

A combination of gas release programmes and ownership unbundling as remedy to a problematic energy merger: E.ON / MOL

Csilla BARTOK, Sophie MOONEN, Pierre LAHBABI and Alessandro PAOLICCHI, unit B-3, and Miguel DE LA MANO, Chief Economist office, Directorate-General Competition

1. Introduction

Following an in-depth investigation, on 21 December 2005, the Commission approved under the EU Merger Regulation the acquisition of MOL WMT and MOL Storage, two subsidiaries of MOL, the incumbent oil and gas company in Hungary, by E.ON Ruhrgas ('E.ON'), a large integrated German energy supplier, subject to conditions and obligations.

The two subsidiaries of MOL part of the transaction are active in the wholesale, marketing and trading of gas (WMT), and the storage of gas (Storage). MOL would keep minority shareholdings (25%) in both companies. MOL would also have a put option for two years to sell its gas transmission subsidiary to E.ON.

MOL already had, prior to the transaction, an almost exclusive control over the access to gas resources and gas infrastructures in Hungary. MOL owned the gas transmission network, all Hungarian gas storage facilities and had a quasi-monopoly position on the gas wholesale markets. This 'gatekeeper' position would be, owing to the deal, taken over by E.ON.

The essential change brought about by the transaction was that E.ON, unlike MOL, has strong market positions in the retail supply of gas and electricity in Hungary, as it controls two out of six gas regional distribution companies (RDCs) and 3 out of six electricity RDCs. Therefore, except for the transmission and gas production businesses of MOL, the transaction would create a fully vertically integrated entity along the gas and electricity supply chains in Hungary.

The Commission's market investigation established that, owing to the new entity's nearly exclusive control over gas resources available in Hungary and its vertical integration in the gas and electricity markets, the transaction would lead to a serious risk of foreclosure of competitors on the downstream gas and electricity markets. As mentioned, contrary to MOL, E.ON is active downstream of the gas wholesale market, in the retail and distribution of gas and electricity, as well as in the generation of electricity. This would lead to a change of incen-

tives of the new entity vis-à-vis its downstream competitors. The new entity would thus have both the ability and the incentive to discriminate against its competitors in the downstream markets both in the gas and in the electricity sectors. Such behavior would undermine the ability of rivals to compete and would lead to price increases to the detriment of consumers. Such anti-competitive effects would occur even if the merged entity would not necessarily acquire a dominant position in retail gas or electricity markets in the near future.

In order to remove the competition concerns identified by the Commission, E.ON submitted a comprehensive and far-reaching package of commitments. The Commission concluded that the undertakings met the concerns expressed by third parties as regards the need to ensure sufficient liquidity on the Hungarian wholesale gas market at price and conditions allowing third parties to compete effectively with the new entity on the downstream gas and electricity markets in Hungary.

From a remedy policy viewpoint, this case is interesting because the package of remedies includes, *inter alia*, a gas release programme, whereby E.ON will sell 1 billion cubic meters ('bcm') through 8 yearly auctions. It is the first time that a gas release programme features in a remedy package in the framework of the Commission's merger control activities. Moreover, E.ON will divest half of its 10-year gas supply contract with MOL Exploration and Production (E&P), covering Hungarian domestic production, through a contract release. These two measures will release 16 bcm until 2015, up to 2 bcm per year, equivalent to 14% of Hungarian consumption. This will be the most significant gas 'release' ever implemented in Europe, both in terms of volumes and duration. As such, it gives all current and future market participants the possibility to conclude gas supply contracts on a level-playing field.

This article will first sketch out the main relevant features of the Hungarian regulatory environment in both the gas and the electricity sectors; it will subsequently describe the main theory of harm of the competitive assessment carried out by the

Commission; and it will finally focus on the remedies package, in particular on the gas release programme.

2. Hungary's regulatory framework

2.1. Gas

The Hungarian natural gas sector is characterised by a hybrid model, with the coexistence of a regulated segment of the market (or 'public utility market'), resulting from the old gas regime in Hungary, and a liberalized segment of the market (or 'open segment of the market'). Since 1 July 2004, all non-residential customers have become eligible customers free to choose their supplier under Hungarian law. Residential customers will become eligible on 1 July 2007 at the latest. In the regulated segment of the market, the public utility wholesaler (MOL WMT) is under an obligation by law to cover the full natural gas demand for public utility purposes of the RDCs, whereas the RDCs are under an obligation to source their natural gas needs for their public utility customers exclusively from the public utility wholesaler (at regulated prices). The RDCs have in turn the exclusive right and obligation to supply (at regulated prices) the customers in the regulated segment who are situated in their territory. Eligible customers have the choice between remaining supplied within a public utility contract by their historic gas supplier (their RDC or the public utility wholesaler, MOL WMT if the customer was supplied directly by MOL WMT) or terminating their public utility contract and purchasing their gas requirements from a trader or importing natural gas themselves. Switching has remained marginal (around 5%), due to the low prices in the regulated segment. It is expected that this hybrid model will disappear after July 2007, in line with the second Gas directive ⁽¹⁾.

2.2. Electricity

The Hungarian electricity sector is also characterised by a hybrid model, including a regulated segment and an open segment. On 1 July 2004, all non-residential customers became eligible customers. Residential customers will become eligible on 1 July 2007, in line with the second Electricity directive ⁽²⁾. As in the gas sector, eligible custom-

ers have the right, but not the obligation to switch suppliers, and may thus stay with their respective regional supplier in the context of a public utility contract. There are however more customers that have switched to the open segment of the market in the electricity sector than in the gas sector. In June 2005, the open segment represented 32% of total Hungarian electricity consumption.

3. The theory of harm: foreclosure of access to gas, due to the vertical integration of the new entity and changed incentives

The essential change brought about by the transaction was that E.ON, unlike MOL, is active in the gas and electricity downstream markets. The merger would thus result in the creation of a vertically integrated company, active both in gas wholesaling and retailing and in electricity generation/wholesale and retailing. Immediately after the transaction, the new entity would likely have the ability and incentive to foreclose its actual and potential competitors on the gas and electricity downstream markets, as its competitors would necessarily have to rely on the new entity to procure their wholesale gas.

3.1. The ability to foreclose: the new entity would be the 'gatekeeper' for all competitive gas resources in Hungary

Due to its previous position as legal monopolist, MOL WMT holds a dominant position in the wholesale supply of gas to RDCs and to traders in Hungary. While MOL WMT retains its former monopoly rights on the regulated segment of the market, the Commission's investigation revealed the existence of significant barriers to entry on the open segment of the Hungarian gas market. The main barrier faced by new entrants in Hungary was the difficulty of access to competitive sources of gas, and the lack of liquidity of the Hungarian gas wholesale market.

In particular, MOL WMT controlled and will keep controlling access to domestic gas resources and to competitive imports.

Hungarian domestic gas production is not negligible and amounted to approximately 3 bcm in 2004, accounting for about 20% of the total national gas consumption. Although MOL E&P was not part of the transaction, MOL E&P and MOL WMT have entered into a 10-year supply agreement for the domestic gas produced by MOL E&P. The Commission found that, pursuant to the agree-

⁽¹⁾ Directive 2003/55/EC of the European Parliament and the Council of 26 June 2003 concerning common rules for the internal market in natural gas, OJ L 176, 15.7.2003, p. 57.

⁽²⁾ Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity, OJ L 176, 15.7.2003, p. 37.

ment, no (or only marginal) volumes of domestic gas would be available for third parties as most of forecasted production would be 'booked' by WMT.

Imports account for 80% of total gas consumption in Hungary and are expected to increase, as domestic production is declining. There are two entry points from which to import gas, the Eastern entry point (Beregovo, at the Ukrainian border) and the Western entry point (HAG, at the Austrian border). The Beregovo entry point is highly congested, while some capacity is available at the Western entry point. However, the Commission found that gas imported through the Western entry point is physically Russian gas and is approximately 30% more expensive than the gas imported through the Eastern entry point.

The investigation showed that all gas imported into Hungary — and the only competitive source of gas — is either Russian gas (i.e., sourced from Gazprom) or gas from a CIS country (in particular Turkmenistan) transiting through Russia and Ukraine (i.e., via transit pipelines under the control of Gazprom). Alternative gas sources are not expected to be available in Hungary before 2012 when the Nabucco pipeline (bringing gas from the Middle East and Caspian area) may become operational.

The market investigation indicated that it was difficult for new entrants to get access to Russian gas in parallel to MOL WMT's existing contracts. It appeared that there would be no incentive on the part of the Russian supplier Gazprom to sell 'more' gas for exports to Hungary.

Gazprom's gas supplies cover most of Hungary's needs. The Commission was of the opinion that it would not be possible to purchase gas from Gazprom to compete with MOL WMT. First, Gazprom would have no incentive to supply another gas trader at cheaper prices as the quantities would simply displace the quantities it already sells for the Hungarian market. Secondly, any gas Gazprom would sell at a price higher than the one charged to MOL WMT would not be competitive in Hungary.

For these reasons, already prior to the transaction, MOL WMT was dominant on the various Hungarian gas wholesale markets (gas supply to RDCs, gas supply to traders, gas supply to power plants). This dominant position as 'gatekeeper' of access to gas resources would now accrue to E.ON through the transaction.

3.2. *The incentives to foreclose:*

E.ON presence in the gas and electricity downstream markets

3.2.1. *Gas markets*

The Commission found that the new entity would likely have the incentive to use its gatekeeper position to foreclose access to wholesale gas to its competitors (RDCs and traders) on the markets for gas supply to small industrial and commercial customers and to residential customers. Most crucially, prior to the transaction MOL (the 'original' gatekeeper) lacked any incentive to exploit its position in a similar way.

Following the merger, the new entity would have the ability and the incentive to pursue this foreclosure strategy and raise its rivals' costs in various ways. In the regulated segment of the market, where prices are regulated, the new entity could engage in non-price discrimination (such as delays in supply, reduction in quality of service, lack of flexibility, unwillingness to renegotiate, etc.). In the open segment of the market, it could directly increase the wholesale price of gas to traders and/or engage in non-price discrimination.

E.ON, through its RDCs, holds a market share of around 15-25% on the market for gas supply to small industrial and commercial customers and a similar market share for gas supply to residential customers. The Commission's analysis indicated that the new entity's incentive to raise the costs of rivals and its optimal foreclosure strategy was likely to evolve with the regulatory environment.

Immediately after the transaction, as long as both retail prices to small industrial and commercial customers, residential customers and wholesale gas prices are regulated, the new entity would have an incentive to raise the costs to rival RDCs through non-price discrimination. Simultaneously, it would be likely to increase the price of wholesale gas to independent traders to capture customers that switch to the open segment of the market.

In July 2007, when regulated prices are expected to be abandoned, all eligible customers would have to switch to the open segment of the market. It is then likely that the new entity would have an incentive to foreclose all its downstream rivals on the market for the supply of gas to end users either by increasing the cost of gas or by reducing the quality of supply, or combining these strategies.

As a result, competitors of the new entity would be likely to be marginalised, thereby allowing the new entity to gain increased market power on the downstream market for the supply of gas to small industrial and commercial customers. This input

foreclosure would also be likely to discourage new entries in this market as potential entrants would not expect to be in a position to contract gas supplies with the new entity under terms and conditions similar to those applicable to E.ON's affiliates. The Commission thus considered that the merger would significantly impede competition on the market for gas supply to small industrial and commercial customers and to residential customers.

Specifically as regards the impact on residential customers, since they will become eligible in July 2007, i.e. only 18 months after the adoption of the decision, the Commission considered that the main anticompetitive effects resulting from the merger would occur as from that date.

Finally, the Commission found that the new entity would acquire a dominant position in the supply of gas to large industrial customers through the addition of MOL WMT's and E.ON's significant customer portfolios (for E.ON, through its controlled RDCs). The new entity would therefore immediately gain access to a significant customer base (a combined market share of around 40-50%) as opposed to EMFESZ, its current only competitor (with a market share below 10%), and to potential entrants.

The Commission also found that the new entity would have control and influence over gas infrastructure (storage and transmission) and that this would lead to further impediments to competition.

MOL Storage was the only company able to offer gas storage services in Hungary. Access to storage is crucial for any gas supplier to be active on the gas wholesale and retail markets, essentially in order to manage the seasonal fluctuations in the demand of its customers. The Commission found that as a result of the merger, the new entity would have the ability and incentive to reinforce its gas input foreclosure strategy by adopting discriminatory behaviour in granting access to storage, even in a scenario of fully regulated prices for storage services.

MOL Transmission, which owns and manages the high pressure grid in Hungary, would remain under the control of MOL. However, the 25% minority shareholding that MOL would retain in MOL WMT would give MOL Transmission an incentive to reinforce the gas input foreclosure strategy to the detriment of E.ON's competitors downstream through discriminatory behaviour in granting access to the transmission network.

3.2.2. *Electricity markets*

The Commission's market investigation also identified competition concerns on various electricity

markets, resulting from the vertical integration of MOL WMT's activities in the upstream market of gas supply to large power plants with E.ON's activities in the downstream markets of electricity generation/wholesale and electricity retail.

Whereas MOL was not active in the electricity markets, E.ON has made significant investment in the electricity sector in Hungary since 1995 and was planning (already prior to the merger) to expand its presence considerably. The group is currently active at the generation level with a small size gas-fired power plant in Debrecen (95 MW), and at the wholesale and retail supply level with ownership of three out of the six electricity RDCs (holding a market share of 40-50%) and the electricity trading company E.ON EK. In addition, E.ON controls various companies involved in electricity retail supply in neighbouring countries.

As to electricity generation/wholesale, it is estimated that significant new electricity generation capacity (5,000 MW or 60% of current installed capacity) will be needed in Hungary by 2020 to replace old power plants (3,500 MW) and to satisfy the increase in demand. Accordingly, Hungarian electricity generation capacity should increase from 8,000 MW to approximately 10,500 MW.

The Commission's market investigation on existing new power plants projects in Hungary established that gas will be the predominant fuel for new power plants. The Hungarian energy regulator considered that gas-fired power plants could reach approximately 60% of new generation capacity.

Prior to the transaction, MOL WMT already had a dominant position in the market for the supply of gas to large power plants. Following the transaction, the new entity would thus have the ability to determine its competitors' power plants gas supply conditions (prices, rules for nomination, take-or-pay penalties, interruptibility, etc.) and to discriminate against rival power generators in several ways. The Commission's investigation showed that, immediately after the transaction, E.ON would be more likely than not to pursue two strategies to strengthen its position in both electricity generation/wholesale supply and electricity retail supply in Hungary.

As regards new power plants, E.ON would be likely to increase the cost of gas to potential entrants, with the aim to deter these rivals from building new gas-fired power plants and to favour its own new power plants projects. This strategy would be attractive for E.ON in view of its strong interest in expanding significantly its power generation capacity in Hungary. E.ON would also be in a position to discriminate against new gas-fired power plants that would not supply its downstream electricity

retail affiliates. This strategy would be economically rational as it would provide E.ON with a certain degree of control over the electricity generation/wholesale market and additional competitive advantage on the electricity retail market.

As regards existing power plants, the new entity would be likely to implement the same foreclosure strategies with the objective of limiting their ability to compete on the open segment of the generation/wholesale market and to eventually induce them to exit the market. Several market players expressed the concern that E.ON would then seek to acquire their assets.

In the future liberalized regulatory framework, greater power generation capacity will be available on the open segment of the market and no longer 'booked' under long term Power Purchase Agreements (PPAs). In that future framework, and owing to E.ON's future larger share in power generation, the foreclosure strategies described above would be even more effective and therefore more damaging. They would reduce the ability of rival gas-fired power plants to compete, and limit the scope for the development of the competitive electricity wholesale market.

E.ON's strategy would lead to a slower and less competitive development of new generation capacity in Hungary starting immediately after the transaction (compared to a situation where new power plants would be built by distinct market players) and ultimately to higher electricity wholesale prices. It would thus impede effective competition on the market for generation/wholesale supply of electricity to traders.

As regards electricity retail, E.ON was the leading player in the retail supply of electricity in Hungary. It was the only group with strong positions in both the regulated segment (with 3 out of 6 RDCs) and the open segment (E.ON EK is one of the three largest electricity traders in Hungary), with a market share around 40-50%.

E.ON's strategy on the electricity generation/wholesale market would significantly impede competition on all the markets for the retail supply of electricity. This impact would first result of the non competitive development in new generation capacity and higher wholesale prices. Second, the new entity's likely strategy to link the gas supply and electricity sales of gas-fired power plants would reduce the ability of rival electricity retailers to source competitive electricity and would increase the new entity's already strong market power in electricity retail. Finally, the Commission's market investigation indicated that dual offers (gas and electricity) were likely to play an important role in Hungary. According to the Commission, E.ON

would have the ability and incentive immediately after the transaction to prevent any other company active in electricity retail from developing dual offers by foreclosing access to gas resources to those competitors willing to pursue this marketing strategy. In combination, these practices would significantly impede competition on the markets for the supply of electricity to small industrial and commercial customers, as well as to residential customers.

3.2.3. *Application of the new substantive test*

It should also be noted that the gas foreclosure concerns described above would lead to higher retail prices in both gas and electricity markets even if the merged entity does not in fact acquire a dominant position in each of such markets in the relatively near future. Thus, arguably the new substantive test adopted in May 2004 is better suited to take these anti-competitive effects into account than the old test.

Following the reformulation of the substantive test, it is no longer a requirement that a dominant position be created or strengthened in order to challenge a merger, as this could lead to under-enforcement or an enforcement gap. The basic intuition behind this argument can be expressed as follows: if the merging parties sell very close substitutes, they impose on each other a significant competitive constraint. Pre-merger if a firm raises prices, customers may simply switch to its rival. However, post-merger, customers may have no other close substitutes to turn to and the merged entity could raise prices significantly, irrespective of whether it becomes the market leader.

Furthermore non-merging rivals will also react to the merger and raise their prices, resulting in a new equilibrium. In other words, when firms compete in prices, the final equilibrium effect will exceed the direct effect of eliminating the merging parties as competitive constraint to each other. A merger test — such as the dominance test — that focuses almost exclusively on the market power of the merged firm may thus not capture the full equilibrium effect. It is important to realize that these equilibrium effects do not arise from any collusion between firms, or from any trade-off of future/current profits. It is simply a change in the competitive equilibrium.

Similarly in vertical mergers, when an upstream firm merges with a downstream firm, that upstream firm has lower incentives to engage in price-cutting competition with other upstream firms in order to serve non-integrated downstream firms. As a result, the rival upstream firms can charge higher prices for their inputs, other things being

equal. This raises the costs of the non-integrated downstream sector. This increase in costs is then reflected in higher final good prices, so that the integrated downstream firm can in turn raise its prices and make higher profits. The end result is that final goods prices rise, total producer surplus becomes larger and consumers are worse off. A monopoly that integrates downstream may have the ability and incentive to raise its downstream rivals' costs. This can lead to significant price increases downstream even if the merged entity falls short of acquiring downstream dominance in the short term. This applies to several of the anti-competitive effects resulting from the E.ON/MOL merger and for which the remedies described below were necessary.

4. The remedies: a complex and innovative package

In order to remove the competition identified by the Commission on the gas and electricity markets, E.ON offered remedies aimed at increasing liquidity of gas on the Hungarian wholesale gas market at price and conditions will allow third parties to compete effectively with the new entity on the downstream gas and electricity markets in Hungary.

The remedies package is based on a combination of both structural and behavioural measures, having in essence a two-fold objective: completing the ownership unbundling (brought about only partially by the transaction) by severing the structural links due to the remaining minority shareholdings of MOL into WMT and Storage; and releasing sufficient quantity of gas for third parties to be able to source their gas needs independently of the new entity and at competitive conditions.

4.1. Unbundling

First, pursuant to the commitments, MOL will divest its remaining shareholdings of 25% in MOL Storage and MOL WMT within six months following the date of closing. In addition, MOL will not acquire direct or indirect minority stakes in MOL WMT and MOL Storage for a period of 10 years as long as E.ON is a majority shareholder of these companies.

The divestiture of MOL's 25% shareholdings in MOL Storage and MOL WMT pursuant to the commitments removed the concerns stemming from the structural links between MOL and E.ON. The ownership unbundling is now complete between MOL controlling gas production and transmission (MOL E&P and MOL Transmission) and E.ON controlling gas wholesale and storage (WMT and Storage).

Secondly, pursuant to the commitments, MOL will not exercise the put option for the 25% interest in MOL Transmission, while retaining the put option for the 75% stake, which would bring about a change in control and therefore would trigger the scrutiny of the competent competition authorities. In addition, MOL will not sell to E.ON or any of its affiliates, for a period of 10 years as long as E.ON is a majority shareholder of MOL WMT and MOL Storage, a share interest in MOL Transmission that would not result in the acquisition of sole or joint control over MOL Transmission by E.ON.

This remedy will provide the competent competition authorities with the opportunity to review the creation of any structural link between the new entity and MOL Transmission (notably if the put option is exercised) in the framework of the market conditions prevailing at such time.

4.2. Gas release and contract release

E.ON undertook to implement a gas release programme in Hungary by way of business-to-business internet auctions. The gas release programme foresees 8 annual auctions of 1 bcm of gas (between 2006 and 2013) and will have a duration of 9 years until July 2015.

In addition, E.ON undertook to assign to a third party half of the contract between MOL WMT and MOL E&P for the supply of domestic gas. Once the contract assignment becomes effective, the third party will take over all the rights and obligations of MOL WMT under the supply agreement for 50% thereof. The assignment will become effective at the beginning of the gas year 2007 (July 2007) and will be valid for the whole duration of the supply contract, until July 2015. The part of the supply contract to be assigned represents approximately 7.6-10 bcm of gas in total, with the volumes to be released in the first year amounting to 1.2 bcm.

4.3. Gas release programmes in Europe: the criteria for success

In view of the novel character (at least in merger control) of the remedies offered by the parties, and of the limited experience of the Commission with gas release programmes at large, the Commission reviewed existing similar programmes in various European countries and carried out a market test with Hungarian and international gas and electricity operators to be in a position to assess properly whether the gas release and the contract release remedies submitted by the parties were suitable to remove the competition concerns identified during the procedure.

4.3.1. General features

Gas release programme and contract release programme aim at making gas available to wholesalers and end users at the wholesale level. In this type of programme, the gas incumbent company undertakes to offer certain quantities of gas for sale to its competitors/customers.

In a gas release programme, the gas incumbent offers for sale certain quantities of gas from its overall gas sourcing portfolio. Purchasers enter into supply contracts with the gas incumbent for these quantities. In a contract release programme, the gas incumbent transfers (assigns) part of its gas supply contracts with gas producers. Purchasers enter into a supply contract directly with the gas producers (without the intermediary of the incumbent) and the transferred gas supply contract(s) of the incumbent is terminated, or the gas quantities in the transferred supply contracts are reduced accordingly. Both types of programme are designed to improve the liquidity of gas markets and enable competing traders and customers to acquire gas for their own use or for resale. The essential difference between contract and gas release is that the incumbent's supply portfolio remains the same in a volume release programme, while it is partly transferred to competitors/customers in a contract release programme. Contract releases are also 'once-off' measures, whereas gas releases are programme running over several years.

The sale of the gas or the transfer of the gas supply contract may be achieved in two ways: (i) auctions, or (ii) bilateral contracts. The gas quantities may be sold through public auctions where companies with the highest bid are selected. In case of bilateral negotiations, the incumbent negotiates with interested companies and gas sales/contract transfers are concluded based on mutual agreement. The undertakings proposed by the parties in the present case comprise both a gas release through auctions and a contract release through bilateral negotiations.

4.3.2. Specific features

Gas release programme have been and are being implemented in several European countries; experience is more limited for contract release programme. Gas release programme are either part of a broader action plan required under national law and/or designed by the national energy regulators to open the gas wholesale markets to competition (UK, Spain, Italy) or are implemented as undertakings in merger or antitrust procedures (France, Germany, Austria).

The Commission contacted the energy regulators in each of the countries where a gas release

programme has been implemented with a view to understanding whether the programme has actually fulfilled its objectives and to establishing which elements are crucial for a gas release programme to be effective.

The Commission also drew useful guidance and suggestions from the paper 'Implementation of Gas Release Programme for European Gas Market Development' published by the European Federation of Energy Traders' ⁽³⁾ (EFET) to which the parties had widely referred ('the EFET paper').

4.3.3. Volumes

The quantities of gas to be released depend on the objectives of the gas release programme and of the regulatory framework. More specifically, in a merger case, the volumes should be sufficient to remove the competition concerns and are thus linked to the number and the size of markets in which competition concerns arise. The released volumes need to be sufficient to exclude that the incumbent supplier can foresee that all or most of the released volumes will be acquired by certain customer categories. Only if the volumes released are sufficient to allow eligible customers in all affected markets to benefit from the programme (as direct purchasers or indirectly as customers of traders buying gas through the gas release programme) can a gas release programme offset the incumbent's ability and incentives to engage in anticompetitive behaviour and thus remove the negative impact on competition.

A gas release programme should in addition foresee that gas quantities that were offered for sale but did not find a buyer a given year should be added to the quantities to be released the following years.

4.3.4. Duration of the programme

A gas release programme generally aims at increasing the liquidity on gas wholesale markets and facilitating new entries. In the context of a merger case, a gas release programme may seek to reduce or eliminate the merging parties' ability and incentives to engage in behaviour that would significantly impede effective competition. To achieve these objectives, the gas release programme should remain in place for a sufficiently long time as to ensure that the market structure and the competitive conditions have the potential to change significantly, and that the level of competition achieved through the programme can be regarded as sustainable.

⁽³⁾ <http://www.efet.org>

4.3.5. *Price and costs*

The price at which gas is available through the gas release programme should enable wholesalers to compete with the supplier of gas under the gas release on the gas wholesale and retail markets. The auction mechanism is a convenient way to allocate efficiently the gas quantities to be released. As the final price results from competitive bids, it is the price that bidders are willing to pay for the gas made available under the programme, given prevailing market conditions.

The Weighted Average Cost of Gas (WACOG) is recognised in the EFET paper as one of the benchmarks for the definition of price mechanisms in auctions for gas release programme. As regards additional costs, all costs incurred by participants to the auctions and by successful bidders should be clearly defined. As a principle, the costs of the auctions should be borne by the incumbent, unless there are specific reasons not to do so.

4.3.6. *Gas supply duration and lot size*

The duration of the gas supply contract and the size of the lots in a gas release programme should be designed so as to meet the needs of the various categories of bidders in the relevant markets.

4.3.7. *Flexibility*

The daily, monthly, quarterly and yearly flexibility provisions for the gas supplied through the gas release programme are essential. Wholesalers and industrial customers should have the ability to structure the gas quantities they purchase according to their own or their customers' consumption profiles. Depending on the conditions of access to storage, the requirements for the flexibility of the gas supplied through a gas release programme differ.

The annual flexibility (swing and TOP levels) should reflect the incumbent's average annual flexibility. As quarterly flexibility needs may be provided by the storage of gas, the flexibility provided by the seller in the gas release programme depends on access to storage.

Finally as regards daily flexibility, it is clear that wholesalers, especially small ones, and end users have higher flexibility requirements than large importers (such as the seller generally). Therefore, it is clear that a base-load gas supply or even a daily flexibility similar to the seller's gas portfolio's average daily flexibility may be insufficient.

Experiences in European countries, particularly in Germany, show that the attractiveness of a gas

release programme for small wholesalers and industrial customers strongly depends on the flexibility provisions of the gas supply.

4.3.8. *Gas delivery points*

The gas should be delivered at a delivery point from which wholesalers can easily transport and store the gas. A gas hub or cross-border entry points are therefore generally appropriate delivery points. A certain degree of flexibility for the choice of the delivery point (as is often the case for the seller) increases the attractiveness of the programme.

The delivery point location is in particular relevant when gas transmission network are split among various owners, when the level of free capacity is low in the transmission or storage system and when entry-exit tariffs (and not post stamp tariffs) are applicable. Availability of gas at more than one delivery point reduces the risk that the transmission regime constrains competition in any market area and ensures that purchasers face similar physical and operational risks as the seller.

In a merger case, the delivery point of a gas release programme should be selected so as to enable wholesalers and end users to source gas from the gas release programme for resale or for their own use in the geographical market where competition concerns have been identified.

4.3.9. *Security of supply*

The gas supply conditions should include standard provisions on security of supply issues (maintenance, force majeure, off-spec, interruptibility, etc.) following the common practices in the relevant markets. The rights and obligations of the purchasers and the seller should be balanced.

4.3.10. *Auction design and guarantees*

The 'ascending clock auction' has been used in several countries as an appropriate procedure to allocate the gas quantities. The organization of the auction should also ensure that the seller does not gain information on its competitors.

The amount of the deposits and guarantees should not be disproportionate and should not constitute a disincentive for potential bidders. Payment terms should reflect standard market practices and in particular should not be less favourable than those of the seller's upstream supply contracts.

4.3.11. *Access to transmission*

Access to sufficient gas transmission capacities is necessary to ensure that wholesalers and end users purchasing gas through the gas release programme can transport gas to the place where the pro-

gramme is intended to solve competition concerns. Thus, access to transmission capacities is essential and a gas release programme is not expected to be successful if little free capacity is available in the gas transmission network. If transmission capacity is booked by the company that organizes the gas release programme, it should be released to the transmission system operator to the extent of the gas quantities released.

Responses from market operators indicated that difficulties to obtain sufficient capacity to transport the acquired gas were one of the main issues explaining the lack of success of the first auctions in the German gas release programme of E.ON/Ruhrgas.

4.3.12. Access to storage

If the flexibility conditions foreseen in the gas release programme are not sufficient to meet the flexibility needs of wholesalers and end users, access to sufficient gas storage capacities is necessary to ensure that wholesalers and end users purchasing gas through the gas release programme can structure the acquired gas according to their own or their customers' needs. Thus, access to storage capacities is essential and a gas release programme is not expected to be successful if marginal free capacity is available in the gas storage system. If storage capacity is booked by the company that organizes the gas release programme, it should be released to the storage system operator to the extent of the gas quantities released.

4.3.13. Access to customers

A gas release programme has little chance to be successful if the majority of customers are bound to their gas suppliers under long-term supply contracts. In these conditions, a gas release programme is not expected to introduce much competition on the gas markets as customers are not able to switch suppliers. Therefore, it is essential that customers purchasing gas in the gas release programme or indirectly from a trader purchasing gas in the gas release programme have the opportunity to terminate their existing gas supply contracts or to reduce their obligation to purchase gas. In case of reduction, it is also important that the incumbent be not allowed to worsen supply terms for the remaining quantities.

4.3.14. Monitoring and review provision

Experience has shown that it was important for an effective gas release programme to be able to review the conditions of implementation to address the difficulties encountered with the practical implementation of the programme. Given the

high complexity and the specificities of the various market conditions, it is essential to provide for a close monitoring by the competent national authorities and for sufficient flexibility to modify the auction and gas supply rules so as to take duly into account the needs of third parties.

While gas release programme imposed by energy regulators may be easily reviewed and improved on an on-going basis, this is more difficult for gas release programme constituting undertakings in merger cases. Therefore the degree of freedom of the parties to set the terms and conditions of the programme should be restricted to ensure the effectiveness of the remedy and most practical/technical rules for the implementation of the programme should not be part of the undertakings attached to a decision, but rather defined at a later stage under the supervision of the relevant regulatory and competition authorities.

4.4. The final assessment of the gas release and the contract release

On the basis of the specific market investigation, whose results were sketched out above, and of its knowledge and assessment of the Hungarian gas and electricity markets, the Commission reached the conclusion that the gas release programme and the contract release as offered by the parties, incorporating the amendments and improvements proposed by third party respondents to the market test, were sufficient to remove all the competition concerns resulting from the transaction. In particular, the combination of the gas release programme and the contract release would ensure that all market participants (whether gas customers or traders) would have the ability to source their gas needs under competitive and non-discriminatory conditions and, for at least a significant part, independently from the merged entity.

In particular, the Commission considered that the volumes offered in the gas release programme (in conjunction with the volumes made available by the contract release for MOL E&P's production) are suitable to create sufficient liquidity of gas on the gas and electricity markets so as to ensure that effective competition can develop and remain sustainable.

At least until 2013/2014, substantial quantities of gas (around 2 bcm) will be released and the programme will last until 2014/2015. The quantities released by the parties account for up to 14% of the total Hungarian demand and represent 21% of total third parties' gas sales. This means that third parties will have the ability to purchase a significant share of their gas from the gas release and/or the contract release.

The commitments do not foresee any restriction on the quality of participants to the gas release programme and the gas released may thus be purchased by commercial and industrial customers and power generators to meet their own needs or by gas traders. It was therefore not possible to estimate which quantities of gas released will be used in each of the relevant market where the Commission identified competition concerns.

However, the total quantities of gas released over the gas years 2007/2008 to 2013/2014 represent approximately 60% of the size of the market for the supply of gas to power plants and 55% of the size of the market for the supply of gas to large industrial customers. The Commission therefore estimated that the released gas quantities will significantly increase liquidity and hence limit the ability of the new entity to engage in anticompetitive behaviour.

The total quantities of gas to be released through both remedies are significant in terms of international benchmark. In this regard, the volumes of gas are significantly higher (in percentage value) than in the similar programme implemented in other European countries. For example, the gas release programme organized by Econgaz in Austria amounts to 2.9% of the total Austrian gas market, the programme by E.ON Ruhrgas in Germany corresponds to 2.5% and ENI's programme in Italy represents 3.1% of total demand.

4.4.1. Gas release programme

The Commission concluded that the gas release programme offered by the parties is designed, as regards its main features (volumes, duration, price mechanism) and in its more technical features (size of lots, duration of contracts, flexibility rules) largely in line with the criteria 'for success' described above. The detailed rules for the effective implementation of the auction and the gas supply contracts will be elaborated by the parties under the scrutiny of the Hungarian Energy Office (HEO), and submitted to the Commission for its approval.

The duration of the gas release programme will ensure that sufficient liquidity will be available for a sufficiently long time so as to ensure that the market structure and competitive conditions have changed. First, as mentioned, the Nabucco pipeline (carrying gas from the Middle East and the Caspian area) is expected to become operational around 2012 and will then provide alternative gas resources. Secondly, it has to be highlighted that all of the new entity's current supply agreements, including those with Gazprom, will have terminated by 2015. The new entity's gas supply

contracts with Gazprom and the privileged access to gas resources (which confer to new entity the ability to foreclose access to gas to its downstream competitors and to significantly impede effective competition on the gas supply markets) will be open for competition at this date.

Furthermore, the price mechanism foreseen for the programme will ensure that successful bidders will obtain gas at the same competitive conditions as the parties, and possibly cheaper, owing to the fact that the starting bidding price foresees a 5% discount off the WACOG. The Commission considered that this pricing mechanism is attractive for third parties and will provide good incentives to participate actively in the programme's auctions.

As regards the implementation of the gas release programme, it is important to ensure that all participants are admitted at transparent and non-discriminatory terms and that the sale is made at competitive conditions.

To this end, the size of the lots was adjusted to meet the specificities of the Hungarian markets: three lots sizes are offered to better meet the needs of the various categories of market players. The period between the auction and the delivery period is considered as sufficient for successful bidders to find new customers if they intend to resell the gas they have acquired.

Access to customers is also granted under the remedies as the parties will amend the existing contracts of their existing customers intending to purchase gas from the gas release programme, either directly or through a wholesaler.

4.4.2. Contract release

The Commission also considered that the assignee of the contract release will constitute a sizeable and sustainable competitive force in the Hungarian gas markets. The assignee will purchase significant quantities of gas from MOL E&P starting in July 2007 (expected date of the further liberalization of the Hungarian gas markets) until 2013/2014, independently from the new entity. It will also have to ability to combine the contract release with the purchase of gas quantities through the gas release programme until 2013/2014. The assignee of the contract release will therefore have sufficient long term gas resources to develop its position on the Hungarian gas markets and introduce liquidity on these markets.

The fact that the terms and conditions of the contract will be similar for the new entity and the assignee ensures that the latter will have the ability to compete with the new entity. In particular, MOL

will grant equal treatment to WMT and the third party in exercising its put options concerning production quantities.

Access to customers is also granted under the proposed remedies as the parties undertake to entitle to amend the existing contracts of their existing customers from the Third Party assignee of the contract release.

The Commission believes that the Hungarian regulatory framework (in particular 'capacity-follows-the-customer' principle) should ensure, for that sufficient transmission and distribution capacities are made available to the successful bidders of the gas release programme and to the assignee of the contract release to transport the acquired gas within Hungary.

Additionally, the commitments of the parties to grant access to storage for the successful bidders of the gas release programme and the assignee of the contract release at regulated prices are sufficient to grant an effective and non-discriminatory access to the storage capacities for the relevant gas quantities. The Commission believes that this commitment will enable traders and customers to structure the acquired gas according to their own or their customers' needs.

Finally, the effective monitoring by the HEO, with the assistance of the Commission's Trustee, will help the Commission ensure that the parties will fully comply with their commitments for their entire duration.

5. Conclusion

The Commission finally reached the conclusion that the commitments submitted by E.ON were sufficient to address the competition concerns raised by the concentration and therefore declared the transaction compatible with the common market and the functioning of the EEA Agreement pursuant to Article 8 (2) of the Merger Regulation.

With this case the Commission has, for the first time in merger control, accepted gas release and contract release as measures aimed at remedying competition concerns in the energy sector.

The experience and knowledge acquired with this case will undoubtedly prove useful in future merger cases and beyond. The preliminary results of the ongoing energy sector inquiry have provided indications that these markets are still not working as they should. While the Commission supports European integration and restructuring of the energy sector, it must ensure that any competition concerns are remedied, and that consumers are protected. The remedies of this case are also consistent with the preliminary findings of the ongoing energy sector inquiry which emphasize the need for structural solutions such as ownership unbundling and for sufficient liquidity to secure pro-competitive conditions for energy markets' development.