

Workshop GREDEG-CNRS, OFCE and Gis Larsen

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Long-term Energy Supply Contracts (LTC) in EC Competition Policy

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Introduction

- LTC in EC competition policy - an interesting case study:
 - Firms/analysts increasingly doubts the ability of fully decentralized markets to solve the problem of vertical relationships >> call for more ‘robust’ vertical arrangements
 - EU Commission consistently emphasizes anti-competitive effects and made them a priority for antitrust review >> but in practice?
- New line of cases recently (e.g. *E.ON Ruhrgas*, *Distrigaz*, *EDF*): how does the EU Commission adapt to the new realities?

Outline of the Presentation

- 1 Market Building Through Antitrust: Keys of Understanding & EU Commission Dilemma with LTC
- 2 EU Competition Policy Methodology for energy LTC is emerging
- 3 Concluding remarks

1 Market Building Through Antitrust in the EU Energy Markets: keys of understanding

- *S1- Allocation of regulatory powers: Antitrust increasingly takes the lead*
 - European *ex ante* regulation is weak (even after ACER):
no strong EU regulator at the Community level while EU Commission derives its antitrust powers from EC Treaty
so EU Antitrust the sole “robust” policy driver for
energy liberalization

Market Building Through Antitrust in Energy C^{ted}

- *S2 - More and more use of quasi-regulatory kind of remedies*
 - Forced divestiture of the transmission network (e.g. RWE and E.ON) – although MS rejected it in the 3rd Package
 - VPP and gas release programs (e.g. Synergen) – may involve long-term monitoring by competition authorities
 - Before only during merger control, now also during antitrust (cartels and monopolization) proceedings
- *S3 - Increasing use of the commitment procedure coupled with stronger fines ('carrot & stick' approach)*

“Actual Antitrust” Dilemma with Energy LTC

	LTC Positive	Negative
EU Market Building	<ul style="list-style-type: none"> • Enable entry if sufficiently long • Help Investment in high fixed-costs technology • Mitigate abuse of market power on the Day Ahead market 	<ul style="list-style-type: none"> • Foreclosure • Dry out spot markets • Potential State Aid Problem for purchasing consortia • market partitioning: single EU market goal • Discrimination <div data-bbox="1189 1145 1722 1313"> <p>“Sector Enquiry”</p> </div>

Market Building Through Antitrust in Energy: C^{ted}

- Conclusion:

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

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

so uncertainty is there for DG COMP as for market players

2 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) (+ new EDF case (04/11/09))
- A four-steps methodology with a ‘pro-entry’ bias:
 1. Market share thresholds and ‘black-listed’ contract clauses
 2. Analysis of Anti-competitive Effects
 3. Balancing Anti-competitive Effects with Efficiencies
 4. Remedies

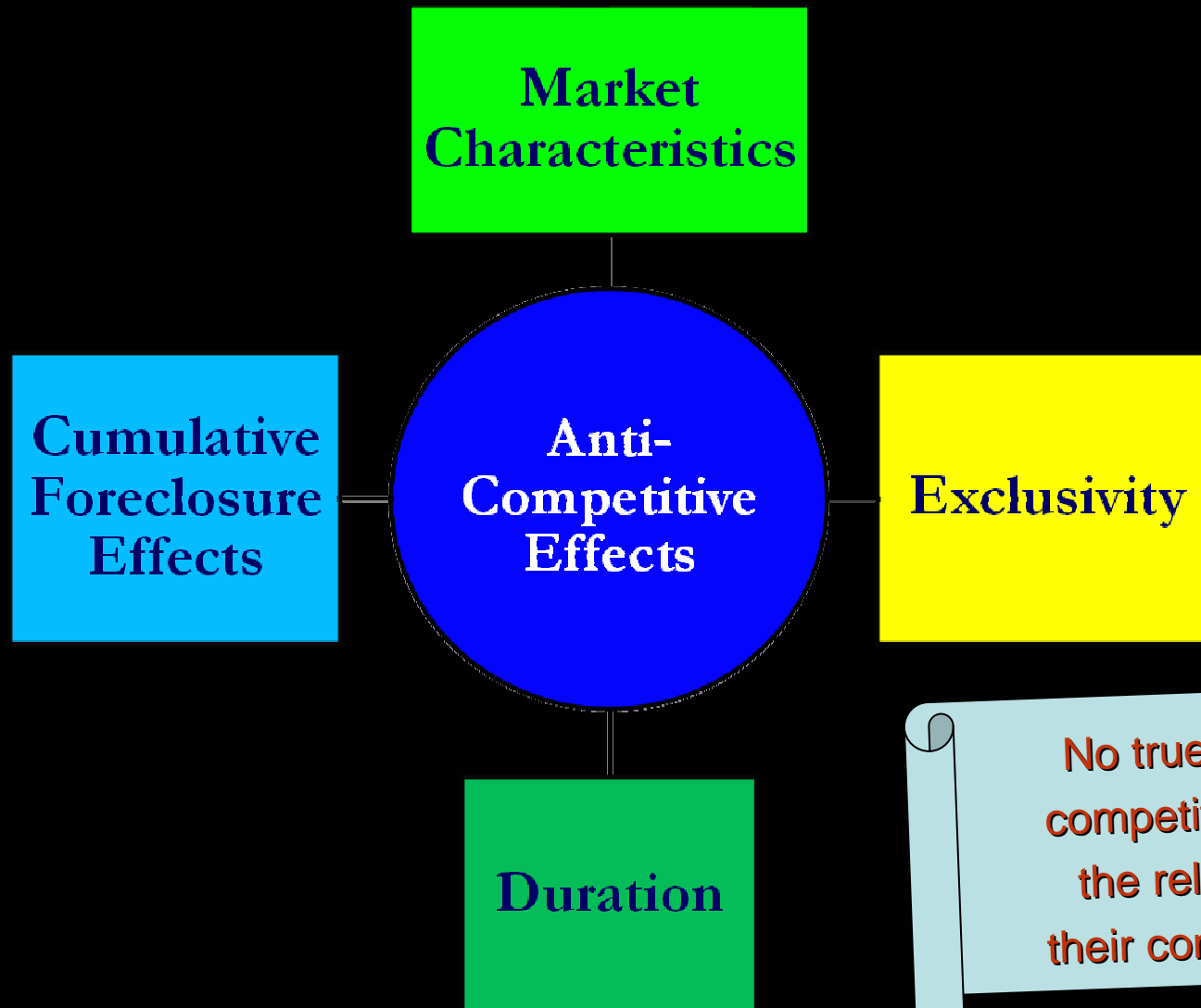
Step 1: Market Share Thresholds and 'Black-listed' Contract Clauses



- *'Hard-core restraints' illegal per se*: destination clauses, use restrictions, min. resale price fixing + *When implemented by dominant firms*: fidelity rebates and retention strategies, tacit renewal are *per se* illegal.
- Market shares $>30\%$, analysis of anti-competitive aspects
- Market shares (of the supplier) $<30\%$ without hard-core restraints: exempted

Object: Limit Reg. Costs

Step 2: Analysis of Anti-competitive Effects



No true sequencing of competition analysis but the relevant facts and their combination is clear

STEP 2 – a/ Exclusivity

Exclusivity

- EU Commission considers Transaction Costs too high when negotiating for a small quantity
It may be uneconomic for an alternative supplier to provide less than (20%) >> 80%: threshold for *de facto* exclusivity
- EU Commission bases its analysis on quantities *actually* received
- Exclusivity is particularly detrimental if the buyer is big enough to motivate a new entry to serve his demand ('critical customer' concept)
- To be analysed along with duration

STEP 2 – b/ Duration

Duration

- No problem with buyer size and exclusivity if contracts < 1 year
- Duration threshold with existing reseller: 2-4y
 - *E.ON Ruhrgas* and *RWE*: 4y if buyer demand tied $\leq 80\%$ and 2y if $\geq 80\%$
- New entrant reseller trying to establish a market position: probably 5y
- For a moderately dominant supplier (*Repsol*): $\leq 5y$
- Overall: LT means over 1y, 5y is max and exclusivity & duration must be analyzed together

STEP 3: Balancing Anti-competitive Effects with Efficiencies

- Analysis of efficiencies much weaker
- The two main efficiency gains recognized have been **investment and entry**
- The Commission has acknowledged that even dominant firm could claim for a certain level of security in fuel supply
- Securing loan not sufficient
- Assessment of proportionality: this is where the **problem** and **discretion** of competition authorities really lie.

Final step: Remedies applied to LTC

- Traditional remedies in EC Competition *Old School*
 - ***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 for energy: Negotiating Commitments *New School*
 - increasing use of VPP and gas releases, even in the context of LTC case
 - **Flexible remedy mix**: *Distrigaz* and *EDF*

Gas Natural/Endesa (2000): Duration + Share + Downstream price effects

Duration	Reduced 15y to 12y to fight foreclosure (<i>early decision not to be seen again today</i>)
Share of the customer demand tied	Reduced from 100% to 70% to enable entry of alternative supplier
Price effects	Pricing schemes amended to avoid “unfair” advantage for Endesa in downstream elec. market

Distrigaz: Super-dominant 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
 - 60% supplied under 2 year contracts and 40% supplied under 1 year contracts
- Commitments as long as Distrigaz market share >40%
- Contracts with a buyer investing in new power plant exempted from duration and “market come back” remedy.

EDF – A Two-step Story

- Take 1: *Exeltium* (2008) – accepted but
 - Opt-out clauses
 - Use restraints prohibited (impact on the ability of industrial users and buying groups to secure attractive deals?)
 - Will be included in the overall analysis of EDF portfolio
- Take 2: LTC with industrial customers (04/11/2009)

<i>EDF Market Test</i>	<i>Distrigaz (2007)</i>	<i>EDF (2009)</i>
Max contract duration	5y	5y
% of sales to come back on the market every year	70%	65% (large consumers buying directly <i>or</i> through a consortia)
Contract clauses	No use restraint, no tacit renewal clauses	No use restraint
Duration of Commitments	4y or Distrigaz under 40% market shares	10y or EDF under 40% market shares
Monitoring of Commitments	Annual Report	Annual Report + third party auditor
Other	Contract with new power plant not included	effective right to contract with alternative supplier
<i>Commitments may be reopened if material changes in national law or the market context</i>		

The Commitment Procedure (Art 9 Reg 1/2003)

Advantages	Weaknesses
Procedural economy = speed, no costly Court trial	<ul style="list-style-type: none"> • No binding precedent • no obligation for the Commission to clarify its reasoning • = no clarification of rules
For the Commission: <ul style="list-style-type: none"> • quick improvement in the market structure • <i>direct access to firms</i> • no judicial control 	‘carrot & stick’ approach: The Commission might extract stronger commitment than under the normal infringement procedure – pb of political legitimacy
For Firms: <ul style="list-style-type: none"> • no public loss of image • no fine 	<div>  <p>Will the ECJ strike back in the <i>Alrosa</i> case?</p> </div>

3 Concluding Remarks (1)

- EU antitrust authorities not as dogmatic as said
- DG Comp still in learning curve
- Clear methodology emerging: uncertainty perceived by players is incrementally reduced. Commission providing guidance through cases
- Strong suspicion against contracts longer than 5y when implemented by dominant firms
- Positive effects of LTC on market power abuse not considered
- VPP often imposed but their real effects on market structure is unconvincing >> ‘pro-entry’ bias but Commission is weak on understanding ‘patterns of entry’ in energy

Concluding Remarks (2)

- The initial institutional infrastructure (lack of legal basis in EC law for energy) continues to determine the quality and the dynamics of regulatory practice, in particular:
 - The legal tools we use
 - How we use them
- Weakness of *ex ante* regulation at the community level → *ex post* increasingly takes the lead → distinction between *ex ante* and *ex post* in EU energy regulation is increasingly blurred
- Increasing problem of political accountability
- The judiciary must play its role