DONG/Elsam/E2: Remedi...
rate market which is Swedish or Danish-Swedish in scope since the wholesale supplies in Sweden do not exercise a strong competitive constraint on wholesale supplies in Denmark.

DONG argued throughout the case that all potential gas deliveries at the German side of the Danish entry/exit point at Ellund belong to the Danish wholesale gas market. The decision leaves open whether actual delivered volumes at Ellund should be included in the geographic scope of the Danish gas wholesale supply market but dismisses the claim that all potential capacity-dependent volumes should be included because gas exported from Denmark to Germany that can be potentially turned back into Denmark does not pose a significant competitive constraint on DONG.

In the competitive assessment the decision concluded that DONG is dominant on the Danish market for gas wholesale supplies, with a market share of above 80%. The (potential) competitive constraints on DONG’s dominant position come from the operators in the Danish offshore area, imports from Germany, turnaround of gas at Ellund, a liquid Danish wholesale market and new pipeline capacity or other import facilities. It was concluded that these competitive constraints are weak or not sufficiently certain to in the short term constitute an effective constraint on DONG’s market position.

The Commission’s investigation showed that DONG’s dominant position would be further strengthened by the removal of E2 as an actual, and Elsam as a credible potential competitor to DONG and at the same time, Vattenfall’s acquisition of a small share of E2’s and Elsam’s gas-fired power plants will not be sufficient to outweigh the loss of competitive pressure caused by the two generators’ integration in the DONG group.

In addition to these horizontal effects, the decision concluded that the transaction will lead to customer foreclosure, and as a result to a significant impediment to effective competition, due to a vertical integration of DONG with E2 and Elsam, which account for about 25% of total Danish consumption. It will thus be more difficult for DONG’s competitors to enter Danish gas markets, both as wholesale suppliers and as suppliers of final customers, thereby raising barriers to entry to these markets.

As regards gas wholesale supplies in Sweden, DONG has a very strong position on that market as well. The decision left open whether DONG is in a position of single or joint dominance in a Swedish or Danish-Swedish wholesale market, since any harmful effects on any of these markets would be derived from a harmful effect the operation would have on the wholesale market for Denmark.

**Gas storage/flexibility market**

The proposed concentration as notified would have led to a substantial impediment of effective competition in the Danish market for gas flexibility/storage. The Commission’s Statement of Objections expressed in that respect both horizontal and vertical competition concerns which could only be removed by DONG’s commitment to divest the larger of its two gas storage facilities in Denmark.

Whereas production in gas fields is rather constant, gas demand varies, both seasonally and in the short term (intra-day and intra-week). Therefore, companies active in the gas industry have to balance their gas supply and demand and thus have a genuine need for gas flexibility services. In addition, gas transmission system operators have to cope with possible imbalances and emergency situations in order to ensure stable gas pressure in the network.

The Commission’s market investigation identified physical gas storage as the most important flexibility tool. However, the investigation also showed that flexible supply contracts (upstream) as well as customers with the ability demand modulation (downstream) are considered important flexibility tools for gas companies. This holds in particular for the flexible consumption of Elsam’s and E2’s gas-fired power plants (central CHPs) which are the largest gas consumers in Denmark with [20-25%] of the national consumption. They are able to generate flexibility in two ways: first, by means of output variation, and second through the switching of fuels between gas, coal, oil and bio mass. Thereby these gas-fired power plants can provide both seasonal and short-term flexibility to their suppliers, and exert thus, at least to some extent, competitive constraints on DONG’s storage operations. However, for the purpose of the present case it was not necessary to determine whether or not gas storage and flexible gas consumption by central CHPs are part of the same relevant product market (see below). As to the relevant geographical market, the Commission found that it was national in scope, both on the hypothesis of a storage market and of a broader market for flexibility.

The Commission’s investigation established that the proposed transaction would have led to a significant impediment of effective competition on the Danish market for flexibility/storage, irrespective of the precise market definition. The concentration as notified gave rise to both horizontal and vertical competition concerns.
As to the horizontal concern, the acquisition of Elsam’s and E2’s CHPs as significant flexibility tools would have strengthened DONG’s dominant position on the storage/flexibility market. The Commission found that DONG was already dominant on the basis of either market definition as it had a monopoly for storage and storage constitutes the largest and most important source of flexibility in Denmark. The acquisition of the flexibility offered by Elsam’s and E2’s power plants would remove a significant competitive constraint on DONG’s storage operations, and thereby strengthen its dominant position.

Regarding the vertical concern, the Commission found that DONG would have the ability and the incentive to raise its (wholesale) rivals’ costs. It has to be borne in mind that storage/flexibility services are a necessary input for gas wholesale companies. Following the merger, DONG would be able to reduce its own storage needs as it could increasingly use the flexibility of Elsam’s and E2’s gas-fired power plants. The combined entity could use the central CHPs as ‘virtual storages,’ i.e. relatively increase their gas consumption in periods of low demand by other customers and reduce their gas consumption in peak periods and in winter. The fact that following the integration of Elsam and E2 DONG would be able to reduce its own storage needs is not a competition concern in itself. However, the harm to competition arises because, due to the current Danish regulatory regime, DONG’s decreasing demand would lead to an increase of storage tariffs for its competitors in the wholesale and supply markets. This is due to the fact that DONG’s storage subsidiary is entitled to a fixed annual revenue to cover its costs from storage operations and that, as a consequence of DONG’s reduced demand following the merger, costs per cubic metre of stored gas would increase accordingly. Therefore DONG would not only have the ability but also the incentive to increase its rivals’ costs for storage.

**Retail gas markets**

All Danish retail gas markets have been fully open for competition since 2004. With this in mind, the Commission identified three distinct gas retail markets: (i) A market for supply of natural gas to central CHP plants (ii) Market(s) for supply of gas to decentral CHPs and to large industrial customers and (iii) Market(s) for supplies of gas to households and small businesses. These markets can be distinguished in terms of regulatory environment, gas consumption, contract types, demand patterns, flexibility needs and prices.

As to the geographic market, the decision considered that (i) the retail market for central CHP’s was most likely national in scope and could at most include also Sweden (ii) the retail market for decentral CHPs and to large industrial customers was national and (iii) the retail market for households and small businesses was not wider than national and possibly still regional in scope.

The Commissions investigations showed that DONG was already pre-merger dominant on all the identified retail markets and that this dominance would have been strengthened on two of the retail markets leading to a significant impediment to effective competition on those markets.

(i) **The market for supply of natural gas to central CHP plants**

The decision considered that there were no concerns on this market since no customers could suffer any harm at least until 2009 and since post-2009 these customers would be protected if the well-functioning of the market is reinforced by the commitment to release gas. The decision also considered whether the concentration eliminated potential competition, but concluded that it would be unlikely that Elsam and/or E2 were potential entrants since it would seem unlikely that other central CHP’s would buy gas from its direct competitors.

(ii) **Market(s) for supply of gas to decentral CHPs and to large industrial customers**

On these market(s), the Commissions investigation showed that, absent the merger, Elsam, E2, Nesa (\(^5\)) and KE would have been likely and effective potential competitors. Elsam and E2 both had access to large gas quantities at competitive prices and they also had access to important means of flexibility. This was also confirmed by the market investigation and from internal papers. Nesa and KE both had strong energy brands and could have achieved cost synergies and customer loyalty by sales of dual fuel. They also already had access to a large customer base of industrial customers.

Moreover, the concentration would raise entry barriers since it would be more difficult for competitors to attain critical size as 20% of Danish gas consumption was removed from the market. The effects of the concentration on storage and wholesale markets described above would also raise entry barriers on the retail markets. Finally DONG will after the merger be in a privileged position to offer dual fuel products, which would be difficult for competitors to match.

\(^5\) The electricity retail company owned by Elsam.
The Commission therefore concluded that the concentration would remove potential competition and raise entry barriers on this market thereby significantly impeding effective competition.

(iii) Market(s) for supplies of gas to households and small businesses.

For the same reasons as above, the concentration would also raise entry barriers on this market. Entry barriers would also be raised because large customers — whose flexibility could have been balanced against the flexibility of smaller customers — were removed.

The decision also found that to some extent, potential competition from NESA and KE would be eliminated through the concentration. As electricity retailers, NESA and KE already had the sales force, IT and billing systems, customer portfolios and brand strength in place and would therefore not meet the high entry barriers that other entrants would meet. However the investigation also revealed that many of KE and NESA’s customers already had their energy needs satisfied by city gas and district heating and that KE and NESA — being situated in the same geographic area as DONG’s gas competitor HNG — could mainly have used their customer portfolios to compete with HNG and not with DONG. It was also considered that other electricity companies could have entered this market, but it was concluded that it would be difficult for other companies to duplicate KE’s and NESAs special position with regards to access to gas.

The Commission therefore concluded that the concentration would remove some potential competition and raise entry barriers on this market thereby significantly impeding effective competition.

3. Assessment of proposed remedies

In order to remedy the competitive concerns identified by the Commission, DONG submitted a package of undertakings. In particular, DONG committed to sell one of the two gas storage facilities and to release a total of 2.4 bcm of gas in a gas release programme.

The storage facility to be divested is Lille Torup in Jutland, the larger of the two Danish facilities. The divestiture will deprive DONG of the ability and incentive to raise rivals’ cost of storage. The storage remedy will reinforce the effect of the unbundling of gas infrastructure assets which has already taken place in Denmark as regards the ownership of the gas transmission network. It constitutes the first structural unbundling remedy in a Commission merger case, separating the assets of the incumbent wholesale operator and infrastructure facilities.

The gas release programme remedy will include 6 yearly auctions of 400 million cubic meters for a total duration of 7 years. The quantities to be auctioned annually thus correspond to about 10% of the Danish consumption in 2005. Lot sizes will be 40 million cubic meters. The first auction is to take place before the end of August 2006.

While gas release programmes have previously been accepted as a remedy by the Commission, the design of the release programme in this case contains a novel two-stage selling procedure. In a first stage the gas will be offered in a swap auction whereby interested buyers must ‘pay’ for the gas delivered in Denmark (at the Danish hub GTF) with gas delivered to DONG at one of any of four northern European hubs in the UK (NBP), the Netherlands (TTF), Belgium (ZBT) and Germany (BEB-VP). The auction itself will determine a competitive level for swap-fees (either positive or negative) to reflect the relative value of gas supplied at the different locations. In order to ensure that the quantities committed to be released will actually be sold, the swap auction will, if necessary, be supplemented with a secondary auction for the same year in which the remaining volumes will be offered in a standard auction against cash settlement.

The Commission accepted DONG’s proposal because the swap component had the potential of contributing to integrating European gas markets without compromising the objective of ensuring that significant quantities of gas would be released in Denmark in order to remedy competition concerns on the Danish wholesale and retail markets. Entry possibilities into the Danish markets are further enhanced by provisions on the flexibility of the daily quantities and the freeing up of DONG’s customers if approached by a successful bidder in a gas release auction with a more attractive offer. The gas release will thus increase the flexible liquidity of the wholesale market and facilitate new entry onto the Danish natural gas markets.

(9) A prior structural unbundling remedy in E.ON/MOL concerns unbundling of the gas producer from the storage operator and separates links between the production incumbent and the wholesale incumbent.

(7) The total delivery of the six auctions will stretch over 7 years due to delivery periods of 2 years per auction.

(8) In E.ON/MOL.

(9) Annual take or pay of 90% of the auctioned annual contractual quantity and daily flexibility of 50-110% of the daily contractual quantity.