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Agenda

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Power plays: the end of the line for long-term energy contracts in Europe?

After years of ambiguity, the European Commission's 2007 energy sector inquiry report led to a flurry of antitrust actions in relation to long-term energy contracts. Rulings against Poland (2007) and Hungary (2008) also saw the application of state aid rules in determining the legality of such contracts. Leigh Hancher, Professor of European Law at the University of Tilburg, considers the Commission's treatment of long-term energy contracts under European competition law

Two features are viewed as characterising the European electricity and gas sectors: extensive vertical integration and a penchant for long-term supply/purchase contracts. If this was not already evident to an informed observer, the evidence gathered in the course of the Commission's energy sector inquiry merely confirmed the obvious.[1] The launch of the report in 2007 was accompanied by a promise of follow-up action to deal with market foreclosure and other ills attributed to long-term contracts. A flurry of dawn raids followed, and virtually every major European energy company has been the subject of an antitrust investigation in the course of the last two years.

To supplement this concerted ex post attack, the Commission's 'third package' of legislative measures (originally launched in September 2007, and likely to be adopted in June 2009) envisages a combination of ex ante structural and behavioural approaches to remove those barriers to competition attributed to vertical integration.[2] The third package—like its two predecessors—does not directly deal with long-term contracts. Indeed, the existing as well as the planned Directives and regulations for the internal gas and electricity markets take a rather equivocal approach to long-term contracts. They merit a brief mention in the annex to the Regulation 1228/03 on cross-border electricity trade, but are deemed worthy of a more central place in the machinery erected by the 2003 Gas Directive and the subsequent Gas Regulation of 2005.

It was perhaps with a view to filling the gap, or to giving clearer guidance on the role of long-term contracts in liberalised—and by implication—more competitive gas and electricity markets that, as part of this third package, the Commission announced its intention to produce some form of guidelines on long-term energy contracts. This was not the first time the Commission had declared its intention to throw some light on this murky subject. Nor probably, will it be the last. Yet the Commission still appears reluctant to commit itself to a clear policy on long-term contracts in the energy sector—either upstream or downstream. Instead, it appears to prefer a pragmatic, case-by-case approach, with the content—and legal form—of its decisions tending to vary. In particular, the Commission has, in many cases, opted for informal settlement agreements, together with mutually agreed 'commitments', and has rarely adopted formal decisions.

Persistently asked but unanswered questions

Certain individual decisions can be—and often are—supplemented with policy guidance, albeit in the form of FAQs (frequently asked questions). A recent example is the decision on Distrigas, discussed below. Reliance on this handy technique allows the Commission to suggest, but without truly committing itself, how it might be inclined to confer precedent value on a particular decision.

Why does the Commission choose this approach in some cases as opposed to others? In the absence of any such guidance (and in the absence of any concrete guidance on when long-term energy contracts are deemed to result in anti-competitive foreclosure), what follows is an attempt to examine some of the most persistently asked but unanswered questions (PABUQs) about the legality of long-term energy contracts under European competition law, and to identify the Commission's recent policy orientations in the field of state aid.

My short list of PABUQs can be reduced to the following:

- what are long-term energy contracts?
- what are their problematic features?
- what action has the Commission taken in the past and why?
- what are the legitimate reasons, if any, to justify such contracts?
- what is the Commission likely to do in the future, and why?

What is 'long-term'?

Even before the Commission embraced a more economic and 'effects-based' approach to Article 81 (prohibiting cartels) and now Article 82 (outlawing abuse of a dominant position) of the EC Treaty, it had never condemned either a gas or electricity purchase or supply contract merely on the grounds of its duration. Additional factors had to be present, including, for example, exclusivity or network effects. At the same time, informal indications were given that certain types of contract could be viewed as problematic if their duration exceeded 15 years, but unproblematic if they were linked to power plant investment. Long-term take-or-pay gas contracts were also tolerated,[3] with periods of up to 50 years considered acceptable, particularly where contracts were concluded with third-country (ie, non-EEA) suppliers that could guarantee security of supply to the European market.

Problematic features

Regarding Article 81(1), the Commission has been less concerned with duration as such than with other related contractual terms (including exclusivity), and other problematic features such as territorial protection and restrictions on export or use of the product. These classic market-partitioning clauses obviously frustrate the goal of creating an internal market, as well as the realisation of the objectives of the various electricity and gas Directives and regulations.

In the absence of territorial protection, where one of the parties to a long-term contract is a dominant buyer or supplier within the meaning of Article 82, this may be an additional, but not necessarily conclusive, ground for concern as to the anti-competitive effects of such contracts. A classic example is the Commission's decision on Gas Natural/Endesa, concerning a long-term (12-year) gas supply contract between Spain's incumbent gas supplier and a leading Spanish electricity generator, which contained a clause requiring Endesa to source all its gas for the foreseeable future from Gas Natural.[4] The long-term element of an energy contract has not, therefore, been viewed as a problem as such.

Past action

Prior to the 'Modernisation' Regulation 1/2003, which led to a major procedural overhaul, most antitrust cases in the energy sector were disposed of by way of informal action—usually a confidential 'comfort letter' giving the parties concerned the 'comfort' that the Commission would not take further action on their contracts. The wider public had to be content with an often cryptic press notice or an equally uninformative summary in the annual competition report. It was not always evident if a particular contract had been found to fall foul of Article 81(1), but was still capable of exemption on the basis of Article 81(3). The eventual applicability of Article 82 was also not easy to discern. A few published decisions threw a little more light on the matter, with the anticipated implications of major settlements spelled out through short articles in the Commission's competition newsletters.

Between 2000 and 2004, a series of important decisions condemning particular contractual clauses emerged. These included the GFU[5] and DUC/DONG[6] cases (dealing with the upstream gas sector), followed by the Gas Natural/Endesa and Synergen[7] cases in electricity generation. These decisions seemed to confirm that contractual duration was not the problem at all: long-term supply contracts could survive antitrust scrutiny so long as any 'destination' and 'end-user restriction' clauses had been purged. Later cases involving GDF, ENI and ENEL confirmed this approach.[8] This strategy is self-explanatory. Contracts requiring gas to be supplied to particular markets or for certain end-users to the exclusion of all others self-evidently lead to market partitioning.

Recent past action

Perhaps the most comprehensive decision to date is the Distrigas settlement of October 2007, accompanied, as fortune would have it, by a five-page list of FAQs.[9] The Distrigas settlement is significant for several reasons.

First, it was intended to give clear guidance to other dominant gas and electricity supply companies in relation to their existing (and proposed) long-term contracts. Indeed, the Commission indicated that these companies would be much less likely to be subject to an antitrust investigation if they were to use the Distrigas decision as a basis when concluding their own contracts.

Second, the settlement could also be interpreted as introducing a 'bright-line approach' in relation to the application of Article 82. On the basis of its calculations of the proportion of the relevant market tied to Distrigas under contracts in force on January 1st 2005, the Commission considered this market to be significantly foreclosed in a way that could constitute an abuse of this dominant position.

The resulting commitments ensure that the maximum duration of contracts with industrial customers and electricity generators (apart from new installations) would be five years, while the maximum duration of contracts with gas sellers would be two years. Resale or use restrictions would be removed in all supply contracts. The proposed commitments specifically did not apply to agreements relating to the supply of gas for new investment in generation capacity of over 10MW. Such agreements will be subject to case-by-case and 'rule of reason' assessments—ie, that the investment might otherwise not go ahead.

What is the Commission likely to do in the future and why?

The answer to this PABUQ is likely to be shaped by a combination of the more effects-based approach to Articles 81 and 82, the findings of the sector inquiry, the implications of the continuing roll-out of the Commission's State Aid Action Plan (launched in 2005),[10] and concerns over growing external energy dependency. This last concern may cast a more persistently favourable light on the purported benefits of long-term supply contracts, as is already evident from the Second Strategic Review[11] and, perhaps, the Finnish nuclear decision of July 2008.[12]

The focus appears to be less on form and duration and more on contractual terms and substance. In its Distrigas decision, the Commission emphasised that it would not take a 'one-size-fits-all' approach—each case would be decided on its own merits, after consideration of the following factors:

- the market share of the supplier;
- the share of the customer's demand tied under the contract in question;
- the duration of the contracts;
- the overall share of the market covered by contracts containing such ties;
- efficiencies.

Crucially, the Distrigas decision did not impose any conditions regarding the duration of investment-related contracts.

The state aid rules

In the meantime, the Commission has begun to play a 'wild card', and to apply EC state aid rules to require the termination of long-term power purchase agreements (PPAs) in its recent decisions concerning Poland (September 2007) and Hungary (June 2008).[13] The potential application of Article 87(1) (which prohibits state aid) to long-term contracts was also raised briefly in the sector inquiry report. The report did not offer any further explanation of the tests to be applied, however, or any other hint as to how Article 87(1) would be applied in the contractual context.

Obviously, the application of Article 87 is not subject to the same refined economic analysis as Article 81 and Article 82. The European courts have interpreted the concept of a state aid very widely to include any measure, irrespective of its form, which has the effect of conferring a selective advantage on an undertaking.

The Commission's State Aid Action Plan introduced a more economic approach as a way of assessing the compatibility of a proposed state aid measure with the objectives of the internal market. It does not extend to the definition of aid itself. When it comes to the application of the state aid rules, the Commission is not required to define relevant markets with any degree of care, nor analyse market shares. Article 87(1) will apply to any state aid measure that confers a selective benefit which the beneficiary would not normally enjoy in the ordinary course of business, and as such, which distorts competition.

The crux of the matter is that the company in question is deemed to enjoy a selective benefit that it would not have enjoyed under normal market conditions. Given that the resources of publicly owned or controlled firms can also be deemed 'state resources' for the purposes of Article 87(1), long-term contracts for the sale or purchase of energy could also fall within the scope of the state aid rules.

The courts, however, require that the Commission demonstrate that the decision to use such 'state resources' is 'attributable' to the state—ie, that the state has some involvement in the use of these resources and has pursued public policy goals, overriding the company's otherwise commercial objectives. Where a state owner follows the same course of action as any other private market investor, however, no state aid will be involved.

As the European Court of First Instance confirmed in the recent Ryanair case, no advantage or benefit is conferred in this scenario.[14]

Prior to the publication of the sector inquiry report, the Commission had only considered the application of Article 87(1) in passing a decision to allow compensation for termination of those long-term contracts it had approved some ten years previously. The relevant decision concerned Portugal, and was adopted in autumn 2004. It indicated that PPAs could amount to state aid if all the normal risks borne by a generator were contractually conferred on the buyer. The Commission's final decision allowed the planned compensation for future termination, subject to compliance with the guidelines espoused in its 'Stranded Cost Methodology' of 2001.

In effect then, the Commission confirmed that this type of compensation could and should be paid if long-term contracts were prematurely terminated (to the detriment of investors) to make way for new wholesale market arrangements. Portugal had, as was permitted under the First Electricity Directive of 1996, opted for a single-buyer arrangement.[15] The phasing out of the latter involved the phasing out of the PPAs.

At around the same time, the Commission began to turn its attention to long-term PPAs in several new Member States. Immediately prior to their accession in May 2004, both Hungary and Poland had notified their plans to deal with the restructuring of their electricity markets, including a gradual amendment to their respective single-buyer systems and the provision of stranded costs compensation.

The Polish government notified draft legislation designed to terminate the various PPAs which its single buyer, PSE Operator S.A. (the Polish transmission system operator) had concluded in the mid-1990s. At the same time, it sought to provide compensation for the stranded investments of both domestic and foreign generators.

The Hungarian government, however, only notified a plan to compensate its single buyer, MVM Group (Hungary's major electricity wholesale trader), for the losses incurred in selling PPA-purchased electricity on to distributors at tightly regulated prices.

The Commission expressed its concern in both cases that the PPAs themselves could involve aid to the generators and, given its doubts as to the compatibility of the alleged aid measures, opened a full investigation into both countries under Article 88(2) of the EC Treaty.

A complicating procedural factor (that the national measures had been notified prior to accession) was also bypassed in order to allow the Commission to proceed to a full inquiry. The two governments withdrew their original pre-accession notifications so that the Commission could mount a new investigation after accession. In both cases the Commission classified the PPAs as 'new' aid measures, to be treated as a form of post-accession support, which was potentially subject to repayment or recovery from the alleged beneficiary as of May 1st 2004. Its decision to classify the pre-accession contracts as potential post-accession aid is still subject to separate legal proceedings (lodged by EDF Energy's subsidiary, the Hungarian generation company BERt) against the Commission in 2006.[16]

The Polish decision

The Commission's final decision of September 2007 assessed the legality of the Polish long-term contracts in some detail.

It confirmed its initial suspicions that the contracts, as such, gave rise to aid as defined by Article 87(1)—ie, they conferred an economic advantage that the generators would not have enjoyed under normal market circumstances.

It is difficult to pinpoint the exact nature or scope of these advantages in any particular contract. It is noteworthy that the terms and effects of the various contracts between PSE and the various generators are not examined separately at all. Obviously such a broad-brush approach precludes any real appraisal of market conditions or market shares.

The Commission's approach is highly unusual. It diverges not just from the earlier stranded cost cases, but also from its approach to recovery of illegal state aid in general. Market simulations or the construction of counterfactual scenarios are extremely rare in state aid cases. The purpose of state aid recovery is a restoration of the status quo ex ante—ie, to the situation before the aid in question was granted. How does one fit the aid element in a long-term contract into this approach? Normally the Commission identifies the nature of the advantage at issue—usually a tax advantage, a loan on terms well below market rates, or other form of grant or subsidy—and requires its repayment. It does not look at the impact of the aid 'on the market' or require a market simulation, as if the offending measure did not exist.

Arguably, this approach could still be necessary in more 'straightforward' cases where, for example, a major player is given a large subsidy to pursue research and development, thus crowding out potential (or actual) competitors. If the subsidy is illegal the beneficiary repays it, plus interest. Any anti-competitive distortion and resulting economic damage to other parties would be not be calculated and subsequently included in the recovery order.

That third parties such as competitors could subsequently sue in the national courts, and demand that the Member State—or, indeed, the beneficiary—compensate for the damage they have suffered, cannot be ruled out. But this is a separate matter and would be successful only if, at the very least, the substantial hurdles of establishing causation and harm can be overcome. It is hardly surprising that damages awards by national courts in state aid cases are very rare indeed.

In the Hungarian case, the Commission has not identified any specific element of the long-term contracts as 'aid'. It is the interaction between their duration, their price, and the impact of the 'capacity clause' (which, the Commission maintains, required MVM to purchase excess quantities of electricity) that

The Hungarian decision

In June 2008 the Commission confirmed that it had ordered Hungary to terminate long-term contracts between MVM— the 'single buyer'—and the various generators. MVM was given six months to do so. Hungary has subsequently adopted legislation declaring all PPAs listed by the Commission decision to be null and void.

Unlike its Polish counterpart, the Hungarian scheme did not involve any compensation. The recent national legislation, however, makes provision for future stranded cost compensation, on the assumption that the sums payable to each company are approved by the Commission, following separate notification and assessment.

The new Electricity Act of 2007, however, provides that the compensation will not exceed the amount of alleged aid already received by the generators under their respective PPAs between May 2004 and their compulsory termination.

The Commission decision does not quantify the amount of aid involved. Instead it requires the Hungarian authorities to conduct a market simulation exercise under a counterfactual scenario of no PPAs after May 2004, to assess the difference between what each generator received under its contract with MVM and what it would have received had it been required to sell its electricity on an hourly basis on a wholesale spot market.

constitute the 'aid' here. Indeed, the Commission recognises that the market price may actually have been higher than the contract price in many periods.

MVM is nevertheless assumed to have behaved differently from a normal private investor. Even though the various PPAs cover different types of electricity plant and relate to different types of products and services, the Commission assumes that, without them, MVM would have got a better deal. With no other source of electricity available to MVM at the relevant time, the Commission is compelled to conduct a market simulation to arrive at an appropriate benchmark.

The process of conducting a market simulation is, self-evidently, no easy task. The Commission draws on the modelling work carried out for the 2007 sector inquiry report to simulate prices on liquid wholesale markets in order to provide the Hungarian authorities with some guidance as to how to go about this complex task. An interesting question, and one which the European courts will inevitably be required to examine, is whether the 'transplantation' of this type of economic approach (which has been developed in the context of merger control) is appropriate for determining the 'status quo ex ante'—the legal standard applied to determining recovery of illegal aid in state aid cases.

Conclusions

The Hungarian case raises several legal issues in relation to long-term contracts in the energy sector. But, as mentioned in the introduction, the Commission has not (yet) provided the energy sector with the benefit of a list of FAQs—resulting in a decision that raises a series of entirely novel legal issues. The role of economics in resolving these issues is equally novel and raises numerous questions in its own right. Given the current policy reorientation towards climate-change-related challenges and the huge investments which will be required to meet them, the role of long-term contracts as efficient mechanisms for risk allocation is receiving renewed attention.[17]

In the absence of some form of long-term contract, or insofar as vertical (re)integration is not an option, recent research indicates that the construction of new, pure merchant plant is very much the exception in Europe and in liberalised markets generally. Insofar as such plants have been constructed under liberalised market conditions, this has been restricted to high-price markets with non-transparent ancillary services markets, such as Spain and Italy.

In both the Polish and the Hungarian cases, the Commission chose not to examine whether PPAs were necessary for project-financing of new investment or for extensive refurbishment. It took 2004—the date of the accession of Poland and Hungary—as the relevant time frame for its assessment, and conveniently dismissed the past. The Hungarian case is now subject to challenge before the Court of First Instance; in the meantime, the majority of the PPAs have been cancelled or terminated. Did this internal energy market exercise deliver lower prices for the consumer? This answer, at least, does not have to be gleaned from a Commission FAQ-sheet!

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