals focus on the need for competing suppliers to have non-discriminatory access to electricity and gas transmission grids in order for competition to be effective. The Commission proposes that the management of these grids should be legally and operationally independent from production and sales activities. Moreover, the proposed legislation provides that network access tariffs must be published and approved by specified independent national regulators before they can enter into force.

To facilitate intra-Community trade in electricity and gas the Commission proposes the following measures be taken:

- adopt a set of trading rules mainly concerning cross-border transmission capacity and congestion management for electricity. This legislation is to be based on the principles of simplicity, non-discrimination, transparency, and reflection of costs;
- develop a European infrastructure plan aimed at tackling bottlenecks in certain trans-national networks and identifying any missing interconnection links of European interest; and
- negotiate electricity market-opening agreements with the European Union’s neighbors. Under such agreements, the EU would open its markets to competition from third-country operators, subject to reciprocity and compliance by third-country operators with EU environmental and safety standards.

To enhance security of supply and ensure universal service, under the new legislative package Member States would be obliged to monitor carefully the balance between supply and demand and to launch public tenders for the creation of new electricity and gas production capacity. Moreover, Member States would be required to ensure that certain categories of vulnerable persons, such as the elderly or disabled, can obtain affordable energy supplies.

#### ***B. Proposed Regulation Setting the Conditions for Network Access.***

Electricity “interconnectors” are the electricity lines linking different networks, typically the networks of different Member States. With the liberalization of electricity markets in the EU, access to interconnectors has become critical for electricity companies to operate in Member States outside their traditional

home markets. Existing interconnectors were designed with low capacity since they were intended only to secure emergency supply, not to support massive trade flows of electricity. Moreover, up to 40 to 60% of existing interconnection capacity is tied up in long term contracts. The Commission has so far identified the following three major interconnection bottlenecks in electricity: (i) to the Iberian peninsula; (ii) to Italy from Austria, Switzerland and France; and (iii) to the U.K. from France. The situation in gas interconnection is substantially better but will become of increasing concern as cross-border trade flows develop.

These concerns were recognized early in the process of liberalisation, and the Commission responded by establishing the European Regulatory Forum for electricity (the “Florence Forum”) to bring together regulators and industry participants.<sup>6</sup> The experience with the Florence Forum in addressing technical issues of interconnection has been very positive. But the limitations of such an informal, consensus-driven body have now led the Commission to propose formal legislation to establish clear guidelines for cross-border tariffs and interconnector congestion management.

In order to increase cross-border trade in electricity (the key to completing the internal EU market), the Commission therefore proposes to address the following areas in the proposed Regulation:

- establish rules for pricing for hosting transit flows of electricity;

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<sup>6</sup> A similar group established for gas is known as the European Gas Regulatory Forum of Madrid (the “Madrid Forum”).

- establish market-based rules for allocation and management of interconnection capacity; and
- increase physical interconnection capacity.

The proposed Regulation lays down the main principles to be reflected in the measures of national regulators. The Commission has reiterated its intention to enforce the requirements in the Electricity Directive that network operators allocate interconnector capacity on the basis of objective, transparent, and non-discriminatory criteria. For example, vertically integrated interconnector operators may not discriminate in favor of generators with which they are affiliated. The Commission has also indicated its willingness to compel the release of interconnector capacity which may have been tied up in long-term exclusive agreements (as happened in the VEBA/VIAG case, *see below*).

### **III. Competition Enforcement Complements Market Opening Measures.**

The principal mechanism for ensuring competition exists in the newly liberalised electricity and gas markets is the Commission’s jurisdiction over enforcement of the EU competition rules. The Commission’s activities, particularly in merger cases, are having the effect of restructuring major parts of the electricity and gas sectors in the EU/EEA. Cases in the energy area since the advent of liberalisation show the Commission’s determination to enforce the competition rules vigorously to prevent anticompetitive practices from closing off the market openings created through liberalisation.

**A. Merger Cases/Dominance: VEBA-/VIAG, EdF/EnBW, Enel/Infostrada, EdF/Louis Dreyfus, Exxon/Mobil and BP Amoco/Arco.**

The Commission has used its power to review concentrations under the EC Merger Regulation to restructure the electricity and gas sectors. It has relied on findings that a number of concentrations would strengthen dominance to compel far-reaching remedies as a condition to granting merger clearance. Considering the low intra-Community trade flows in electricity, the Commission continues to find the geographic markets for electricity are national in scope. The incumbent electricity operators are typically dominant in their national markets. For example, in the case of Electricité de France (“EdF”), it supplies some 94% of the market demand in France. In the case of the VEBA/VIAG combination, the Commission found a high potential for joint dominance with RWE AG. In cases involving these operators, the Commission required substantial divestitures and the severing or reforming of various restrictive contractual links as a condition to clearing the merger.<sup>7</sup>

The Commission has also imposed other sorts of remedies in merger cases. In VEBA/VIAG, the Commission obliged VEBA to free up interconnection capacity between Germany and Denmark. In EdF/Energie Baden-Württemberg AG (“EnBW”), the Commission required EdF to auction 6,000 MW of electricity in a bid to increase the liquidity of the trading market in France.

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<sup>7</sup> The German Federal Cartel Office imposed similar obligations on RWE AG/VEW Energie AG as a condition to approving their combination.

The Italian competition authority, after referral by the Commission, applied similar but extended reasoning to the acquisition of the Italian telecommunications operator Infostrada by the dominant electricity supplier Enel. The authority required Enel to dispose of 5,500 MW of its generating capacity to resolve competition concerns. According to the Italian authority, it was necessary to reduce the presence of Enel on the market for electricity production to avoid the risk of strengthening Enel’s dominant position on the related market for electricity supply.

In the case of EdF/Louis Dreyfus, which concerned the establishment of an electricity trading joint venture, the Commission was content with a behavioral undertaking: it cleared the combination in September 1999 after the joint venture agreed not to trade until after the electricity market was legally open (the French implementing legislation had not yet been enacted). The same concerns identified in EdF/EnBW regarding EdF’s dominant position in the French market formed the basis for the Commission’s objections.

In the gas sector, the Commission compelled significant divestitures from the parties in both Exxon/Mobil and BP Amoco/Arco in their respective merger procedures in 1999. Mobil’s interests in wholesale transmission of natural gas in the Netherlands and some of its underground storage facilities for natural gas in Germany were divested, while Exxon’s equity stakes in long distance wholesale gas transmission companies in Germany were likewise sold. In BP Amoco/Arco, the Commission focused on overlaps in the transportation of natural gas by offshore pipelines from fields in the southern North Sea. BP Amoco was obliged to sell equity interests in pipelines and processing facilities that would put it

back to a position similar to that existing prior to the BP-Amoco merger.

Given the high barriers to entry in the energy sector, it can be expected the Commission will continue to examine concentrations involving energy concerns very closely and impose all structural and behavioral remedies it considers appropriate.

***B. Joint Selling: GFU and EdF/CNR.***

After several years of discussion, in June 2001 the Commission formally objected to the joint selling of gas by Statoil and Norsk Hydro in Norway through the Gas Negotiating Board (“GFU”), a state-sanctioned consortium for gas sales. The GFU violates competition rules by, among other things, fixing prices and volumes in long-term contracts with a number of industry participants. The Norwegian government recently announced sales through GFU will cease, but the Commission is maintaining the pressure until the necessary changes are implemented at the company level.

The Commission also investigated the contractual links between EdF and ostensibly independent producer Compagnie Nationale de Rhône (“CNR”) in 1999. CNR sold power under exclusive long term contracts with EdF. This arrangement was finally terminated in the context of EdF’s acquisition of EnBW (*see* above), in which the Commission required EdF to renounce its influence over CNR.

***C. Customer Lock-in: Gasnatural/-Endesa.***

The relationship between the electricity and gas markets has also been the object of Commission attention. In March 2000, the Commission accepted amendments to the

long term exclusive supply agreement for gas from the dominant supplier in Spain, Gas Natural, to Endesa, the market leader in electricity, in exchange for closing an investigation into this relationship. The Commission reasoned that exclusive long term deals of this type could hinder competition in both the gas and electricity markets. The terms of the agreements were amended such that Endesa would be permitted to purchase some of its requirements from others and could resell the gas purchased from Gas Natural. The term of the deal was also reduced to 12 years. These changes are intended to attract new gas suppliers into the market since Endesa will now be available as a customer. Granting Endesa the right to resell will also give other power generators access to gas at spot market conditions, making the electricity market more competitive.

**IV. Cross Border Investment Rules.**

The uneven pace of liberalisation has also created the need to guard against unilateral measures by Member States to protect their markets from competition. Recently, EdF’s aggressive international expansion strategy has prompted such a reaction. EdF has invested in Montedison in Italy and EnBW (controlled by EdF) has invested in Hidroeléctrica del Cantabrico SA in Spain. In Italy, the Italian government has limited EdF to voting only 2% of the shares of Montedison, although it has purchased a total of 20%. In Spain, a 1999 law limits state-controlled entities with stakes in national energy companies from exercising more than 3% of the company’s voting rights unless approved by the Spanish cabinet. The Commission had no right to intervene in these investments on competition grounds because the stakes do not confer any

measure of control within the meaning of the EC Merger Regulation.

The Commission has demonstrated its commitment to opening the French electricity market in numerous cases involving EdF. At the same time, the Commission cannot permit Member State governments to retaliate against EdF in order to protect their home markets in ways that may violate other EU rules.

The action of the Italian and Spanish governments has thus prompted the Commission to clarify the rules on cross-border investment. First, Member States can only establish conditions to the sale of part of a privatized company if the public authority is a controlling shareholder. Second, once the company is privatized, intervention is not lawful unless based on non-discriminatory, specific policy objectives which must be defined

beforehand. The Commission has not yet ruled definitively on whether Italy and Spain have violated EU rules on free movement of capital and the right of establishment, but is expected to take a tough line on these efforts to intervene in privatized energy companies in its forthcoming ruling.

**V. Conclusion.**

Liberalisation of the electricity and gas markets in the EU has brought valuable benefits. More rapid and uniform progress throughout the EU is central to addressing the problems that have arisen. The Commission can be expected to continue its recent efforts in the legislative and competition arenas to accelerate the opening of these markets to competition.

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