

*Case No IV/M.931 -
NESTE / IVO*

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**REGULATION (EEC) No 4064/89
MERGER PROCEDURE**

Article 6(1)(b) NON-OPPOSITION
Date: 002/06/1998

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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 02.06.1998

PUBLIC VERSION

MERGER PROCEDURE
ARTICLE 6(1)(b) DECISION

To the notifying parties

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Dear Sirs,

Subject: Case No IV/931 - Neste/IVO

Notification of 14.4.1998 pursuant to Article 4 of Council Regulation N 4064/89

1. On 14.4.1998, the Commission received a notification of a proposed concentration pursuant to Article 4 of Council Regulation (EEC) No 4064/89 by which the state-owned holding company IVO-Neste Yhtymä Oy ("IVO-Neste") would acquire sole control in Imatran Voima Oy ("IVO") by purchase of shares.

I. THE PARTIES AND THE OPERATION

2. Neste is active in oil, energy (natural gas, liquefied petroleum and heat supply) and chemical business. The major shareholder in Neste is the Finnish state which owns 83.17% of the shares. The remaining shares are widely dispersed among minor shareholders.
3. IVO is the largest Finnish company in the energy sector. IVO's business activities consist of power and heat generation, power trading and electricity distribution and supply, operation and maintenance of power plants, energy measurement and grid services. The state owns the majority of the shares also in IVO (95.6%).
4. IVO-Neste is a holding company specially established to implement the merger between the two state-owned companies. The Finnish state owns 100% of the shares of IVO-Neste.
5. The proposed operation consists of two parts: First, the holdings of the Finnish state and those of the minority shareholders in Neste will be transferred to IVO-Neste. The shares held by the Finnish state will be exchanged in new shares in

IVO-Neste and the minorities will be offered either new shares in IVO-Neste or cash payments in exchange for their shares in Neste. The share exchange offer was launched 28 of April. The second and notified part of the operation consists of an identical operation vis-à-vis IVO.

6. Subsequently, the Finnish state intends to sell shares in IVO-Neste to the public and to institutional investors in Finland and outside Finland in an offering. The state will retain a majority holding of no less than 50.1% of the shares in IVO-Neste.

II. THE CONCENTRATION

7. The Merger Regulation is, in principle, applicable to concentrations between public companies. The decisive criteria is whether each of the state-owned companies constitutes an economic unit with an independent power of decision (see recital 12 of the Merger Regulation). The companies can be considered to be independent undertakings in the meaning of Article 3 of the Merger Regulation if they are given the power to implement independently their respective commercial conduct on the market and their commercial policy.
8. On the basis of the investigation carried out by the Commission, it can be concluded that both Neste and IVO act independently on the market. Both companies' operative matters are run independently by the respective operative managements. The state exercises its ownership control only in questions relating to the shareholding of the state, such as sales of shares, listings etc. There are no indications that the commercial conduct of Neste and IVO has been coordinated in the past. Subsequently, the Merger Regulation is applicable to the present operation.
9. The first phase of the operation, where IVO-Neste acquires the state's shares in Neste is considered internal reorganisation within the state. Only the second step, which consists of the holding company acquiring the shares in IVO, constitutes a concentration in the meaning of Article 3 of the Merger Regulation.
10. The proposed transaction will result in IVO-Neste, which at that stage will have sole control over Neste, acquiring the majority of the shares in IVO and thus sole control within the meaning of article 3(1)(b) of the Merger Regulation.

III. COMMUNITY DIMENSION

11. Created specially for the notified operation, IVO-Neste has no activities outside its ownership of Neste that would generate turnover prior to the implementation of the concentration. Neste and IVO have a combined aggregate world-wide turnover in excess of ECU 5,000 million (Neste ECU 9,018 million, IVO ECU 2,342 million). Both of them have Community-wide turnover in excess of ECU 250 million (Neste ECU 6,357 million, IVO ECU 2,091 million), but they do not achieve more than two-thirds of their aggregate Community-wide turnover

within one and the same Member State. The notified operation therefore has a community dimension in the meaning of Article 1(2) of the Merger Regulation.

IV. COMPATIBILITY WITH THE COMMON MARKET

A. Relevant product markets

Space heating

12. According to the official statistics 4% of all detached houses are connected to the district heating network. The remaining 96% are detached houses outside the district heating network. 37% of these houses use electricity and 27% light fuel oil for the space heating purposes. The remaining 36% is attributed to wood, heavy fuel oil, peat and natural gas. About 1% of the detached houses in Finland have a boiler for dual use of electricity and oil. Natural gas is used for space heating purposes only to a negligible amount (1%), which is due to the limited distribution networks to the end users.
13. In 1996, IVO accounted for about half of the electricity supply directed for space heating. At the same time [.....¹] % of the total amount of heating oil consumed by detached houses for heating purposes originated from Neste. At the retail level, Neste's share of the heating oil market was about 41%.
14. The parties argue that there is no relevant market for space heating. The parties base their argument on the assertion that any substitutability between electricity and other heating methods remains limited due to technical requirements specific for each heating method and relating high investment costs that switching from one method to another would require. According to the parties, the choice of the heating method in Finland has a direct influence on the structure of the thermal heat insulation, ventilation and the heating system. Once the choice of the heating method is made, a change into another method takes place normally only in connection with renovation.
15. The investigation has confirmed that there is very limited substitutability for the purposes of space heating between electricity and light fuel oil and that any substitution can take place only over a long period of time.
16. Based on the above, it can be concluded that in Finland there is not one relevant market for fuels used in space heating in general, but separate markets for each type of fuel used for space heating. As there is only a very limited substitutability between electricity and light fuel oil in space heating, there is no horizontal overlap between Neste and IVO in the space heating sector. Moreover, the investigation has not revealed any negative comments concerning the space heating sector. The vertical relationships resulting from the operation will be dealt with below.

Electricity and natural gas

17. IVO is active in the market for generation, wholesale and distribution of electricity. Neste has no direct activities in the production of electricity but, through its subsidiary Gasum Oy ("Gasum"), is the only importer, supplier and seller of

¹ Confidential information, >70%

natural gas, which is used as a primary fuel for electricity generation. Following this, IVO and Neste would have vertical relations in the field of electricity generation.

18. According to the parties, the relevant product markets are, on one hand, natural gas and, on the other hand, electricity. The parties argue that natural gas constitutes one relevant product market since there are no substitutable products. This is confirmed by the investigation carried out by the Commission which strongly suggests that power plants fuelled with natural gas have no possibilities to directly substitute natural gas for another fuel. Light fuel oil and air-propane can be used as a back-up fuel in cogeneration plants in the event of supply disruption. However, due to *inter alia*, substantial price differences none of these products can economically be used as a substitute for natural gas.
19. The Commission has accepted the division of gas and electricity in its decision *IV/M.493 - Tractabel/Distrigaz II* and, later on, in *IV/M.568 - EF/Edison-ISE*. The Commission concluded that, from a demand-side point of view, electricity is characterised by the universality of its usages. It is possible to distinguish between the exclusive usages (such as lighting and the utilisation of electricity to obtain chemical reactions) and the usages for which there exists, from a technical point of view, a potential substitutability with other sources of energy (such as traction and the production of heat). The technical substitutability relates only to the non-exclusive usages (in particular the production of heat) and it remains very imperfect as electricity is produced from another source of energy, and is therefore more expensive. It is thus utilised only when the characteristics of heat and the technical process require it. Lastly, this substitutability could take place only over a long period of time because it involves different choices of equipment, according to the source of energy chosen.
20. From the supply-side point of view, every source of energy presents some different requirements as far as production, storage and transport are concerned. This distinguishes both electricity and natural gas from one another as well as from other sources of energy as they require specific and significant investments.
21. On the basis of the above, it can be concluded that there are separate relevant markets for natural gas and electricity. In addition, on the electricity market it is necessary to make a distinction between electricity which is produced for the open market and electricity that is produced mainly by industry and municipalities for their own consumption. Since the latter, captive production, has no impact on the conditions of competition on the open market, it must be excluded from the relevant market for wholesale sales of electricity.

B. Relevant geographic markets

Natural gas

22. According to the parties the geographic market depends on the location of the pipelines, since natural gas can only be transported through such pipelines. The parties submit Finland or the part of Finland where the gas pipe lines extend to as the relevant geographic market for natural gas.

23. All natural gas consumed in Finland is transported from Russia and, to date, Finland is not connected to any other sources of natural gas. There are no exports of natural gas from Finland. Therefore, it can be concluded that the relevant geographic market is Finland and, more precisely, the relevant part of Finland where the gas pipe lines extend to.

Electricity

24. The parties submit Finland as the relevant geographic market for electricity, but maintain that there is significant cross-border trade of electricity between Finland, Sweden and Norway. The parties base this view *inter alia* on the argument that trans-border tariffs will be abolished between Finland and the Scandinavian countries in the course of the current year and that, as the major players are active in the Nord Pool electricity exchange (an organised market place for professional electricity trading), the Nord Pool increasingly influences the price level in the Nordic countries.
25. The investigation carried out by the Commission indicates, however, that the Finnish electricity market remains essentially national in scope. In 1996 Finland imported 2% of its total consumption of electricity from Sweden and no imports were made either from Norway or Denmark. Total imports were 8.5% of which 6% was imported by IVO from Russia. Imports have somewhat increased and in 1997, according to estimates, the net imports covered about 10% of the total electricity supply. At the same time IVO's imports from Russia accounted for [.....²] % of IVO's total power supply.
26. Despite the slight increase in imports, the markets remain essentially national. The investigation shows that imports between the Nordic countries are subject to significant seasonal variations due to the level of water reserves in the Norwegian and Swedish hydro-power plants. The available data also indicate the existence of relatively significant price differences between Finland and the other Nordic countries. In addition, a cross-border fee is charged by the grid companies for the transmission. Other barriers to cross-border trade revealed during the investigation are differences in electricity taxation, environmental policies and the Finnish requirement that electricity producers maintain certain levels of back-up capacity. Furthermore, import and export between the Nordic countries is limited due to the maximum capacity of the border network and there are bottlenecks in the transmission of electricity between the Nordic countries. There are also differences in the frequencies used for import/export e.g. between Finland and Russia which limits the cross-border trade. Finally, the current trend where IVO is acquiring generation capacity in Sweden, and its Swedish counterpart, Vattenfall, is doing the same in Finland, could be seen as indications that a physical presence on the national market is required in order to achieve significant sales.
27. At the same time the market is not narrower than Finland. Wholesale of electricity is mainly done on a national basis. Even if a producer's generation capacity is limited to one part of Finland, he can sell throughout the country, since a system of balancing is used to deal with potential bottle-necks in the transmission network. This effectively means that the wholesale prices for electricity are homogeneous

² Confidential information, between 10-20%.

throughout the country. In view of the above, it should be concluded that the relevant geographic market is Finland.

V. ASSESSMENT

a) Natural gas

28. The Finnish government granted Neste the right to import and distribute natural gas from the former Soviet Union to Finland in 1971. In 1992 the Finnish Competition Authority ruled that as a sole importer and distributor of natural gas Neste had a dominant position in the Finnish natural gas market.
29. In 1994 Neste established a natural gas company, Gasum, which is jointly owned by Neste and Russian RAO Gazprom (“Gazprom”). Gasum has currently a *de facto* monopoly on the market for natural gas in Finland. It is the sole importer and seller of natural gas in Finland and owns the Finnish natural gas transmission system.
30. Because there is only one external supplier and the Finnish natural gas pipeline network is not linked to that of any other Member State, Finland has been exempted from the main provisions of the Directive concerning the liberalisation of natural gas³. Neste and Gazprom are currently examining possibilities to construct a northern natural gas route by extending the pipeline via Finland to continental Europe. However, the possible implementation of the project would take several years and the liberalisation of the Finnish natural gas market may be accordingly postponed.
31. On the basis of the above it can be concluded that Gasum, and therefore Neste, has a dominant position in the Finnish natural gas market. Furthermore, given the strategic importance of natural gas and the government’s active gas-favoured energy policy (see below), there is reason to believe that the importance of this position would increase over time. Lastly, the liberalisation of the gas market may be postponed as long as Finland is not connected to any other external transmission network. Following the concentration, this would mean that IVO-Neste, via Gasum, would retain its monopolistic position in the Finnish natural gas market also in the foreseeable future.

b) Electricity

The position of the parties

32. Neste does not have any significant activities on the markets for production or distribution of electricity. Instead, competition concerns arise from Neste’s position in the upstream market for fuels used in power production and, specifically, from its ownership of Gasum.

³ Common Position (EC) No 17/98 adopted by the Council on 12 February 1998 with a view to the adopting Directive 98/.../EC of the European Parliament and of the Council concerning common rules for the internal market in natural gas, OJ No. C 91, 26/03/1998 p. 46.

33. About 10% of all electricity production in Finland uses natural gas. About 70% of all natural gas consumed in Finland is used as fuel in combined heat and power production (“CHP-production”). A small part of the natural gas is distributed to households (gas cookers, gas-fired central heating) and other smaller end-users (e.g. green houses).
34. Despite the current relatively small share of natural gas in electricity generation, the investigation indicates clearly that natural gas is strategically very important for electricity production in Finland and that its importance will continue to increase over the next years.
35. The reason for the favoured position of natural gas is that, compared to other fuels, natural gas offers high efficiency, better and more flexible output control, lower investment cost and environmental advantages. Natural gas is a clean fuel since it contains no sulphur or heavy metals. Like other fossil fuels, natural gas produces carbon dioxide when burnt. The level of carbon dioxide emissions, however, is considerably lower than that of other fossil fuels.
36. There are also important political considerations to be taken into account. The Finnish government implements an active energy policy which aims at guaranteeing the availability of energy by diversifying the country’s primary energy portfolio and, consequently, increasing the use of natural gas. The favoured position of natural gas can therefore also be seen in the context of the government’s active energy policy. Finland has committed to cut down carbon dioxide emissions and to accelerate the use of natural gas the government has introduced some concrete measures, such as a significant tax relief for natural gas compared to other fossil fuels.
37. Furthermore, witnessing the fact that CHP-plants using natural gas are preferred in the energy production, out of the nine new power production plants built in Finland in 1997 six use natural gas. Three more plants using natural gas are at a planning stage. Third parties have also indicated that the tax treatment of coal is uncertain and in this respect natural gas is a more secure long-term investment.
38. Based on market studies and the investigation carried out by the Commission, it has been established that IVO has a market share of about 40% at the level of electricity production in Finland. The other main electricity producer, Pohjolan Voima (“PVO”), which is owned by a number of large industrial companies, controls about 23% of the production. About 19% of the production is attributed to industry and the remaining 20% to other producers, which include mainly municipal power companies.
39. The investigation suggests, however, that IVO’s share of the “freë” wholesale market is considerably higher than 40%. Based on the wholesale to distributors and industry, IVO’s market share of electricity is close to [.....⁴]%. This difference can be explained by captive production: industry generates electricity almost exclusively for its own use, the municipal companies generate electricity for local distribution and PVO distributes its electricity mainly to its owners, selling only about 20% of the production to others. Comments from third parties have also

⁴ Confidential information, between 60-70%.

confirmed that this captive production is not traded on the market and that IVO, with its [.....⁴] % share of the open market, has a considerable degree of market power on the wholesale level. The Finnish Competition Authority has previously held that there is a separate relevant market for wholesale sales of electricity, which does not include captive production.

40. In addition to its large market share, IVO's position is further strengthened by the company's unmatched versatility as regards its generation capacity (hydro, nuclear, coal, gas, peat, biofuels and oil) which allows it to use the most inexpensive raw materials flexibly in any given time.

Other market characteristics

41. During the past few years the Finnish electricity market has been largely deregulated and the last obstacles to free competition are estimated to be removed within the next few years. The liberalisation of the market started in 1995, when a change in legislation obliged network operators to provide open access to their networks for all sellers and buyers of electricity on non-discriminatory basis. In 1997 the control of the national grid together with the trans-border connections, which were previously owned by IVO and PVO, were taken over by a new company, Finnish Power Grid Ltd ("Fingrid"). The regional grids are owned mainly by local network operators.
42. IVO holds 25% of the shares in Fingrid. PVO has equally a 25% stake in the company, the State has 12% of the shares and the remaining 38% has been attributed to institutional owners (insurance companies). Third parties have indicated that IVO, with its extensive experience in the electricity market, has an important influence over Fingrid. IVO has also been gradually integrating vertically into distribution by buying electricity distribution companies and concluding cooperation agreements with distribution companies. IVO holds currently an estimated 15% of the electricity distribution market in Finland.
43. Supply of electricity has also been liberalised and, since the beginning of 1997, all customers have been free to choose their electricity supplier. An amendment in legislation, which is expected to take effect in the course of 1998, will abolish the requirement of a costly metering device that has so far posed a practical barrier for private consumers to switching from one electricity supplier to another. Consequently, any consumer will be able to choose his power supplier without significant cost.
44. Comments from third parties indicate, however, that the described liberalisation measures have not had the effect of significantly reducing IVO's strong position in the Finnish market for wholesale sales of electricity. According to third parties IVO's position in the electricity market has remained very strong, partly due to the lack of sufficient alternative sources of supply on the open market, partly due to its versatile generation capacity, which enables it to respond to e.g. changes in energy taxation more effectively than its competitors.
45. Nord Pool, a common power exchange between Sweden, Norway and Finland, started its operation in Finland in the beginning of 1997 through EL-EX, the Finnish electricity exchange established in 1996. The aim of the exchanges is to create a pan-Nordic electricity market. However, as discussed above, transborder

markets have not yet been developed so as to challenge IVO's position in the national market. It is also important to note that EL-EX is currently owned by Fingrid, over which IVO exercises considerable decision-making power as discussed above.

46. Consequently, it may be concluded that IVO has a strong position in the Finnish electricity market, and in particular as concerns wholesale sales of electricity, far ahead of that of all the other players in the market.

c) Serious doubts as concerns the compatibility with the common market

47. The operation as notified would lead to a situation where IVO-Neste would take over the *de facto* monopoly held by Gasum on the market for natural gas, and also sell electricity generated by itself on the open market to third parties. Given IVO-Neste's strong position in both electricity and natural gas markets, it is highly likely that the merged entity would be in a position to control, or at least exert significant influence, over both electricity and gas prices in Finland. Although Gasum had already prior to the concentration a *de facto* monopoly on sales of natural gas, the merged entity would as a result of the vertical links between natural gas and electricity production be in a position to successfully adopt market strategies that would not have been possible prior to the concentration. Firstly, as any price increase on natural gas would have the effect of increasing the costs for competing electricity producers, IVO-Neste could use such tactics, or the threat thereof, to successfully increase electricity prices. Moreover, given that demand for electricity is less elastic than that for natural gas, the situation where Gasum, prior to the concentration, may have had limited means to compensate for the possible decrease in volume that would follow a significant increase in natural gas prices will change. Following the concentration IVO-Neste would, through its vertical integration, be able to compensate a decrease in the sales volumes of natural gas by increased sales of electricity. Thus, the company's decisions on pricing of natural gas would be of crucial importance, not only on the market for sales of natural gas, but also on the wholesale market for electricity.
48. IVO-Neste would also be able to influence future investments in new electricity generation capacity through its influence over this price mechanism. Currently most investments in new electricity generation capacity in Finland are based on natural gas. However, if the concentration were to go ahead in its original form, any competing electricity producer would have to base his future investment decisions on the fact that he in investing in a gas fired plant, effectively would become dependent on his largest competitor for supplies of fuel. Third parties have confirmed that these considerations may lead to sub-optimal investment strategies, that in the end may lead to increased prices for electricity. Third parties have also argued that Neste's favoured position in the construction of gas-fired plants in Finland might further affect the development of both the electricity and natural gas markets.
49. On the basis of the above it can be concluded that the merged entity would enjoy a superior competitive position in the Finnish electricity market that none of the other power generators would be able to match.

50. The consumption of natural gas in Finland has risen steadily since 1983. The total gas transmission capacity in Finland has been increased by 50% during the past three years *inter alia* by building new pipelines. The relatively rapid growth of gas consumption is estimated to continue: in 1997 sales of natural gas totalled 3.5 bn cubic metres and the consumption is estimated to rise to 5 bn cubic metres by the end of the millennium.
51. The consumption of natural gas is increasing in all consumption sectors. The biggest growth area, however, is in electricity generation. Electricity consumption is expected to increase strongly in Finland in the near future and according to official estimates the demand for electricity will almost double by the year 2025.
52. The high consumption of natural gas is largely attributed to the high electricity generation in the Finnish industry. In 1997 the Finnish industry used 8.5% more electricity compared to the previous year and in 1998 the consumption is estimated to grow by 4%. At the same time the importance of natural gas as a raw material for electricity production is increasing as the use of oil and coal will be reduced for environmental reasons. Cogenerated power and heat in industry and municipalities have traditionally been a natural growth area in natural gas consumption and this trend is expected to continue in the future.
53. Natural gas prices have increased steadily during the past ten years and due to the pressure in demand the trend has been estimated to continue. Natural gas has, however, been very competitive in the Finnish energy market and the competitiveness of natural gas is expected to remain good, in particular in CHP-production.
54. Given IVO-Neste's strong position in the sales of both electricity and natural gas, the expected increase in the electricity demand and the strategic importance of natural gas, it can be concluded that the operation as notified would threaten to create or strengthen a dominant position on the market for wholesale sales of electricity in Finland, and that it therefore raises serious doubts as to its compatibility with the common market.

VI. UNDERTAKINGS SUBMITTED BY THE PARTIES

55. To remove the competition concerns arising from the operation, it is necessary to ensure that IVO-Neste will not be in a controlling position in Gasum and, thus, able to coordinate both the electricity and the natural gas markets *inter alia* through price control.
56. With a view to removing the competition concerns, IVO-Neste has submitted undertakings on its behalf and on behalf of Neste. The Finnish government, in its role as a shareholder in Gasum, has also submitted commitments. The undertakings will ascertain that IVO-Neste will relinquish control over Gasum.
57. Currently, Neste owns 75% of the shares in Gasum and Gazprom 25%. The Finnish state has one K-share which gives it special voting rights. IVO-Neste

undertakes to sell within [.....⁵] months from the date of the Commission's approval of the concentration 50% of the shares in the company, thereby reducing its share in Gasum to 25%. The Finnish state will be offered 24% of the shares and the remaining 26% will be sold to Finnish or European corporations independent from IVO-Neste and subject to the Commission's approval. Gazprom will retain its 25% stake in Gasum.

58. The Supervisory Board, where all the strategic decisions of Gasum are taken, consists of eight members. Each shareholder, or shareholder group, will have two members on the Board. The structure of the Board effectively means that the votes of three other members and the Chairman's casting vote will always form a majority. To fulfil the requirement that IVO-Neste will not be in a controlling position in Gasum, IVO-Neste undertakes to secure that none of its members on the Supervisory Board will act as the Chairman.
59. The government of Finland has committed to ensure that IVO-Neste will not have a controlling position in Gasum. The government has also undertaken to exercise the rights associated with its ownership to secure that the balance between the various owners' interests will be preserved in the composition of the governing bodies of the company and that the interests of the new shareholders will be taken into account.
60. A trustee, approved by the Commission, will oversee that the sale of the shares to new investors will take place on a non-discriminatory basis to entities independent, directly or indirectly, from IVO-Neste, and that pending the divestiture the business is run as a viable business. The trustee will report to the Commission.
61. Through these undertakings, IVO-Neste's position in Gasum will change from one of sole control over the company to one of a minority owner. The Commission has noted the argument put forward by the parties that the continued dependency of Gasum on supplies from one single supplier necessitates a continued involvement by IVO-Neste, at a level below that of control, since Neste is the sole Finnish company that over the last 27 years has been involved in the trade of natural gas. Taking all the undertakings together it can be concluded that there will not be a situation where IVO-Neste would be able to block decisions together with Gazprom or the Finnish state. Furthermore, the state has undertaken to consult the new investors when voting, thereby ensuring the balanced control of Gasum. It can therefore be concluded that the undertakings and commitments given by the parties relinquish IVO-Neste's control over Gasum and are thus sufficient to remove the competition concerns arising in the Finnish market for wholesale sales of electricity.

VII. CONCLUSION

62. For the above reasons and subject to full compliance with the commitments made by IVO-Neste and the state of Finland, the Commission decides not to oppose the notified operation and to declare it compatible with the common market and with the functioning of the EEA Agreement. This decision is adopted in application of

⁵ Confidential information.

Article 6(1)(b) and Article 6(2) of Council Regulation (EEC) No. 4064/89 as amended by Council Regulation No. 1310/97.

For the Commission