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Up for grabs: Endesa, E.ON, economic nationalism and EU law

The ongoing struggle in European merger activity between the principle of a Single Market and the tendency towards national protectionism may be coming to a head. Dr Michael Grenfell, Partner at Norton Rose, examines how the outcome of the takeover battle for Endesa could trigger a new wave of cross-border utility mergers, thanks to EU law

It now appears likely that the German-based utility conglomerate, E.ON, will succeed in its bid to take over the Spanish electricity company, Endesa, marking the end of a long saga. Over a year has passed since E.ON first announced its bid in February 2006. Even before that, in September 2005, a rival bid for Endesa was launched by the Spanish company Gas Natural (a distributor and supplier of natural gas that also generates electricity in Spain).

The takeover battle for Endesa has raised a number of issues. The Spanish authorities had sought to put impediments in the way of E.ON's bid, reflecting concerns that an important national utility should be protected against falling into foreign hands. This attempt at protectionism has effectively failed, running aground against the twin rocks of:

- EU law—in particular, the rules on free movement of capital and freedom of establishment, and the provisions of the EC Merger Regulation;
- related to this, the underlying EU policy of a Single Market without boundaries, leaving little room for national protectionism.

This article examines the legal and policy strands that are making it increasingly difficult for national governments within the EU to protect their key utilities from foreign takeovers by companies in other Member States.

The current climate

International mergers versus national protectionism

The E.ON/Endesa saga is not the first instance of cross-border mergers and acquisitions in Europe coming up against national protectionism. A year ago, a battle erupted over the hostile takeover bid by the UK-based steel giant, Mittal, to acquire its rival, Arcelor, a company that was essentially a joint venture between major French, Spanish and Luxembourg steel producers. Although the European Commission had cleared the Mittal bid on competition grounds (subject to certain conditions), it ran into strong political opposition in France and Luxembourg on the grounds of being a 'foreign' takeover of key national assets. The Luxembourg government even tried to draft legislation to block the acquisition by restricting takeover bids with a non-cash element, but eventually backed down after it became clear that doing so could contravene EU law.

These issues will come increasingly to the fore as key national utilities are privatised across the EU, making it possible for takeover bids to be launched. Indeed, the UK, which led the way in privatisations within Europe, provides a glimpse of what might happen. With no policy or legislation against foreign takeovers, the UK has allowed most of its privatised electricity and water companies to come under foreign ownership. In addition, three of its four original mobile telephone operators are controlled by telecoms companies from other Member States—France, Germany and Spain. Only last year Britain's main airport operator, the privatised BAA, succumbed to a takeover bid by an international consortium led by Ferrovial, which (interestingly in the context of the E.ON/Endesa saga) is a Spanish acquirer.

Yet it has been the E.ON/Endesa case which has most dramatically pitted the forces of globalised capitalism, pushing for cross-border mergers and acquisitions, against the forces of economic nationalism, which are seeking to protect treasured national utilities against foreign takeover.

The longest chase

How Spain tried to protect Endesa from E.ON's clutches

As a broad rule under EU law, the only grounds on which a merger or acquisition can be blocked are that it would

significantly reduce competition in a relevant market in the EU. There are a few exceptions to this rule (see the section below, 'What EU law says'), but being a 'foreign' company is not one of them!

When independent competition authorities reviewed the rival bids for Endesa, they recommended that the bid by Gas Natural, which raised competition concerns in Spanish markets, should be blocked, and that the bid by E.ON, which did not raise competition concerns, should be cleared.

The politicians in Spain took a different view, however, and tried to give the green light to the bid by the 'home side', Gas Natural, while impeding E.ON's bid.

What the competition authorities decided

As far as the role of the competition authorities is concerned, within the EU a merger or acquisition is scrutinised either by the European Commission under the EC Merger Regulation (if the transaction parties satisfy the turnover thresholds laid down in the EC Merger Regulation), or by the national competition authorities in the individual Member States affected (if the transaction parties do not satisfy those turnover thresholds).

The parties to a Gas Natural/Endesa merger would not satisfy the turnover thresholds (because more than two-thirds of each company's EU-wide turnover was derived in the same single Member State—ie, Spain). Accordingly, the Gas Natural bid was reviewed not by the European Commission but by the Spanish Competition Tribunal, which recommended, in a non-binding opinion in January 2006, that the Spanish government should block the proposed Gas Natural/ Endesa merger.[1]

The parties to an E.ON/Endesa merger would satisfy the thresholds set out in the EC Merger Regulation, and so the E.ON proposal was assessed by the European Commission. In April 2006, after an initial Phase I examination of just five weeks, the Commission cleared the proposed merger on the grounds that it would not significantly impede competition in the EU or in any substantial part of it.[2] The Commission's reasoning was that, in Endesa's main market (Spain), E.ON was neither present nor a likely potential market entrant, and that the merging parties had limited overlapping activities in other European electricity markets, such as Germany, France, Italy and Poland.

What Spain's politicians decided

However, on a political level, the attitude in Spain was wholly different. Competition issues mattered less than the desire that any acquisition of Endesa should result in a strong Spanish 'national champion', rather than in Endesa becoming a German subsidiary. In February 2006, the Spanish government overruled the Competition Tribunal's recommendation that the Gas Natural bid be blocked, and conditionally approved it.[3]

As for the E.ON bid, the fact that the European Commission had cleared it on competition grounds did not prevent the Spanish government intervening to block it. A few days after E.ON announced its bid, Spain's Council of Ministers adopted a new urgent legislative measure increasing the supervisory powers of the national energy regulator over takeover bids.[4] Any acquisition of over 10% of share capital in a regulated entity in Spain would be subject to approval by the Spanish energy regulator, which would have broad discretion to withhold approval—eg, whenever an acquisition posed 'risks' in relation to the regulated activities, or where blocking the acquisition was necessary to protect 'the general interest'. Exercising this discretion, in July 2006, and then in modified form in November, the energy regulator imposed a number of conditions on the proposed E.ON takeover.[5] After the November modifications, these conditions included obligations to use Spanish-produced coal, maintain the Endesa brand, and retain Endesa's assets outside mainland Spain for at least five years. The effect of the regulator's conditions could be seen as the equivalent of a 'poison pill', making it commercially unviable for E.ON to proceed with its proposed bid, and so in practice impeding it.

What EU law says

EU law could not overrule Spain's clearance of Gas Natural's bid for Endesa, since this proposed merger did not meet the EC Merger Regulation thresholds and therefore came under the jurisdiction of the national authorities rather than the European Commission. (Nevertheless, Endesa had tried, and failed, to persuade the European Court of Justice that the Gas Natural bid did satisfy the EC Merger Regulation thresholds and so should be assessed by the European Commission.)

However, EU law did have something to say about the attempt by the Spanish authorities to impede E.ON's bid—ie, the Council of Ministers adopting legislation allowing the regulator to block acquisitions of regulated utilities, and the regulator imposing poison pill conditions on E.ON. There were two main reasons for regarding these impediments as contrary to EU law.

– Since the E.ON bid satisfied the EC Merger Regulation thresholds, placing it under European Commission jurisdiction, the Spanish legislation and the regulator's conditions violated Article 21(3) of the EC Merger Regulation, which provides that no Member State may apply its national competition legislation to any merger which satisfies the EC Merger Regulation thresholds.

- The impediments were contrary to the 'free movement' provisions in the EC Treaty, which underpin the EU Single Market—specifically, Article 43 of the Treaty, which gives every EU company 'freedom of establishment' in any Member State; and Article 56, which provides for 'free movement of capital' across borders between Member States.

On September 26th 2006, the European Commission declared the Spanish energy regulator's measures unlawful.[6] The regulator then modified the conditions. On December 20th, the Commission affirmed that even the modified conditions were unlawful, and gave the Spanish authorities until January 19th 2007 to withdraw them.[7] The authorities failed to do so, and on January 31st the European Commission initiated legal proceedings against Spain at the European Court of Justice.[8]

Article 21(3) of the EC Merger Regulation

Article 21 embodies the principle that there should be a 'one-stop shop' for mergers within the EU—ie, scrutiny either by the national authorities *or* by the European Commission. Article 21(3) states that:

> No Member State shall apply its national legislation on competition to any concentration that has a Community dimension [ie, any merger or acquisition satisfying the Regulation's turnover thresholds].

There are four exceptions to this principle, such that a Member State may intervene to protect:

- public security;
- plurality of the media—ie, rules designed to protect the public against newspapers and broadcasting outlets being concentrated into too few hands;
- 'prudential rules'—ie, financial services supervision; or
- 'any other public interest' which, at the request of that Member State's government, has been recognised by the European Commission.

The Spanish regulator's imposition of conditions on the E.ON bid for Endesa clearly was not covered by any of the first three exceptions. The fourth exception was more promising in that utility regulation has on occasion been recognised as having legitimate public interest grounds for a Member State to intervene in a merger satisfying the EC Merger Regulation thresholds. For example, in 1995, the European Commission recognised the right of the UK Competition Commission to intervene in the acquisition by Lyonnaise des Eaux of Northumbrian Water, in order to assess whether the proposed acquisition would prejudice the system of comparator-based regulation in the water sector.[9]

However, the European Commission ruled that the fourth exception did not apply in the case of the E.ON/Endesa merger. It could not recognise this as a public interest because the Spanish authorities had not requested approval from the Commission; as the Commission noted, the Spanish regulator's decision had been adopted 'without prior communication to (and approval by) the Commission'.[10]

'Free movement' provisions

The other reason for the European Commission bringing proceedings against Spain was that the Spanish regulator's intervention infringed two key provisions in the EC Treaty guaranteeing free movement across Member States' borders, the legal underpinning of the Single Market. These were:

- Article 43, prohibiting 'restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State';
- Article 56, prohibiting 'all restrictions on the movement of capital between Member States'.

Again, there are exceptions. These were clarified by the European Court of Justice in a number of judgments in 2002 and 2003, which examined the extent to which 'golden shares' in privatised utilities (that is, government-held minority shares giving rights of veto over takeovers of the privatised company) were compatible with Articles 43 and 56.[11] The European Court acknowledged that there were exceptional circumstances when government golden shares could be used to restrict takeovers of a privatised utility, but only if three very rigorous criteria were satisfied:

- the restriction must be justifiable on grounds of 'public policy' or 'public security', or 'overriding requirements of the general interest';
- the restriction must apply to all individuals and businesses pursuing activities in the Member States concerned—that is, they must be non-discriminatory;
- it must be no more restrictive than is proportionate.

The third criterion is the most difficult to satisfy, and it emerged from the judgments that only government intervention that was limited to circumstances where a takeover might actually jeopardise national security or security of energy supply would be tolerated. An absolute bar on foreign takeovers, and arbitrary impediments to foreign takeovers, would not be tolerated. One of the judgments concerned the UK government's golden share in the airport operator, BAA; it was the European Court's ruling that the golden share must be removed that paved the way for BAA to fall under the control of the Spanish operator, Ferrovial, a couple of years later.

The European Court must decide

Of course, one cannot be certain about the outcome of the proceedings which the European Commission has

now initiated before the European Court. Yet it is highly significant that, in bringing the proceedings, the Commission has signalled its view that interventions by Member States to prevent foreign takeovers are unacceptable.

The politics of it all

The European Commission's action against Spain affirms its commitment to upholding EU law and the fundamental principle of cross-border free trade underpinning the Single Market.

It might be thought that this is a 'no-brainer' for the Commission, and that all its political interests point in the direction of taking this action. But it is not so simple. The recent controversy over cross-border takeover bids—whether Mittal/Arcelor or E.ON/Endesa—has highlighted serious hostility on the part of key Member States, such as Spain, France and Luxembourg, to national utilities falling under foreign control. These Member States have traditionally been among the greatest supporters of the EU project, and the European Commission cannot easily afford to alienate them. Moreover, their hostility reflects widespread sentiment among their populations in favour of economic nationalism and protectionism, often born out of fears that untrammelled free trade and globalisation threaten employment patterns and traditional ways of life. The Commission is conscious of the danger that such widespread popular sentiment can easily translate into hostility towards the EU project; indeed, it is arguable that this was one of the main causes of the defeat of the EU Constitution proposal in the French referendum in 2005. By bearing down hard against protectionist measures by Member States, the Commission risks inflaming anti-EU sentiment.

So, on the one hand, the European Commission has a policy interest in upholding the Single Market, knowing that failure to do so would make a nonsense of the ideal of a Europe with trade without frontiers. On the other hand, in doing so, the Commission knows that it risks provoking anti-EU sentiment on the part of Member State governments and populations. Its decision to opt for the former approach is of enormous significance—a clear signal that it intends to face down the forces of economic nationalism.

As for the future, that signal will be understood by companies and markets, as well as by governments. It is a green light for cross-border mergers and acquisitions in the European utility sectors.

Michael Grenfell

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[1] Opinion dated January 3rd 2006.
[2] European Commission decision of April 25th 2006 in Case COMP/M.4110.
[3] Decision of [Spain's] Council of Ministers, February 3rd 2006.
[4] Royal Decree-Law 4/2006.
[5] Decisions of CNE, July 27th and November 3rd 2006.
[6] European Commission (2006), 'Mergers: Commission Rules against Spanish Energy Regulator's Measures Concerning E.ON's Bid for Endesa', press release IP/06/1265, September 26th.
[7] European Commission (2006), 'Mergers: Commission Decides that Spanish Measures in Proposed E.ON/Endesa Takeover Violate EC Law', press release IP/06/1853, December 20th.
[8] European Commission (2007), 'Mergers: Infringement Procedure against Spain for not Lifting Unlawful Conditions Imposed on E.ON's Bid for Endesa', press release IP/07/116, January 31st.
[9] European Commission decision of March 29th 1995 in Case IV/M.567.
[10] European Commission (2006), 'Mergers: Commission Rules against Spanish Energy Regulator's Measures Concerning E.ON's Bid for Endesa', press release IP/06/1265, September 26th.
[11] See Grenfell, M. (2003), 'The End of Golden Shares?', *The Utilities Journal*, Oxera, July, pp. 40–41; *Agenda* (2005), 'One Share, One Vote? Golden Shares in Privatised Companies', August; and Oxera (2006), 'Special Rights of Public Authorities in Privatised EU Companies: The Microeconomic Impact', report prepared for the European Commission, February.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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