

Will recent and future cross-border M&A activity reduce market competition across the EU?

Robin Cohen

Partner, Economic Consulting, Deloitte

Setting the scene

Over the past 18 months, the media and industry analysts have reported on a new wave of M&A activity in the European utilities sector. In 2006 a new peak was reached with a total of 211 deals in the energy sector (as reported by Thompson One Banker) with a value of Euros 204bn as compared with only 171 deals in 2004 with a value of Euros 118bn. Among the largest of these deals were transformational cross-border acquisitions such as the purchase of Scottish Power by Iberdrola which was worth €17.1bn and the proposed merger of Gaz de France and Suez to create a new utility capitalised at €75bn.

In practice, this level of M&A activity has been building from the late 1990's and is now culminating in the clear emergence of some so-called 'super-regional' utilities. The market capitalisation of the top 10 power and gas utilities in 2007 is shown in the table below and compared with that of the same companies in 2000. This demonstrates substantial growth of around 130%.

Market Cap (€m) as at 3 rd April 2007			Market Cap (€m) as at 3 rd April 2000		
Name	Country	Market Cap	Name	Country	Market Cap
EdF	France	116,895	EdF*	France	85,987
EON	Germany	76,353	Enel	Italy	56,628
Suez	France	52,515	Suez	France	36,716
Enel	Italy	51,479	EON	Germany	27,733
RWE	Germany	43,305	Endesa	Spain	26,776
Endesa	Spain	42,988	RWE	Germany	18,604
GdF	France	35,693	Centrica	UK	16,422
Iberdrola	Spain	33,859	Scottish Power	UK	15,999
National Grid	UK	33,140	National Grid	UK	13,930
Centrica	UK	21,642	Iberdrola	Spain	12,630

Source: *Datastream*, *= market cap 2005

The emergence of these super-regionals has coincided with increasing frustration on the part of the European Commission with the rate of progress being made towards completion of the internal energy market and the development of effective competition. The Commission in January this year completed its sector inquiry into the gas and electricity markets and concluded that particular competition problems include: high levels of market concentration; vertical integration of supply, generation and infrastructure leading to a lack of equal access to, and insufficient investment in infrastructure; and insufficient market transparency and liquidity. The identification of these problems with market structures clearly prompt the question: how much further M&A activity will be tolerated by the Commission?

The level of market competition across the EU

The Commission's concerns with the level of competition across the EU are supported by a number of studies. For example, Metthes et al have measured changes in market concentration across six regional power generation markets from 1996 to 2004. The critical level for the Herfindahl-Hirschman Index above which markets are generally regarded as


concentrated is 1800 and their analysis shows that concentration was above this level in several EU countries, in particular in France, Benelux, Germany and Spain. Similarly, the UK's Department of Trade and Industry in 2006 completed a study assessing energy market competitiveness across the EU. This study reported diverse results with only three countries scoring 7 points or more (out of a possible 10).

Accordingly, this high-level analysis is suggestive that mergers and acquisitions that lead to increased horizontal and vertical concentration within an integrated market area are likely to face increasing difficulties in gaining regulatory clearance. However this restriction does not apply to a large number of possible transactions, including the development of super-regionals that operate across market areas (that set the limits to feasible competition). It is no doubt in part for this reason that some of the largest recent transactions have been cross-border where this has also meant being cross-market.

National and cross-border M&A

The largest number of transactions has been national and principally involving a degree of horizontal concentration. This is not surprising given the large number of small scale utilities in many countries. The largest transactions by value have been a mix of national and cross-border; and, moreover, the large value cross-border transactions have been a mix of within and across market-areas.

Mergers & Acquisitions by market segment 2004 - 2007

	Ten largest deals				Ten smallest deals			
	Within market	Across market	Horizontal Integration	Vertical Integration	Within market	Across market	Horizontal Integration	Vertical Integration
1. Gaz de France/Suez		✓	✓		1. Kviinge EI Energi/Lund Eastern Energy	✓		✓
2. Scottish Power/Iberdrola		✓	✓		2. Gestora Fotovoltaica de Castell/Fersa Energia Renovables	✓		✓
3. Nuon/Essent	✓		✓		3. Solarcentury/Scottish and Southern	✓		✓
4. Electrabel/Suez		✓	✓		4. Nemmoco Slovenia Corp/Ascent Resources		✓	✓
5. Endesa/Enel		✓	✓		5. DDH Contractors/Dansk Biogas	✓		✓
6. Endesa/Acciona	✓			✓	6. PW Atex/Pratem SA	✓		✓
7. Union Fenosa/ACS	✓			✓	7. GK Energie/GHP German Hydro Power	✓		✓
8. Iberdrola/ACS	✓			✓	8. Ringsjo Energi AB/Lund Eastern Energy	✓		✓
9. Hidrocantabrico/EDP		✓	✓		9. MVV Energie Portugal/Cavalum	✓		✓
10. National-North of England/Gas Network	✓		✓		10. Allianceneftegaz/Imperial Energy Comp	✓		✓
 = Pending								

This confirms that where some utilities have begun to be restricted by competition law in terms of additional acquisitions in their national markets because of their market shares, they have then pursued horizontal diversification and cross-border/cross-market transactions.

This is in part illustrated by the acquisition of Endesa by Acciona and ENEL. In 2006 Endesa dominated the Spanish generation and supply markets, controlling 70% of retail supply together with Iberdrola. In the Italian electricity generation market, ENEL is the pre-eminent operator with a 39% market share whereas Acciona is a Spanish construction and power

group. In April this year, ENEL and Acciona jointly outbid E.ON to acquire the remaining of Endesa's shares, with a bid amounting to €43.7bn.

The development of super-regionals and governmental policy objectives

There are three key governmental policy objectives that are shared to a greater or lesser extent across EU governments and the Commission. These are (i) security of supply – which is principally a function of timely investment in network and production capacity and access to non-indigenous primary fuel supplies (ii) environmental sustainability – which primarily requires a range of measures to mitigate and counteract the effects of climate change by reducing carbon emissions and (iii) promotion of effective competition – which entails delivering cost-effective energy supplies to consumers. The extent to which the emerging super-regionals are best suited to deliver these policy objectives must be a key concern for both policy-makers and the utilities themselves.

Security of supply

Significant investment is required in electricity and gas infrastructure over the next few decades. The European Commission has estimated an increase in EU-25 energy consumption of 15% over 2000 by 2030. This will require investment in replacement and new power plant of around €625bn over the next 20 years. Total investment in gas infrastructure (pipelines, LNG terminals and storage) may add a further €100bn investment requirements.

Large-scale vertically integrated utilities are arguably beneficial to ensuring security of supply for the following reasons.

- Risk management: large scale vertically integrated utilities are likely to experience lower volatility in profits than smaller scale utilities. This is because size reduces exposure to the performance of individual assets, the development of a multi-fuel generation portfolio reduces exposure to specific input fuel costs and vertical integration allows pricing risks to be diversified across wholesale and retail markets. In this way committing to significant incremental investment is often more attractive for large scale utilities than it is for small scale utilities.
- Access to capital: large scale utilities with accompanying strong cash flows are better placed to raise capital to support large scale investments.
- Bargaining power: large scale utilities are in principle able to exert a degree of bargaining power, for example, with counterparties in fuel supply markets and with equipment suppliers. This enables such utilities to reduce the costs of new investments and better safeguard security of supply.
- Technical skills: large scale utilities will benefit from the ability to commit more skilled internal resources to developing investment projects. This both reduces the risks for a utility in making such investments as well as enabling more such opportunities to be appropriately evaluated and developed.
- Diversification of supply/technology: large scale utilities may arguably be better placed to avoid a 'herd effect' and to invest in a diversified portfolio of technologies and fuel supplies.

However the incentive to make timely investments to enhance security of supply is importantly affected by the level of market competitiveness. This is discussed further below.

Environmental sustainability and carbon reduction

Carbon reduction is incentivised across the European Union by the Emissions Trading Scheme. The main investments that will assist in carbon reduction comprise wind power, nuclear and carbon capture and storage (for gas or coal plant).

While wind power is now a relatively mature technology and may, at least onshore, comprise small scale investments, nuclear and CCS have quite different financial characteristics. A new nuclear power station will be efficiently constructed at the scale of at least 1000MW and will cost around €4.1bn in contrast to wind turbines that may be as small as 1MW at a cost of €1.5m off-shore and of €1m on-shore. CCS technology is currently not fully tested on a commercial scale and hence its application retro-fitted to coal or gas fired power stations carries with it significant risks. Moreover the costs of this retro-fit for a 1000MW station also represent a significant financial commitment of up to €1bn.

The EU will require substantial investments of this kind if it is to meet a 2020 target of a reduction in emissions of 20%. However these carbon reducing investments are more than usually risky: this is not just because of their capital intensity or innovative nature but also a consequence of the fact that they are not economic in the absence of a significant price on CO₂. And a CO₂ price, while it may be determined by market-based interactions, is principally the product of inter-governmental policy which itself is subject to associated political uncertainty. For example, the second phase of the EU-ETS when it enters into force in 2008 will only be defined through to 2012 which is an extremely short-time frame relative to the economic lives of the underlying assets required to mitigate carbon emissions. Consequently, it is most likely that it will be the largest energy companies that are able to take the financial risks associated with large scale carbon-mitigating investment. For example, in the UK it is EDF that has been most active among the leading power companies in progressing nuclear new build.

Competition

The European Commission's energy sector review has identified some serious structural problems that it argues are impeding the development of competition. The European Commission contentions are that:

- As a result of vertical integration of networks with production and retail operational and network investment decisions may be taken on the basis of the production/supply interests of the vertical integrated incumbent to the disadvantage of new entrants and security of supply;
- Horizontal concentration in local markets may lead to reduced liquidity and competitiveness which would serve to undermine investment incentives since profits may be maintained without investments.
- Lack of pipeline and interconnector capacity is limiting market liquidity and the potential for new entry.

From this analysis, it follows that cross-border M&A is only detrimental to competition – and with it efficient investment – where crossing national borders to make an acquisition still results in horizontal concentration within an existing regional market – or a market-area that may feasibly become integrated as a result of some further investment in network capacity. The concern with horizontal concentration would be at all levels – production, networks and retail.

The counter-argument to the benefits of competition in terms of promoting efficient investment is that market competitiveness leads to investment cycles. While this may be manageable in many other industries characterised by the need for large scale investments, this can be problematic in the energy sector given concerns over security of supply.

Conclusions – the limits to cross-border M&A activity

There are clear benefits in terms of investment capacity from building scale in the power and gas markets. This benefit will be more than usually important over the next few decades in the light of the emerging energy capacity gap in the EU and the need to mitigate carbon emissions. Thus the development of a significantly larger power and gas companies over the last few years is likely to prove a positive development for the European Union. The alternative to large scale businesses managing the risks of substantial investments would be

for governments and regulators to step in to manage markets and mitigate risks for businesses. While this may be acceptable to pump-prime investments in new technologies, it is unlikely to prove effective as a means of delivering efficient investment. Thus the appropriate development path for the European Union is to accept a degree of cross-market growth in scale.

However it must be recognised that at some point, growth in scale conflicts with market competitiveness. And while a high level of competitiveness may not be conducive to security of supply, moderate levels of competition are necessary to stimulate efficiency. The European Commission is in any event active through its merger control regulation in limiting such anti-competitive merger activities and is committed to taking measures to complete the internal market.

In conclusion, how far the trend in cross-border activity will be able to go and the resulting structure of the EU power and gas markets will largely depend on:

- The extent to which regional markets are developed with investments in pipelines and interconnections;
- The extent to which carbon reduction is focussed on investments in renewables, nuclear or CCS; and
- The extent to which the European Commission is successful in promoting competition.

Vision for the future

A vision for the future – consistent with the policy concerns and merger trends set out above - which would satisfy the European Commission's commitment to the internal market while also providing a platform for ensuring security of supply and environmental sustainability might comprise the following:

- 3 to 4 unbundled independent integrated gas and electricity system operators running regional markets on a co-ordinated basis;
- Multiple unbundled network assets owned by governments, municipalities and infrastructure funds with investments co-ordinated by over-arching regional supervisory bodies;
- 8 to 10 large producer/retailers operating across multiple regional markets providing financial scale and market risk mitigation to sustain production investments; and
- a competitive fringe of small scale producers (often with innovative technologies) sustained by governmental grants and subsidies and joint venture with the large producer/retailers.

However the coherence of a vision is of course no guarantee that it will be realised.