



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

**DAF/COMP/WD(2007)18
For Official Use**

ROUNDTABLE ON ENERGY SECURITY AND COMPETITION POLICY

-- Note by Lithuania --

This note is a joint contribution prepared by the Competition Council and the Ministry of Foreign Affairs of Lithuania. It is submitted to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21-22 February 2007.

JT03221015

Document complet disponible sur OLIS dans son format d'origine
Complete document available on OLIS in its original format

1. What is energy security and how much is it worth?

1. Energy security may be described shortly as a reliable and diversified supply of energy at a reasonable (or market) prices. Effectively functioning energy sector is a backbone of the economy of every modern state. Therefore threats to energy sector may have direct or indirect impact on state's economy and national security. Growing deficit and prices of traditional energy resources and the need to take into account climate change requirements make impact to energy security.

2. Energy security is not a problem until it remains an economic category and is solely used for economic purposes. But in the 21st century we can see growing temptation to use energy as a political tool in the international relations. Therefore energy security becomes a part of foreign diplomacy. Tendency to use energy as a political leverage can be explained by the consequences of globalisation. World energy sector develops in contradiction with the processes of globalisation. 85-90% of world energy is concentrated in the national state owned companies with a growing inclination to further re-nationalisation and monopolisation. Redistribution of energy supply and demand centers in the world also contributes to the "energy politisation."

3. It must be noted that both energy supply and demand may be used as political tool. Therefore binding rules based on competition, transparency and non-discrimination in the global energy relationship between the energy producing and consuming countries would be desirable thus helping to prevent geopolitical tensions in the world related to energy resources.

4. Russia as an energy partner deserves special attention. Russian vertically integrated monopolies dominate in the supply of energy to Europe. Some of the EU states depend on one single monopoly supplier of energy. From the economic and security point of view it is not acceptable. Energy relations with Russia must be balanced better. Most of the European energy companies are not even comparable in size and strength with Russian hyper-monopoly Gazprom. In parallel with the ongoing liberalisation of energy market in the EU by unbundling of the monopolies, EU should elaborate effective safeguards against eventual distortion of competition by the vertically integrated monopolies from the third countries.

5. Lithuania is not interconnected with energy infrastructure of European Union because of historical heritage and is considered as an "energy island" in European Union. Therefore energy security is a top priority of Lithuanian State.

6. Lithuania imports all its natural gas from a single source which is the Russian Federation. Domestically produced nuclear energy presently accounts for the largest share in the primary energy supply (approximately 30% in 2005) and a large percentage of the electricity generated (approximately 70% in 2005). The second largest share in the primary energy supply belongs to oil (approximately 31%) and the third largest share belongs to natural gas (approximately 28%). Natural gas is very important for the whole economy now and its importance will only increase after the only nuclear power station in Lithuania is decommissioned in 2009. Reliability of natural gas supply is posing a problem of national security now and it will become more acute in case Lithuania is not able to secure the alternative sources of natural gas supply from countries other than Russian Federation. It is difficult to quantify the worth of energy security but clearly, it is a necessary condition for the sustainable growth of the economy.

2. What is the effect of competition on energy security?

7. In general, competitive markets make industry supply as efficient as possible and eliminate undue market power and supra-normal profits. Transparent and liquid wholesale markets for energy provide clearer signals and encourage efficient use of energy. There is no reason to believe that natural gas

market could be an exception. Therefore the only suitable way to ensure energy security for customers in Lithuania is to create as much competition as possible on the market starting with diversification of supply.

8. At present time the only technically possible supply alternative to Russia's Gazprom OAO is an underground natural gas storage facility in Latvia. Unfortunately, this does not help much because Latvia gets its natural gas also from the same source and the majority of natural gas stored in this facility is owned by Gazprom OAO. The dependency on a single import source is further exacerbated by the isolation from the gas infrastructure of the rest of Europe. The Government of Lithuania is exploring possibilities of constructing interconnections with the gas pipelines of other EU countries and especially its southern neighbour Poland. According to the public statements of the Presidents of both countries such interconnection of pipelines is needed to ensure and strengthen the energy security in Central and Northern Europe¹.

9. Lithuania and Poland recognise that geographical location of both countries makes it difficult to find the alternative sources of natural gas supply. The most promising alternative source is the Caspian Sea region because such countries as Azerbaijan, Kazakhstan, and Turkmenistan are rich in natural gas resources. The major problem for Lithuania in diversifying natural gas supply sources is to find a way to circumvent the transmission pipelines controlled by Gazprom OAO. The Russian Federation refuses to ratify the Energy Charter and therefore Gazprom OAO avoids EU's rules of competition in non-EU markets. Furthermore, in 2006 Russian Duma passed the legislation which granted exclusive rights to Gazprom OAO to export gas from Russia to Europe. This makes it impossible to Lithuania to get gas from the alternative supply sources through the gas transmission system operated by Gazprom OAO. Although a successful common European energy policy could in the future change the situation for the better, other alternatives must be explored as well.

10. Privileges granted to Gazprom OAO by the Duma only strengthen the situation that has existed for over a decade. Gazprom OAO purchases gas from Kazakhstan, Turkmenistan and to a lesser degree from Uzbekistan at low prices and sells it to the European customers at much higher prices. One of the most significant changes that could expand export possibilities from the Caspian region to Europe is South Caucasus Pipeline. It should open access to gas from Azerbaijan although it is not clear yet how it might affect the gas exporters in Central Asia. In 2006 the major energy companies of Turkey, Bulgaria, Romania, Hungary, and Austria established the Nabucco Gas Pipeline international Company which should develop the gas pipeline connecting these countries. This project has the utmost importance to Europe because presently both Iran-Turkey gas pipeline and the South Caucasus Pipeline have Turkey as the final destination. This could help the EU to find the alternative ways to Middle Eastern, Caspian and possibly Central Asian gas and reduce its dependence on the most important natural gas source. Lithuania could benefit from the Nabucco project if it was extended towards Poland. The recently announced Georgia-Ukraine-European Union pipeline project could be a third possible way to deliver gas from Azerbaijan to Europe avoiding Gazprom OAO infrastructure. Such project would potentially benefit Lithuania if its infrastructure became interconnected with Poland.

11. Another possibility to avoid or at least reduce the dependence on a single supply source is to get a reliable access to a LNG terminal. Presently Lithuania is exploring the possibilities of co-operating with Poland, Latvia and Estonia in building such terminal in the Baltic region².

12. Probably the best way to improve resilience to supply shocks is by employing emergency stocks. At present time Lithuania is performing research works to build the domestic underground storage facility.

¹ "Polish, Lithuanian Presidents Call for Pipeline Connection," *Interfax News Agency*, 5 September 2005.

² *National Strategy on Energy*, approved by Seimas of the Republic of Lithuania on 18 January 2007.

Also participation in the future expansion of the underground storage facility in Latvia is under discussions.

13. The isolation of Lithuanian gas infrastructure from the rest of Europe and the inevitable reliance on the single source of supply severely distorts the functioning of the domestic gas market. The liberalisation of the natural gas sector was started in 2000, when the Parliament adopted the Law on Natural Gas. Although all customers with annual consumption of natural gas exceeding 1 million cubic meters were eligible to choose their supplier in 2004, the opening level of the natural gas market has been stable since then. A new draft of the Law on Natural Gas has been submitted to Parliament for consideration. In this draft, all provisions of the Directive 2003/55/EC are to be implemented including the requirement to open the gas market to all consumers on 1 July 2007. No matter how good these legislative measures could be, they would not introduce the additional wholesale suppliers of natural gas in a country with a single source of supply. In 2005 and 2006 there were only two wholesalers (Lietuvos Dujos AB and Dujotekana UAB), that purchased their natural gas under pre-defined quotas from Gazprom OAO and supplied all customers eligible to choose their supplier. Although the National Control Commission for Prices and Energy (NCC) has issued several supply licenses no other supplier has entered the market so far. One of the reasons why entry did not occur is the duration of the long term contracts between Lietuvos Dujos AB and Gazprom OAO (until 2015) and between Dujotekana UAB and Gazprom OAO (until 2012). Unusually long contracts are permitted because Lithuania has decided to apply the provisions of article 28 of the Directive 2003/55/EC (emergent market). Lietuvos Dujos AB³ supplied 62% and Dujotekana UAB⁴ supplied 38% of the total natural gas requirement of the eligible customers in 2005. The eligible customers had only two suppliers to choose from; therefore one of the suppliers was able to exercise a significant influence on natural gas prices. Lietuvos Dujos AB sold natural gas with profit margin that could not exceed 15% because the owners of this enterprise were obligated not to violate such a condition of the privatisation agreement signed with the Government of Lithuania. The other wholesale supplier Dujotekana UAB was able to get almost 21% profit margin in 2005.

14. Lietuvos Dujos AB supplies not only the eligible customers but also the regulated retail market where natural gas is purchased by households. According to the national law, gas companies selling natural gas to households are obliged to have their retail gas tariffs approved by the Regulator and can not exceed the approved tariff. According to the Directive 2003/55/EC, this is a public service obligation (PSO) which has to be notified to the European Commission. There is the on-going discussion in Lithuania concerning the extent of gas market liberalisation and regulation including the need for tariff regulation. Opponents of price regulations usually argue that there is little economic sense to exercise price regulation on the domestic market when it is Gazprom OAO that has the market power and is outside the reach of the national regulator.

15. One of the wholesale suppliers Lietuvos Dujos AB also operates the natural gas transmission system and the largest of the distribution networks. Six local distribution systems are managed by other private operators. The Law on Natural Gas provides that vertically integrated gas undertakings must keep separate accounting systems for gas transmission, distribution, storage, and supply activities. Accounting systems for all activities must be handled in such a way as they would be handled, if such activities were carried out by separate undertakings. Legal unbundling of natural gas transmission and supply is not implemented because the current Law on Natural Gas does not contain the requirement for legal unbundling of vertically integrated natural gas undertakings. Lithuania has applied the provisions of article 28 of the Directive 2003/55/EC (derogation because of an emergent market). Consequently, the gas

³ Lietuvos Dujos AB is owned by Gazprom OAO (37.1%), E. ON Ruhrgas (38.9%), the State Property Fund (17.7) and private individuals and legal persons (6.3%).

⁴ According to the official information provided by the Gazprom OAO and Dujotekana UAB, the former does not have any direct or indirect shareholdings in the latter.

transmission system and the largest gas distribution system are operated by the same undertaking that is also the largest supplier of natural gas. The market opening and unbundling requirements may not be met until 2010.

16. Despite a clear lack of competition on the domestic market and a single source of supply, the natural gas prices in Lithuania are among the lowest among the EU Members States. The prices for households in 2006 were about 47% below the European average although they have increased by 14.5% since 2004. Similarly, the gas prices for industrial customers were 46% below the European average. Nevertheless, it is expected that from 2007 natural gas prices will begin to approach the Western European prices and will reach 220 USD for 1000 cubic meters⁵.

3. Does applying competition law help to increase energy security?

17. In 2002 the Competition Council received a notification from Ruhrgas AG and E.ON Energie AG concerning their intentions to acquire 34 percent share of Lietuvos Dujos AB during its privatisation. After the clearance of the notified merger Ruhrgas AG and E.ON Energie AG together with the State Property Fund have acquired joint control of Lietuvos Dujos AB. Later that year the Government of Lithuania invited companies to participate in an international tender to become a natural gas supplier to customers in Lithuania and to acquire 34 percent shareholding in Lietuvos Dujos AB. Gazprom OAO was announced a winner of the tender. On 23 January 2004 the Government and Gazprom OAO signed an agreement establishing that Gazprom OAO will supply Lietuvos Dujos AB with the quantity of natural gas that satisfies at least 70 percent of the total requirement of all customers in Lithuania⁶ which will be expressed by Lietuvos Dujos AB. The discretion of Gazprom OAO was not restricted with respect to how to supply the remainder of the total requirement.

18. The Competition Council took into account the fact that Lietuvos dujos AB had a dominant position in the markets of natural gas transmission and distribution. Gazprom OAO was and still is the only feasible supplier of natural gas into Lithuania. Transmission network that belongs to Lietuvos dujos AB was not connected with the networks of other EU Member States, except Latvia. The latter country also receives its entire natural gas requirement from Gazprom OAO. Technically it is possible to receive natural gas from other companies in Russian Federation or former Soviet Republics in Central Asia. However, their ability to deliver natural gas to Lithuania is very remote because it is severely limited not only by the capacity of the transmission network that is operated by Gazprom OAO but also by the policy of the Russian Federation.

19. The Ministry of Economy of Lithuania expressed a written opinion that the agreement concluded between the Government of Lithuania and Gazprom OAO does not preclude the eligible customers from entering into purchase agreements with other suppliers of natural gas. The Competition Council decided to allow Gazprom OAO to implement concentration according to the submitted notification by acquiring a 34% shareholding of Lietuvos dujos AB and acquiring joint control with State Property Trust, Ruhrgas AG and E.ON Energie AG. The permission was issued subject to the condition that undertakings participating in the concentration will not create any obstacles for gas suppliers holding appropriate licenses and having concluded contracts with buyers in Lithuania, as well as consumers using gas for their own needs to conclude the gas purchase contracts with any natural gas production or supply company, as well as other undertakings producing natural gas to supply it to buyers in Lithuania.

⁵ *National Strategy on Energy*, approved by Seimas of the Republic of Lithuania on 18 January 2007.

⁶ Excluding the two largest industrial consumers of natural gas in Lithuania, that is Achema AB and Kauno Termofikacine Elektrine UAB. These undertakings import natural gas for their own needs and do not participate in the domestic wholesale market of gas as sellers.

4. What are the limits to the application of competition law in this area?

20. In the case study presented above the Competition Council took all necessary steps to ensure that the merger would not create barriers to entry. This case is also relevant to the question to what extent state actors are subject to competition law and to what extent enterprises compelled to behave in an anticompetitive way by a foreign government are subject to competition law. We believe that anticompetitive conduct of Gazprom OAO with respect to alternative gas suppliers for Lithuanian customers could result in revocation of merger clearance because the Competition Council issued only a conditional clearance for the merger in which Gazprom OAO has acquired 34% shareholding of Lietuvos Dujos AB. However, all actions of the foreign government are beyond the reach of the national institution responsible for competition policy. Therefore the exclusive rights to export gas from the Russian Federation to Europe granted to Gazprom OAO by the Duma of the Russian Federation allow this subject to behave in anticompetitive way and creates immunity against possible investigations by the foreign antitrust agencies.

21. Finally, it seems that attention should be paid to another limitation of the competition law. Competition law, at least when confined to antitrust matters and merger control, is typically designed to prevent certain actions of market players. The latter are expected to act as profit maximising entities. For example the SSNIP test employed in the market definition explicitly assumes profit maximising behaviour. Post-merger effects are simulated in oligopoly settings using game theoretical models that also assume profit maximising market players. Therefore one can wonder whether the antitrust law can prevent an undesirable behaviour of an entity which may not be a profit maximising in a reasonably defined relevant market. Such an entity could be a foreign government and its conduct might be very different from a profit-maximising business entity. This leads to a conclusion that in merger review (or some other cases that are so important that their consequences can affect energy security) competition law may be complemented by considerations of national security. In 1996 the Parliament of Lithuania adopted the Law on Fundamentals of National Security. The law specifically forbids a single investor to dominate in one or several sectors of national economy that are important to national security, e.g. the energy sector. The Government is obligated to present a list of objects that are strategically important to the national security and must remain under the ownership of the Government to the Parliament for approval. The list also includes the objects that can be owned by private domestic and foreign investors according to the specified proportion on condition that a foreign investor fulfils the criteria of European and Trans-Atlantic integration provided that the decisive influence is reserved for the Government.