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Long-term energy contracts
in European Competition Policy:
Building Markets through Antitrust

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Introduction to the drama

• Long term energy contracts assumed efficient for contracting parties
• Competition authorities’ goal is to build competitive markets to get out of monopoly era. It can conflict with surplus of individual contracting parties
• Competition Authorities have limited information on all effects of long-term contracts on competition dynamics but they must rule anyway
Outline of the Presentation

1 Antitrust LTC Dilemma & Uncertainty

2 However EU Competition Policy
   Methodology for energy LTC is emerging

3 Illustrating Cases & conclusion
3 sources of uncertainty in EU Energy LTC Regime

S1- Antitrust is usually enforced in sectors where competition is more mature
   In Gas & Elec. antitrust faces an incumbent monopoly or a quasi cartel in place since decades

S2- Modernization of EC Antitrust Policy
   Towards a more economic approach! The Eu Commission tries to devise new methodologies and criterion to enforce antitrust in a context of market building while remaining constrained by the procedural aspects of the law
Uncertainty $C^{ted}$

**S3- Allocation of competition & regulatory powers**

- DG Comp not an independent regulatory body. Antitrust formal decisions taken in the European Commission as executive branch of European Union $>>$ Independent judicial review by European Court of Justice

- European *ex ante* regulation is weak: no strong EU regulator at the Community level while Eu Commission derives its antitrust powers from EC Treaty (Arts 81 and 82) so EU Antitrust the sole “robust” policy driver for energy liberalization

- Opposite in the USA where *ex ante* regulation is strong with FERC and DOJ “absent”
Conclusion:

‘Market building’ in the EU is notably carried out through Antitrust

but DG COMP (as economists...) has limited information on all actual effects of LTC practices on competition dynamics in energy markets

so uncertainty is there for DG COMP as for market players
# EU “Actual Antitrust” LTC Dilemma

<table>
<thead>
<tr>
<th>Market Players</th>
<th>LTC Positive</th>
<th>LTC Negative</th>
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<tbody>
<tr>
<td></td>
<td>• Mitigates counterparty credibility problems for investment</td>
<td>• If contracting party has monopoly power</td>
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<td></td>
<td>• Mitigates prices volatility; <em>John</em>: questionable over 3 months = cash flow problem?</td>
<td>• Mark-up may be too high given potential gain from hedging</td>
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<td></td>
<td>• Duration, volume, use &amp; (destination) clauses may bring gains (“efficiency””)</td>
<td>• If they do not allow for efficient re-negotiation</td>
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“Energy companies’ strategies”
## “Actual Antitrust” Dilemma

<table>
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<tr>
<th>EU Market Building</th>
<th>LTC Positive</th>
<th>Negative</th>
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<tr>
<td></td>
<td>• Enable entry if sufficiently long</td>
<td>• Foreclosure</td>
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<td>• Help Investment in high fixed-costs technology</td>
<td>• Dry out spot markets</td>
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<td>• Mitigate abuse of market power on the Day Ahead market</td>
<td>• Tacit collusion: stabilize market shares</td>
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<td></td>
<td></td>
<td>• State Aid Problem for purchasing consortia and stranded PPA</td>
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<td></td>
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<td>• Market partitioning: single EU market goal</td>
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<tr>
<td></td>
<td></td>
<td>• Restriction to use</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Excessive pricing</td>
</tr>
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<td></td>
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<td>• Price discrimination</td>
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The “pro-entry” anti-trust priority

- Key problem: “EU market building” and “entry” mainly pursued at the Community level while powers on ownership divestiture remain at the Member States’ level.
- “Entry” being a “market building” key does not contradict having a methodology to favor entry.
- Methodology reduces uncertainty.
II- Emerging EU Competition Policy Towards Energy Long-term Contracts

• Methodology to analyze “access to customers” in long-term contracts emerged in recent cases: Gas Natural/Endesa (2000), Synergen (2001), Repsol (2005), E.ON Ruhrgas (2006) and most importantly Distrigas (2007)

• A two-steps methodology:
  1. market share thresholds
  2. Weighting anti-competitive aspects with gains
Methodology Step 1 at DG Comp: The Tresholds

- ‘Hard-core restraints’ illegal per se: destination clauses, use restrictions, min. resale price fixing + When implemented by dominant firms: fidelity rebates and retention strategies are per se illegal.

- Market shares >30%, weighting of pro and anti-competitive aspects

- Market shares <30% without hard-core restraints: exempted
STEP 2 – a/ Market Characteristics relevant for entry

- Dominance must be assessed even more strictly on emerging energy markets.
- Level of vertical integration, difficulties in setting up a parallel network of resellers are important.
- Interaction gas/elec taken into account.
- Are supply to Resellers (Direct Energy) -to elec Gen- and to Energy Intensive Industries (Rhodia) the same or different product markets?
STEP 2 – b/ Share of Demand Tied for each Customer

- Eu Commission considers Transaction Costs to high when negotiating for a small quantity.
  It may be uneconomic for an alternative supplier to provide less than (20%) >> 80% threshold.
- Particularly detrimental if the buyer is big enough to motivate a new entry to serve his demand.
- To be analyzed with duration and pattern of consumption.
**STEP 2 – C/ Duration**

- Eu Commission position depends on market share of the buyer
- No problem with buyer size if contracts <1 year.
- Duration threshold with existing seller: 4y if buyer demand tied ≤ 80% and 2y if ≥ 80%
- New entrant reseller trying to establish a market position: probably 5y (*Direct Energy*)
- For a moderately dominant supplier (*Repsol*): ≤ 5y
- Uncertainty for energy intensive users: Eu Commission currently working on that issue.
STEP 2 – d/ Share of total demand

Assessment of the overall share of the total market demand covered by long term contracts with any supplier
### Gas Natural/Endesa (2000): Duration + Share + Downstream

<table>
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<tr>
<th>Duration</th>
<th>Reduced 15y to 12y to fight foreclosure (<em>NB: early decision not to be seen again today</em>)</th>
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<tbody>
<tr>
<td>Share of the customer demand tied</td>
<td>Reduced from 100% to 70% to enable entry of alternative supplier</td>
</tr>
<tr>
<td>Price effects</td>
<td>Pricing schemes amended to avoid “unfair” advantage for Endesa in downstream elec. market</td>
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STEP 2 – e/ GAINS

- Commission repeatedly accepted LTC for **new investment** and **entry**:
  e.g. no restriction on fuel supply contracting for new power investment

- **Price efficiency** for the buyer:
  criteria accepted depending on the competitive position of buyer in his market (be wary of price discrimination giving unfair advantage downstream)
Final step: Remedies applied to LTC

- Traditional remedies in EC Competition
- **Tailoring**: shorten duration, tailor duration to the share of customer demand tied
  - **Prohibiting**: delete clauses (e.g. destination clause), forbid vertical M&A for a while (Repsol)...

- New remedies
  - increasing use of VPP and gas releases, even in the context of long term contracts case
  - **Flexible remedy mix**: the Distrigaz “paella”
Distrigaz “paella”: a superdominant firm with multiple criteria rem.

- *Distrigaz manages contract durations as long as:*
  *No contracts over 5 years (2y. for resellers)*
  **70% customers must come back to market (termination of existing contract) every year**

- *Examples of duration flexibility management:*
  37.5% supplied under 5 year contracts and 62.5% supplied under 1 year contracts
  40% supplied under 4 year contracts and 60% supplied under 1 year contracts
  60% supplied under 2 year contracts and 40% supplied under 1 year contracts

- *Commitments as long as Dist. market share > 40%*
Distrigaz “flex/ remedy”: C\textsuperscript{ted}

- However contracts with a buyer investing in new power plant exempted from duration and “market come back” remedy.
- Key remaining uncertainty concerns the ability of a dominant electricity firm to sign upstream and downstream LTC linked to a new investment in GEN, especially if the LTC could accommodate the needs of electro-intensive users.
- The Commission struggles at the moment with this problem in France for Exeltium.
- Some indications are given in Synergen but the interaction gas/elec complicates the story.
**Synergen (2001): new CCGT in Ireland**

- ESB is dominant in the JV
- Upstream & downstream LTC accepted but:
  - Gas contract enables entry so “balancing effect”
- Resale contract with ESB retail subsidiary accepted only for 50% of the capacity
- VPP is organized with limited access for ESBIE
Concluding remarks

- Clear methodology emerging: uncertainty perceived by players is reduced
- EU antitrust authorities not as dogmatic as said
- Strong suspicion against contracts longer than 5y. when implemented by dominant firms
- Positive effects of LTC on PX market power abuse not considered
- VPP often imposed but their real effects on market structure -especially generation entry- unconvincing
- Uncertainties remain on the treatment of energy intensive users
Last: legal uncertainty vs efficiency in energy antitrust enforcement

- Methodology built in cases in beer and ice-cream sector
- The “more economic approach” still to be improved
- This shows the difficulties of antitrust authorities in building energy markets from a “path dependency” in enforcement
- Methodology favoring predictability over a “case by case” approach makes sense
- However European Commission still in learning curve & “sitting between two chairs”?