MERGER ANALYSIS IN THE GAS DISTRIBUTION SECTOR IN ITALY: THE “ISONTINA CASE”

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1. INTRODUCTION

Between January and April 2013, the Italian Competition Authority (ICA) scrutinized in “phase II” a merger in the market of gas distribution - the s.c. “Isontina case” - for the first time after the enactment of the new regulatory measures that introduced the obligation for public authorities to assign new distribution concessions only through competitive tenders.

The aim of this new regulatory framework is to induce undertakings operating in the sector to reach the optimal dimension necessary to provide the distribution service on a larger and more efficient scale. The natural effect of the new regulatory context is, therefore, the undertakings’ dimensional growth through mergers. Hence, following the mentioned regulatory change, M&A activities taking place in this sector are, in principle, to be considered as the main instrument to obtain a more efficient system of gas distribution provided by more efficient companies. However, this outcome highly depends on the degree of the tenders’ competitiveness; that is, it strictly rests on the adequacy of offers presented by as many efficient undertakings as possible.

The merger analysis performed by the ICA in the Isontina case followed these principles and, thus, is consistent with and complementary to the legislative objectives.

2. THE NEW REGULATORY FRAMEWORK

By transposing the Directive 98/30/CE, the Legislative Decree no. 164 of 23 May 2000 (hereinafter, the “Decreto Letta”) has greatly changed the structure of the gas distribution sector in Italy. Before said reform, distribution concessions were generally assigned by municipalities for a period of 25-30 years on average, without any competitive procedure, and then renewed thereby excluding market contestability.

The Decreto Letta provided for gas distribution to be a public service with connection and network access obligations (s.c. Third Party Access obligation) according to the criteria and tariffs laid down by

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1 Italian Competition Authority.

2 Phase II is an in-depth analysis of the merger’s effects that is opened when the case cannot be cleared in Phase I, i.e. when the ICA has concerns that the transaction could restrict competition in the relevant market.
the Italian Energy Regulator (AEEG). It also provided for the distribution and sales to final customers to be separated and provided by different companies within January 2003 (the s.c. ‘legal unbundling’). Moreover, it established that existing concessions were to be terminated by law no later than 2005 and that new distribution concessions were to be assigned solely through competitive tenders for a 12-year period (maximum).

Subsequently, art. 46-bis of the Decree Law no. 159 of 1 October 2007 provided for call for tenders no longer to be issued by a single municipality, but only by municipality groups, within larger territories, the so called “Ambiti Territoriali Minimi” (ATEM), whose size and number were to be identified by ensuing ministerial decrees. Such decrees were actually issued only in 2011, with a serious delay.

At last, the Ministerial Decree of 19 January 2011, divided the Italian territory in 177 ATEMs, and the Ministerial Decree of 18 October 2011 provided the complete list of municipalities belonging to each ATEM. Each ATEM roughly corresponds to the area of a province, although in some cases larger provinces include more than one ATEM.

The Ministerial Decree of 12 November 2011 no. 226 established a timeline that public authorities are to follow when running the administrative procedures foregoing the tenders: firstly, it set a date (different for each of the 8 groups in which the 177 ATEMs were divided) by which the provincial authority must identify the contracting authority responsible for the competitive procedure, among the municipalities belonging to the ATEM; secondly, it regulated that within the subsequent 15 months - or 18 months for ATEMs that do not have a provincial capital - the contracting authority must gather the necessary technical information regarding the distribution service from the existing providers and publish the tender notice.

Moreover, pursuant to art. 3 of the Decreto Letta, if the referred timeline is not respected, the Region to which the ATEM belongs can first send a letter of formal notice to the responsible authorities indicating a final deadline before which the latter must act, and if such deadline is not respected, the

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3 Such prohibition triggered a judicial saga started with the lawsuits filed by the municipalities, which claimed that, absent any definition of the ATEMs, they held the right to assign the concessions at municipal level. According to the Council of State, Sez. V, decision No. 5419, dated 12 November 2013, municipalities actually had such right, considering that i) without the definition of the size and location of the ATEMs, it was impossible to issue calls for tenders; ii) absent such right, the municipalities should have renewed existing concessions, thereby blocking competition and contravening the law, which established the mandatory expiry of such concessions by 31 December 2009, or in some cases by 31 December 2010; iii) art. 46-bis could not be considered as imposing the obligation to adhere to the ATEMs, given that it provided them just a financial incentive to do so. However, art. 24, paragraph 4, of the Legislative Decree No. 93/2011, finally established that the participation in the ATEMs and the use of competitive tenders in order to assign the concessions were mandatory. Such provision was declared legitimate from the Constitutional Court, decision 7 June 2013. Likewise, the limitation to the municipalities’ freedom was considered necessary in order to achieve the goals of the Legislative Decree No. 164/2000, i.e. a more efficient and competitive system of gas distribution.
Region can directly run the procedure. However, due to a variety of reasons, such final deadline has been postponed several times up to the end of 2014, and in some cases, depending on the group of ATEMs, to the beginning of 2015.

Finally, the Decree also provided for uniform criteria for the evaluation of the offers presented by the competing undertakings as well as for the adjudication of the tenders. Such criteria aim at granting technical adequacy and efficiency of the service, as well as lower prices for consumers, by mainly considering two elements: possible discounts carried out by the company on the regulated tariff laid down by the AEEG and investment plans aimed at improving the energy efficiency of the infrastructure.

3. **THE NOTIFIED MERGER**

The notified merger consisted in the acquisition from ENI of the joint control of a local gas provider, Isontina Reti Gas (Isontina), by Italgas – the main national gas distributor - and Hera/Acegas Aps – a major local distributor in the northwest Italian Regions. The acquisition of Isontina was explicitly aimed at creating a vehicle whose purpose was the participation in the competitive tenders to be issued for the appointing of the concessions for the gas distribution in the ATEMs of Padova 1, Padova 2, Padova 3, Pordenone, Trieste and Gorizia.

At the time of the notification, it emerged that one or both acquiring undertakings had a significant presence, in terms of ‘points of gas delivery’ (PGDs), in each relevant ATEM, as shown in the following table.

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4 Mainly related to the need to wait for the results of legal litigations raised from both companies and several local authorities.

5 See the Decree law of 21 June 2013, No. 69 (art. 4).

6 At the moment of the notification ENI and Hera/Acegas Aps jointly controlled Isontina, with respectively 70% and 30% of the share capital. The notified merger was structured in two phases: during the first phase, Eni would have sold 50% of Isontina’s shares to Italgas, and 20% to Hera/Acegas-Aps. During the second phase, both Italgas and Hera/Acegas-Aps would have transferred to Isontina some of their assets related to the activity of gas distribution in the provinces of Padova, Pordenone and Trieste. After such transfer, 49% of Isontina’s share capital would belong to Italgas and 51% to Hera/Acegas Aps. Specific statutory provisions would have granted the joint control of the company.

7 PDG is an acronym that stands for “point of gas delivery” and consists of a 14 number code that identifies the physical point of the network where it is delivered to the final consumers.
4. **The Relevant Market**

All undertakings involved in the merger operate in the gas distribution sector, namely they transport natural gas from the high-pressure transmission network to a low-pressure distribution network, and finally they deliver it to the final customers.

As mentioned above, under the current legislation, the gas distribution activity is going to be provided by distributors that will operate in a regime of exclusivity under the concession assigned by public authorities through competitive procedures. As a consequence, calls for tenders represent the only moment in which undertakings compete with each other in order to “win” the concessions, i.e. the right to be the exclusive distributors in a given area for the whole concession period. Once the undertakings are granted the concession for a given ATEM, they are required to supply gas to final customers at previously negotiated contractual terms (as well as under the regulation of the AEEG) and they do not face any competition until the expiry of the contract.

In light of the above, in the Isontina case, the ICA defined the relevant product and geographic markets affected by the notified merger as the competitive procedures for the assignation of the concessions for the exclusive distribution of gas in a given ATEM (s.c. ‘bidding markets’). In particular, the merger affected six public tender procedures related to the ATEMs in which the involved undertakings intended to participate and, should they have been successful, they could have become the exclusive gas distributor (ATEM of Padova 1, Padova 2, Padova 3, Pordenone, Trieste and Gorizia).

In this sector it would be conceptually flawed, according to the ICA, to perform the merger analysis by focusing either on the current or on the future (post-tender) gas distribution activity. Indeed, as already

### Table 1. – The position of the Parties and of the main competitors in the relevant ATEMs

<table>
<thead>
<tr>
<th>Distributor</th>
<th>National % in PDR</th>
<th>Padova 1</th>
<th>Padova 2</th>
<th>Padova 3</th>
<th>Pordenone</th>
<th>Trieste</th>
<th>Gorizia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italgas</td>
<td>(30-35%)</td>
<td>(0-5%)</td>
<td>(25-30%)</td>
<td>(35-40%)</td>
<td>(85-90%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
</tr>
<tr>
<td>Hera/Acegas-Aps</td>
<td>(5-10%)</td>
<td>(65-70%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
<td>(95-100%)</td>
<td>(95-100%)</td>
</tr>
<tr>
<td>F2i Reti</td>
<td>(15-20%)</td>
<td>(10-15%)</td>
<td>(0-5%)</td>
<td>(30-35%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
</tr>
<tr>
<td>Edison</td>
<td>n.r.</td>
<td>(0-5%)</td>
<td>(65-70%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
</tr>
<tr>
<td>Enerco</td>
<td>n.r.</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
<td>(25-30%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
<td>(0-5%)</td>
</tr>
</tbody>
</table>
pointed out, there is no competition in the market, as the winning undertaking is the exclusive distributor in that area. Therefore, the only form of competition existing in this sector is the competition for the market that takes place in the context of the tender procedures.

The evaluation of a merger on the basis of the competitive conditions of the tender procedures (i.e. which and how many are the undertakings that are actually going to participate in the procedures) is generally performed by competition authorities on the basis of the outcomes of the previous tenders, in order to assess the strength of each competitor as precisely as possible.\(^8\)

However, given that the merger was intended to take place after the enactment of the new sectorial regulation, the ICA could not rely on the past tenders for its analysis, as, on the one hand, the forthcoming tenders would have followed completely different rules of adjudication, and, on the other hand, the geographic markets were re-shaped. In fact, previous concessions were directly assigned at a municipal level without any tender, whereas from now on tenders will take place at the level of the ATEM, i.e. for a larger territory that requires stronger technical and financial means.

That is why the market definition required both a careful analysis of the involved undertakings’ internal documents (such as business plans) and an in-depth market test, involving a large number of potential competitors and other stakeholders.

5. **The Market Test**

In theory, all gas distributors, no matter where they operate, can be considered potential competitors in each tender launched throughout the national territory. However, in practice this is never the case in the gas distribution sector, as an important financial barrier prevents companies from participating in all tenders: in fact, as a matter of regulation, winners have to pay back to the existing providers an amount of money equal to the residual value of the network. Therefore, the market test enabled the identification of the companies that more credibly can be in the position of making such offer in the relevant tenders. This was carried out in three prognostics steps. First of all, the characteristics that companies must possess in order to participate in the relevant six tenders were identified. Secondly, on the basis of such characteristics, the undertakings that were actually more likely to participate in the relevant tenders were also identified. Thirdly, the likely effects of the merger on the identity and on the number of the participating undertakings were assessed.

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\(^8\) See, for example, the Commission case No. Comp/M.3083, *GE/Instrumentarium.*
With regard to the first step, the majority of the respondents indicated the following elements as determinants of the participation in a tender:

- **Incumbency**: a provider, already operating in a given ATEM (s.c. incumbent) is more likely to participate in the related tender than companies which do not already operate there. The higher the number of PGD served in the ATEM, the higher the likelihood that the incumbent will participate in the tender and the higher the likeliness that the later will win the tender;
- **Proximity**: the presence of a company in the neighbouring ATEMs also strongly influences the decision to participate in the tender involving the relevant ATEM;
- **Financial strength**: the greater the undertakings’ financial strength, the more likely the participation in the tender. This, in fact, helps companies to overcome the above mentioned financial barrier created by the regulation.
- **Temporary Business Associations**: the possibility to form s.c. Temporary Business Associations can strongly help smaller companies facing the financial barrier. However, small distributors are excluded from the participation, even the association, in tenders related to ATEMs characterized by the presence of strong incumbents.

Therefore, in the end, the market test confirmed that the specific features of the regulation in the gas sector tend to reduce markets’ contestability, by allowing only undertakings with “deep pockets” to actually overcome the financial entry barriers and participate in the forthcoming tenders. Moreover, the market test also confirmed the importance of the monitoring activity performed by the ICA on undertakings’ business decisions that have the potential effect of further reducing such contestability.

6. **The Assessment of the Effects of the Merger**

The results obtained from the market test enabled the ICA to identify at a pre-merger stage the most credible participants in the relevant tenders, generally in the number of three for each of the six tenders in the absence of the merger, and then to assess the merger’s effects.

In particular, from the assessment of the results of the market test it emerged that Italgas and Hera/Acegas Aps were to be considered as two of the three main potential competitors in four of the six relevant tenders. In fact, their characteristics were fully coincident with those emerged from the market test: i) Italgas exhibits strong financial means and is also a strong incumbent in the ATEM of Pordenone, whereas Hera/Acegas Aps has a strong incumbency position in the ATEMs of Gorizia, Trieste and Padova 1 (see table 1); ii) Italgas is already active in many ATEMs close to those of Gorizia and Trieste, whereas Hera/Acegas Aps is operating in several ATEMs close to Gorizia, Trieste and Padova 1; iii) Neither local distributors nor international companies have been found to possess the characteristics that would have made them credible competitors.

In addition, the business documents acquired during the investigation also evidenced a clear intention of the two undertakings to participate, even individually, in the absence of the merger, in the relevant
tenders, which further proved that both Italgas and Hera/Acegas Aps were actual potential competitors in the relevant markets.

Therefore, the ICA considered that the merger would have reduced the number of credible participants in the relevant tenders. In particular, in the tenders related to the ATEMs of Padova 1, Gorizia, Pordenone and Trieste, the merger would have eliminated the competition between two of the three potential participants, namely Italgas and Hera/Acegas Aps, which post-merger would have participated as a single company. In other words, after the merger, the concentrated undertakings (through Isontina) would have been dominant in at least four of the relevant tenders. This would have affected negatively the competitiveness of the tenders and ultimately adversely impacted on the service supplied to final consumers. That is why the merger was finally prohibited.9