



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

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ROUNDTABLE ON ENERGY SECURITY AND COMPETITION POLICY

-- Note by Germany --

This note is submitted by the German Delegation to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21-22 February 2007.

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1. Significance of security of energy supply in Germany

1. The Energy Industry Act has laid down five major objectives for the energy sector in Germany: In addition to security of energy supply, these are: competitive pricing, environmental compatibility, consumer friendliness and efficiency. The conflicting priorities inherent in these objectives make it impossible to completely fulfil all of them at the same time. Rather, what has to be aimed at is a solution which takes as much account as possible of each different interest. In this context, the Federal Constitutional Court has declared the security of energy supply a “community commodity of the highest order”. According to the Court, it is an “absolute” community commodity. Consequently, energy supply is seen as one of the public services of general interest that are “indispensable for a life in keeping with human dignity”. In this context, security of energy supply means on the one hand that there have to be sufficient supply capacities, and on the other that technical security has to be ensured.

2. The current debate focuses in particular on the high level of energy prices. In Germany, the energy monopolies were broken up in 1998 by far-reaching amendments to the Energy Industry Act. Since then the German energy market has been subject to constant change. The liberalisation of the energy market was mainly driven by the realization that, with the exception of the natural gas and electricity networks, natural gas and electricity supply did not necessarily have to be seen as natural monopolies.

3. Against the background of the gas supply dispute in Eastern Europe, the security of energy supply has recently gained new significance. Germany has made this issue one of the priorities for its EU presidency in the first half of 2007 (quote from the Presidency Programme “Europe – succeeding together”):

1.1 “Guaranteeing a secure, environmentally sound and competitive energy supply

4. A secure, environmentally friendly and competitive energy supply is crucial if Europe is to experience positive economic development. Yet guaranteeing such a supply is becoming increasingly difficult due to the finite nature of fossil fuels, combined with growing international demand, persistently high oil and gas prices, mounting instability in certain regions of the world and the effects of climate change. In view of these challenges, adoption of the European action plan on energy policy will be a priority of the European Council in spring 2007.

5. Completion of the Internal Market for gas and electricity by 1 July 2007 is an important goal of European energy policy. The German Presidency will work to obtain the complete opening of the markets for electricity and natural gas on the basis of blanket application of European legal provisions in all EU Member States. Given the high electricity and gas prices, it is vital that competition in Europe increases. In early 2007 the European Commission’s report on implementation of the Second Internal Market Package and its final report on the sector inquiry will reveal where problems still exist, where the Member States need to do their homework, and where additional guidelines might be necessary.

6. Outside its borders the EU must put the energy policy partnership with key producer, transit and consumer countries on a solid and reliable footing by conducting intensive dialogue as part of a cooperative approach and involving the Member States more closely. Extending the energy dialogue with Russia and the United States in particular will play a key role. Energy issues will also receive greater priority within the European Neighbourhood Policy.”

2. Regulation of the energy sector

7. The network sector is mainly regulated by the Energy Industry Act which allows for “competition within the network” by means of transmission competition. Based on objective and justified criteria, operators of energy supply networks have to grant everyone non-discriminatory access to their networks. As far as distribution and the operation of networks used for general supply is concerned, the legislator has decided to introduce a “competition for the networks” as well, by having the municipalities invite to tender for the network every 20 years.

8. In July 2005 the German Energy Industry Act was radically amended. One of the key elements of the amendment was the creation of a regulatory authority. State control of the electricity and gas network operators was transferred to the former Regulatory Authority for Telecommunications and Posts, subsequently named the “Federal Network Agency for Electricity, Gas, Telecommunications, Posts and Railways”. In terms of content the most significant amendments were the separation of network monopolies in the electricity and gas sector from other business areas, and the regulation of network access and network fees.

2.1 *Competencies of the energy regulatory authority*

9. Overlaps of competencies between the Bundeskartellamt and the Federal Network Agency are avoided by separating the areas of application of competition law and regulatory law. In particular, the regulatory authority has been given a number of ex-ante powers. The rules governing network fees, in particular, are subject to the regulatory authority’s ex-ante control. The rules governing connection to the network, network access and network fees are *lex specialis* in relation to the general competition rules.

10. In addition to its regulatory tasks the regulatory authority constantly monitors activities in the network sector. This includes, *inter alia*, compliance with the rules for the management and allocation of connection capacities, mechanisms to resolve capacity constraints, conditions for granting access to storage capacities as well as conditions and tariffs for the connection of new electricity producers.

2.2 *Fees for network use*

11. Fees are calculated on the basis of the costs of operation, which must correspond to the costs an efficient and structurally comparable network operator would incur. To ensure that network fees correspond to these standards, the regulatory authority may compare the network fees, revenues and costs of the individual operators of energy supply networks.

12. Furthermore, on the basis of a report by the Federal Network Agency, the Federal Ministry of Economics and Technology is currently drafting a regulation to introduce an incentive regulation system. Under an incentive regulation system, a company’s prices or revenue are not rigidly linked to its actual costs; inefficient companies are granted lower yields while efficient companies can have higher yields. Incentive regulation serves to replace the competitive pressure which, in competitive sectors, continually provides incentives to increase efficiency.¹

¹ As soon as the fees for network use are established by means of incentive regulation the interest rate on equity capital will be set by the regulatory authority for the first time. Until then the interest rate on equity capital will be 6.5% for old network facilities and 7.91 % for new network facilities in the electricity sector and 7.8% for old network facilities and 9.21% for new network facilities in the gas sector, all figures net of tax.

2.3 *The balancing energy system*

13. The provision of balancing energy serves to balance short-term deficits or excesses in energy consumption resulting from a discrepancy between the amount of electricity fed into the network by electricity providers and the actual amount of electricity used by the end consumers. It therefore helps to ensure security of energy supply in Germany. The Energy Industry Act reform has improved the balancing energy system by obliging the transmission network operators to put balancing energy out for tender by means of a joint Internet platform, and to cooperate with one another in order to lower expenses incurred in the provision of balancing energy.

2.4 *Divestiture*

14. The provisions on divestiture laid down in the Energy Industry Act create transparency to counteract distortions of competition, in particular cross subsidies. The Act stipulates legal, operational and information divestiture as well as the separation of accounting operations. Legal divestiture obliges vertically integrated energy providers to organise their network-related services independently under company law. *Operational* divestiture concerns organisation and decision making processes. Accordingly, certain groups of employees working for a network operator may not be employed at the same time by a legally independent network operator or the connected vertically integrated energy provider. In the interest of non-discriminatory network access vertically integrated energy providers and network operators are obliged to ensure the confidentiality of economically sensitive data (*information* divestiture). The separation of *accounting operations* is also of particular significance. Energy providers are obliged to keep separate balance sheets and accounts for network operation activities in the individual operational areas in such a way as if the respective activity had been carried out by an independent company.

3. **Competition Policy Competencies and Decisions of the Bundeskartellamt in the Energy Sector**

15. Apart from the network area, which is subject to regulation, the general provisions on competition apply to the upstream and downstream markets, i.e. generation, supply of and trading with energy. The Bundeskartellamt and the competition authorities of the *Länder* are responsible for their enforcement. Abuse control under competition law is applied in particular to the obstruction practices of dominant energy providers and the control of abusive pricing to excessive overall prices for electricity and gas. The Act against Restraints of Competition generally provides for the obligation of dominant companies to open up essential infrastructure facilities and networks to third parties against adequate remuneration. Finally, the Bundeskartellamt is the competent authority for merger control in the energy supply sector.

3.1 *Merger control*

3.1.1 *E.ON / Ruhrgas Merger*

16. One merger project which has raised much attention in Germany and Europe and in which energy supply also played a role, was the E.ON Ruhrgas case.

17. The opening-up of the German energy sector in 1998 was followed by an increase in the number of horizontal and vertical mergers between energy providers. In anticipation of expected competition in the electricity markets the European Commission and the Bundeskartellamt cleared a series of mergers (e.g. Veba/VIAG or RWE/VEW) subject to far-reaching conditions. The mergers led to higher concentration in the electricity distribution markets.

18. In its decisions of 17 January 2002² and 26 February 2002³ the Bundeskartellamt prohibited E.ON AG from acquiring a majority share both in the energy provider Gelsenberg and Bergemann. Both companies, which through interlocks belonged to several shareholders, had stakes in Ruhrgas. By means of these two transactions E.ON would have virtually acquired a 100 per cent share in Ruhrgas. The Bundeskartellamt had substantiated its prohibition decisions with the argument that the concentration of E.ON and Ruhrgas at a time of emerging liberalisation in the gas markets would cement Ruhrgas' dominant position in the gas distribution market. This would considerably diminish the likelihood of any effective competition from other gas transmission companies. There was also the danger of E.ON's dominant position in the electricity distribution sector being further strengthened to the detriment of smaller competitors and consequently consumers.

19. The E.ON/Ruhrgas merger was, however, cleared by ministerial authorisation on 18 September 2002 subject to far-reaching conditions, under the aspect of security of supply. Under German law a so-called ministerial authorisation can be issued if the restraint of competition is outweighed by advantages to the economy as a whole resulting from the concentration or if the concentration is justified by an overriding public interest. The obligations imposed on E.ON/Ruhrgas were as follows: to divest several vertically integrated corporate investments, to carry out legal unbundling, to offer their customers with long-term supply contacts a special right of termination for up to 20 per cent of their gas requirement and to implement a gas release programme.

20. With security of supply in mind the then Minister of Economics (and Labour) argued that the E.ON/Ruhrgas merger would help to improve the security of supply of natural gas in Germany. He argued that after the United Kingdom, Germany was the second largest consumer of gas in the European Union. A considerable increase in demand for natural gas was to be expected for the future, accompanied by a constant increase in dependency on gas imports. In the long term natural gas from Russian and Central Asian sources would be the most economic alternative for central Europe and, in particular, Germany. According to the minister, the E.ON/Ruhrgas merger could directly help to secure the reliability and ability to deliver of the Russian natural gas sector. It was undisputable that there would be great need for investment in the Russian gas sector in the coming decades. It seemed certain that the extensive need for investment could not be satisfied without huge commitment from companies in the consumer countries. The merger would thus give German companies the necessary financial power to cover their part of the investment requirements.

21. This decision demonstrates the great significance attached to the security of supply in the gas industry.

3.1.2 *Vertical Mergers*

22. As the E.ON/Ruhrgas merger has considerably strengthened the companies' position in the market, in merger control proceedings concerning vertically integrated companies in the electricity and gas sector, the Bundeskartellamt examines particularly critically whether even minor participations will lead to a strengthening of a dominant position. The Bundeskartellamt has prohibited a number of participations planned by E.ON, RWE or other first level suppliers of gas to municipal utilities and local distributors or has cleared them only subject to strict obligations. For example, in 2004, it prohibited the proposed acquisition of shares in Aschaffenburgener Versorgungs GmbH ("AVG") by Mainova AG ("Mainova").⁴ In

² Available at www.bundeskartellamt.de/wDeutsch/download/pdf/Fusion/Fusion02/B8_206_01.pdf.

³ Available at www.bundeskartellamt.de/wDeutsch/download/pdf/Fusion/Fusion02/B8_206_01.pdf.

⁴ Available at www.bundeskartellamt.de/wDeutsch/download/pdf/Fusion/Fusion06/B8_103_05.pdf. Cf. Also prohibition of E.ON/Stadtwerke Lübeck: Available at: www.bundeskartellamt.de/wDeutsch/download/pdf/Fusion/Fusion02/B8_206_01.pdf.

the Bundeskartellamt's view the project was likely to strengthen the dominant positions of Mainova and AVG in the gas supply market through vertical integration.

3.2 Restraints of competition/abuse control

3.2.1 Proceedings against market foreclosure due to long-term gas supply contracts

23. The proceedings concerning long-term gas supply contracts are also significant in terms of security of supply. The following résumé provides some background information on the market structure in the gas sector in Germany:

- E.ON/Ruhrgas and six other national gas transmission companies⁵, which either produce gas themselves or import it from abroad, form the first level of the three-level structured gas industry in Germany. In 2003 E.ON/Ruhrgas accounted for almost 65 per cent of the total domestic natural gas output of 992 billion kilowatt hours.
- A second level is formed by eight regional gas transmission companies, which neither own their own production sources or shares in them nor import gas.
- Active on the third level are approx. 690 regional and local gas distributors, which supply gas to industrial customers and also end consumers (larger customers are often supplied directly by providers on the first and second level).

24. In 2004, as development in the gas market was only sluggish even six years after liberalisation, the Bundeskartellamt started to examine the problem raised by long-term gas supply contracts between gas transmission companies and gas distributors. A survey has shown that almost three-quarters of the 513 contracts concerned cover 100 per cent of the gas distributor's requirement or at least quantities of between 80 per cent and 100 per cent of the distributor's requirement. Almost all of these contracts run for more than four years, in some cases up to twenty years. This combination of long contract periods on the one hand and a high degree of requirement satisfaction on the other leads to considerable foreclosure effects.

25. The Bundeskartellamt initiated proceedings against 18 Gas suppliers including E.ON/Ruhrgas. The Bundeskartellamt initially tried to achieve a consensus-based solution in order to counteract this restraint of competition. It took up the problem of long-term gas supply contracts *ex officio* without immediately initiating prohibition proceedings against the companies. Instead the authority conducted numerous discussions with the gas transmission companies, trading companies and distributors. The purpose of these discussions was to find a solution which serves the interests of effective competition and provides both the established and new gas suppliers with a clear schedule for their planning processes. However, the attempt to open up long-term gas supply contracts by consensus failed, in particular due to the fact that the market leader, E.ON/Ruhrgas, was not prepared to sign the formal obligation required.

26. Therefore the Bundeskartellamt moved on to issue prohibition decisions against the gas suppliers. In January 2006, it released its first decision against the market leader E.ON/Ruhrgas. By this decision the Bundeskartellamt prohibits E.ON Ruhrgas' existing long-term contracts with distributors which cover more than 80 per cent of their actual gas requirements. These contracts are to be terminated at the latest by the end of the last gas year on 30 September 2006. As regards the conclusion of new contracts with

⁵ RWE Energy AG, Dortmund (RWE), WINGAS GmbH, Kassel/Wintershall Erdgas Handelshaus GmbH & Co. KG, Berlin, ExxonMobil Gas Marketing Deutschland GmbH & Co. KG, Hannover, Verbundnetz Gas AG, Leipzig (VNG), Shell Erdgas Marketing GmbH & Co. KG, Hamburg and Erdgas-Verkaufs GmbH, Münster.

regional and local gas companies, those contracts are to be prohibited which run for more than four years and which cover more than 50 per cent of actual gas requirements, or which run for more than two years and cover more than 80 per cent of requirements. Tacit extension clauses are also prohibited. The decision is immediately enforceable.

27. To justify its contractual provisions E.ON/Ruhrgas stated that it was forced to bring its commitments on the sales side largely in line with those on its purchasing side. As a reason for this the company referred to the long-term import contracts on a take-or-pay basis which in turn were necessary to ensure the security of supply to German gas customers and which contributed to a lower price level while ensuring a proper risk distribution. Specifically referring to the security of supply it stated that long-term import contracts were politically desired and also typical of countries which depend on imports. In the UK, for example, which was currently undergoing a transition process from an exporting country to an importing country, importers were concluding long-term contracts for the first time.

28. In response to this the Bundeskartellamt stated that it acknowledged security of supply as a commodity worth protecting in Germany and that it was included as an important criterion in the current European Directive concerning the internal natural gas market.⁶ However, the decision did not affect the security of supply as it did not deal with the existing import contracts, but solely concentrated on the downstream trade level. The Bundeskartellamt thus did not recognise the security of supply as justification in these proceedings.

29. The Bundeskartellamt also rejected the argument that short-term contracts lead to a permanently higher price level in Germany. It may be the case that gas transmission companies grant more favourable prices for longer contract periods, and, given comparatively low price levels, some purchasers may also wish to cover their requirements on a long-term basis. However, it must be noted that the current price level is the result of foreclosed markets and that, according to economic theory and economic experience, the price level on the whole is thus unusually high. The high price level on the purchasing side is also illustrated by the example of regional and local gas companies which, after terminating their long-term contracts with established gas transmission companies, have found other, more favourable supply opportunities which above all offer short-term contract periods. Short-term contracts would for the first time allow for third party offers on a large scale, leading to an overall reduction in price levels.

30. Finally the Bundeskartellamt's view is that the long-term commitment of purchasers to the extent established in the present case cannot be justified under the aspect of risk distribution. This is doubtful first of all from a quantitative point of view as the contractual provisions objected to could only be justified from the companies' perspective to the extent to which import volumes have to be purchased on a long-term and take-or-pay basis at all. Particularly under qualitative aspects, the Bundeskartellamt's view is that it is not necessary to almost completely mirror the risks existing on the purchasing side, neither in order to maintain the gas transmission companies' distribution business nor to ensure security of supply in the markets for distributing gas. First of all it is in the nature of business that traders have to sell the goods they purchased at their own risk. Furthermore, the suppliers concerned are left with the possibility to make attractive offers to existing customers at short intervals.

31. Secondly it should be taken into account that long-term gas purchase contracts are not necessarily to be seen as mere sales risks incurred by the gas transmission companies, but can also entail advantages. Through these contracts they can secure long-term access to procurement sources abroad and achieve planning security as regards their purchase prices.

⁶ Cf. Recital 27 of Directive 2003/55/EC of the European Parliament and of the Council of 26.06.2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC, OJ 2003 L 176/57.

32. E.ON Ruhrgas filed a complaint against this decision at the Düsseldorf Higher Regional Court and requested the suspensive effect of the appeal to be restored. With its decision of 20 June 2006 the Higher Regional Court rejected this decision. A decision on the merits is still pending. The Düsseldorf Higher Regional Court confirmed above all the Bundeskartellamt's view on the effect of gas supply contracts with shorter terms on the security of supply:

“The party concerned [E.ON/Ruhrgas] unsuccessfully invokes the indispensability of long-term sales commitments when it points out that security of supply for consumers requires a long-term commitment on the demand side, i.e. the regional and local gas companies, to mirror the long-term commitment on the purchasing side. The party concerned is free to continue concluding long-term supply contracts. However, it is unlikely that the security of supply for consumers will be jeopardised by the conclusion of supply contracts with shorter terms between the party concerned and regional and local gas companies. Other competitors can take over the supply to consumers or become active as alternative suppliers. The required volumes of gas can either be purchased from the party concerned or from gas producing or exporting companies. In an effective competitive system it is sufficiently probable to assume that competitors are active in the relevant market which are able to meet the consumers' requirements.”

33. In the meantime several other gas supply companies against which proceedings had been initiated have submitted binding commitments to the Bundeskartellamt (Article 32b of the ARC) stating that their gas supply contracts meet the conditions under which the Bundeskartellamt considers contracts to be admissible under competition law (above all contract periods of not more than two years for the supply of 80 – 100 percent of gas requirements and not more than four years for the supply of 50 - 80 percent of the customers' requirements).

3.3 Further proceedings in the energy sector

34. The Bundeskartellamt conducted further proceedings in the areas of gas/oil price linkage, emissions trading and the pricing in of the value of emission allowances into electricity prices, including proceedings against several companies on account of excessive gas prices (exploitative abuse).

4. Conclusion

35. These decisions illustrate that there can be but may not necessarily be room for a conflict in Germany between the security of supply and competition law. In individual cases companies may invoke the security of supply as justification for restrictive practices. It will remain the objective of all actors involved, i.e. politicians, the Federal Network Agency, the Bundeskartellamt and also energy providers, to safeguard a balanced co-existence of security of supply and competition law.