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*The Liberal Bases of EU Competition Policy  
and the Case of Gas Sector*

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Liberalne podstawy polityki konkurencji UE a rynek gazu

**Keywords:** liberalization, EU, competition, gas

**Słowa kluczowe:** liberalizacja, UE, konkurencja, gaz

## **Introduction**

The European construction has given a fundamental contribution to increase competition among firms. Market exchanges have been hugely facilitated through the creation of the Single European Market. The SEM has given impetus to the economic development. The sequence of enlargements has progressively widened the dimension of the SEM since 1973, giving the enterprises more commercial opportunities and creating more competition.

Firstly, this paper examines the liberal bases of EU competition policy. Secondly, it focuses on liberalizations, specifically on gas market liberalization.

### **1. Competition in the liberal thought: entry freedom, competition order, state aid, and cartels.**

In the present section, in order to explore the liberal bases of EU competition policy, attention is concentrated on four aspects of competition theory:

I) entry freedom and potential competition;

- II) effective competition and the correlated concept of competition order;
- III) state aid;
- IV) cartels.

Not surprisingly, these elements are also a part of the definition of competition that can be drawn from the Treaty on the Functioning of the European Union (TFEU).

**Entry freedom.** As a starting point, the liberal theory provides a vision of the competition process quite close to the one used in ordinary life. The word competition recalls firstly sport contests where every participant has the same chances to be successful. No one has additional advantages. Transferred to the economic life, competition means freedom to enter into a market and play the game under a neutral set of rules. No one is protected, no one is privileged and the game takes place on a flat ground. Neutrality of the regulatory framework is essential, as differential treatments (e.g. State aid to public enterprises) jeopardise entry freedom. Consequently, a market is competitive not accordingly to the number of producers, but on the base of the freedom to entry. Uncompetitive conditions may prevail in a market where a relatively high number of enterprises are producing and selling and where legal barriers prevent newcomers from entering the competition with the existing actors. On the contrary, a market where there is only one or a few enterprises is competitive if the enterprises fear potential competition and their market conduct is determined accordingly. To put it differently, it is the risk of new competitors that may threaten profit rates or market shares (or both) of dominant firms that compels them to adopt process and product innovations in order to maintain their competitiveness.

Potential competition is even more efficient than effective competition. An entrepreneur competing in a certain market knows his competitors. He knows their products and prices, can estimate their costs and so on. However, potential competitors are like ghosts. The entrepreneur does not know anything about them, they are his nightmare. Potential competitors represent a countervailing power<sup>1</sup> to already established businesses and exert a relevant pressure on their strategies.

When legal entry barriers are low or non-existent, the number of potential entrants increases. The larger the number of potential entrants, the larger the likelihood that some of them will turn into an effective competitor by entering the concerned market. The worst a State can do against competitive markets is build up legal entry barriers in order to shield the *status quo* of a certain market structure by protecting the enterprises already existing and operating in it. Several times these protected enterprises, examples of crony capitalism, are referred to as national champions, which means strategic enterprises (energy, telecommunications, etc.) are so important that they do not deserve exposure to the waves of free markets and international competition, but to be hold in the maternal arms of the State.

The concept of potential competition is deeply rooted into the liberal thought. In 1924, the great Italian liberal economist Luigi Einaudi wrote [1973, p. 833]:

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<sup>1</sup>This expression and concept comes from J.K. Galbraith, see: *American Capitalism: The concept of Countervailing Power*, 1952.

“Until the monopoly, master or warden, is free, as long as it is lawful for anyone to criticize him and attempting to shoot it down, can it cause some damage; but it is perhaps not relevant and transitional. The necessary condition for a lasting equilibrium [...] is not the actual existence of the competition. *It is the juridical possibility of having competition.* To the State we should ask nothing except that *granting everyone a chance to deny the monopoly of someone else.*”

What Einaudi defines as “juridical possibility of having competition” is potential competition. What the State has to do is to remove legal entry barriers so as to give any entrepreneur the power to deny the possibility for a monopolistic firm to continue to behave as such.

**Competition as “discovery” and as “order”.** An environment where free entry is ensured leads us to the Hayekian concept of competition. First, competition is a process of discovery, as new processes, new products, new markets, and new efficient combinations of productive factors are found under the pressure of competitive forces. Secondly, what is relevant is the process leading to a certain result, not the result itself. When a single undertaking is producing in a certain sector, we must distinguish whether this position has been obtained by merits or by the use of power. In this latter case, conditions of monopoly are prevailing.

Quite near to Hayek’s concept of competition is the one developed by Walter Eucken and more generally by the Freiburg School or Ordoliberal School [Nemo and Petitot, 2006, pp. 911– 936]. According to this school, competition is an instrument for building a free society. Eucken’s concept of “complete competition” (*wollständiger Wettbewerb*) is only apparently similar to the neo-classical one. The number of participants on the market is not relevant for Eucken; but the coordination of individual market conducts through prices is. Each producer is facing a demand curve. This fact implies that firms must hold a certain degree of market power. However, in contrast to the Misesian tradition, a competitive market needs a set of rules in order to work in an efficient way. Pure *laissez-faire* may not necessarily lead to complete competition. It might favour the rise of monopolistic market structures where distorted prices fail to play their role as regulators of the economic process. The essence of the market economy is a “competition order” (*Wettbewerbsordnung*) guaranteeing equal conditions for all players. The ordoliberals are against direct State intervention in the economy and State-led economic planning, but they favour the organization of public institutions to preserve “complete competition” and to realize the “competition order”. This order can be achieved only by means of an economic constitution bound to preserve market competition face monopolistic pressures. In this light, constitutional principles would inspire ordinary legislation. An anti-trust legislation drawn from the constitutional principles and a competition authority are the institutional elements of the “competition order”.

**State aid control.** The best a State can do, in order to enhance competition, is guaranteeing entry freedom and a level playing field. In a market with entry freedom, State aid control preserves potential and effective competition. State aid produces

unintentional consequences and does not provide the results attended by those who have invented and enforced it. Besides, State aid determines an unsound allocation of resources leading to a reduction of labour and capital productivity. Consequently, given a specific quantity of these two productive factors, the overall production is less than the level which could have been attained without the intervention of the State. Most of State interventions claim that they do not restrain production, but conversely enhance the productivity of the economic system. The historical experience and evidence show how fallacious this statement is and how far away from these expectations the results of State interventions in sectors such as, for instance, steel have been [Leboutte, 2008]. The building-up of inefficient concerns champions in devouring resources (provided by the taxpayers) rather than in the creation of wealth for the benefit of the citizens.

As in the case of money (the famous Gresham Law) where State aid is provided, the bad firm rules out the good one off the market. The competition policy of a national State or of a supranational institution (the European Commission, for instance) should be axed on assuring the highest degree of freedom of entry into the economic scene, essentially by eliminating legal barriers.

**Cartels.** In the Liberals' Oxford Manifesto<sup>2</sup> of 1947 we read:

“The suppression of economic freedom must lead to the disappearance of political freedom. We oppose such suppression, whether brought about by State ownership or control or by *private monopolies, cartels and trusts.*”

Liberals oppose, in principles, monopolies, cartels and trusts, however, their position is more articulated than the neo-classical one. A cartel, a dominant position in a market or what is referred to as “market power” is not necessarily harmful or anti-competitive. It is surely against competition when its strength or inner stability is the consequence of entry impossibility, because of legal barriers, even in the form of State aid. When legal barriers prevent new competitors from entering a market, existing producers can be stimulated to set up a horizontal agreement to fix prices or to share markets and so on. However, the same type of agreement cannot be considered anti-competitive and harmful to consumers when the condition of free entry is respected. Potential competition is impeding the proliferation of anti-competition cartels. It is the watchdog against monopolistic market conducts.

The TFEU is not providing any definition of what competition is. Consequently, its meaning has to be drawn out of the contents of articles 101–109 of the TFEU.

We propose the following definition:

*A policy bound to: 1) detect and **deter** cartels among firms; 2) **avoid** mergers containing the threat of abuse of dominant position by an undertaking in the market, 3) control and **prohibit** State aid to enterprises, 4) **promote** liberalisations.*

Anti-cartel policies, prohibition of State and promotion of liberalizations represent the four basic elements of the liberal competition theory.

<sup>2</sup> See: [http://www.liberal-international.org/editorial.asp?ia\\_id=535](http://www.liberal-international.org/editorial.asp?ia_id=535)

## 2. The ordoliberal bases of the EU's competition policy

In this section we focus on the ordoliberal bases of EU competition policy [McLachlan and Swan, 1963]<sup>3</sup>:

“It is (...) no exaggeration to state that, economically, the Rome Treaty is basically a Treaty for more competition; (...) it (competition) has been considered as one of the principal pillars on which our building rests.”

This quotation gives a correct view of the economic idea behind the European construction. The need for a single market was felt by the founding fathers of Europe, both on theoretical and political level. Consequently, concerns about a policy for preserving competition were strongly felt when the European Coal and Steel Community (ECSC) and European Economic Community (EEC) treaties were negotiated. In 1961, the European Commissioner in charge of Competition Policy, Hans von der Groeben, expressed himself in the following way in front of the European Parliament [McLachlan and Swan, 1963]<sup>4</sup>:

“It is... beyond dispute, and the authors of the Treaty were fully aware of this, that it would be useless to bring down trade barriers between the Member States if the *Governments* or private industry were to remain free through economic and fiscal legislation, through *subsidies* or cartel-like restrictions on competition, virtually to undo the opening of the markets and to prevent, or at least unduly to delay the action needed to adapt them to the Common Market.”

Von der Groeben was an official at the German Ministry of Economic Affairs in 1952 and in charge of implementing the ECSC Treaty. In that same year, Ludwig Erhard, the Minister in charge, appointed Alfred Müller-Armack as head of the Central policy unit of the Ministry. Both Müller-Armack and Erhard are prominent adherent of the Ordoliberal School. We cannot thus be surprised in finding the concept of competition developed by this School at the root of the EEC competition policy.

According to von der Groeben [McLachlan and Swan, 1963]:

“Because in the Common Market competition has an important part to play in giving guidance to producers, and because any distortion of competition is a threat to the best supply of goods in the Community. In all our six national economies *the day-to-day co-ordination of individual economic plans and measures depends on the functioning of the market*; the supplies the consumers wish to have and those the producers are able to provide are so attuned to one another by the play of prices that the maximum of satisfaction results.”

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<sup>3</sup> Mussard R., *The Regulation of Restrictive Business Practices under the Common Market Treaty*, [in:] *Restrictive Practices, Patents, Trade Marks and Unfair Competition in the Common Market*, International and Comparative Law Quarterly Supplementary Publication No. 4, 1962, p. 17. Quoted by: [McLachlan and Swan, 1963].

<sup>4</sup> European Parliamentary Assembly Debates, October 19, 1961. Quoted by: [McLachlan and Swan, 1963].

From 1958 to 1963, Müller-Armack was the German state secretary for European affairs, and von der Groeben held the post of European Commissioner until 1970. We also have to notice that both Müller-Armack and von der Groeben, participated intensively in the negotiations for the Rome Treaty [Melchionni and Ducci, 2007, pp. 114–139]. The latter and Pierre Uri were responsible for drafting the Spaak Report.

### 3. The liberalisation of EU gas market

The EU energy policy objective concerning gas is that of the gradual liberalisation of this market and the consequent creation of a single European energy market. Between 1996 and 2003, two gas directives have been adopted requiring, among other things, full market opening, abolition of import monopolies and unbundling of vertically integrated companies. These first directive demonstrated clearly the benefits of the liberalisation of the gas market in terms of price reductions, increased efficiency, higher quality, and enhanced competitiveness. However, in spite of the adopted regulatory framework and the abovementioned gains, some gas market malfunctioning has persisted in the form of entry barriers and final consumer's (households, commerce and industry) restricted freedom to choose. For these reasons, the second gas directive aimed at ensuring level playing field, publishing of tariffs prior to their entry into force, reducing the risks of market dominance and predatory behaviour. The second gas directive indicated that by 2007 final consumers (households and firms) in the EU had to enjoy effective freedom to choose their gas suppliers. However, by 2007 several barriers of entry and free competition still remained, along with other market malfunctioning. This situation led the Commission to start a process leading to the so-called third energy package including, among others, the third gas directive.

#### The third gas directive

As a part of the so-called third energy package, in July 2009 the European Parliament and the Council have adopted the directive 2009/73<sup>5</sup>. The following parts of this Directive point to the liberal features embodied in EU's policies:

“The internal market for gas aims to deliver real *choice* for all consumers of the EU, be they citizens or business. Actually the *freedoms* which the Treaty guarantees are achievable only in a *full open market*, which enables all consumers *freely to choose* their suppliers and all suppliers *freely to deliver* to their customers. However, there are obstacles to the sales of gas on equal terms and *without discrimination* or disadvantages in the Community. [...] Functioning open gas markets are essential for public security, for the *competitiveness of the economy* and for the well-being of the citizens of the Union. To create a *level playing field at retail level, effective*

<sup>5</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0036:0054:EN:PDF>

*market access for all market players, including new entrants, non-discriminatory and cost-reflective balancing mechanisms are necessary [...] Promoting fair competition and easy access for different suppliers should be of the utmost importance for Member States in order to allow consumers to take full advantage of the opportunities of a liberalized internal market in natural gas.”*

In conclusion, the internal market for gas aims to guarantee final users freedom to choose. Unbundling, creating an effective entry freedom and non-discriminatory access to the gas networks, develops competition and promotes investments in the internal market for gas. Market prices should provide the correct incentives for the development of the networks, including cross-border interconnections. An efficient working of the gas market is thus, an indispensable ingredient for the security of energy supplies and more generally for public security and peaceful international relations.

### **The working of the internal market for natural gas**

Gas wholesale markets in the EU Member States are largely dominated by incumbent firms, controlling imports and internal production. Imports have been rapidly increasing since the beginning of the eighties for all European countries. Consequently, their share on overall final consumptions has been on the rise, passing from 40% in 1985 to 75% in 2012. This means that the EU is producing around 25% of its gas needs. As indicated in Table 1 the gap between total consumptions and internal production is widening.

The situation emerging out of Table 2 indicates the dimension and strength of power in the hands of monopolistic importers. Traditionally, the dominant monopolist in European markets has been State-owned enterprise. Several times this enterprise has also been the owner of the internal distribution network and storage facilities and the exclusive provider of gas to final consumers. Table 1 data show the dominant firm degree of control over gas supply in their home markets.

Table 1. EU-28. Gas production, imports and consumptions (millions tonnes of oil equivalent)

| <b>Year</b> | <b>Imports</b> | <b>Primary production</b> | <b>EU consumptions</b> |
|-------------|----------------|---------------------------|------------------------|
| 2003        | 285            | 201                       | 486                    |
| 2004        | 299            | 205                       | 504                    |
| 2005        | 323            | 191                       | 514                    |
| 2006        | 335            | 182                       | 517                    |
| 2007        | 329            | 171                       | 500                    |
| 2008        | 349            | 172                       | 521                    |
| 2009        | 338            | 157                       | 495                    |
| 2010        | 365            | 159                       | 524                    |
| 2011        | 355            | 141                       | 496                    |
| 2012        | 344            | 133                       | 477                    |

Source: [Eurostat, 2014]

Table 2. Dominant firm control of gas supply, 2004 (in billions cm and percentages)

| Countries      | Total imports<br>(bln cm) | Import share | Total domestic<br>prod. (bln cm) | Production share |
|----------------|---------------------------|--------------|----------------------------------|------------------|
| Austria        | 9                         | 80–90%       | 2                                | –                |
| Belgium        | 16                        | 90–100%      | 0                                | –                |
| Czech Republic | 9                         | 90–100%      | <1                               | –                |
| Denmark        | 0                         | –            | 10                               | 80–90%           |
| France         | 49                        | 90–100%      | 1                                | –                |
| Great Britain  | 13                        | 20–30%       | 105                              | 40–50%           |
| Germany        | 88                        | 90–100%      | 18                               | 80–90%           |
| Hungary        | 11                        | 90–100%      | 3                                | 90–100%          |
| Italy          | 67                        | 60–70%       | 13                               | 80–90%           |
| Netherlands    | 18                        | 50–60%       | 73                               | 90–100%          |
| Poland         | 10                        | 90–100%      | 5                                | 90–100%          |
| Slovakia       | 7                         | 90–100%      | <1                               | –                |

Source: [European Commission, 2006, p. 23].

As we can see, with the exception of the United Kingdom, the dominant firm share of imports and domestic production is in most cases between 90% and 100%. The most favourable conditions in the UK are the consequence of the unbundling of the former gas monopolies. In such a highly concentrated market, competition is not working and its benefits in terms of lower prices, wider consumer choice and higher levels of efficiency and innovation are not felt.

Hereafter we summarize the main finding of the inquiry by European Commission [European Commission, 2006, p. 23]:

1) The gas sector maintains a high degree of market concentration, generated by entry and expansion barriers. Dominant firms largely control up-stream gas imports and domestic gas production. Potential new entrants are strongly dependent “on vertically integrated incumbents [dominant firms] for services through the supply chain”.

2) A major barrier to enter is represented by the still high level of unbundling (the decoupling between network owner and the network user). The network owners “are suspected of favouring their own affiliates”. Consequently, the new entrants “lack effective access to networks, despite the existing unbundling provisions”.

3) A second barrier is represented by the “prevalence of long term contracts between gas producers and incumbent importers”. Actually, in this situation it is “very difficult for new entrants to access gas on the up-stream markets”.

4) National markets are still relatively isolated. The transit capacity is controlled by dominant firms having “little interest to expand capacity to serve the needs of new entrants”.

5) Information symmetry is another way to reduce entry barriers. However, between incumbent firms and new entrants, the information asymmetry is ample.

6) Liberalizations give full advantage to final consumers (private and enterprises) only if price formation is left to market forces. Actually, “regulated supply tariffs below market prices discourage new entry”.

7) The length of retail contracts is another constraint for new entrants. Final consumers “demand more competitive offers from non-incumbent suppliers and regret the absence of pan-European supply offers”.

## Conclusions

Today, in spite of the effective regulatory framework elaborated and approved by the EU institutions, the European gas market is still relatively closed to competition. Incumbent undertakings still hold the most of privileges they had in past times. Unbundling, wholesale and retail contracts duration, information and lack of market integration represent the main entry barriers, preventing final consumers from harvesting full benefits of the liberalisation process and from the opening of the markets to competition.

The crisis that has been hitting Europe since 2008 has not helped the development of the European gas market. We have seen a sort of euro-sclerosis, like the one of the seventies. We saw a kind of multiple sclerosis attacking the policies of liberalization in recent years. Europe nowadays is facing a major problem: lack of growth and, consequently, unemployment. How to restore growth is a matter widely discussed by economists, policymakers and pundits. The SEM and its soul, competition, are the two main assets of the European Union. Only by completing the former and enhancing the latter, Europe will be able to find a sustainable path for growth.

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### **Liberalne podstawy polityki konkurencji UE a rynek gazu**

Traktat o funkcjonowaniu Unii Europejskiej nie zawiera definicji konkurencji. Zaproponowana w pracy definicja mówi, że jest to polityka zmierzająca do wykrywania i zapobiegania powstawaniu karteli, unikania fuzji, które mogą prowadzić do nadużywania pozycji dominującej, kontroli i ograniczania pomocy publicznej i promowania liberalizacji. W dalszej części pracy poszczególne elementy tej definicji są poddane szerszej analizie: swoboda wchodzenia na rynek, zasady konkurencji, pomoc państwowa oraz kartele. Liberalizacja jest ściśle powiązana z koncepcją Einaudiego dotyczącą możliwości zapewnienia konkurencji na rynku. Trzecia Dyrektywa Gazowa jest przykładem takiego podejścia. Jednak postępy w jej implementacji są niewielkie. Co więcej, kryzys spowodował pojawienie się swoistej eurosclerozy w procesie liberalizacji. Dynamizacja tego procesu jest niezbędna do odbudowania wzrostu gospodarczego w Europie.

### **The liberal bases of EU competition policy and the case of gas sector**

The TFEU is not defining competition. The definition we propose is: A policy bound to: detect and deter cartels; avoid mergers leading to abuse of dominant position, control and prohibit State aid, promote liberalisations. This definition contains the main elements of the liberal theory of competition. The paper explores them: entry freedom, competition order, state aids and cartels. Liberalizations are strictly linked to Einaudi's concept of "juridical possibility of having competition". The third Gas Directive represents an example of this "juridical possibility". Progresses in its application have been small. Furthermore the crisis has produced a sort of euro-sclerosis of the liberalization process. The revitalization of liberalisations is essential to regain growth in Europe.