COMPASS LEXECON

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SPECIAL REPORT Q&A August 2020

Antitrust & competition challenges in the energy and utilities sector

FW discusses antitrust & competition challenges in the energy and utilities sector with Catriona Hatton at Baker Botts, Antón Garcia at Compass Lexecon and Joseph Krauss at Hogan Lovells US LLP.

Q&A:

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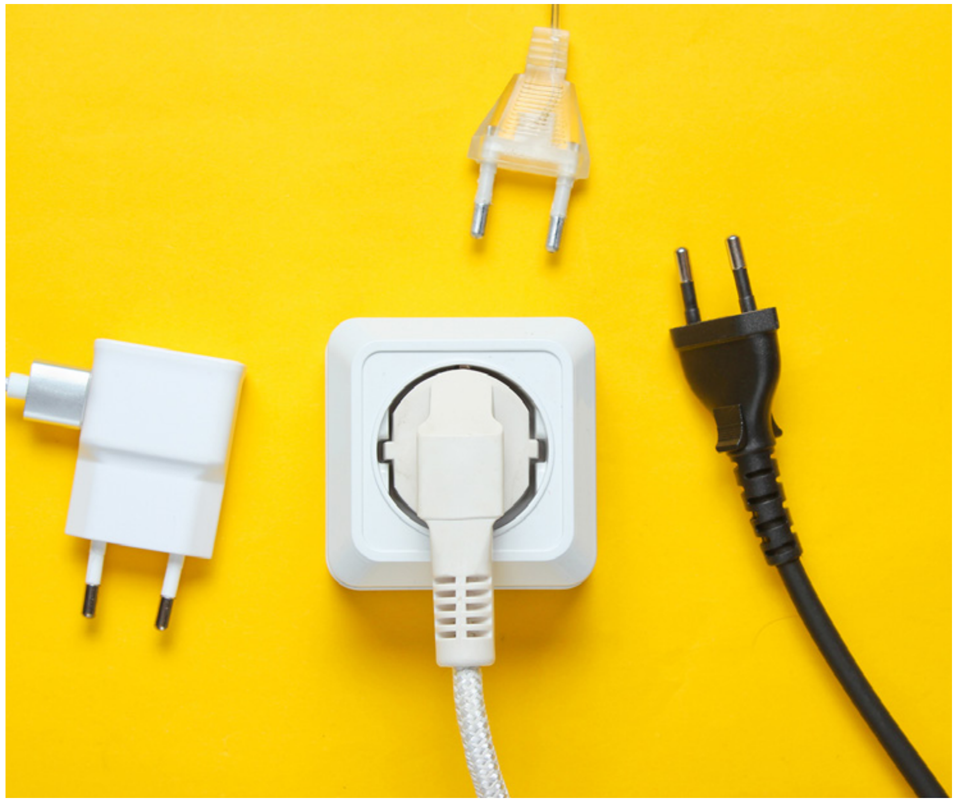

FW: What do you consider to be the key trends currently shaping the energy and utilities sector? What are the likely effects of economic volatility stemming from the COVID-19 crisis and recent trends in oil prices?

Krauss: Even before the pandemic, we were seeing increased use of proprietary analytics to better predict pricing movements and prepare for fluctuations and market volatility. Competition regulators have been concerned in the past that such analytics could lead to increased coordination and pricing stability, so, as the industry tries to manage the effects of the crisis, I expect we will see increased scrutiny of such tools. In addition, utilities will be looking for ways to create efficiencies and reduce costs, so acquisitions could be considered to consolidate facilities. In lieu of acquisitions, I expect companies to seriously consider joint ventures and other cooperation agreements, where they could obtain those same efficiencies without a large outlay of cash.

Hatton: The oil industry has taken the double hit of a price war combined with a massive slump in demand due to coronavirus (COVID-19). This comes on top of the longer-term industry challenges of overproduction and the energy transition to lower carbon which is predicted to bring a wave of consolidation in oil and oilfield services. At the same time, Europe's nuclear industry may see further restructuring as it continues to face its own challenges. It seems the jury is out on whether, at a global level, the COVID-19 crisis could slow down or even accelerate a lower carbon greener economy. That said, the European Union (EU) is making it clear that 'green' is here to stay, with ambitious goals and policies to become carbon neutral by 2050, as set out in the European Green Deal. The green agenda should continue to spur further innovation across renewables, hydrogen and energy storage, as well as oil and gas, as they prepare for a low carbon future. However, with falling investment overall, we may see more collaboration between companies in trying to achieve environmental goals.

Garcia: In Europe, and more broadly, key trends are related to increasing the environmental sustainability of the energy system, for example reducing emissions. The main ways of achieving this are through a greater penetration of renewables, particularly in electricity generation, a greater electrification of the economy – to the detriment of fossil fuels – and increasing energy efficiency by consumers and industry. The COVID-19 crisis has seen the price of both oil and gas reach historic lows. Futures prices suggest that it may take several years for prices to reach pre-COVID-19 levels. Lower oil and gas prices may also dampen the incentives for electrification, renewable energy sources (RES) penetration and energy efficiency.

FW: In this environment, what are the substantive competition/antitrust issues that energy and utilities companies need to consider?

Hatton: For M&A, EU commissioner Vestager made it clear that dealmakers should not expect an "easy pass" notwithstanding "economic pandemonium". That said, there will be greater scope for consolidation, as regulators factor in the impact of the crisis on the competitiveness of companies going forward. We will likely see more companies seeking to rely on the failing firm defence, as buyers look to acquire assets which may otherwise exit the market. While rarely invoked successfully by merging parties – Nynas' acquisition of Shell's Harburg refinery is a rare EU example – there will be more deals where the defence is relevant to the competition assessment. There are additional considerations for foreign companies investing in European energy assets, with new and strengthened controls on foreign investments in strategic assets, as the EU and UK move to prevent 'predatory buying'.

Garcia: Energy companies, and particularly oil and gas companies, have been hit hard by the COVID-19 crisis. This may pave the way for a wave of consolidation where weaker companies are taken over by stronger rivals. Furthermore, although there have not been any significant COVID-19 related energy supply disruptions, given the shortages experienced in certain health industry products, there may be a resurgence of concerns related to energy dependence by foreign countries. We may also see a resurgence of industrial policy and of policies aimed at supporting national champions. This may result in increased subsidies for energy companies that are considered 'strategic' and a greater push by national governments to include industrial policy considerations in merger and, where relevant, state aid control.

Krauss: Competition regulators will use their traditional analysis to determine whether any acquisition or conduct substantially reduces competition. Greater consolidation in the energy sector has always been of concern to the Federal Trade Commission (FTC) and any significant transactions should be subjected to a strenuous and time-consuming review. Companies should be prepared for a lengthy review and be prepared for an investigation of both potential horizontal and vertical issues.

FW: What steps can companies in this space take to understand, evaluate and mitigate competition/antitrust risks?

Krauss: Companies should engage counsel and economists early to fully examine all potential issues raised by their business activities or plans. Preparation is the key to be ready to actively engage with the competition authorities as quickly as possible, so as to increase the chances that any investigation will be concluded quickly.

Garcia: There are a number of antitrust risk factors which affect energy companies. First, they tend to be very large, so they have a higher risk of being found dominant in certain markets, Second, they tend to enter into very long-term contracts and in many cases are vertically integrated, both of which can be a source of antitrust concerns. Finally, they participate in a number of day ahead and futures markets, which are subject to both antitrust and market manipulation scrutiny. In order to evaluate and mitigate these risks, companies need to put in place a comprehensive framework directed by a compliance officer without conflicts of interest. Once a risk factor is identified, there has to be a protocol for addressing it. For instance, trading arms should have clear rules regarding how they formulate their bids in markets where the company may have market power. Ideally, these protocols should be assessed by external counsel and economic experts.

Hatton: Companies need to keep collaboration with competitors under close review, with upfront assessment and ongoing monitoring, as well as training for business. The risk of collaboration overstepping the limits is higher now when news of authorities relaxing enforcement can be misconstrued. It is important for businesses to understand that collaboration on selling prices or market allocation while in the highest risk area, is not the only area of collaboration risk. Purchase prices, innovation and quality, including improvements in sustainability, are all important aspects of competition and any collaboration needs to be kept under review. Evaluating areas of potential dominance allows a company to identify products and services where its unilateral conduct is at risk of challenge, and to design appropriate controls around key decisions in these areas. These include review of proposed price increases, plans to withhold supply, refusal to grant access to infrastructure and restrictions of exports within the EU.

FW: Have there been any significant legal or regulatory developments in competition/antitrust law? How would you describe recent enforcement efforts to curb anti-competitive business practices in the energy and utilities sector?

Hatton: Pricing issues remain high on the agenda for utilities which have been subject to heavy intervention by regulators. The UK water regulator Ofwat's recent price cap plan for the next five years is under challenge from water companies before the UK competition authority. The price cap plan was pre-COVID-19, and it will be interesting to see how the Competition and Markets Authority (CMA) will factor the impact of COVID-19 into its assessment. The EU has continued to focus on enforcement to support a single EU market in energy, taking on several energy companies for suspected abuse of

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dominance by restricting exports within the EU.

Garcia: Besides the publication of the Electricity Market Directive and Regulation, a development in 2019 that merits attention was the adoption by the German competition authority and energy regulator of the guidelines for the control of abusive practices by electricity generators. Notably, the guidelines establish that prices above marginal costs are legitimate if required by a dominant supplier to cover the costs of its generation park. While this cost sufficiency defence has been argued by generators before, it is, to my knowledge, the first time it has been explicitly accepted by an authority. Regarding enforcement, antitrust efforts at the EU level have continued to be centred on eliminating barriers to a single gas market. This includes the commitments reached with Gazprom to, among others, eliminate restrictions on the resale and shipment of gas across EU markets, the commitments by Transgaz to allow for greater exports of gas from Bulgaria, and the ongoing investigation into restrictions to the free flow between member states of liquified natural gas (LNG) sold by Qatar Petroleum, which accounts for around 40 percent of the EU's overall LNG imports.

> IN EUROPE, THERE HAS BEEN EVIDENCE OF A SLOWDOWN IN CARTEL CASES PROBABLY DUE TO RISKS PERCEIVED BY POTENTIAL LENIENCY APPLICANTS FROM FOLLOW-ON DAMAGES.
>
> ANTÓN GARCIA
> Compass Lexecon

Krauss: The FTC has always been especially aggressive in reviewing transactions in the energy sector, as confirmed by its recent challenge to the proposed joint venture between Peabody and Arch Coal. I expect that high level of scrutiny to continue.

FW: Have any recent competition/antitrust cases in this sector caught your attention? What insights do they offer into the current attitude of regulatory authorities and the level of risks companies face?

Krauss: The FTC's challenge to the Peabody and Arch Coal joint venture was particularly noteworthy in that it was another attempt by parties to consolidate operations in the Powder River Basin. The FTC's challenge indicates a continued emphasis on narrow markets even in the face of arguments of broader competition.

Garcia: In 2019, the General Court overturned the European Commission (EC)'s decision to allow Gazprom to fully utilise the Ostsee-Pipeline-Anbindungsleitung (OPAL) pipeline – a key alternative for Ukraine for the supply of Russian gas to central Europe. Beyond its evident impact on conditions of supply in several European gas markets, the decision may have a broader impact as it seems to require the EC to explicitly analyse how its decisions affect security of supply in the energy markets of all member states. It is unclear how substantive the EC's analysis will need to be to meet the General Court's standard, but, in principle, it could require the EC to engage in comprehensive modelling of EU electricity and gas markets to assess the impact of its energy-related decisions. Another notable decision in 2019 was the rejection by the EC of the complaint by PGNiG, a Polish gas supplier, regarding an alleged abuse of dominance by Gazprom in the Polish gas market. Having agreed commitments with Gazprom affecting broadly the same conduct raised in the complaint, the EC rejected further action, but noted that parties affected could seek compensation for any alleged past excessive pricing in national courts.

Hatton: In merger enforcement, Germany's E.ON and RWE's asset swap raised an array of jurisdictional and substantive issues – requiring two separate EU approvals for the swaps – as well as approvals under UK and German merger control for an acquisition by RWE of a minority stake in E.ON, which the EU did not have jurisdiction to review. The regulatory review highlights complexities and timing implications of securing multiple merger approvals and agreeing suitable remedies. Ironically, RWE's side of the deal, which was the first to be approved by the EU more than a year ago without conditions and without opening an in-depth investigation, has been challenged recently by several regional utilities that are appealing the decision to the European Court.

FW: What issues and challenges are emerging in connection with applying leniency in competition/antitrust cases? What lessons do companies need to draw from recent developments?

Garcia: In Europe, there has been evidence of a slowdown in cartel cases probably due to risks perceived by potential leniency applicants from follow-on damages. Although traditional cartel cases are infrequent in the energy sector, this issue could also affect any potential whistleblowers in the energy sector.

Hatton: Exposure of leniency applicants to follow-on damage claims in national courts, and the ability of courts to order discovery of evidence submitted in the context of leniency, can be a deterrent to companies coming forward to disclose cartels. While being first to disclose the cartel can secure immunity from fines, this needs to be weighed against the fact that an EC infringement decision or settlement in a cartel case is increasingly the trigger for cartel victims to launch damage claims – facilitated by the possibility in some countries of collective action by entities aggregating claims to bring a single action on behalf of multiple victims. However, avoiding or limiting exposure to increasingly high EC fines will often weigh in favour of leniency, particularly if a company believes the EC would have a strong case.

Krauss: Companies should understand that a leniency application will require complete cooperation with the Department of Justice (DOJ) since any failure to provide all relevant facts and evidence could result in a revocation of the leniency application. Therefore, parties need to be prepared to reply accurately to numerous DOJ requests, and this requires significant resources and time.

FW: What advice would you offer to energy and utilities companies on meeting their competition/antitrust obligations and maintaining regulatory compliance?

Hatton: At the risk of sounding like a mantra, an effective, tailored compliance programme which is regularly updated and supported by ongoing training is essential. Recent statements by the DOJ on the evaluation of corporate compliance programmes are helpful, with evaluation based around three big questions: is the programme well designed, is it adequately resourced and empowered to function effectively, and does it work in practice? For mergers, the importance of actively managing gun-jumping risks is underscored by recent high-profile cases in Europe, with fines of over €200m and increasing international enforcement. Limiting exchange of confidential information in due diligence and integration planning, using non-disclosure agreements (NDAs) and clean teams, and screening sale and purchase agreement (SPA) provisions designed to preserve the value of the target business, are all key to managing risk. Early assessment of deals and investments to determine if merger approvals are required is more important than ever.

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> CATRIONA HATTON
> Baker Botts

Krauss: Knowledgeable counsel can advise companies on ways to avoid antitrust pitfalls and expensive and time-consuming investigations. A small amount of work upfront can avoid potentially expensive investigations later.

Garcia: It is important to have a robust compliance process. If a substantial risk is detected, companies should bring in external counsel and economists early on. Treat antitrust compliance as a form of insurance. The risks are large in the form of fines, follow-on damages and reputational damages. While companies should aim to get the best value for money, they certainly do not want the cheapest coverage in the market.

FW: In your opinion, what will be the prevailing issues for competition/antitrust issues in the energy & utilities sector over the coming months?

Garcia: In the EU, we are also likely to see state aid cases in the electricity sector. In a period where investment incentives may be dampened, member states will move to review their capacity payments and RES support schemes to attract the required investment to ensure they meet security of supply and environmental objectives. Finally, a case to watch for in the EU is the legal challenge initiated by a number of German municipal suppliers against the EC's decision in the E.ON Innogy asset swap, the only significant energy concentration assessed by the EC for many years. Following the UK capacity market and OPAL decisions, another reversal in the EU courts would weaken the EC's credibility in energy matters, which is likely to result in more challenges to its decisions in the future.

Krauss: Companies will be looking for ways to emerge from the pandemic and be stronger. Creativity will be the key – finding creative ways to better position itself as we emerge from the pandemic and the new business 'normalcy' becomes a reality. Energy demand may shift, and supply sources may change. Companies will need to be flexible to respond to this new 'normal'. Competition advice will be critical to make sure efforts to respond to this environment stay within the confines of competition laws.

Hatton: The green agenda and promotion of sustainable low carbon energy will continue to permeate many aspects of antitrust developments in Europe. Upcoming revisions to guidelines for state aid to companies active in energy and environmental sectors are set to focus on decarbonisation, including developments in hydrogen and energy storage, with the scope for continued aid to renewables under review, given their lower cost base and success. The EU's horizontal guidelines on cooperation agreements between competitors are also under review, and companies are calling on the EC to provide more guidance and scope for important collaboration on environmental and sustainability initiatives. ■

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