

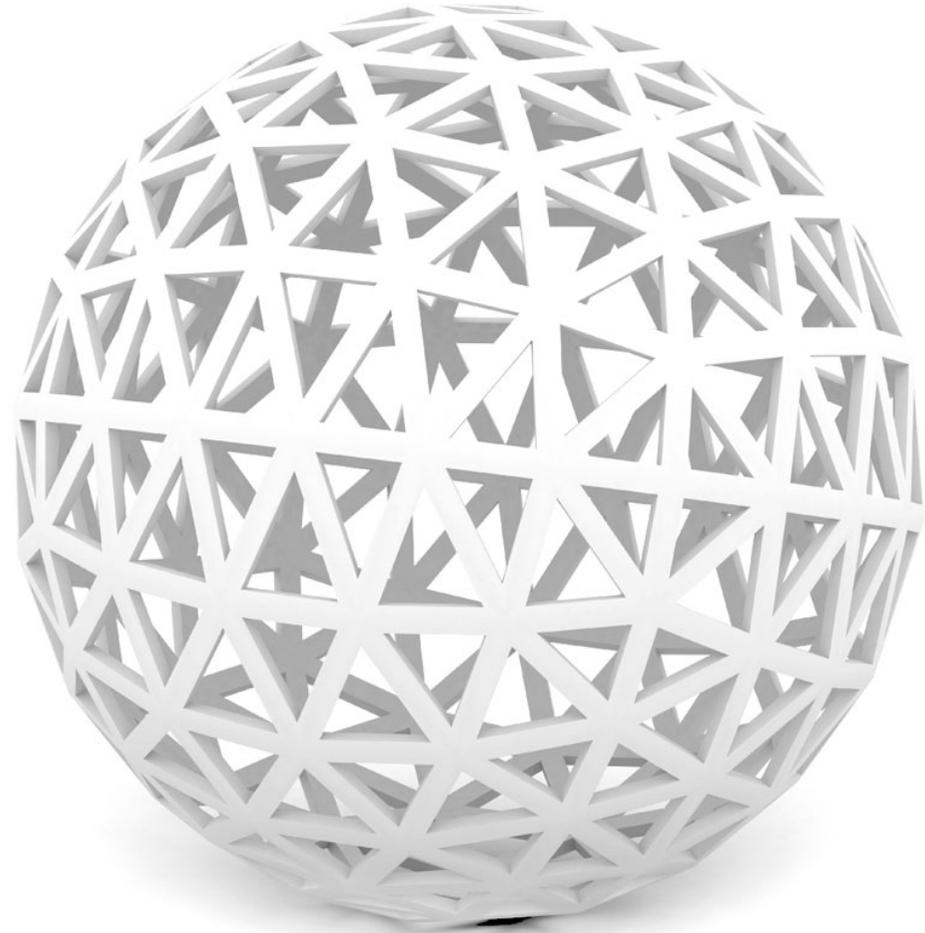
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***INVESTING IN THE
ENERGY SECTOR***

***Between regulation and
competition***

The EU perspective



Structure of the presentation

- **Introduction:** EU energy policy background and fundamentals

- **Integrated (liberalised) energy market – what consequences for businesses?**
 - **Regulatory aspect:** Impact on the permissible *legal structures* for businesses operating in the European gas and electricity markets
 - *Unbundling (restructuring incumbents...)*
 - *Exemptions for new cross-border infrastructures (investment incentives)*

 - **Competition aspect:** Impact on the permissible *daily commercial practices* of businesses operating in the European gas and electricity markets
 - *Antitrust*
 - *Merger control*
 - *State aids*

European Energy Policy and the Treaty on the Functioning of the European Union (*TFEU*)

– Treaty of Lisbon (1.12.2009):

- **Energy** receives an explicit recognition as one of the Union's **shared competences** (EU/Member States) (**Article 4 TFEU**)
 - *Compare: competition – exclusive EU competence (Article 3 TFEU)*
- **Article 194 (1) TFEU** - sets out the 4 main aims of EU Energy policy:
 - ensure the functioning of the energy market;
 - ensure security of supply of the EU;
 - promote energy efficiency and saving and the development of new and renewable forms of energy;
 - promote the interconnection of energy networks.
- **Article 194 (2) TFEU** specifies how competence is to be shared
 - EU legislation should not affect a **Member State's choice between different energy sources and the general structure of its supply**
 - Can/should take into account environmental policy

Achievement of an integrated energy market – The “energy packages”

- Liberalisation process = previous (often state/national) monopolies become open to competition
 - **First step (1996/1998):**
 - Directive 96/62/EC (electricity) and Directive 98/30/EC (gas) already provided for a gradual opening of the European market to competition
 - **Second step (2003):**
 - Directive 2003/54/EC (electricity), Directive 2003/55/EC (gas) repealed the previous directives
 - Regulation (EC) 1228/2003 on conditions for access to the network for cross-border exchanges in electricity
 - **Third step (2009):**
 - Directive 2009/72/EC (electricity), Directive 2009/73/EC (gas) repealed the previous directives
 - Regulation (EC) 713/2009 establishing an Agency for the Cooperation of Energy Regulators (ACER); Regulation (EC) 714/2009 on conditions for access to the network for cross-border exchanges in electricity and Regulation (EC) 715/2009 on conditions for access to the natural gas transmission networks

Achievement of an integrated energy market – The fundamentals (Second energy package)

1. Liberalised electricity/gas supply:

- since 1 July 2004, all **non-household (industrial)** customers can choose their suppliers
- since 1 July 2007, all **household** customers can do so too

2. Accounting separation (*financial transparency, avoids illegal cross-subsidisation*):

Electricity and Natural Gas undertakings keep, in their internal accounting, separate accounts

- for each of their transmission and distribution activities (*electricity*)
- for each of their transmission, distribution, LNG and storage activities (*natural gas*)

3. Independence of the transmission system operator in terms of its legal form, organisation and decision making from other activities not relating to transmission, **when it is part of a vertically integrated undertaking**

- strengthening more effectively non-discrimination obligations

4. Designation of one or more competent an independent bodies with the function of regulatory authorities

- responsible for ensuring non-discrimination, effective competition and the efficient functioning of the market

Third energy package – Genesis

- Commission’s Energy Sector (**competition**) inquiry (**2007**):
identification of **market failures**:
 - continuing market power of incumbents in many Member States
 - inadequate separation of network and supply companies leading to foreclosure of new entrants and investments
 - lack of cross-border integration of networks and cross border regulatory supervision
- New package adopted on **13 July 2009**
 - **broadens and supplements** the sector architecture introduced by previous legislation
 - However, this liberalisation package is the result of a **compromise** agreed between the European Parliament and the Member States

Third energy package – Key features

- Strengthening of the national regulator’s powers (“Third country clause”)
- Creation of a European energy agency (ACER)
- Unbundling of energy supply and production from network operations
- Facilitating development of cross-border infrastructure

Directive 2009/72

– “Without effective separation of networks from activities of generation and supply (**effective unbundling**), there is an **inherent risk of discrimination** not only in the operation of the network but also in the **incentives for vertically integrated undertakings to invest adequately in their networks.**”

– « Без ефективно отделяне на мрежите от дейностите по производство и доставка („**ефективно отделяне**“) съществува вътрешно присъщ **риск от дискриминация** не само в експлоатацията на мрежата, но и в **стимулите на вертикално интегрираните предприятия да инвестират адекватно в мрежите си.** »

Third energy package – External outreach

- The ***‘third country clause’*** (aka the ***‘Gazprom clause’***...)
 - The unbundling rules are also extended to third country companies, via the **certification procedures** (*Article 11 of the 2 Directives*)
 - Where certification is requested by a TSO which is controlled by a person from a third country, the **NRA notifies the Commission** of any circumstances which would result in a third country company acquiring control of a transmission system or transmission operator
 - The NRA must refuse certification if it has not been demonstrated:
 - that the entity concerned complies with one of the unbundling models and
 - that the granting of certification will not put at risk the security of energy supply of the Member State and the EU

Integrated energy market – what consequences for businesses?

- One of the main aims pursued by the energy policy of the European Union is the achievement of a single integrated gas and electricity market
 - Closely linked to the objective of creating a single area where competition is undistorted
- Strengthened by the third energy package
- **Two major consequences** on business activities of companies:
 - Impact on the permissible legal structures for business operating in the European gas and electricity markets (**Regulatory aspect**)
 - Impact on the permissible daily commercial practices of businesses operating in the European gas and electricity markets (**Competition aspect**)

Regulatory aspects – Impact on the legal structures

What kind of regulation for vertically integrated electricity and gas companies?

I. Unbundling obligations

Article 9 of Directive 2009/72 (**electricity**)

Article 9 of Directive 2009/73 (**gaz**)

Impact on legal structures – Why unbundle?

- **Previous regime: mere legal unbundling**
 - In a vertically integrated energy group, a transport system operator (TSO) must be a distinct company from the company in charge with supplying or generating the energy
 - But: both entities can be controlled by the same company (*French example*)

- **Several issues** raised by the European Commission (2007 Sector Inquiry)
 - systemic conflict of interest inherent in the vertical integration of supply/production and network activities,
 - discrimination concerning access to privileged information,
 - lack of investments...

- Only solution to foster effective competition in the sector: **structural unbundling**

Impact on legal structures – How to unbundle? (1)

- The third package as **originally** proposed by the Commission only included **two options** available for Member States:
 - **Full ownership unbundling (FOU)**: networks are not controlled or majority-owned by energy production or supply companies.
 - **Independent system operator (ISO)**: possible ownership of the transmission network by the production / supply companies, however its operation must be left to a designated independent system operator
- Strong reaction by certain Member States (with traditionally powerful, state-controlled incumbents...)
 - **France** (GDF Suez, EDF)
 - *Versus*: UK, Sweden (traditionally more liberal approach)

Impact on legal structures – How to unbundle? (2)

- The third way: **Independent Transmission Operator (ITO)** (*also supported by Bulgaria*)
 - possible ownership of the transmission networks by the production/supply companies
 - however the latter have to abide by certain rules to **ensure an independent conduct** of the production/supply and transmission network operations (*accounting separation, non-discrimination obligations...*)
- gives the right to former state monopolies to stay owners of their gas and electricity networks
- **But:** the Commission has to adopt, by **3 March 2013**, a specific detailed report assessing whether the ITO option can lead to effective unbundling
 - *Article 47 of the Directive 72/2009 (electricity) and Article 52 of the Gas Directive*

Implementation of “unbundling” requirements under Directives 2009/72/EC and 2009/73/EC – Examples

COUNTRY	UNBUNDLING SOLUTION IMPLEMENTED
Belgium	FOU
Czech Republic <i>(Implementation in progress)</i>	Electricity – FOU Gas – ITO
France	ITO
Germany	FOU/ITO/ISO
UK	Electricity – FOU/ ITO+ (Art 9(9)) Gas – FOU/ ITO
Hungary	ITO
Italy	Electricity – FOU Gas – ITO
Netherlands <i>(Implementation in progress)</i>	FOU
Romania <i>(Implementation in progress)</i>	<i>To be decided</i>
Slovakia <i>(Implementation in progress)</i>	Electricity – FOU Gas – ITO
Spain <i>(Implementation in progress)</i>	FOU

Regulatory aspects – Impact on the legal structures

How create incentives for private investment for fostering the development of energy infrastructures throughout the EU?

II. New and Cross-border infrastructure

New and Cross-border infrastructure – investment incentives through (wise) regulation

- **As a matter of principle:** transmission system operators (TSO) are entrusted with the development, construction and operation of regulated interconnectors (**public lines**)
 - Remuneration: e.g. through regulated tariffs
- Is it sufficient to encourage the construction of new infrastructure to link markets together?
 - Private interest from investors (e.g. infrastructure companies – highways... - France/Italy) (**merchant lines**)
- **New gas infrastructures** (interconnectors, storage and LNG facilities) and **new electricity infrastructures** (direct and alternating current interconnectors) + **significant increases of capacity** in existing infrastructures, **can be granted exemption** from:
 - **third party access (TPA)** → capacity reservation for project promoter or specific users
 - **unbundling obligations** → e.g. separation from generation activities if investor is vertically integrated
 - **network reinvestment obligation** → revenue cap (ensuring profits are reinvested in capacity increase) (for a limited period)

New and Cross-border infrastructure – getting the regulatory approval – assessment of the exemption criteria

- **GAZ: Article 36 Directive 2009/73/EC**
 1. The investment must **enhance competition** in gas supply and enhance security of supply (*benefits the project is expected to create for consumers and competition*);
 2. The level of risk attached to the investment is such that the **investment would not take place unless** an exemption was granted;
 3. The infrastructure must be owned by a natural or legal person which is **separate at least in terms of its legal form from the system operators** in whose systems that infrastructure will be built;
 4. Charges are levied on users of that infrastructure;
 5. **The exemption is not detrimental to competition** or the effective functioning of the internal gas market, or the efficient functioning of the regulated system to which the infrastructure is connected. (*the emphasis here is on whether granting the exemption would itself act as a barrier to competition*)
- **ELECTRICITY: Article 17 Regulation (EC) No 714/2009**
 1. The investment must **enhance competition** in electricity supply
 2. The level of risk attached to the investment is such that the **investment would not take place unless** an exemption was granted;
 3. The interconnector must be owned by a natural or legal person which is **separate at least in terms of its legal form from the system operators** in whose systems that infrastructure will be built;
 4. Charges are levied on users of that infrastructure (*e.g. fee per MWh paid by users, auctions...*);
 5. Since the partial market opening referred to in Article 19 of Directive 96/92/EC, **no part of the capital or operating costs of the interconnector has been recovered from any component of charges made for the use of transmission or distribution systems** linked to the new interconnector.
 6. **The exemption is not detrimental to competition** or the effective functioning of the internal electricity market, or the efficient functioning of the regulated system to which the infrastructure is connected.

New and Cross-border infrastructure – Exemption procedure (*for info*)

- Two stages regulatory process: a gas or electricity undertaking must demonstrate to the NRA that the conditions are satisfied
- If the NRA agrees, the European Commission decides whether to approve the NRA's position
- Exemption can be for whole or parts of the capacity of the new infrastructure, and it can be conditional and time-limited.
- In case of disagreement between two NRAs on a cross-border infrastructure: referring of the exemption the ACER and final decision of the Commission

New and Cross-border infrastructure - Examples

- **Gas infrastructures:** 22 exemption decisions since 2004:
 - approval **without any objection from the Commission:** many projects in the UK: LNG terminals (Dragon, South Hook)
 - Cross-border pipelines approved **subject to conditions** (Balgzand Bacton Line, Opel, Gazelle).
 - **Refusal:** for a gas storage in the Czech Republic (second criterion not met)
 - **Nabucco** (5 national decisions for different portions of the pipeline): Austria (2), Romania, Bulgaria, Hungary

- **Electricity infrastructures (cross-border interconnectors):** 4 exemption decisions since 2004:
 - E.g. Exemption **subject to conditions** for *Britned* (2007): the Commission required from the NRAs to examine the revenues earned in the first ten years and can only prolong the exemption if these have proved insufficient
 - *Arnoldstein/Tarvisio* (Austria/Italy) (2011) - Partial refusal to grant exemption for TPA

Competition aspects – Impact on the commercial practices of businesses

(As an ex-post intervention, Competition law is the other way for the European Commission to ensure an integration of the energy single market)

I. Antitrust enforcement

II. Merger control enforcement

III. State Aid law enforcement

Impact on the commercial practices of businesses –

I. Antitrust enforcement

- After the **Sector Inquiry** final report published in 2007, the European Commission launched a **series of dawn raids** at major energy companies across Europe
- Subsequently, several proceedings for potential breaches of Articles 101 and 102 TFEU closed on the basis of **commitments**
- Preference for **behavioral** remedies over **structural** remedies:
 - less burdensome and intrusive
 - **but, they have to be equally efficient** as structural remedies
 - several recent cases of abuse of dominant position settled however with structural commitments

Antitrust enforcement in energy – Example n°1

E.ON - abuse of dominant position on the German gas market
(Case COMP/39.317 — E.ON Gas) (4 May 2010)

– **Competition risk:**

- E.ON may have foreclosed competitors from the market by booking almost the entire capacity at key entry points into the gas network on a long-term basis, thereby potentially abusing its dominant position in the markets for the supply of gas in Germany

– **Commitments:**

- reduction of E.ON's shares of firm, freely allocable entry capacity and the duration of these commitments to ensure that competitors and new suppliers can rapidly and permanently become active in the downstream gas supply markets

Antitrust enforcement in energy – Example n°2

**ENI - abuse of dominant position on the Italian gas market
(Case COMP/39.315 — ENI) (29 September 2010)**

- **Anticompetitive conduct and competition risk:**
 - systematic and constructive refusal to supply might have reduced ENI's competitors' opportunities to transport gas into Italy in its international network
 - the foreclosure of access to the import pipelines would therefore restrict competitors' ability and incentives to develop an effective competition on the downstream gas supply markets in Italy

- **Remedies:**
 - divestment of ENI's shareholdings in companies related to international gas transmission pipelines to a purchaser independent from and unconnected to ENI;
 - save exceptions, no prolongation or renewal of any transport contract or conclusion of any new transport contract for its benefit as shipper.

Impact on the commercial practices of businesses –

II. Merger control enforcement

- Numerous mergers in the energy sector as a result of the liberalisation of the European Energy market
- Liberalisation of the energy markets played as an incentive a consolidation of the main players on the European market
- Illustration of how competition and regulation connect:
 - As a result of commitments taken within antitrust proceedings, several German energy companies sold their transmission system operator (unbundling)
- Examples:
 - Consolidation trans-border merger: *EDF / Segebel* – 12.12.2009 (Case M.5549) ;
 - Unbundling obligation follow-on: *Molaris / Commerz Real / RWE / Amprion* – 23.08.2011 (Case M.6225), *TenneT/E.ON* – 4.02.2010 (Case M.5707)

Merger control enforcement – Example n°1

EDF / Segebel – 12.11.2009 (Case M.5549)

- Acquisition by EDF (France) of exclusive control of Segebel (Belgium), a holding company whose only asset is a 51% stake in SPE S.A., the second largest electricity operator in Belgium
- **Competition concern:** reduction of incentives of EDF to continue its plans to build additional electricity generation capacity in Belgium after the proposed acquisition
- **Remedies:**
 - Divestment of assets of one of its companies in charge of the development of one of EDF's planned power station projects
 - in case EDF were not to invest in a second planned power station, or no decision to invest has been taken by then, EDF has committed to divest the assets of the company in charge of the development of that project at that time

Merger control enforcement – Example n°2

TenneT / E.ON – 4.2.2010 (Case M.5707)

- Transaction results from E.ON's commitment vis-à-vis the Commission, to separate and subsequently divest its transmission system business (Commission decision of 26 November 2008 under the Article 9 of Regulation 1/2003)

- **Competition risks:** E.ON may have:
 - withdrawn available generation capacity from the German wholesale electricity markets (to raise prices), and have deterred new investors in generation and
 - favoured its production affiliate for providing balancing services, while passing the resulting costs on to final consumers, and prevented other power producers from exporting balancing energy into its transmission zone.

- **Commitments:** E.ON offered to divest:
 - parts of its generation capacity to address the concerns regarding the generation market
 - its extra-high voltage network to meet the concerns on the electricity balancing market

Impact on the commercial practices of businesses – III. State aid law enforcement

- The State aid dilemma: reconcile competition imperatives with other general interest concerns
- In sectors to be opened to competition: state intervention can:
 - (unduly) favour incumbents
 - impact trade conditions on the market (and have an effect not only on energy companies, but also on financial investors)
- Examples:
 - Cross subsidies (aids for restructuring (EDF) ; public service compensation (Spanish aids for electricity generators)
 - Sunk and stranded costs (aids in Poland and Hungary, PPA issues)

State aid law enforcement – the PPAs issue

- *Case study: Long-term power purchase agreements ('PPA') of electricity in Poland and Hungary*
 - **Aim:** ensure security of supply and the modernisation of power generation infrastructure
 - **Mechanism:** Poland and Hungary introduced a system of PPAs as an incentive for power generators to invest
 - **Substance of the PPAs:** some generators have the obligation to buy a fixed quantity of electricity at a fixed price
 - **Practical result:** PPAs guarantee the generators a return on investment without any risk, as well as a profit element.
 - **Market effect** (impact on competition): PPAs strengthen the position of PPA-bound generators in comparison with others

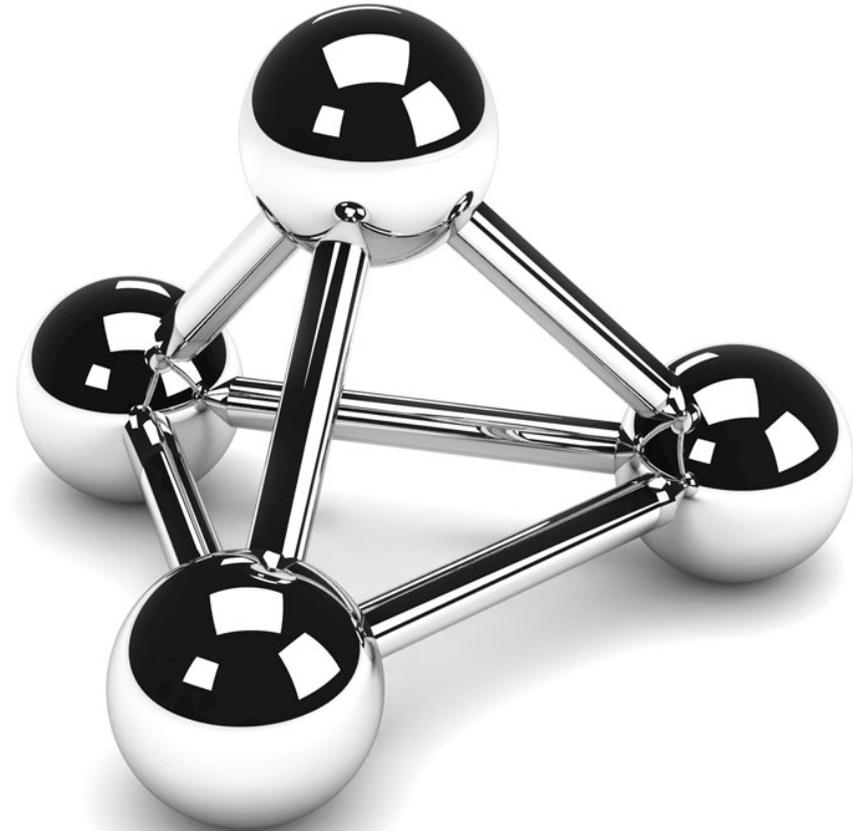
- **Commission position in the Hungarian and Polish cases:** PPAs constitute state aid
=> States have to recover them
 - **state resources** (public companies) and imputable to it (aid used in a way imputable to the state)
 - **economic advantage:** according to the Commission, the parties to these agreements are placed in a better economic position than other companies

State aid law enforcement – the stranded costs issue

- Schemes aimed to compensate power generators for the costs incurred as a result of the termination of their power purchase agreements (PPAs) and which they cannot recoup (so called "***stranded costs***")
- Costs taken into account for the calculation of the compensation could be eligible for aid, when they concern investments in assets that have become non-economical as a result of the liberalisation of the electricity sector
- **Compatibility assessment:** Communication of the Commission relating to the Methodology for analysing State aid linked to stranded costs

State aid law enforcement – other issues

- Other State measures impacting trade conditions:
 - Purchase obligations ***Preussen Elektra*** decision (case C-379/98)
 - privately owned companies were compelled by the State to purchase electricity from specific electricity producers at a price fixed by the State and higher than the market price
 - the Court ruled that in such a case there is no transfer of public resources and therefore no state aid
 - Regulated tariffs
 - In *Federutility* (case C-265/08, 24 April 2010) the ECJ upheld the **legality of retail price control**
 - **However**, preferential tariffs and specific tariffs systems could raise state aid issues: e.g. French 'TarTAM'



Questions?

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