ENERGY

Christian von Hammerstein and Dr. Carl Stephan Schweer, partners with Hogan & Hartson in Berlin discuss investment opportunities in Germany for foreign utility companies.

A sleeping beauty awakes…

Investment opportunities for foreign utility companies in Germany

Germany is one of the largest energy and water markets worldwide, but for many years attracted little attention among foreign utility companies. Today, after four years of experience with liberalization, the German utility market faces a wave of competition that will restructure the highly fragmented market. More than 600 regional and local utility providers remain, whose customer base is key to the German market.

A closed shop for many decades

Germany's energy market used to be a closed shop for many years. National, Regional and local suppliers were state-owned. The German legislator had exempted the utility sector from the relevant antitrust laws. This enabled energy suppliers to form regional monopolies concluding exclusive demarcation and concession agreements with local municipalities and other suppliers. Accordingly, consumers had no competitive choice or influence on prices. Benefits from the energy market were often used to cross-subsidize local infrastructure.

Due to strong government control, the energy networks in Germany were reliable and generally in very good condition. Water quality was excellent, too. The system worked to the benefit of everyone – except the customer. Energy was and water still is more expensive than in other countries.

The reform of the electricity market since 1998

This situation changed dramatically after 1996, when the European Commission directed its member states to partially open their electricity markets by 2000 (Directive 96/92/EG). Unlike most other EC member states, the German legislator opted for a maximum opening of the electricity market. According to the Energy Commerce Act of 1998, antitrust law is now fully applicable to the electricity market. Demarcation and concession agreements are no longer possible. Competitors shall be able to claim full access to the transmission grids at fair market conditions. In addition, the German legislator, intending to withdraw from energy market regulation, did not establish a regulatory authority. It trusted the free market and opted for negotiated grid access.

Of all other member states in the European Union, the only other countries to open their markets to the full extent were Great Britain, Sweden and Finland. Unlike Germany, however, the electricity markets of these three countries are protected by natural barriers. Given the size and geographical location of the German market (with open borders to neighboring States), Germany should be the ideal venue for new entrants into the electricity market and gateway to further activities across Europe – at least in theory.

It is no surprise that the practice falls behind such ambitions. In the first years of reform, two main obstacles to competition emerged: Firstly, customers could not always benefit from lower prices. The advantages of competition were partially neutralized by a general price increase for oil and gas on the world market. In addition, the federal legislator introduced "ecological taxes" on energy in 1999. The Renewable Energy Act of 2000, as well as the Act on Combined Heat and Power Facilities, required electricity suppliers to purchase electricity generated by renewable sources, regardless of cost.

Secondly, the free electricity market did not immediately prove fair. When the first new market entrants claimed their right to grid access, they often faced a lack of cooperation among the established market players. Many local suppliers used unlawful means to prevent their customers from changing suppliers. Soon, courts and the Federal Cartel Office were playing a major role in liberalization. The Federal Cartel Office issued several reports on agreements reached by the main industry associations on negotiated grid access and prices (called the "Verbändevereinbarung", the last version of which came into effect on January 1, 2002). These agreements proved discriminative to new market entrants. In April 2001, the Federal and State Cartel Offices issued a report on unfair practice and grid access prices under these agreements. The report strongly influenced the courts. Since then, most of the competitors' court actions on unfair denial of grid access have been successful. The Cartel Offices are still carefully assessing the electricity market and transmission prices. In January 2002, the Federal Cartel Office initiated formal proceedings on unfair transmission prices against 10 regional suppliers.

Liberalization of the gas market

Liberalization of the German gas market developed at a different speed. In 1998, the European Commission requested a 20% market opening by 2000 (Directive 98/30/EG). Again, Germany opted for a total liberalization of the market by abolishing the former exemption of gas-utilities from antitrust rules. The government has failed to this day, however, to introduce effective rules facilitating competition in the gas sector. The transmission of gas is still a delicate issue. The major industry associations, consisting of the incumbents, concluded an agreement on the conditions for Third Party Access (TPA). The agreed point-to-point-model, however, discriminates against newcomers without own pipelines. Major issues remain unsolved, such as balancing, access to storage and the handling of different gas qualities. The European Commission is increasing pressure on the German Government to introduce an effective network access regime based on an exit/entry-model with package prices, regardless of the distance of the actual gas transport and the number of transmission networks used. If the industry fails to agree on non-discriminatory TPA-conditions, both the Commission and the federal government threaten to establish a regulatory authority that will decide on prices and other terms of TPA.

The water market

The experience with electricity and gas liberalization recently encouraged the Federal Ministry of Economics and Technology to review the chances and risks of water-market liberalization. More than 86% of the water supply in Germany remains in the hands of municipal authorities or associations of neighbored municipalities. Unlike electricity and gas, water often derives from sources in the local area. Local communities are sometimes emotionally attached to supplying "their own water."

The Ministry installed a task force of technical, environmental, economic, and legal experts, which presented a report in July 2001. They concluded that competition in the water market is possible and may result in lower costs and greater efficiency. The task force sees two possible methods of creating a more competitive water market. The group expects an increase of concentration in the market, which will enhance "competition in the market": Similar to the liberalization of water markets in neighboring countries this can rely on such classic instruments as common carriage, cross-border supply and inset appointments. The group, however, favored "competition for the market": Municipalities shall issue public tenders and attract suppliers offering higher efficiency and lower prices over time. A system of benchmarking will provide for better transparency in identifying inefficient water suppliers.

The federal government has not yet decided whether it will implement the recommendations of the task force. The next step in water privatization can be expected after the general elections in fall 2002.

Investment opportunities arising from restructuring

Competition has already made a strong impact on the structure of the German utilities market. The dramatic process of restructuring affects large-scale producers, regional, and local suppliers. Unlike most other countries in Europe, the German market is highly fragmented. There are some large-scale energy producers, and more than 600 regional and local suppliers. Most of these regional and local suppliers are very small. They must merge with larger groups to survive in the changed business environment. They need professional expertise in competitive markets. They are an ideal target for foreign investment.

The first wave of concentration focused on the large-scale energy producers. RWE and VEW, both large electricity groups, merged in July 2000, followed by an even larger merger of VEBA and VIAG, now E.ON. Today, the new RWE and E.ON groups together operate 70% of the electricity capacity and high-voltage grids. The duopoly controls about 50% of the middle and low voltage grid. In 2002, the remaining major players will merge (HEW, Veag and Bewag), except EnBW, which cooperates with its main shareholder EdF. According to the Federal Cartel Office's decision on the E.ON and Ruhrgas merger in January 2002, the concentration process has now reached the maximum level. Further concentration would endanger emerging competition.

The restructuring of the German energy industry will now focus on regional and local distribution companies. Their large customer base is the key to the German market. Almost all will merge with competitors or form "strategic partnerships" with national or international energy producers. At present, most of the municipalities owning the local and regional suppliers are encouraging investment. By selling minority shares to experienced investors, they hope to increase efficiency and expertise, or to provide companies with larger supply territories. Some municipalities even plan to fully sell the companies for financial or strategic reasons (e.g. purchase of the supplier of Stuttgart by EnBW). In 2000 and 2001, about 200 local and regional supply companies were already at least partially sold. This concentration process will speed up in the next few years. Since most of the transactions in 2000 and 2001 involved either E.ON or RWE, the Federal Cartel Office and the municipalities favor investment by other competitors in order to enhance competition. According to the Federal Cartel Office's decision in February 2002, E.ON and RWE will no longer be allowed to acquire more than 20% of the shares of supply companies. Hence, other investors are welcome to enlarge their German customer base by the acquisition of or strategic partnerships with local and regional distribution companies.

For further information see law firm profile at the end of the handbook

HOGAN & HARTSON

Christian von Hammerstein
This article was co-authored by Christian von Hammerstein (cvhammerstein@hhlaw.com), partner with Hogan & Hartson Raue L.L.P. in Berlin. His practice involves representing clients from the energy sector on regulatory and antitrust issues as well as in national and transborder transactions. He has special experience in supporting new entrants in the energy market with regard to third party access to the gas and power grids including litigation and the negotiation of domestic and international supply and trade agreements.

Carl-Stephan Schweer
This article was co-authored by Dr. Carl-Stephan Schweer (csschweer@hhlaw.com), partner with Hogan & Hartson Raue L.L.P. in Berlin. He concentrates on administrative law and litigation, advising cities, municipalities, public bodies, and private investors in regulatory matters, privatizations, public/private partnerships, and joint investments. He focuses on utilities industries and urban development, practicing in National/European law, financing regulations, state-aid law, and competition law in Germany and the EU.