



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 27.01.1999

PUBLIC VERSION

MERGER PROCEDURE
ARTICLE 21(3) DECISION

Dear Sir,

Subject: Council Regulation (EC) N° 4064/89 : Request dated 8 January from the United Kingdom for the recognition of a legitimate interest under article 21(3) Case N° IV/M.1346 – EdF/London Electricity

1. On 4 December 1998, Electricité de France (EdF) notified to the Commission under Regulation (EEC) 4064/89 ('the Regulation') a proposed concentration regarding the acquisition by EdF of London Electricity (LE). The notified operation is considered to constitute a concentration with a Community dimension under the Regulation.
2. On 8 January 1999, the United Kingdom (UK) authorities submitted a request for the recognition of certain 'legitimate interests' under Article 21(3) of the Regulation .

Article 21

3. Article 21(1) of the Regulation provides that (subject to review by the Court of Justice) the Commission shall have sole jurisdiction to take the decisions provided for in the Regulation. Article 21(2) reinforces this by prohibiting, subject to certain exceptions, Member States from applying their national legislation on competition to any concentration that has a Community dimension. Article 21(3) provides that, notwithstanding the general prohibition, Member States may take appropriate measures to protect 'legitimate interests' other than those taken into consideration by the Regulation, provided they are compatible with the general principles and provisions of Community law. Interests relating to public security, plurality of the media, and prudential rules are expressly to be regarded as 'legitimate' interests. Any other public interest must be communicated to the Commission by the Member State concerned, and recognised after an assessment of the interest's compatibility with Community law, before the measures referred to may be taken.

The Request

4. The public interests for which recognition is sought are described in the request as:
 - i) the UK's public interest in the ability of the UK authorities to maintain the integrity of the regulatory system for the electricity sector by enabling the Secretary of State for Trade and Industry ('SoS') and the Director General of Electricity Supply ('DGES') to undertake the duties conferred on them by Section 3 of the Electricity Act [DATE???];
 - ii) the UK's public interest in the ability of the UK authorities to make modifications to the statutory licence of a Public Electricity Supply company ('PES') where a PES is a party to a concentration with a Community dimension.

The Proposed Measures

5. The modifications proposed to the PES's licence by the DGES would :
 - i) prevent internal trading between the generation activities and supply business of the undertakings involved;
 - ii) prevent the construction or acquisition of generation plant embedded in the PES's system without prior permission from the DGES;
 - iii) secure a ring fence around the business of the PES and secure the placing of generation outside this ring fence.

EdF and LE have indicated that they are prepared to accept these modifications.

Background

6. The activities of the electricity industry can be divided into four different types of operation, *generation*, the production of electricity in power stations; *transmission*, its transport over high tension cables; *distribution*, the transport of the electricity over the low tension local cables, and *supply*, the delivery of the electricity to the final consumer.
7. In privatising the electricity industry in England and Wales, the United Kingdom authorities entrusted transmission to a single company - the National Grid Company - and separated the generation of electricity from its distribution and supply. Electricity is distributed and supplied with only minor exceptions by Regional Electricity Companies (RECs). There was a separation between the large generators who were not allowed to engage in the supply of electricity and the regional electricity companies (RECs) who hold the PES licences. Each REC was limited to the generating capacity it was allowed to operate or have an interest in.
8. To secure, inter alia, the supply of electricity and to protect the interests of consumers of electricity, the privatisation legislation subjected the electricity sector to the regulation of the SoS and the DGES. No company may engage in the generation, transmission or supply of electricity without regulatory approval and a licence. Generators sell the electricity they produce into a Pool, a system put in place by the authorities and monitored by the DGES to provide continuity of supply and a price-setting mechanism. RECs then buy their requirements from the Pool. Generators and

suppliers (and indeed others) are however allowed to ‘hedge’, by way of ‘contracts for differences’, the very volatile prices that may arise from the Pool mechanism.

9. In recent years a number of vertical integrations between generators and RECs have taken place, none of them giving rise to a concentration with a Community dimension under the Regulation. In each case the DGES sought and obtained modifications to the PES licences. The DGES wishes to modify LE’s PES licence in the same manner.

Assessment

10. Both Articles 21(2) and 21(3) apply to the regulation of mergers : Article 21(2) ensures that concentrations within the Commission’s competence are not made subject to a second control under national competition law; and Article 21(3) allows Member States either to prohibit a concentration or to make it subject to additional conditions and requirements on legitimate grounds other than those covered by the Regulation.
11. The Regulation does not, however, preclude the application by a Member State of regulatory provisions under its national law governing the industry in question, in so far as such application is aimed not at the concentration itself but at the conduct of undertakings on the market.
12. In the Commission’s view, the three modifications to LE’s PES licence referred to in the request fall within the scope of such regulatory provisions :

i) prevent internal trading between the generation activities and supply business of the undertakings involved;

When the regulatory framework was established there was a clear separation between the generators who had to sell their electricity into the Pool and the PESs who had to purchase nearly all their electricity from it. The contracts for differences allowed both generators and PESs to hedge against fluctuations in the Pool price. These contracts were between independent parties. If that were not the case, it would be very difficult for the DGES to identify for monitoring purposes the actual costs and profits of a PES, and so exercise his duties properly. The proposed modification ensures that contracts for differences continue to be made between independent operators. It accordingly ensures that the DGES will continue to be able to adequately monitor the operation of the Pool after the concentration.

It can therefore be considered that this modification simply continues the ongoing regulation of the PES’s conduct by the DGES.

ii) prevent the construction or acquisition of generation plant embedded in the PES’s system without prior permission from the DGES

The regulation of the electricity industry is premised on a large degree of separation between generators and PESs. This separation may be compromised by the construction or acquisition of additional generation capacity by the PES. A PES might therefore enter into contracts with its in-house generator to build such plants. In the same manner as regards internal trading, vertically integrated companies have an incentive to have in-house generators and suppliers enter into contracts at conditions which do not correspond to market realities. In such cases, it would, other things equal, be very difficult for the regulator to trace the actual costs and profits of a PES.

Similarly as with the first proposed modification, this proposed modification ensures that the DGES will continue to be able to trace the actual costs and profits of the PES. Accordingly its application is, like the first one, not a further condition or requirement for the concentration, but a regulatory provision adapting the PES's licence to the post-concentration situation.

iii) secure a ring fence around the business of the PES and secure the placing of generation outside this ring fence.

The activities of a PES are already 'ring fenced' to ensure that the DGES can identify the costs, revenues, resources and responsibilities of the PES (as opposed to those of its parents, subsidiaries etc), that adequate financial and management resources are available to the PES to comply with the obligations defined in its licence, and that the regulating authorities can obtain from the PES all the information needed to undertake their duties. As the supply of electricity in England and Wales was largely separate from its generation, and PESs had only small generating activities, those activities could remain inside the ring fence. Once there is an integration between a generator and a PES, however, the scale of the potential involvement in generation, previously limited by the licence, is increased significantly; hence the need to place generation outside the PES's ring fence.

This proposed modification therefore ensures, like the other two, the effective continuation of the PES's existing obligations after the concentration.

13. It follows that all the above modifications are of an ongoing regulatory character. Moreover, the DGES has powers to modify licences at any time. Accordingly, similar licence modifications could be (or could have been) imposed, as a precautionary measure, on other PESs before they became involved in a vertical integration.

Conclusion

14. The modifications of LE's PES licence proposed by the UK authorities in their request concern the application of regulatory provisions governing the electricity industry. In securing them the DGES would be regulating the conduct of the merged entity as part of his ongoing regulatory duties, and accordingly he would not be precluded from doing so by Article 21(2) of the Regulation. The measures proposed by the UK authorities are therefore not considered to be measures applied to a concentration in order to protect a 'legitimate interest' under Article 21(3). There is therefore no need for the Commission to make a derogation as requested.
15. This decision is made pursuant to Article 21(3) of Regulation (EEC) 4064/89.

For the Commission