COMPETITION, INTERNATIONAL INVESTMENT AND ENERGY SECURITY

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Participants at the December 2007 Roundtable on "Freedom of Investment" heard and discussed a report from the OECD Competition Committee Secretariat on the role of competition policy in promoting energy security. The report does not attempt to establish a precise definition of energy security, but notes that it is mainly about managing vulnerability to supply disruptions and associated price spikes. These disruptions can arise from such sources as "political turmoil, armed conflict, terrorism, piracy, natural disasters, nationalism and geopolitical rivalry".

The main conclusion of the report is that competitive markets, including markets allowing entry of foreign competitors, help reduce vulnerabilities in the energy sector. They do this in several ways. First, competitive markets – which, by definition, involve rivalry among incumbents and the threat of new entry – promote diversity of supply. Second, competitive markets provide incentives for making investments that contribute to the resilience of energy markets and their ability to adjust to shocks. These would include investments in spare or surge capacity in the electrical power sector or in emergency stocks in oil and gas. Third, a broad, open market creates interdependence among local markets and lowers the risks of supply shocks for each locality via diversification effects. In other words, by connecting themselves to a broader market and more diversified sources of supply, various local markets are able to pool their risks of supply disruptions. Fourth, the market information systems that tend to arise in competitive markets increase the ability of the market to adapt quickly to supply shocks.

What role can policy play in promoting energy security? First, open investment policies enhance energy security. They will help consumers benefit from the diversity of supply, adaptability and resilience of a healthy market economy which go with open competitive markets. For example, in Europe, according to the report, a continent-sized energy market would be a better assurance of security than a collection of local monopolies. Second, effective competition policy is needed, including pro-competitive practices in the regulation of price, entry and ways of doing business in the energy sector. It also includes safeguards against anti-competitive mergers, whether initiated by domestic or foreign investors. The report views vertical mergers as being a particular source of concern where they might allow incumbents to hinder non-discriminatory access by potential competitors to essential facilities.

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In February 2007, Competition Committee Roundtable discussions of energy security in February 2007 concentrated on the natural gas industry. This industry is of particular interest to countries that are dependent on pipeline supply from other countries or on imports of liquefied natural gas. The Secretariat's background paper for that discussion examines the connection between energy security considerations and competition policy. These in turn could have an effect on investment policy, notably in decisions about mergers and acquisitions, which may consider contentions that foreign investment affects market competition in ways that could also be described in terms of energy security.

The chief concern in energy security is vulnerability to disruption. More specifically, it is vulnerability to politically motivated disruption. Political turmoil, armed conflict, terrorism, piracy, natural disasters, nationalism and geo-political rivalry threaten to various degrees to interrupt the everyday trade in oil, natural gas, coal and electricity. This political dimension might be a reason to define a special category of security, one that is in addition to the usual competition policy concerns about the consequences of monopoly, of reduction in output and thus increase in price.

From an economic perspective, if the concern is risks and uncertainties due to supply disruptions, then the interests of producers and consumers would be similar. Disruptions of supply produce spikes in price or a non-price allocation mechanism such as rationing. Consumers prefer stability in both price and in supply. Producers also prefer long-run stability, particularly if their economies and state budgets depend on revenues from national oil or gas industries. If the concern is the level of price during a non-emergency period, though, then interests will differ, since producers like high prices and consumers like low prices. Where price discrimination is feasible, different consumers will have different interests. Reaching a global agreement in those conditions is difficult.

Where important actors in the market are political, the usual expectations about economically rational behaviour need to be adjusted. Decisions about investments, sales and purchases are more closely related to political considerations in energy markets than in most other markets. In energy markets, economic considerations can include how best to react to or prepare for changes that are due to political considerations, notably the application of market power pressure to achieve other objectives. Energy security problems can look like problems of economic monopoly, but the monopolist may not be playing by all of the usual economic rules.

In developing policies to enhance energy security, the goal should not be just to increase security, but to get the right amount of security. Beyond some point the additional benefit of more security may not be worth the additional cost. Competition analysis proposes four principal market-based strategies for improving energy security, that is, for finding the right balance between the costs and benefits of security improvements.

The first is diversification, creating more choices. Diversification can take the form of alternative sources of a particular fuel or power supply, alternative means of transporting it or the capacity to switch between different sources. Having more choices reduces the risk of damage from disruption of any one of them.

The second strategy is resilience and flexibility, so that a short term disruption can be dealt with quickly. Flexibility can take the form of investment in spare capacity, in surge or peaking capacity, in storage facilities or in emergency stocks. A system of secondary trading, although more virtual than physical, could also increase capacity to respond quickly.

The third strategy, sometimes described as interdependence among markets, is better described as making the market larger. Energy markets are often treated as national, perhaps because they have been subjected to national regulation. But as a matter of technology and economic scope and scale, a larger market may feasible and more efficient. Expanding geographic markets through interconnection with nearby regions is a form of diversification, reducing the risk from disruption of any one source.

The fourth strategy is improved information, so that the market actors know what is going on in time to react appropriately. Exchanging information can forestall irrational short term panic reactions by consumers and buyers who do not know what is likely to happen and fear the worst. Improved information can also make it easier to collude about price or output, though, so measures to improve information should include consultation with competition enforcers.

Market competition should thus have a great deal to do with energy security. Nonetheless, the question often arises whether energy security is stronger if there is a national champion with buyer power, as a counterweight to a seller or cartel with market power. In competition analysis, this is the problem of bilateral monopoly: if there is one seller and one buyer, what is the price and output outcome? Theory alone cannot answer this question. Either the buyer or seller could get the entire advantage of its power, or the outcome could be a combination of effects; it is not likely to be the same as the competitive price and output, though. Experience matters more than theory. The competition policy community tends to believe that a resilient competitive market, in which resources and assets can shift in response to signals generated in the market, sending information about changes in demand and cost, is a better assurance of energy security than creation of a supposedly powerful buyer.

Merger policy will be relevant to energy security, because anti-competitive mergers would undermine market diversity, resilience and adaptability. Horizontal mergers, between current or potential competitors, may be thought desirable to increase bargaining power. But a distribution firm’s demand is derived from the demand of its customers, and suppliers will consider the customers’ situations, so the relative size of the distributor may not make much difference. A combination of distributors could support larger scale investments, but whether corporate integration is a more efficient way to do this than other methods of funding large projects, such as joint ventures, is a fact specific inquiry. The effects of vertical mergers, combining suppliers and distributors at different stages, are similarly hard to predict in theory. In principle, if there are monopolies at two stages, combining them eliminates some inefficiency. But the analysis changes if one of those monopolies is regulated, because the combination of a competitive operation and a regulated operation creates opportunities for abuse and for preventing competition at other stages.

Merger policy can anticipate the risk that monopoly and collusion will escape correction through enforcement action, because responsible parties are governments or are closely tied to governments. For example, enforcing a legal prohibition of cartels against the members of OPEC could be impracticable or impossible. But competition policy assessment of mergers cannot normally deal well with issues such as energy security, if they are not themselves competition issues. In several countries, a body other than the competition agency may review and authorise or prohibit a transaction where interests and policies other than competition are at stake.

One recent merger case became an explicit conflict between competition and energy security. When E.ON sought to acquire Ruhrgas, to create a firm with a 65% market share in a German market for natural gas, the Bundeskartellamt and the Monopolies Commission rejected the transaction. The Ministry for Economy and Technology then authorized it, finding that the restraint of competition was outweighed by advantages to the economy as a whole, namely improved energy security. The Ministry argued that demand for gas would increase, as would dependency on imports, for which the most economic source would be Russia and Central Asia, but reliable supply would require large investments there which could only be secured through a serious commitment by consuming countries. The Ministry concluded that the combined entity would have the necessary financial capacity, and indeed that it would be in a position to take a strategic stake in Gazprom itself, with a seat on the board from which to influence its pricing and investment decisions. This chain of reasoning depends upon the quality of corporate governance and long term strategies of Gazprom as well as other determinants of investment in the producing countries. It also treats Germany as a single, separate market, evidently assuming that a larger European market will still be subject to constraints on competition and integration.

An older merger case from the United Kingdom treated energy security as a competition problem. Kuwait purchased a substantial share in British Petroleum after the stock market turmoil in October 1987 disrupted a plan to privatize the firm through a share offering. The investment arm of the Kuwait government stepped in to buy the underwriters' inventory, amassing a 20% share. The matter was referred to the Monopolies and Mergers Commission to examine whether this holding, conferring substantial elements of control, was in the public interest. Under the competition law applicable at that time, "public interest" was the substantive legal standard. But public interest elements in this case were the same as the competition elements. The United Kingdom, although a major oil producer, was also a major consumer, and it had been a net buyer when the OPEC producer cartel had cut production and raised prices in the 1970s. Preventing a leading member of that cartel from controlling important productive assets implemented the pro-competitive strategy of maintaining diverse sources. Thus the remedy to improve energy security was a competition policy remedy, applied by the competition policy authority.

Several transactions involving firms in Spain have invoked energy security. In Spain, decisions to approve or disapprove mergers are made by the government, although the competition agency may make recommendations. Thus decisions will likely consider factors other than competition policy. The decisions of the government and of the European Commission in some of the cases illustrate the tensions between the approaches taken by competition analysts and by sector regulators, and between the views of national regulators and those of the European Commission on the right scale for responding to these issues. Even where these tensions arise, decision makers tried to reach results about security and competition that look consistent.

In competition policy analysis of a merger where energy security might be relevant, the foreign dimension can matter. A key issue is whether there is a tie to governments, either at the supplying end or at the consuming end. These ties weaken the usual inferences about how rational economic actors are likely to respond. Indeed, a link to government might strengthen the capacity to act anti-competitively. Entities that are subject to direct or indirect government control may not be fully subject to competition law enforcement. Anticompetitive conduct might be shielded by sovereign immunity, and in some jurisdictions competition law may treat state-controlled enterprises differently than private entities. These limitations may be of particular note in the energy sector, where there are many state-owned enterprises. This situation poses complex issues for international competition law, which are being explored in many jurisdictions. The risk that sovereign immunity could shield anti-competitive conduct might be factored into the decision under national competition law to clear or block a merger or acquisition. But where the prospect to use competition law remedies against collusion or abuse is limited, this could create an incentive for using restrictive investment policies as a substitute for them.