

Unfair and excessive prices in the energy sector

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Introduction

The concept of competition refers to a process where firms dispute the favour of their customers by proposing better products at the lowest possible price. This consumer welfare creating process is to a large extent Darwinian in nature: those who cannot compete must die. The law of supply and demand is ruthless and so is competition law. Principles of fairness and justice are extraneous to competition law: the lion eats the deer.

Still, EC competition law is not amoral, as illustrated by the very first example of abusive conduct given by Article 82 EC: “*directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions*” can constitute an abuse. The concept of fairness as a constituent element of EC competition law may disturb those who analyze the competitive process through a scientific lens. Fairness does not relate to economic effects and cannot be measured or quantified. It is a concept that appeals to ethics and norms.

The dichotomy between competition as an amoral welfare creating process, that can be the subject of economic research, and the normative concept of fairness does not necessarily lead to a contradiction. Fairness becomes relevant where the competitive process has ceased to play its welfare creating role: *i.e.* where monopolies prevail over perfect competition. When confronted to a monopoly, abstention is the customer’s only choice and for some goods, such as food, clothing and housing, abstention is not considered as a realistic choice. In scenarios where the monopolist faces an inelastic demand curve, fairness is probably the customer’s only safety buoy.

The energy sector is one of the sectors where these situations occur. In our modern societies, customers expect the light to go on, when they turn the switch, and their houses to be heated, when activating their boilers. Candles and jumpers not offering realistic alternatives, demand is close to inelastic, at least on the short term. Moreover, the energy sector is characterized by the existence of monopolies, not only as regards distribution and transport facilities which cannot easily be duplicated, but also with respect to production and supply businesses. As shown by the Commission’s report on the energy sector inquiry, these businesses remain heavily concentrated and are quasi-monopolistic in some Member States. In fact, complaints by large industrial users about rising prices were at the very origin of this inquiry.

This contribution will focus on the possibilities to assess the compatibility of these high prices with EC competition law under Article 82(a) EC: when do energy prices become unfair within the meaning of this provision? This question will be addressed in five sections. The first section further elaborates upon the dichotomy referred to above. It reflects some personal views about the meaning of Article 82a) EC. The second section contains a brief overview of the interpretation given to Article 82(a) EC by courts and competition agencies. The third section tries to identify pricing issues in the energy sector which could possibly qualify for an assessment under Article 82(a) EC. The fourth section deals with some recent price related interventions by national competition authorities in the energy sector. The last section summarizes the earlier findings.

1. Conceptual observations

1.1. The origins of Article 82(a) EC

The concept of dominance exists in Community law since 1952. Article 66 ECSC authorized the Commission to address recommendations to undertakings that held a dominant position shielding them against effective competition, if those undertakings used (not abused) that position for purposes contrary to the objectives of the Treaty. It was designed to control those undertakings which had already acquired a dominant position prior to the entry into force of the ECSC merger control rules or which had acquired such dominance through internal growth. According to Joliet, this power was “*directed at the misuse of power (for instance through unilateral fixing of unduly high prices or monopolistic reduction of output).*”¹

Article 82 EC has made the power to intervene against price practices more explicit. However, the founding documents of the EC Treaty apparently do not provide much guidance as to the reasons and economic ideas which led the authors to include this provision in the Treaty. David Gerber notes that the competition law provisions were constitutional in nature. Legal practice was supposed to give these provisions their normative content.²

¹ “*Monopolization and abuse of dominant position*”, by René Joliet, Martinus Nijhoff, La Haye, 1970, page 218.

² “*Law and competition in twentieth century Europe*”, David Gerber, Oxford University Press, 2003, page 345.

1.2. Dominance and monopoly pricing

The ECJ has systematically defined the concept of dominance by referring to the independence of the dominant firm *vis-à-vis* its competitors, customers and suppliers. This independency implies that the dominant firm is a price setter and not a price taker. The fact that it can set its prices as a function of its own cost considerations is indeed one of the features of a monopoly is; the industry demand curve is its demand curve. This means that monopoly pricing is inherent to the concept of dominance.

It also means that unfair prices within the meaning Article 82(a) EC cannot logically correspond to monopoly prices. If this provision were to aim monopoly pricing, it would implicitly condemn the dominant position which Article 82 EC assumes to exist. Joliet notes in this respect that a condemnation of monopoly pricing would imply that all pricing by dominant firms would necessarily be abusive.³

In other words, an unfair price should logically exceed a monopoly price. To introduce a neologism, an unfair price is a supra-monopoly price.

1.3. Dominance and unfairness

As already mentioned above, fairness is a concept that cannot be measured in economic terms. It is a philosophical, ethical and normative notion that transcends economic analysis and that has its role to play in competition law where the market mechanism has ceased to function. As any normative principle, fairness implies a balance of interests. In this case, it is a balance between, on the one hand, the interest of the customer to have access to a certain good or service, and, on the other hand, the commercial interests of the dominant firm. It seems to me that several elements are relevant in striking this balance.

Firstly, the degree of dominance should be such that the customer cannot realistically turn to alternative sources of supply. Nor should they be in a position to hope for market entry. The dominance should be monopolistic or quasi-monopolistic in nature and effectively protected by high barriers to entry. Or, as Article 66§7 ECSC puts it, a dominant position shielding the firm from effective competition.

³ René Joliet, o. c. page 242 and 243.

Secondly, the goods in question must be indispensable: *i.e.* goods that customers cannot afford not to have. But, what is indispensable? Obviously goods satisfying basic objective human needs, such as food or medical care, are more likely to be indispensable for the end consumer than luxury goods. It is interesting to note in this respect that a substantial part of the (national) case law on excessive pricing deals with pharmaceuticals. However, a good or service can also be indispensable if it is a necessary input for a downstream activity or if it is an “*essential facility*”.

The third element is related to the second: inelasticity of demand. If customers cannot and will not flee, the supplier will not lose volume when he increases his prices, even beyond monopoly price levels. In fact, it would be irrational for him not to increase his price, since it will enable him to substantially increase his turnover and profits.

Fourthly, what is the conduct of the dominant firm over time? Monopolies can be temporary in nature. They can occur as a result of strikes, accidents or plant outages affecting the competitors’ ability to supply the market. Customers may consider it abusive to take advantage of such “windfall” monopolies, but they also have the means to discipline the temporarily dominant firm once the market has returned to a competitive situation. If the market can sanction real or perceived injustice, there is no need to rely on public fairness provisions. Time is also relevant to assess supra-monopoly pricing by permanently dominant firms. If such pricing occurs momentarily, the justification for outside intervention under Article 82(a) EC is less apparent than in a situation of systematic overcharging.

Fifthly, one can never exclude the possibility that there are objective reasons explaining supra-monopoly pricing. Exceptional investment plans could possibly offer such justifications.

1.4. Unfairness and other abuses; the subsidiary nature of Article 82(a) EC

When assessing unreasonably high prices under Article 82(a) EC, it is important to distinguish two scenarios: one where such pricing conduct takes place in isolation and the other where that conduct forms part of a wider scheme or practice. The first scenario is unlikely to occur very often. Relying on the criteria developed above, it assumes that a series of

exceptional conditions are fulfilled; systematic supra-monopoly pricing by a lasting monopolist supplying indispensable goods and facing an inelastic demand curve.

As illustrated by the case law cited below, unreasonably high prices are more often part of wider strategy of the dominant firm. They may be a means to raise funds in the monopolized market in view of financing predatory and/or discriminatory pricing policies in competitive markets. Overpricing may also occur to bar parallel trade, if the monopoly concerns a service which is indispensable for that trade to occur. Or, it may be a constituent element of an economic tying practice, encouraging customers to buy the cheaper bundle rather than its highly priced components.

I submit that Article 82(a) EC should not apply in a scenario of combined restrictive practices. As already mentioned above, the concept of fairness is a notion of last resort. It should prevail only where the competitive process has (nearly) ceased to function. However, where a still functioning competitive process is threatened by a series of restrictive practices, antitrust enforcement should focus on these practices. The priority should indeed lie with ensuring a system of undistorted competition within the meaning of Article 3(g) EC.

Article 82(a) EC is therefore of a subsidiary nature. It applies only as a means of last resort.

1.5. Proof of unfairness

As discussed below, it is important to distinguish two elements when assessing unfair prices; first, the definition of unfair pricing and, second, the proof that the elements of that definition are met. Proof of unfair prices may be obtained by comparing the prices of the dominant firm to costs, to prices charged by the dominant firm in other periods or markets, or to prices charged by comparable undertakings in the same market or in different markets. It should be noted, however, that such differences are elements of the evidence showing that the conditions of the definition are met, but that they do not coincide with that definition. For example, the difference between prices and costs is not unfair, but is just an element that may point to the existence of unfair prices.

1.6. Unfairness and enforcement

There is also a practical reason to support this view. The application of Article 82(a) EC is a delicate and complicated task. As a normative concept, fairness cannot be quantified. Something is unfair or it is not unfair, but it will be hard or impossible to determine a criterion as of when a price starts or ceases to be unfair. The cursor can be placed on wide spectrum. In addition, the circumstances which led the administrative or judicial body to consider that the prices were unfair may change over time.

These findings raise questions as to the enforceability of Article 82(a) EC. A cease and desist order may have a repressive effect, but will offer limited guidance for the future. Its future effect will at best be equivalent to a maximum price regulation for the dominant firm.⁴ Even so, Regulation 1/2003 offers both the Commission and national competition authorities more enforcement options. The dominant firm can avoid repressive action by proposing commitments. These commitments can not only contain a code of conduct as to future pricing, but can also contribute to a structural solution of the supra-monopoly pricing problem. Finally, if that problem persists, Article 7 of Regulation 1/2003 offers the Commission the means to impose structural remedies, which may include divestitures.

1.7. Conclusions

The Treaty and the founding documents do not offer guidance as to the interpretation of Article 82(a) EC. Since the Treaty assumes the existence of dominance and, hence, of monopolies, Article 82(a) EC should logically not prohibit monopoly prices. Conceptually unfair prices are supra-monopolistic prices. The conditions under which supra-monopolistic pricing can be considered unfair are exceptional: the dominant firm should enjoy a lasting (quasi-)monopolistic position in respect of indispensable goods, face an inelastic demand curve and systematically charge above monopoly price levels. Given this exceptional nature and the need to ensure undistorted competition, enforcement action under Article 82 EC should primarily focus on practices that harm a still existing competitive process. Article 82(a) EC intervenes only after that process has ceased to play its

⁴ "It must not become an instrument for fixing administered prices. It would be ironic for the pursuit of liberalization of the electricity and gas sectors to lead to return to regulated prices in power generation", François Lévêque, in "Antitrust Enforcement in the Electricity and Gas Industries: Problems and Solutions for the EU", *The Electricity Journal*, 2006, pages 27 to 34.

welfare creating role. As regards enforcement action, structural solutions contributing to the revival of that process should be preferred.

Let's us now compare this proposed test with the case law of the ECJ and decisional of the Commission and national authorities.

2. Interpretation by the institutions

2.1. The case law of the ECJ

2.1.1. The early case law

The notion of unfair prices entered Community competition law in the Court's case law of the sixties and early seventies which dealt with the level of royalties for IP rights.⁵ In *Sirena v. Eda*, the ECJ held that: "*As regards the abuse of a dominant position, although the price level of the product may not of itself necessarily suffice to disclose such an abuse, it may however, if unjustified by any objective criteria, and if it is particularly high, be a determining factor.*"⁶

In *General Motors* the Commission used the wording of excessive prices for the first time, suggesting that an excessive price would be unfair. Although the decision was annulled by the ECJ, it upheld the principle ruling that "*Such an abuse might lie, inter alia, in the imposition of a price which is excessive in relation to the economic value of the service provided [...]*"⁷

2.1.2. United Brands: an orientation on costs

The ECJ reiterated and specified this principle in *United Brands* by ruling that "*charging a price which is excessive because it has no reasonable relation to the economic*

⁵ In Case 24/67, *Parke Davis and Co. v Probel, Reese, Beintema-Interpharm and Centrafarm*, [1968] 55, the ECJ paved the way for this reasoning by determining that "although the sale price of the protected product may be regarded as a factor to be taken into account in determining the possible existence of an abuse, a higher price for the patented product as compared with the unpatented product does not necessarily constitute an abuse."

⁶ Case 40/70, *Sirena S.r.l. v Eda S.r.l. and others* [1971] ECR 69.

⁷ Case 26/75, *General Motors Continental NV v Commission of the European Communities* [1975] ECR 1367.

*value of the product supplied would be such an abuse*⁸ Ever since, *United Brands* has become the main precedent for unfair pricing.

However, the ECJ did not specifically set out how the economic value of a product should be determined. It introduces a two-stage test for determining whether a price is reasonably related to the economic value of the product supplied:

“[t]his excess could inter alia, be determined objectively [...] by making a comparison between the selling price of the product in question and its cost of production, which would disclose the amount of the profit margin.

The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products.”

This two limb test corresponds to the test proposed in section I above. The first part of the Court’s test could be seen as a means to identify the existence of supra-monopoly pricing, whereas the second part of the test concerns the questions whether this excessive price is unfair. Comparisons with prices of competing products may offer guidance to determine unfairness.

The case law is not clear as to whether a cost/price analysis is always required to identify the existence of unfair prices. One of the grounds which led the ECJ to annul the Commission’s decision in *United Brands* concerns the fact that the Commission had omitted to analyze UBC’s costs structure. This suggests that mere price comparisons do not suffice to establish the existence of unfair prices.

2.1.3. SACEM: comparisons

In the SACEM cases, however, the ECJ focused on comparisons rather than on cost/price analysis. In *Lucazeau v Sacem* the ECJ held that

“When an undertaking holding a dominant position imposes scales of fees which are appreciably higher than those charged in other Member States and where a comparison of

⁸ Case 27/76, *United Brands v Commission* [1978] ECR 207.p. 250.

the fee levels has been made on a consistent basis, that difference must be regarded as indicative of an abuse of a dominant position. In such a case it is for the undertaking in question to justify the difference by reference to objective similarities between the situation in the Member State concerned and the situation prevailing in all the other Member States.”⁹

It should be noted, however, that the SACEM cases dealt with the level of royalties for music in discothèques and that a cost/price analysis for artistic creations is hard to make. Moreover, the ECJ was relatively cynical as regards the cost and profit levels put forward by SACEM to justify the price differences.

“It is apparent from the documents before the Court that one of the most marked differences between the copyright-management societies in the various Member States lies in the level of operating expenses. Where - as appears to be the case here, according to the record of the proceedings before the national court - the staff of a management society is much larger than that of its counterparts in other Member States and, moreover, the proportion of receipts taken up by collection, administration and distribution expenses rather than by payments to copyright holders is considerably higher, the possibility cannot be ruled out that it is precisely the lack of competition on the market in question that accounts for the heavy burden of administration and hence the high level of royalties.”

I interpret this paragraph as an implicit criticism of the relevance of a cost/price analysis for establishing the existence of unfair prices. Within the limits set by the shareholder, a monopolist is indeed free to determine its costs and profits. The absence of profits does not offer conclusive evidence as regards the absence of unfair prices.

In *Bodson v Pompes Funèbres*, the ECJ also preferred a comparative approach to a cost/price analysis of the firms own cost structure.¹⁰ The comparison focussed on prices charged by other concession holders:

“The French Government and PFRL have denied that the prices charged by the subsidiaries of Pompes Funèbres Générales are unfair. The documents before the Court do not contain any information enabling that problem to be resolved. Since over 30 000 communes in France have not granted to an undertaking the concession to provide “external services” for funerals, but have left that service unregulated or operate it

⁹ Joint cases 110/88, 241/88 and 242/88, *Francois Lucazeau and others v Sacem and others*, [1989] ECR 2811, p. 25.

¹⁰ Case 30/87, *Bodson v Pompes funèbres libérées*, [1988] ECR 2479, p. 31.

themselves, it must be possible to make a comparison between the prices charged by the group of undertakings which hold concessions and prices charged elsewhere. Such a comparison could provide a basis for assessing whether or not the prices charged by the concession holders are fair.

2.2. The Commission's decisional practice

Apart from its decisions in *General Motors* and *British Leyland*, which essentially dealt with parallel trade rather than unfair pricing issues, the Commission never condemned unfair pricing practices. It is not unreasonable to argue that its latest decisions are discouraging more than encouraging enforcement under Article 82(a) EC.

The *Euromax v IMAX* decision can be seen as an implicit rejection of price comparisons as a means to identify unfair pricing. In that case the Commission rejected a complaint brought against the allegedly excessive rental fees charged for the IMAX system. It held that the price comparison with competitors was not the adequate means of comparison in this case as: *“The differences in type of contracts and performances compared are therefore too great to allow a sufficiently qualified and appropriate comparison.”* Moreover, Euromax had not provided a consistent comparison with other products, that is to say: *“a comparison that involves the same products with similar quality and functionality and subject to the same terms and conditions. This is the standard, which is required by the Court of Justice.”*¹¹ In other words, the complainant failed to identify the adequate benchmark.

In the parallel *Scandlines* case, the Commission is equally sceptical as regards cost/price analysis to establish the existence of unfair pricing. The case concerns port charges of the port of Helsingborg, which were unfair in Scandlines eyes.¹² In a relatively long decision the Commission rejected Scandlines complaint. First, the Commission explained the difficulties in finding out which costs of Helsingborg's integrated port activities could be allocated to the accommodation required for the ferry line to Denmark. Second, once it had identified the relevant costs, the Commission specified that *“[t]he fact that the port charges would be non-cost based or the pricing non transparent do not constitute as such as abuses under Article 82 of the EC Treaty.”*:

¹¹ Case COMP/C-2/37.761, *Euromax v IMAX*, Commission decision of 25 March 2004.

¹² Case COMP/A.36.568/D3, *Scandlines Sverige AB v Port of Helsingborg*, Commission decision of 23 July 2004.

More is required,

“It is important to note that the decisive test in United Brands focuses on the price charged, and its relation to the economic value of the product. While a comparison of prices and costs, which reveals the profit margin, of a particular company may serve as a first step in the analysis (if at all possible to calculate), this in itself cannot be conclusive as regards the existence of an abuse under Article 82 EC Treaty.”

and,

“even if it were to be assumed that the profit margin [...] is high or even excessive, this would not be sufficient to conclude that the price charged bears no reasonable relation to the economic value of the services provided. The Commission would have to proceed to the second question as set out by the Court in United Brands, in order to determine whether the prices charged to [...] are unfair, either in themselves or when compared to other ports.”

Third, the Commission stressed in *Scandlines* that demand-side considerations should also be considered in the assessment of the economic value of the product or service. Customers may be prepared to pay a premium for the unique service offered by the Helsingborg port. Fourth, when assessing the economic value, due consideration should also be given to the need to recover large initial investments, the intangible value of the product itself and any opportunity costs. Based on all the above considerations the Commission concluded that:

“[i]n the present case, the economic value of the product/service cannot simply be determined by adding to the approximate costs incurred in the provision of this product/service as assessed by the Commission, a profit margin which would be a pre-determined percentage of the production costs. The economic value must be determined with regards to the particular circumstances of the case and take into account also non-cost related factors such as the demand for the product/service, [(i.e. the valuation by the customers and consumers of the product/service)] [or e.g. costs of capital].”

As a consequence, finding a positive difference between the price and the approximate production costs exceeding what Scandlines claims as being a reasonable margin, would not necessarily lead to the conclusion that the price is unfair, provided that this price has a reasonable relation to the economic value of the product/service supplied.”

It is not unreasonable to submit that the *Euromax* and *Scandlines* decisions do not reflect a great degree of enthusiasm to deal with excessive or unfair

pricing issues and that future action in this area is probably not high on the Commission's priority list.

2.3. National decisions: the Napp case

By contrast, national authorities have been less reluctant to interfere against unfair prices.¹³ A substantial part of these interventions concerns pharmaceutical products. Both in Germany and in the Netherlands, the regulators have sought to control vitamin and valium prices on the basis of competition law in the late seventies. Finding the right standard for assessing the unfairness was also the key issue in these cases. German courts rely on market comparisons as a first method to spot the existence of excessive prices, but require that proper adjustments are made to take account of possible differences between these markets.¹⁴

The ruling of the British Competition Appeals Tribunal probably offers one of the most elaborate decisions on unfair prices at national level, even if the pricing conduct formed part of a wider abuse. The case concerned Napp, a pharmaceutical company with market shares above 90% in a market shielded by high barriers to entry. Relying on *United Brands*, the OFT found that Napp charged prices that exceeded those that would have existed in a competitive market and that there was no actual or potential competitive pressure to bring these prices down to competitive levels within a reasonable period.¹⁵ These high prices in the community segment of the market served, inter alia, to finance predatory rebates in the hospital segment.¹⁶

In order to establish the difference between Napp's prices and the prices which could have prevailed in a competitive environment, the OFT relied on various comparisons: (i) between Napp's prices and own costs, (ii), between Napp's prices and the costs of its most profitable competitor, (iii) between Napp's prices and those of its competitors, (iv) between Napp's prices and Napp's prices in other markets.

¹³ The Dutch authority has been particularly active in the field of abusive pricing issues. See E. H.Pijnacker Hordijk and Y. De Vries, «*Onbillijk hoge prijzen als vorm van misbruik van een economische machtspositie onder het Europese en het Nederlandse mededingingsrecht*», SEW 2002, p. 430.

¹⁴ References

¹⁵ *Napp Pharmaceutical Holdings v. Director OFT*, 15 January 2002, case 100/1/1/01.

¹⁶ This means that the Napp case is not a pure unfair pricing case. Compare with *Deutsche Post*, OJ 2001 L 331/40.

It resulted from these comparisons that

- “Napp’s prices in the community segment are typically around [...] [between 30 to 50] per cent higher than its competitors”,
- “Napp’s price in the community segment has remained the same since the launch of MST in 1980, ..., notwithstanding the expiry of its formulation patent in 1992”,
- “Napp’s list price (less wholesale discount) in the community segment of the market is on average over 1400 per cent higher than its price in the hospital segment of the market for ... tablets, where Napp faces competition”,
- “Napp’s highest level of discount, the list price in the community segment is on some tablets over 2000 per cent higher than Napp’s hospital prices”,
- “Napp’s prices in the community segment are over 500 per cent higher than its prices for export on a contract manufacture basis”,
- “Napp’s gross profit margin on sales to the community segment is [...] [in excess of 80] per cent, compared with a margin of around [...] [between 30 and 50] per cent on Napp’s other products sold to the NHS”, and that
- “Napp’s gross profit margin of [...] [in excess of 80] per cent on sales to the community segment compares with a gross profit margin of [...] [less than 70] per cent for Napp’s next most profitable competitor”.

In its appeal against the OFT’s decision, Napp argued that the relevant time frame to assess the pricing policy should correspond to the life time of the product and that the profits made on MST were needed to finance R&D costs for and losses on other drugs in its product portfolio. The CAT did not share these views and rejected the appeal. It considered that launching and promotion costs had been recouped a long time ago, that prices should be assessed per relevant market and that there were no objective reasons to price excessively during twenty years and more than ten years after the expiry of the patent. In taking this decision, the CAT stated that it was not bound to indicate precisely as of which level prices are excessive.

2.4. Conclusions

It follows from this summary overview that unfair pricing cases are exceptional and that most precedents are negative since they conclude on the absence of unfair prices. Enforcement activity is more important at national than at Community level. At both levels *United Brands* is the main precedent.

The two pronged test developed by the ECJ in that case corresponds to the idea of supra-monopoly pricing developed in section I above; monopoly profits alone do not suffice to establish the existence of unfair pricing. Conversely, *SACEM* shows that the absence of such profits does not necessarily constitute proof of the absence of unfair pricing. Comparisons in time, between geographic and product markets and between competitors can offer other evidence. Whatever the test used by the authority, it will be difficult to apply.

“The fact that the exercise may be difficult is not, however, a reason for not attempting it”, as stated by the CAT in *Napp*.¹⁷ The *Napp* ruling offers a convincing example of a combination of converging parameters that reveals the existence of unfair pricing in the normative sense as proposed in section I above. The case meets nearly all the proposed criteria.

It is now time to apply these principles in the energy sector.

3. Issues in the energy sector

3.1. The sector inquiry

Significant rises in gas and electricity wholesale prices and persistent complaints about barriers to entry and limited consumer choice led the Commission to open an inquiry into the functioning of the European gas and electricity markets in June 2005. On 10 January 2007 the Commission presented its final report. The conclusions were not really surprising: despite the liberalisation, there is no European energy market and there are few well functioning national markets.

Although high prices prompted the energy inquiry, the conclusions of the report pay relatively minor attention to pricing as a stand-alone issue. The section on gas mostly deals with pricing patterns and the indexation of gas prices to oil prices. The electricity chapter also reports about interaction of electricity prices and primary fuel prices. Both chapters also allude to the price distorting effects of public price regulation. The section of the report on price formation only refers to possibly unfair pricing conduct in respect

¹⁷ Paragraph 392.

of the so-called windfall profit issue; *i.e.* the practice according to which electricity producers include the market prices of freely obtained CO-2 certificates in their electricity sales prices. The report refers in this respect to the pending case before the German FCO, which will briefly be discussed below.¹⁸

This finding is not surprising. The sector inquiry focuses on the causes underlying the relatively high price levels in the gas and electricity markets: market concentration, vertical foreclosure, market integration and insufficient transparency. This structural approach explains why high prices are dealt with in the section of the report dealing with market concentration.

Competition rules can be applied to remedy some of these causes, for example by challenging long term exclusivity arrangements or a discriminatory use of infrastructure. As regards Article 82 EC, the report identifies in my view three areas for future enforcement action: (i) non-transparent use of network infrastructure leading to congestion problems, (ii) long term contracts concluded by incumbents with gas and electricity producers, foreclosing access to essential inputs and (iii) long term contracts concluded by incumbents with major customers foreclosing access to downstream markets.

These three options primarily concern exclusionary practices and not exploitative conduct within the meaning of Article 82(a) EC. This makes sense. Combating exclusionary practices contributes to make markets work, and if markets work unfair prices should logically not occur. As proposed under Section 1 above, Article 82(a) EC is only of subsidiary nature. It enters into play when the market mechanism has ceased to play its welfare creating role. The findings of the sector inquiry are worrying, but do not justify the conclusion that markets do not work at all.

Even if future enforcement actions will primarily address exclusionary practices, there are two issues which may possibly qualify for an examination under Article 82(a) EC and which were already the subject matter of enforcement action at national level, as will be illustrated by Section 4 below.

¹⁸ Press release Bundeskartellamt 20.12.2006 concerning a possible abuse of a collective dominant position by incumbents E.ON and RWE.

3.2. Networks

The first issue concerns the use of transport and distribution networks. These facilities are often regarded as natural monopolies in that sense that their duplication is not justified in economic terms. They are also regarded as essential facilities because access is required to enter downstream supply markets. These features and their ownership by vertically integrated companies have led the Community and national legislators to regulate the access conditions of these networks.¹⁹

This sector specific regulation has a dual aim. Its first objective is to ensure equal access by third parties, in other words tariffs and other access conditions should not be discriminatory. Its second objective concerns the subject matter of this contribution: tariffs should also be “*proportionate*”.²⁰ Even completely unbundled network operators can still have an incentive to charge disproportionate tariffs for access to their network. Tariff regulation has become an inherent element of the network operating business. It can take various shapes, but nearly all its manifestations are cost orientated. The network operator is allowed to obtain a reasonable return (often in a 5 to 7% range) on his regulatory asset base. In addition, some Member States have chosen models that try to simulate competition by cutting admissible cost by an efficiency reduction factor (also called the X-factor) or by benchmark methods comparing network operators. The Dutch system even went as far as imposing turnover regulation instead of tariff regulation, until the Dutch economic appeals court annulled the methodology on the simple ground that it did no longer deal with tariffs.²¹

All these cost orientated tariff regulations seek to constrain price setting by the network operator and, hence, to avoid monopoly pricing; the operator’s cost curve is supposed to intersect the demand curve at a lower point than the point that would have prevailed in the absence of tariff regulation. This type of tariff regulation is considerably stricter than the fairness test imposed by Article 82(a) EC. As mentioned above in section I and confirmed by the ECJ in *United Brands*, unfair prices are prices that exceed monopoly prices. The rationale of Article 82(a) EC does not relate to efficiency or cost cutting, but to fairness. This finding makes it difficult to rely on Article 82(a) EC as an alternative to ex ante tariff regulation.

¹⁹ “*Competing Gas Pipeline Infrastructure*”, by Marc van der Woude in *International Energy Law and Taxation Review*, 12, 2005.

²⁰ Article 23§4 Directive 2003/54/EC.

²¹ *GTS v. NMa, CBB*, 30 November 2006.

3.3. Wholesale markets

3.3.1. Marginal cost pricing in the electricity sector

Price formation for gas and electricity differs. Prices for gas correspond to commodity prices.²² Simplifying, one could say that competition rules, including Article 82(a) EC can be applied to gas in the same way as in other commodity industry.

By contrast, electricity price formation is complex.²³ Market prices are set in function of the marginal costs of the last plant to be dispatched. Paragraph 370 of the sector inquiry report notes the following: *“the SRMC of the price setting unit determines not only the revenues of the owner of the marginal plant, but also of all other operators with nuclear, lignite or run-of—river units”*. This marginal cost pricing method generates considerable revenues for these other operators, even if they did not set the price. The sector inquiry report also notes that *“whilst their marginal costs are often significantly lower, it is generally argued that they need a higher price than the marginal costs to recover the higher fixed costs associated with base load generation”*.

The functioning of wholesale markets is further complicated by their high degree of concentration. In some countries the previous monopolist still enjoys market shares in the 90 to 100% range. Lack of interconnection capacity and illiquidity of wholesale markets are considerable entry barriers that contribute to the protection of those positions.

According to the sector inquiry report, the combination of high concentration degrees and lack of liquidity enable dominant generators to manipulate wholesale prices either by withdrawing capacity or *“by imposing high prices when they know that their production is indispensable to meet demand”*.²⁴ In that latter scenario, *“it is possible to raise prices (“excessive pricing”) even with a relatively small portfolio because the structure of the generation assets and indispensability of certain assets to meet demand at parts of the merit curve, or in certain locations in the network. The higher the concentration in the relevant parts of the merit curve concerned the greater is the scope for influencing prices ...”*.²⁵

²² The sector inquiry report also contains study into the price hike on the UK gas markets. The study did not reveal the existence of abusive pricing practices.

²³ The report deals with various markets: generation, forward markets and spot markets. This section will focus on generation.

²⁴ Paragraph 403.

²⁵ Paragraphs 405 and 428.

3.3.2. Difficulties to apply Article 82(a) EC

Seen from this angle, the wholesale markets in these countries seem obvious candidates for the scrutiny under Article 82(a) EC. There are several factors, however, that complicate the analysis. These factors concern the above mentioned system of marginal cost pricing according to which the latest dispatched plant sets the market price.

This system implies that large market shares are not necessarily indicative of market power. The sector inquiry revealed *“the possibility that companies with a limited share in generation capacity might have market power at certain moments”*.²⁶ Market power is determined inter alia by the diversity of a generators production portfolio. An operator owning most of the marginal plants in the merit order of production plants is most probably the market’s price setting firm rather than a larger operator that owns base load plants which are more at the left hand side of the merit order. It would be bizarre to accuse the price setting firm of excessive pricing, if it just prices in terms of its marginal costs. The price setting firm is unlikely to make “excessive” profits.

High profits are more likely to be found with the owners of the base load plants which can sell their electricity at a high market price significantly exceeding the marginal costs of their production plants. But these owners are not necessarily the price setting firms and, even if they are, the additional revenues may be needed, as mentioned above, to cover their fixed costs and their need to invest in new capacity.

The need to recover fixed costs and to ensure investment possibilities raises the fundamental question as regards the time frame under which pricing practices should be assessed. A rigorous or ruthless application of Article 82(a) EC aimed at combating short or medium term pricing, may deprive the accused firms of their ability to invest and hence exacerbate the lack of liquidity. Investments should be taken into consideration, as regards both the firm’s individual investment requirements and the industry investment cycle.

²⁶ Paragraph 408.

3.3.3. Price setting frequency and volumes sold at clearing price

Even so, the sector inquiry report offers some interesting materials to assess market power in the generation markets and, possibly, to overcome the difficulties identified above. Paragraphs 429 to 436 combine two elements to establish a firm's dominance.

The first element deals with the price setting frequency: how often does an operator set the clearing price? *"Hypothetically, if only one operator "sets the price" most of the time, it means that there are very few, if any, alternative offers around the clearing price most of the time. The operator builds-up knowledge about the inelasticity of demand on a specific part of the supply curve where he operates by comparing his bids with the exchange clearing price. If demand is very inelastic, he can increase the price without the risk (or with little risk) of being replaced by another operator"*²⁷ The report contains quantitative data about such price setting frequencies.

The second element concerns the volumes by the price setting operator at the clearing price. Here again, the report provides an overview of markets where the largest price setter controlled more than 50% of the electricity offers at a price around the clearing price. That table shows that the price setter in some markets accounts for 100% of electricity sold at the clearing price.

3.3.4. Unfair pricing?

The combination of these two elements overcomes some, but not all difficulties referred to above. The frequency element ensures that price setting by the firm under scrutiny is not occasional and the volume conditions imply that the advantages of marginal prices also accrue to its base load operations at the left hand side of the merit curve: price setting and profits coincide within the same firm. Still, this does not suffice to establish the existence of unfair prices.

Marginal cost pricing is an intrinsic feature of electricity generation markets. Why would such pricing suddenly become abusive if it is applied by a frequent price setter that may be selling large volumes, but which follows the same market conduct as the conduct that prevails under competitive conditions?

²⁷ Paragraph 429.

In addition, even if one were to assume that the price setting firm makes additional profits on its plants at the left end side of the merit order, the argument that marginal cost pricing does not suffice to cover total long term costs of and investments for these plants remains a valid one.

Relying on the test developed under section I above, the application of Article 82(a) EC requires additional elements.

Firstly, there should be no other means to intervene against the pricing problem. The sector inquiry report refers for example to the possibility of some price setting firms to push prices up by withdrawing capacity. In that event, Article 82 EC should apply to the withdrawal policy as a form of output reducing behaviour. Preference should indeed be given to fighting causes rather than symptoms.

Secondly, price setting should occur at a level that exceeds marginal cost pricing. The sector inquiry report suggests that this situation can arise where the unique position of the price setting firm has allowed it to gain specific knowledge about the demand curve and where it has used this knowledge to push prices above usual marginal cost prices. In other words, prices should be supra-monopolistic in nature.

Thirdly, the product should be indispensable and have an inelastic demand curve. In the electricity sector these two conditions are likely to be fulfilled.

And, fourthly, one could also require that the price setting firm is systematically pushing prices above monopoly levels without incurring the risk to stimulate market entry. The conduct should be systematic and not be accidental.

All these conditions are admittedly hard to meet and even harder to prove. A cocktail of cost/price analyses and various comparisons, comparable to the approach followed by the OFT in *Napp*, will probably offer the only means to meet that burden of proof.

4. National precedents

4.1. Ex post network regulation

In the absence of *ex ante* tariff regulation in the electricity and gas sectors by an energy specific regulator, the German Federal Cartel Office (FCO) has dealt with tariff regulation on an *ex-post* basis. It intervened in several instances against excessive transmission and distribution charges²⁸. In the Stadwerke Mainz case, it compared the tariffs of the Stadwerke Mainz to the tariffs of a comparable city distribution company, RWE Net and assessed whether any differences could be explained by objective factors, such as differences in costs, the structure of the grid, geographical features, number of connected customers, economies of scale and reliability. On the basis of this comparison, the FCO found that the tariffs of Stadwerke needed to be lowered with 19.9% to suppress their abusive nature²⁹.

On 7 February 2006, Germany's Supreme Civil Court, confirmed the legality of this type of ex post tariff regulation in the Strom II plus case.³⁰ It noted that a voluntary framework agreement, called Strom II Plus, which lays down the cost calculation for network access pricing, did not exclude the possibility that the prices charged were excessive. It referred the case back to a lower court requiring it to applying German sector specific legislation and competition law. It also referred to Article 82 EC as a provision which that court should take into consideration.

The FCO intervened in a similar manner against network operators on other aspects of their business, such as metering conditions and prices of balancing power³¹. The Dutch authorities (NMa) intervened informally against the compensation for transformation losses applied by Essent in respect of windmill procedures³². Since the Dutch system has a detailed system of tariff regulation, the intervention of the NMa can be seen as complementary in nature.

It is not clear whether these German precedents are relevant for unfair pricing issues under Article 82 EC. This is because the provisions on the

²⁸ TEAG, FCO 19.02.2003.

²⁹ *Stadwerke Mainz AG*, 21.03.2003.

³⁰ Bundesgerichtshof, 7 February 2006; *Strom II plus*, KZR 8/05.

³¹ FCO 21.02.2003 *RWE Net* and FCO 21.02.2003 *RWE Net*.

³² Press release NMa, 30.09.2004.

German Act against Restraints of Competition (ARC) seem stricter than Article 82 EC, at least in so far as unfair pricing is concerned, because they prohibit conduct that is not necessarily unfair.³³ Article 19(4) sub 2 ARC prohibits that a dominant firm “*demands payments or business terms which differ from those which would very likely arise if competition existed; in that context, particularly the conduct of undertakings in comparable markets where effective competition prevails shall be taken into account*”.

4.2. Wholesale markets

4.2.1. Spanish temporary congestion cases

The Spanish competition authorities decided that four electricity producers had abused the monopolistic positions which each of them held in their respective service areas during three consecutive days when “congestion problems” prevented a normal functioning of the Spanish electricity market³⁴. During these three days, each vertically integrated producer applied unusually high prices. These prices considerably exceeded variable costs, were significantly higher than the prices charged in comparable situations of technical constraints and exceeded peak prices during the past twelve months. Even if the Tribunal implicitly admitted that the prices corresponded to rational commercial conduct, it considered that each producer had abused its individual dominant position and imposed a fine of € 0.9 million on each of them.

The ruling of the Tribunal primarily reflects a normative point of view; the four producers unduly took advantage of the temporary congestion problem on the Spanish grid. The producers should have priced as if they would have done in the absence of that problem. The sanction therefore seems to focus more on an abuse of unexpected advantage rather than on the excessive nature of the prices as such.

³³ Article 3(2) of Regulation 1/2003 authorizes Member States to maintain stricter prohibitions for unilateral conduct.

³⁴ *Empresas Electricas*, Tribunal de Defensa de la Competencia, 552/02, 7.07.2004. My Spanish is insufficient to understand all nuances of the case. The OMEL daily market does not accept prices which are too high. These prices are sold under a “technical restraints” regime. The markets resulting from these regimes are local in nature: due to capacity problems on the transport grid, local users must buy from local producers. This gives rise to local dominant positions. See also *Viesgo Generacion*, 602/05, 28.12.2006.

4.2.2. The Elsam case

On 30 November 2005 the Danish Competition Council also took a decision against unfair prices charged by Elsam A/S.³⁵ The reference period was considerably longer than the period examined by the Spanish authorities; *i.e.* 1 July 2003 until 31 December 2004. During this period Elsam is supposed to have abused its position on wholesale OTC market in Western Denmark. The Council found that this market constituted the relevant market despite price interaction on the spot market between Western Denmark and other parts of the Nord Pool area. This is because the available price data were already affected by Elsam's excessive prices. Bottle necks on the electricity grid isolate Western Denmark from the rest of the country. Within this area Elsam enjoyed a dominant position with a 90% market share. Decentralized production and wind mills did not constrain its market power.

As regards the assessment of Elsam's prices, the Council applied the *United Brands* test, described above. It held that these prices exceeded average total costs plus a mark up which was calculated in function of the average rate of return in the industry. This part of the test revealed that prices were excessive. As regards the second part of the test, the Council compared the prices charged during the relevant period with prices charged during other periods. This showed that Elsam had been charging unfair prices during 900 hours. Elsam appealed against this decision before the Competition Appeals Court. On 14 November 2006, this jurisdiction confirmed the Council's substantive assessment, but annulled the price control order which the Council had imposed as a remedy.³⁶

In so far as I understand the case, the Danish authorities have given a very rigid interpretation of the *United Brands* test. Their objections concern monopoly pricing during a period of congestion. They do not address the question as to whether that monopoly pricing was unfair in itself or in comparison to competing products.

³⁵ Danish Competition Council, 30 November 2005, Elsam A/S.

³⁶ Danish Competition Appeals Court, 15 November 2006, Elsam A/S.

4.2.3. ENEL price manipulation

The Italian Energy regulator and competition authority intervened in 2005 and 2006 against ENEL. They accused ENEL of price manipulation. The publicly available documents do not describe the nature of the practices in question, which seem to boil down to a cocktail of repression of and compensation for competitors in view of imposing ENEL's market leadership. These practices do not include unfair pricing in the above mentioned sense. Even so, the case is interesting because of the remedies offered by ENEL. This company and its subsidiary offered to auction 700 MW per year in order to increase liquidity in certain markets.³⁷

4.2.4. CO2 prices

In 2006 the FCO initiated proceedings against E.ON and RWE, because these companies had increased their prices by including a cost component relating to CO2 emission rights which these companies had obtained for free. The FCO considers that these two companies hold a collective dominant position on the national energy markets and that they abused that dominance contrary to Article 19§4 ARC, quoted above. Competitive conditions in other Member States do not allow electricity producers to pass on opportunity costs of freely obtained emission rights. Curiously, the FCO does not object to 25% of these costs being passed on. Any pass on above that percentage is considered to be abusive.

In order to avoid further proceedings, RWE undertook on 26 September 2007 to release a capacity of 6300 Mw under auction schemes during the four coming years. In the process, RWE will credit industrial customers with the value of the free CO2 allowances. This measure will undoubtedly increase liquidity in the German wholesale market. Although a commitment decision does not imply necessarily the existence of an infringement, I doubt whether the FCO could have found such an infringement for two reasons. To my knowledge, market prices of freely obtained CO2 emission rights are also passed on in electricity prices in countries which are not necessarily characterized by dominant positions.³⁸ Is it unfair for a dominant firm to apply the same pricing practice as the one which would have

³⁷ Case 16250 of 20 December 2006, A 366, Bolletino 49/2006.

³⁸ See Frontier Economics "CO2 trading and its influence on electricity markets", Final report for DTE, February 2006.

prevailed in competitive conditions? In addition, does the increase generate windfall profits or does it anticipate windfall costs? The pass on some may seem unfair when assessed as an isolated event, but may be less so when assessed over a longer period, as suggested in Section 1 above.

4.2.5. German electricity prices

Large electricity intensive industrial users are concerned throughout Europe that energy prices rise. These users often compete on worldwide markets, unlike electricity producers which reside in local markets without effective competitive constraints. This mismatch may lead to relocations of energy intensive users outside Europe, i.e. in countries with regulated energy markets and with less CO₂ concerns. These concerns also affect the EU's manufacturing power house. In an attempt to assist large users and comfort other users, such as households, the German government has amended the ARC on the point of excessive prices in the energy industry.³⁹

Article 29 of the proposed act prohibits an undertaking that holds, individually or collectively, a dominant position as supplier of electricity, gas or heat (supply company), to abuse that position, where it imposes tariffs or trading conditions that are more disadvantageous than those of other supply companies or companies operating on comparable markets, even if the difference is not considerable, or where it imposes tariffs that disproportionately exceed costs. The prohibition does not apply if the dominant supply firm is able to demonstrate that its prices are commercially justified. However, costs or cost components that would not have been incurred to the same extent under competitive conditions cannot be taken into consideration when determining the existence of an abuse within the meaning of Article 29.

The new prohibition is very strict and considerably lightens the burden of proof on the FCO to show the existence of a price abuse. Prices can be abusive, either when they exceed, even slightly, the price level of benchmark undertakings or when they are disproportionate in comparison to the cost of the dominant firm. In either scenario, the prohibition applies and the burden of proof shifts from the FCO to the dominant firm to justify those prices. In addition, monopoly costs of the type to which the ECJ alluded in

³⁹ See for example, '*Wettbewerb auf dem Strommarkt*', Orientierungen zur Wirtschafts- und Gesellschaftspolitik, Ludwig Erhard Stiftung Bonn, December 2006.

the SACEM cases, may not be taken into consideration to that effect. Moreover, the proposed prohibition considerably widens the choice for the FCO to find benchmark companies: these may energy supply companies in other markets, but also supply companies in non-energy markets.

The German Ministry of Economic affairs has argued that the prohibition corresponds to or specifies the prohibition laid down in Article 82(a) EC. I do not think this is entirely correct. Article 29 is not only procedural in nature in that it eases the burden of proof for the regulator, but it also imposes a substantive norm that prohibits pricing that would not be caught by Article 82(a) EC. Charging higher prices than one's competitors or making monopoly profits is not unfair as such. The test proposed under section I and the case law of the ECJ require a wider combination of elements to make the normative judgment that a dominant firm is acting unfairly. More in general, the objectives pursued by Article 29 are hard to reconcile with the subsidiary nature of Article 82(a) EC and may even be counter-productive.⁴⁰ Article 29 reflects distrust in the competitive process. It may discourage investments and, hence, contribute to reducing liquidity. Finally, it may exacerbate the problem it tries to cure.

5. Concluding remarks

It was a widespread political belief that the opening of energy markets to competition would lead to lower prices. This is a fallacy: prices merely reflect the interplay between supply and demand. The market mechanism does not guarantee absolute price levels. Moreover, the sector inherited its monopolistic structure from the past. Legal liberalisation cannot set economic realities aside. Still, confronted by political impatience and dissatisfaction, competition regulators and authorities are called upon to intervene. In this context Article 82(a) EC and equivalent provisions of national law have attracted new attention.

Article 82(a) EC does and should not, however, be relied on to hastily. This prohibition is of subsidiary nature and should be applied only if competition ceased to function. Competition law interventions should primarily focus on practices harming the competitive process and on the causes of relatively high prices, rather than on the high prices themselves. It is only when the

⁴⁰ The Monopolkommission issued a negative opinion on the proposed act.

dominant firm ceases to feel competitive or other market constraints that Article 82(a) EC should come into play. This is when norms and ethics offer the only recourse against the dominant firm.

These exceptional circumstances can occur in the European energy sector that is still characterized by the presence of quasi-monopolies in many markets and by relatively high entry barriers. Gas and electricity are indispensable in our modern societies. Demand for these products is often inelastic, particularly in the electricity sector. This inelastic demand allows the still remaining monopolies to lift prices beyond the point where their marginal cost curve intersects the demand curve. Such supra-monopoly pricing is in my view unfair, if it is a persistent feature of the dominant firm's pricing conduct.

It is not an easy task to find the evidence that all these conditions are met. There will rarely be one conclusive factor. The application of Article 82(a) EC will most probably require the convergence of various indicators, as shown by the CAT in *Napp*.

There are few convincing precedents dealing with unfair pricing in the energy sector. A large part of these precedents concern ex post tariff regulation as a substitute for ex ante regulation. However, unfair pricing within the meaning of Article 82(a) EC is a different concept than efficiency driven tariff regulation. Article 82(a) EC does not allow the regulator to compress the costs of the network operator. The precedents relating to wholesale markets are not convincing either. The Spanish and Danish cases concern price increases limited in time. Moreover, the Danish authorities seem to consider that a price above a cost plus level is excessive and therefore unfair. It follows from *United Brands* that such above cost pricing is not necessarily unfair. Nor does the *United Brands* brand correspond to the proposed German act on abusive pricing in the energy sector.

Article 82(a) EC is and will remain difficult to apply. It is also dangerous to apply. Too rigorous enforcement can negatively affect the investment climate.

Finally, I would like to conclude my contribution by expressing some general concerns about competition in the energy sector. I have doubts as to the welfare creating role of competition in that industry. Is competition the best method to achieve Europe's environmental and geopolitical objectives?

What's the welfare creating role which downstream competition has to play when upstream gas prices are set by public authorities or companies in function of political imperatives rather than of economic considerations? What's the point of imposing competition in the electricity industry where demand is inelastic and where the supply curve reflects a rigid merit order?