The return of long term contracts in electricity markets – Implications for competition / state aid reviews

18th GCLC Annual Conference:

The future of energy markets: which role for competition policy in the current geopolitical context

Fabien Roques

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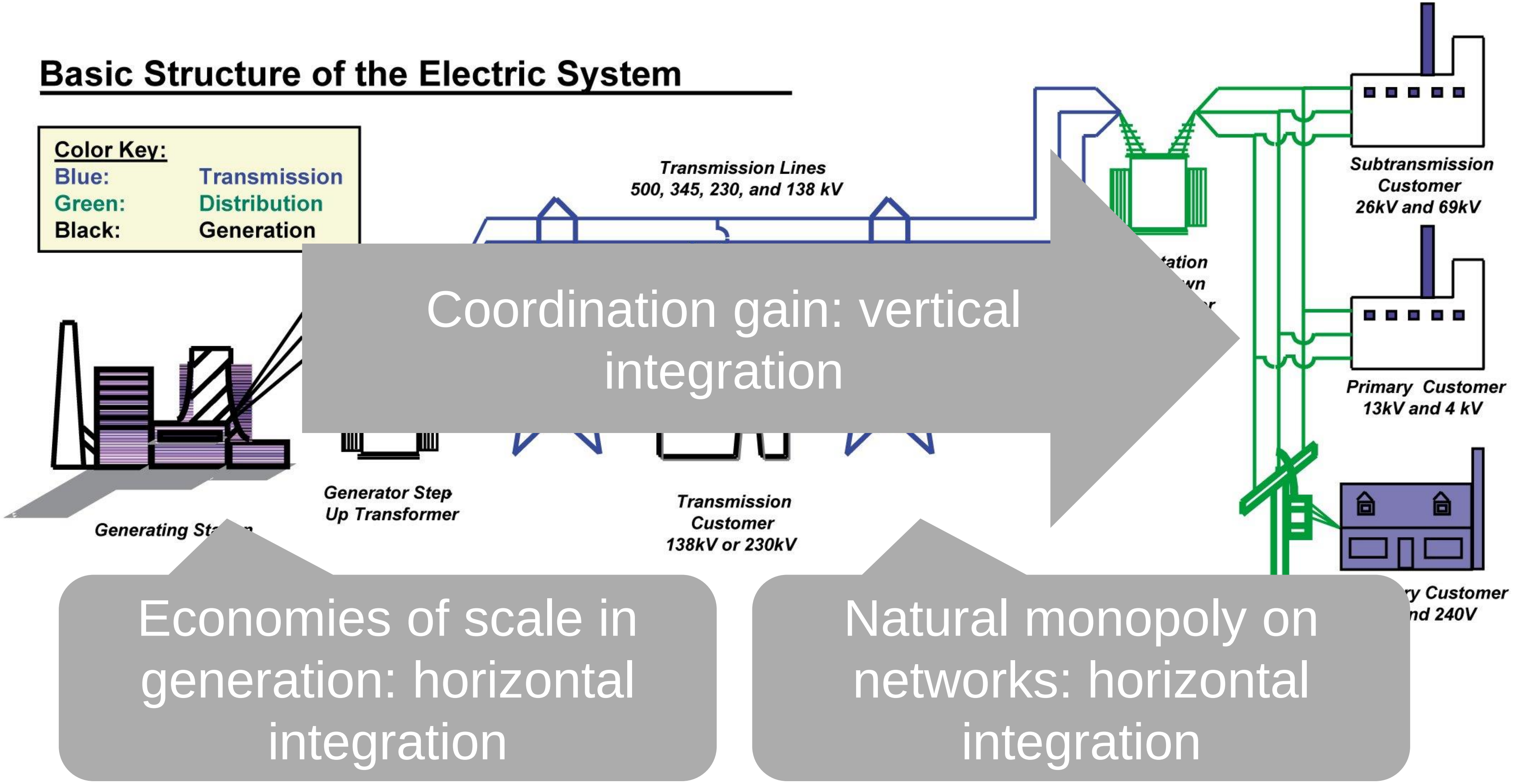
COMPASS LEXECON

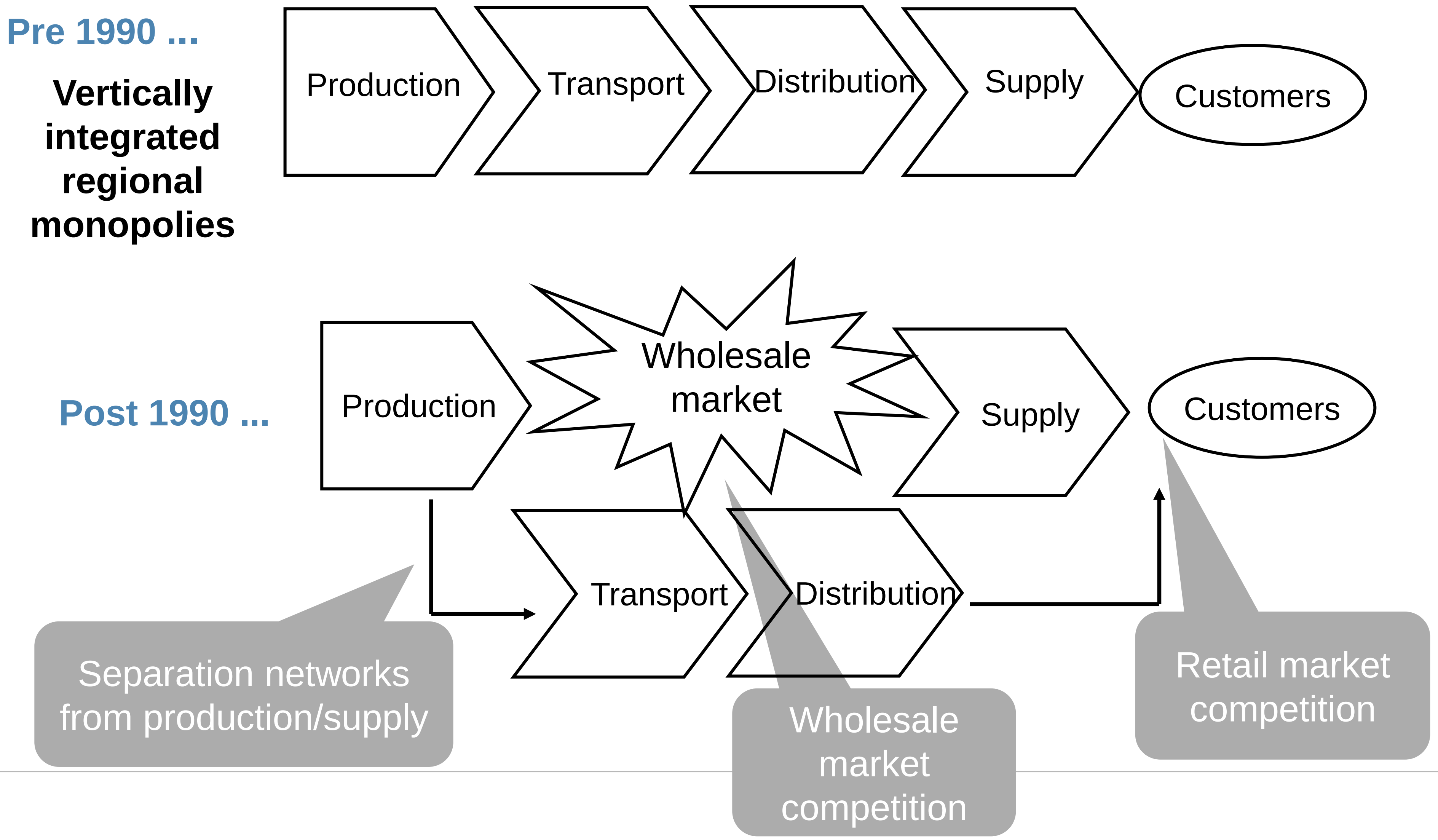
Agenda

Key drivers of vertical & horizontal integration in the electricity industry in the 20th century

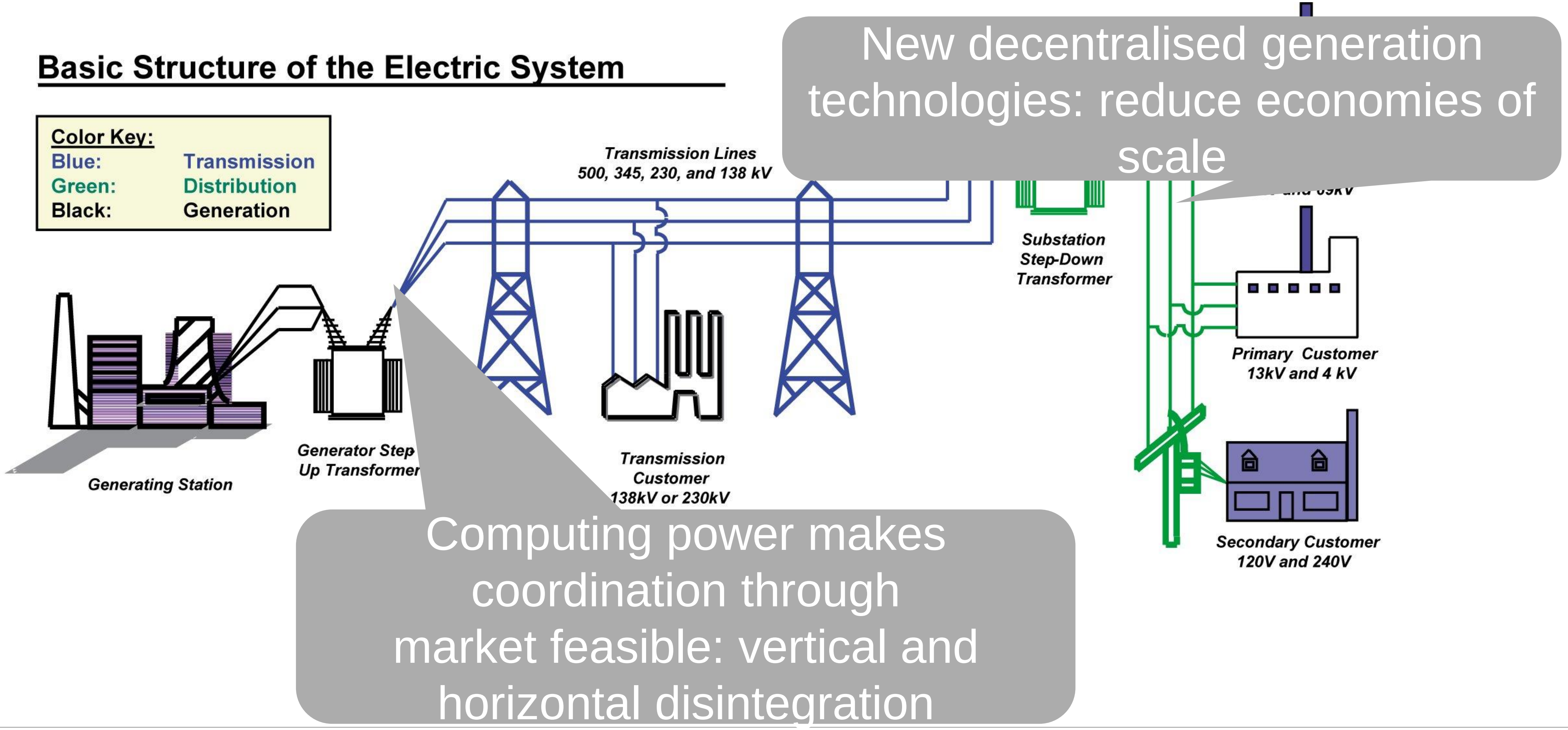


Source: http://www2.econ.iastate.edu/classes/econ458/tesfatsion/Home458Team.htm

Liberalisation and electricity industry restructuring in the 1990s/early 2000s - long term contracts as substitutes to vertical integration



Key technology enablers of liberalisation: Digitalisation and new decentralised generation technologies



After liberalisation, long-term contracts have been scrutinized by regulatory and competition authorities

Regulatory authorities perceived long term contracts in the 2000s as standing in the way of liberalisation

- Limiting development of liquidity
- Preventing development of new entry and retail competition

Competition authorities focused on the potential anticompetitive effects of long-term contracts

- Risk of foreclosure when dominant suppliers conclude long-term power purchasing agreements
- Focus on exclusivity clauses in some contracts
- Remedies for dominance: Divestments and/or Virtual Power Plants (VPP) commitments enforced on e.g. EDF in France or Endesa and Iberdrola in Spain

Power purchase agreements were also scrutinised in some cases as potential State Aid under the article 87(1) of the EC Treaty

- PPAs can be found to be State Aid when they give to the purchaser or the seller and advantage that sets them apart from the competition

The 2007 Sector Inquiry identified long-term contracts as one of the barriers to liberalisation

- **The 2007 sector inquiry identified PPAs as one of the issues undermining progress toward competitive markets**
  - Locking-in consumers on the downstream market represented a barrier to entry
  - The issue was worsened by the national scope of the market, due to few international substitution opportunities, caused by low interconnection capacity.

« Electricity generation assets are in the hand of a few incumbent suppliers or are indirectly controlled by them on the basis of **long-term power purchase agreements (PPAs)** giving the incumbents control over the essential inputs into the wholesale markets. »

DG Competition report on Energy Sector Inquiry (2007), European Commission

The EC refined its approach on foreclosure and limits to forward contracts after the conclusions of the Sector Inquiry

- The analysis of LT contracts under the articles 81-82 of the EC treaty reached a key milestone with the Distrigas[2] (2007)[3] decision
- Long-term PPAs transferring the risk usually borne by the generator onto the buyer fell under article 87(1)[2] of the EC Treaty on State Aid.

« As regards the obligation to ensure that adequate volumes come back to the market every year, it is recalled that the effect of the commitments is to oblige Distrigas on average not to tie **more than 20 percent of the total market or 30 percent of its own sales portfolio** more than one year ahead […]. The effect of the commitments will be to reduce the level of foreclosure of the customers in the market significantly with the exact level depending on how Distrigas' market share develops. »

Distrigas decision (2007), European Commission

Source :
[1] DG Competition report on Energy Sector Inquiry, [2] Distrigas decision, European Commission, [3] Oxera

Following the Sector Inquiry and the first state aid cases, a structured approach for assessing LTCs emerged

Key features of the EC approach for assessing LTCs following the Distrigaz[1] (2007) decision[2]

1. Contract features

- Destination clauses, resale price fixing are forbidden, as well as fidelity rebates and tacit renewal

2. Competitive position of the parties

- A market share > 30% for one or both of the parties triggers automatically an analysis of anti-competitive aspects

3. Share of customer demand tied

- When the contestable demand is too low (<20%), the competition authority considers *de facto* exclusivity to be the case.

4. Duration

- The threshold that does not pose problem is low (1 year)
- For a new entrant, a contract duration up to 5 years does not raise concern

5. Overall share of the markets covered by the contracts

- The case will raise particular concern in where the customer is large enough to justify new entry to serve his demand

6. Efficiencies

- Investment and entry are the most common efficiencies considered, capital costs are not considered

Source :
[1] Distrigaz decision, European Commission
[2] Adrien de Hauteclocque (2009), Long-term Energy Supply Contracts in European Competition Policy: Fuzzy not Crazy

The European Commission launched several proceedings to terminate PPAs/LTCs under state aid and/or article 102

PPAs in Poland and in Hungary were **terminated** as it was found the PPAs **represented State Aid** under the article 87(1).

Poland (2007)[3]

Domestic and foreign generators PPAs were terminated: the Polish system operator agreed to purchase power and generators received **compensation for stranded costs**

Hungary (2008)[4]

MVM PPAs were terminated and it was **compensated for stranded costs** by the government for losses resulting from the gap between PPA-purchased electricity and regulated resale prices to retailers

EDF was found guilty under the article 102 TFUE of **foreclosing the market** for new entrants.

France (2010)[5]

EDF had entered into a series of long-term contracts with industrial customers that were **foreclosing the market**.

Problematic clauses included both *de jure* and *de facto* **exclusivity** of supplier for the customers.

The **long duration** of the contracts was seen as reinforcing the foreclosing effect, due to fewer opportunities to contest clients.

As remedies, EDF had to give to at least 65% of its customer portfolio, each year, the **opportunity to switch** suppliers or to source their electricity from several providers, at no cost and was forced to **facilitate resale** of the volumes not consumed, to enhance the liquidity of the market.

Source :
[1] Distrigaz decision, European Commission [2] Adrien de Hauteclocque (2009), Long-term Energy Supply Contracts in European Competition Policy: Fuzzy not Crazy,
[3] EC decision C 43/2005, [4] EC decision C 41/05, [5] EC decision COMP/39.386 – Long-term contracts France

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The investment challenge : stepping up capacity additions requires LTCs to reduce risks

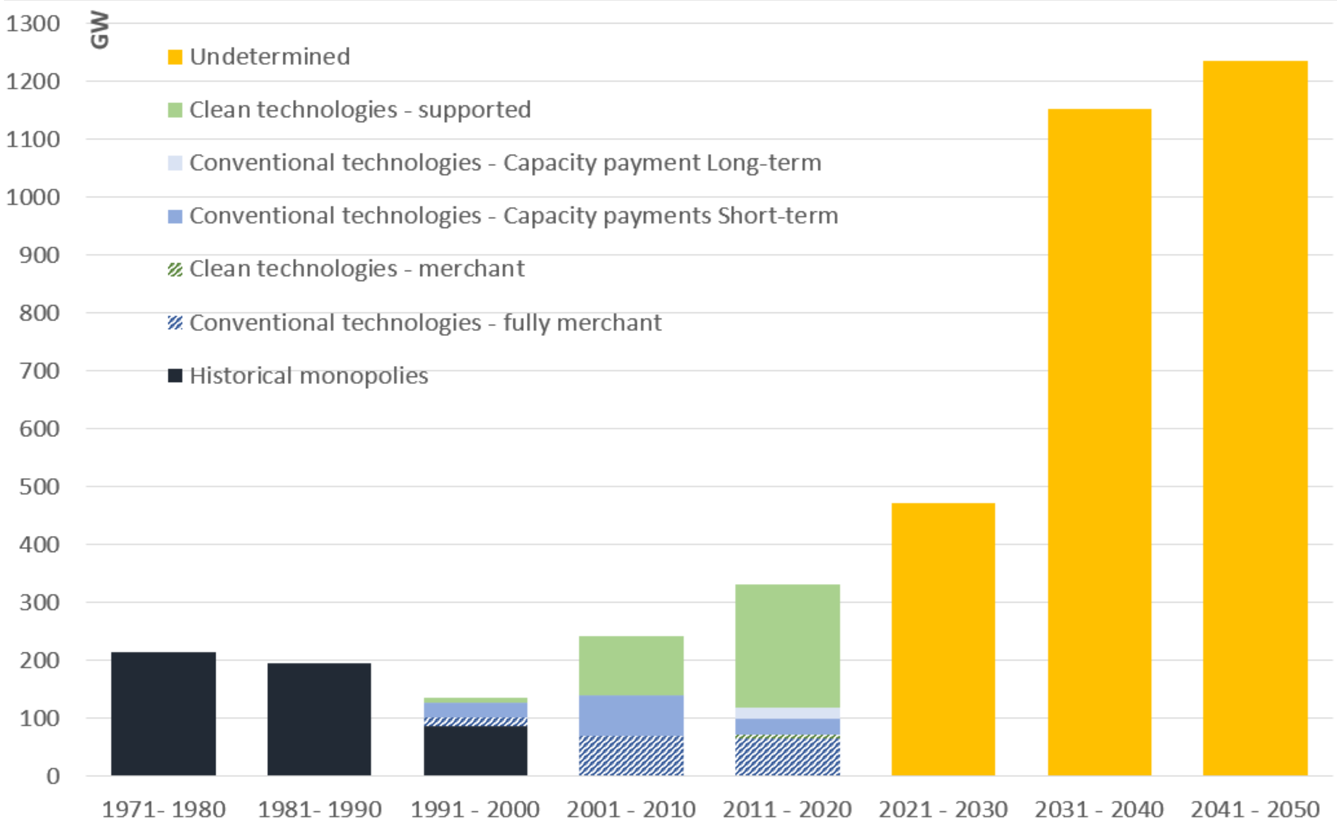
The EU decarbonisation ambition requires a step up in power sector investments

- 800 bn€ investments needed in power generation in the next decade, a significant increase compared to the previous decades

LTCs are necessary support investment in capital intensive clean technologies

- Attracting private investments in energy assets requires predictability of revenues
- Historically, most of the existing generation fleet in Europe has been supported by LTCs or regulation

Capacity additions in Europe based on the regulatory framework when the decision was taken



Source: CL analysis based on Platts, Country NECPs and CL Intelligence
European Commission - Final Report of the Sector Inquiry on Capacity Mechanisms
CEEM – Capacity Remuneration in power markets : an empirical assessment of the cost of production
CEER - 2nd CEER Report on Tendering Procedures for RES in Europe

In recent years, LTCs to support investment in renewables and firm/dependable resources avec been implemented throughout Europe

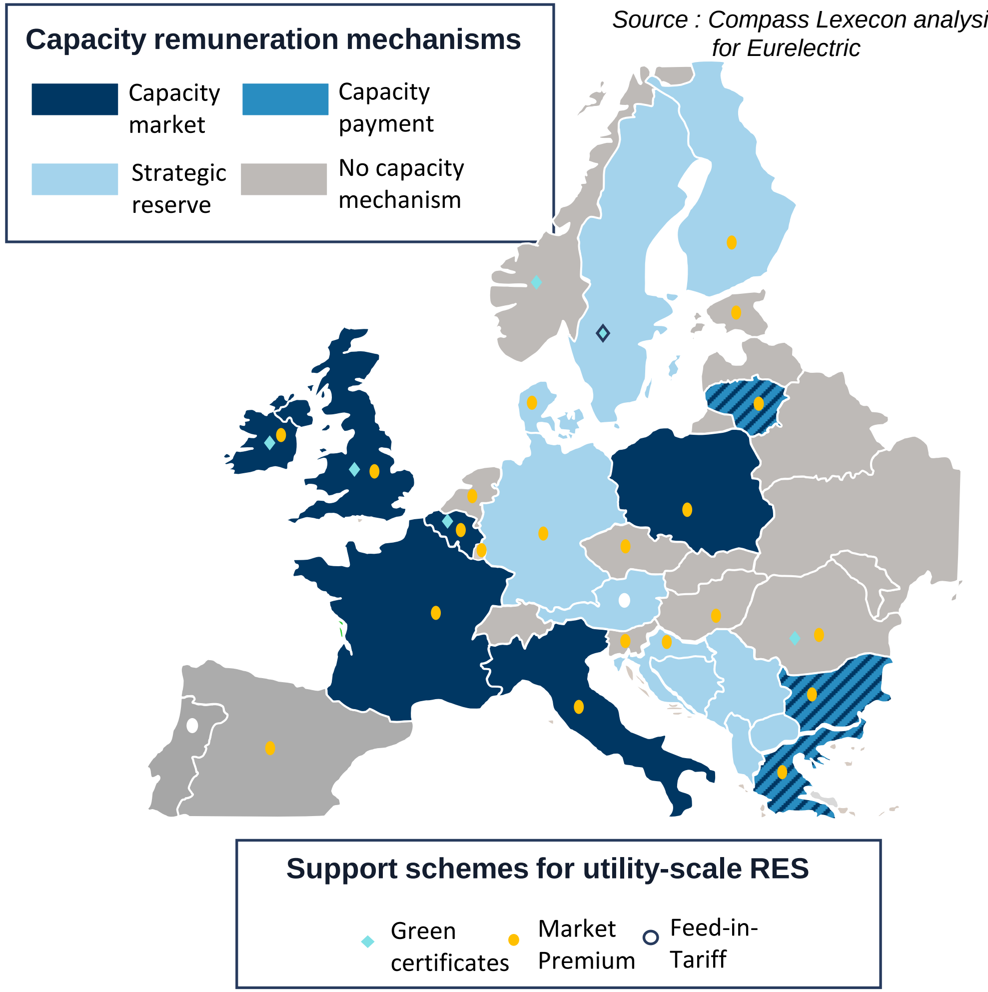
In recent years, there has been renewed interest in long-term contracts

- Long-term contracts can contribute to the EC decarbonisation objective through:
  - Lower cost of capital for new RES projects and a smoother transition to zero emissions
  - Better options for consumer to hedge and partially alleviate the pressure on household budgets across Europe
  - Develop market-based capacity remuneration mechanisms to support firm / flexible resources

LTCs can take several forms, but the most well known are Power Purchase Agreements (PPAs) and feed in tariffs / Contracts for Difference (CfD)

- As shown on the map, the capacity remuneration mechanisms and the support schemes for RES are heterogeneous across the countries of the Union

Source : Compass Lexecon analysis for Eurelectric



The European Commission proposed in March 2023 new regulation on market design which supports a greater role for long term contracts

The EC recognizes the key role of forward markets and long-term contracts to support decarbonisation

- LTCs are deemed necessary and proportionate to the decarbonisation objective
- Member States should aim to foster forward markets liquidity and LTCs

The EC provides some guidance on the types of LTCs that can be beneficial

- Both private PPAs and state driven CfDs have a role to play, as well as long term contracts for capacity and flexible resources
- The Directive 2019/944 and Regulation 2019/943 state that long-term contracts should be leveraged to shield suppliers and consumers from price volatility

« *Consumers and suppliers need effective and efficient* ***forward markets*** *to cover their long-term price exposure and decrease the* ***dependence on short-term prices****.* »

« *In order to allow market participants to be protected against price volatility risks on a market basis, and* ***mitigate uncertainty on future returns on investment****, long-term hedging products* ***shall be tradable*** *on exchanges in a transparent manner and* ***long-term electricity supply contracts shall be negotiable*** *over the counter, subject to compliance with Union competition law;* »

Article 3, Regulation 2019/943 (2022), European Commission

« *The proposed measures to incentivise the use of long-term contracts such as* ***power purchase agreements*** *and* ***two-way contracts for differences*** *may lead to increased administrative costs and burden for undertakings and national administrations. However, the envisaged economic impacts are* ***necessary and proportionate*** *to achieve the objective of incentivising the use of such long-term contracts […].* »

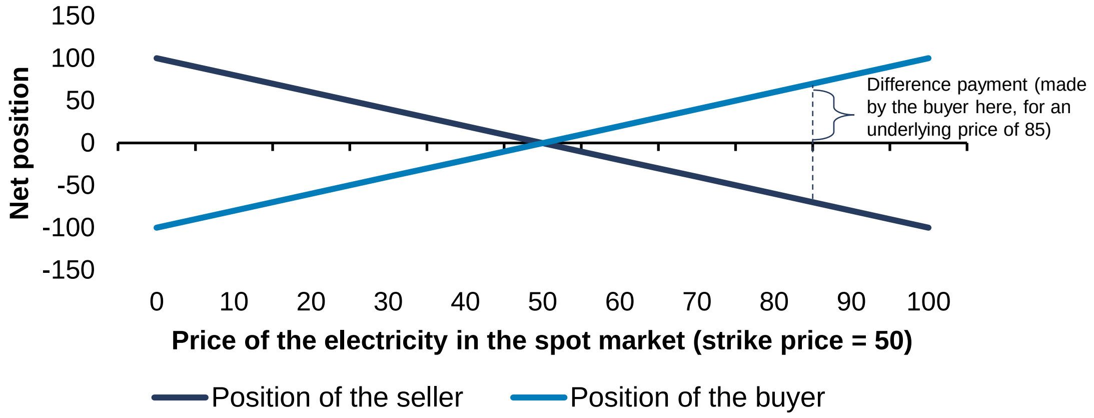
Proposal for amendment to regulation regarding the Union's electricity market design (March 2023), European Commission

Source :
[1] Proposal for amendment to regulation regarding the Union's electricity market design (2023)

The two main options highlighted in the market design reform are PPAs and two-way CfDs

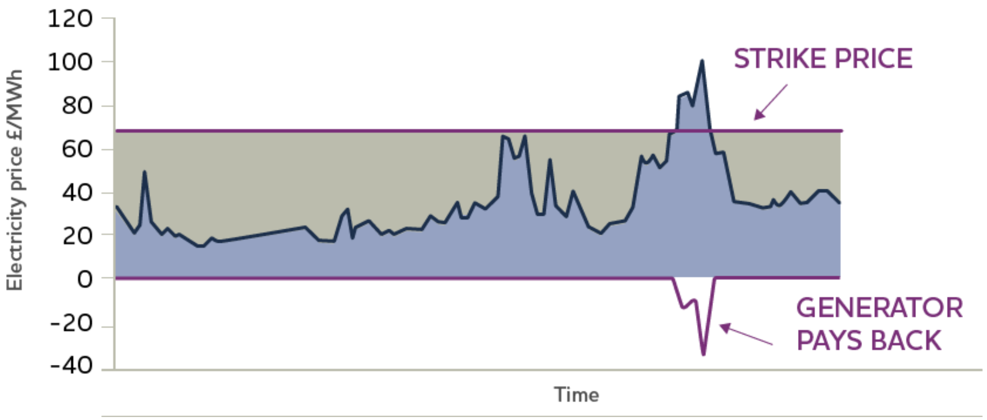
Power Purchase Agreement (PPA)

- The buyer commits to buying a specified amount of power at a fixed-price from a power producer for a given period of time (up to 20 years)
- Those contracts are meant to shield large consumers, whose profits are very dependent on energy prices, as well as power producers that need a return on capital to pay off their investment in renewable generation
- These allow the buyer and the seller to hedge or to make a profit on electricity trading if the volumes are not bought for delivery.



Contracts for Difference (CfD)

- The contract sets a strike price for the energy sold by a power-producer, and the producer sells its electricity on the wholesale market.
- If the settlement price is higher than the strike price, the other party, usually a State, will compensate the power producer for the difference.
- In some CfD, if the settlement price is higher than a pre-defined cap, the power producer pays the difference back to the State.

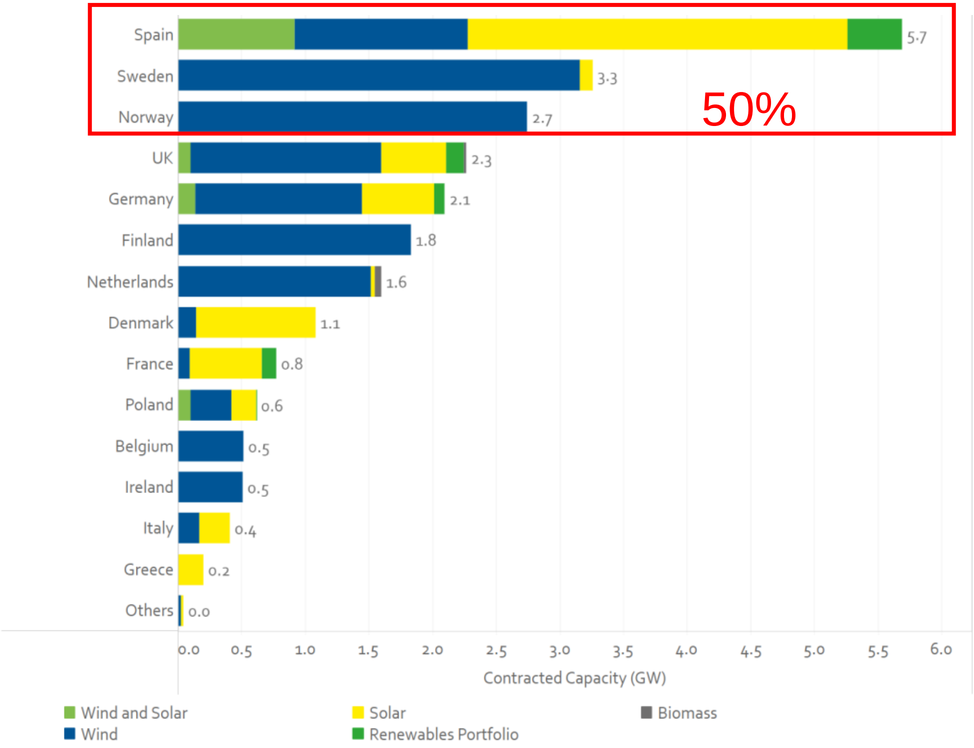


Corporate PPAs are developing at different speeds across Europe - many barriers remain in some countries to their development

Barriers to broader uptake of corporate PPAs

Regulatory barriers	▪ Legal constraints to sign direct contracts between generators and off-takers ▪ Barriers to signing contracts with more than one supplier
Policy barriers	▪ Barriers to the transfer of Guarantees of Origin (GoOs) to the off-taker ▪ Support schemes that are incompatible or compete with corporate PPAs
Economic barriers	▪ Limited visibility on the evolution of support schemes ▪ Creditworthiness of off-takers ▪ High transaction costs ▪ A lack of long-term hedging products to address imbalances or counterparty defaults ▪ The variability of renewable electricity production and the associated costs for managing volume imbalances between the renewable project output and corporate demand via ‘sleeving contracts’
Awareness issues	▪ Limited awareness and interest, especially for SMEs ▪ Perception that corporate PPAs are more expensive than wholesale electricity prices.

Renewable PPAs are concentrated in only a few member states



Source: EC, 2022. Data based on Re-Source (2022)

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The 2022 Guidelines on Vertical Restraints suggest exemptions for LTCs in clean generation

The 2022 Guidelines on Vertical Restraints suggest exemptions for LTCs in clean generation

- Non-compete obligation clauses may be a necessary condition for the investment in clean generation to be made.

Suppliers may favor an undertaking that meets specific environmental criteria

« *The criteria used by the supplier to select distributors may be qualitative or quantitative, or both. […] Qualitative criteria limit the number of distributors indirectly, by imposing conditions that cannot be met by all distributors, for instance, relating to the product range to be sold, the training of sales personnel, the service to be provided at the point of sale or the advertising and presentation of the products. Qualitative criteria may refer to the* ***achievement of sustainability objectives, such as climate change, protection of the environment or limiting the use of natural resources.*** »

Guidelines on Vertical Restraint (2022), European Commission

Conclusion: Assessment of LTCs under competition/ state aid will need to consider a broad set of potential efficiency gains and distortions

Efficiencies

- By reducing the volatility of revenue of the investor, lower the cost of capital, therefore achieving a cheaper transition to clean energy
- Better predictability of prices and revenue promotes market-entry, therefore increasing competition
- LTCs can mitigate incentives to exercise market power on the day-ahead market and lower overall prices
- Some specific LTC contract provisions can have pro competitive effects (e.g. indexation on forward markets supporting liquidity)

Potential effects on competition / distortions

- The type and design of the contract is key to assess potential adverse effects / distortions leading e.g. to inefficient dispatch
- Contracts with a public counterparty (e.g. CfDs) may require different approach than contracts with private counterparties
- Allocation process could narrow down eligibility / competition
- To respect the goal of proportionality, the duration of the contracts should strike a balance to avoid locking in customers for longer than necessary to efficiently fiancé the asset

Guidelines would be useful to avoid case by case assessment

- Differentiate between:
  - Type of product (energy or capacity)
  - Type (financial of physical) and duration of contract
  - Nature of allocation process (transparent / competitive process vs bilateral negotiation)
  - Market position of parties
  - Assessment of potential efficiencies / benefits
  - Etc.

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Thank you for your attention

Fabien Roques
22, place de la Madeleine, 75008 Paris, France
Direct: + 33 1 53 05 36 29
Mobile : +33 7 88 37 15 01
Email: froques@compasslexecon.com