Comparison of Long-Term Contracts and Vertical Integration in Decentralised Electricity Markets

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Overview

• Terminology and Context

• Analytical framework:
  – Why contract?
  – When is ownership (i.e. integration) to be preferred

• Contracting problems in electricity systems

• Advantages of vertical integration

• Policy implications
Terminology

- Long-term contracts (LTCs) are any contracts for electricity supply of longer duration than spot energy supply – we call the use of such contracts “contracting”

- Vertical integration (VI):
  - Arises when electricity generators or their customers (i.e. energy retailers, industrial firms) or fuel suppliers own each other to some degree
  - Is assumed precluded between competitive and monopoly/network (i.e. grid, lines) activities

- Decentralised (liberalised) electricity markets are those relying on competition rather than “design”, with pricing and investment decisions made by private parties
Context

Stylised decentralised electricity system – assumed role of contracts (no VI):

A Problem:

Cascading hold-up risks arise if parties at one level can breach or renegotiate contracts with parties higher up

→ Results in sub-optimal investment at each level
Context – cont’d

• Reformers initially focused on:
  – Constraining generator market power and promoting retail competition
  – Shifting investment risks from consumers/taxpayers to investors

• LTC markets and retail entry have not emerged as expected, and generation investment has suffered from retailer defaults and falling investor confidence

• Now reformers are increasingly concerned with supply security and hence encouraging investment:
  – “Missing money” problem in some decentralised markets
  – “Hold-up” problems – customers reneging on contracts when prices change, leaving counterparties (e.g. generators) with stranded long-term investments
  – Bankruptcies and “inadequate” investment (with associated political “twitchiness” about keeping the lights on)

• VI is emerging other than by design – makes regulators suspicious about thinning contracts markets, entry deterrence, over-pricing …
Why contract? (vs Spot trading)

• In general:
  – To reduce transaction costs from repeated spot contracting
  – To manage input and output price and quantity risks – e.g. securing supply at a predictable price/margin (especially where such risks are correlated)
  – As a commitment device (albeit imperfect), e.g.:
    • To manage investment risk – e.g. to better align demand with investment horizons, reducing hold-up risks for long-lived assets
    • To constrain market power – where parties have counter-veiling power (e.g. large customers, retailers)

• In decentralised electricity systems – as above, plus:
  – To smooth the transition to competitive electricity markets
  – To facilitate competitive retail entry
  – To offload legacy contracts previously entered into by liberalising states (e.g. with large industrials)
Why integrate? (vs Contracting)

• When the costs/risks of market contracting exceed those of ownership → optimally, ownership should fall to the firm patrons (i.e. suppliers, customers, etc) that enjoy the lowest sum of such costs – does liberalisation even allow this …?

• Relevant costs of ownership include:
  – Agency costs – arising when ownership and control are separated
  – Costs of collective decision-making
  – Costs of risk bearing (diversification/capital access)

• Relevant costs of market contracting include:
  – Transaction costs
  – Contractual incompleteness and bounded rationality – especially when forecasting future supply and demand is hard
  – Hold-up costs
  – Market power costs (if they cannot be contracted away) – especially if parties have asymmetric information
  – Regulatory risks – these differ by owner
Contracting problems in electricity markets

• Need for continuous real-time balance presents highly volatile demand and wholesale prices worsened with uncertain plant and fuel availability, unpredictable weather, inelastic demand, ...

• Hold-up risks, e.g. due to:
  – Differing generator and customer investment/contracting horizons, driven by risk of competitive predation in customer output markets:
    • Retailers – tend to prefer short-term only
    • Industrial customers – sometimes prefer longer contracts
  – Liberalisation itself, and regulation (especially of LTCs!)
  – Degree of diversification – i.e. plant/fuel/customers for generators; generators/load profiles for customers
Contracting problems – cont’d

• Other contracting problems include:
  
  – Adverse selection risks – due to market power, asymmetric information and bounded rationality
  
  – Contract market illiquidity – due to non-storability and locational pricing, and asynchronous energy/transmission auctions (complicating arbitrage), or VI
  
  – Outages, fuel risk and load profiles – *force majeure* clauses vs call options, base vs peak preferences, cyclical loads
  
  – Relative risk aversion – affects contracting appetite of generators and customers
  
  – Initial conditions – e.g. excess capacity, vesting contracts, pre-existing LTCs (e.g. with industrials)
Benefits of vertical integration

- Contrary to common fears, evidence and theory point to VI not just improving investment and risk management, but also reducing wholesale market power and supporting retail competition.

- VI provides a natural and self-sustaining hedge against wholesale price and quantity risks, as well as market power and asymmetric information costs – VI (mostly) internalises these risks and costs to the firm.

- VI reduces regulatory risk – rationale for and ability to regulate wholesale prices is reduced, as such prices are marginalised, and other relevant variables (e.g. generation costs) are not observable.

- VI enables better matching of load profile and supply security preferences (e.g. cogeneration by industrials, or peaking investment by retailers).

- By thinning contracts markets, integration:
  - Reduces the risk of retail entry (tying entry to owning generation as well), fundamentally reducing hold-up risks!
  - Enhances scale differences between integrated firms and retail entrants, reducing integrated firms’ exposure to predation.
Benefits of VI – cont’d

Ownership costs:

- Favour upstream VI by large customers
- Favour downstream integration by large generators, or more targeted upstream VI by retailers
Benefits of VI – cont’d

• A possible virtue of transmission constraints in systems with nodal pricing:
  – Price separation without effective congestion hedges complicates contracting, and deters retail entry and hence reduces retail hold-up risks
  – However, for integrated firms with capacity above and below constraints customers can still achieve hedged supply (and constraints can also be gamed to deter predation)

• A possible virtue of hydro-exposed systems – e.g. New Zealand (65% hydro, low storage, volatile inflows) – wholesale price surges in “dry years” are long-lived:
  – Complicates contracting, but of marginal impact on integrated firms
  – Means price caps are less viable, and helps to resolve the missing money problem

• Claim: VI is better able than contracting to sustain any given level of retail competition, given its advantages in terms of supporting investment, managing risks and mitigating generator market power
Benefits of VI – cont’d

Haywards Daily Average Wholesale Price (NZ$/ MWh)
"Dry Years" versus 2007 "Normal" Year

Source: Data courtesy of M-Co
Note: NZ$50 ≈ €20
Summarising

Rationales for up/down VI:
- Market power
- Hold-up risk
- Regulatory risk
- Fuel security (price or quantity)

Rationales for upstream VI by large customers or retailers:
- Market power
- Hold-up risk
- Regulatory risk
- Asymmetric information
- Supply security (price or quantity)
- Risk allocation/management

Rationales for downstream VI by generators:
- Buyer market power
- Hold-up risk
- Regulatory risk
- Demand security (price or quantity)
- Risk allocation/management
Policy implications

- VI is often seen as anti-competitive, and undermining contract markets → this presumes you are committed to contracting and that VI is precluded.

- On closer examination some of the “problems” of VI are non-existent, shared with contracting, or are natural solutions to shortcomings in LTCs (which LTCs often arise by design rather than by evolution).

- VI, LTCs and spot trading should be seen as natural complements.

- Some authors propose regulating for contracts to remedy contracting deficiencies, but this possibly imposes an inefficient approach instead of permitting efficient VI to evolve.

- Other authors propose the retention/reinstatement of franchise areas to remove hold-up risk from “excessive” retail competition, but this:
  - Presumes contracting is required, and that VI cannot resolve the problem.
  - May be necessary absent VI, or other system features constraining competition (e.g. grid constraints) or assisting investment (e.g. no price caps and sustained scarcity rents as in hydro-exposed systems) – but is extreme.
  - Could similarly be proposed for industrial customer output markets to reduce hold-up risks, but that would be very extreme.
Policy implications – cont’d

- These proposals do, however, highlight the need to re-evaluate the optimal degree of retail competition – given a system’s characteristics – and also the optimal approach to achieving that competition.

- Such a re-evaluation needs to weigh short-term consumer protection against long-term consumer welfare (i.e. investment, not just entry).

- This is a tricky political calculus, fundamentally affecting the prospect of successful liberalisation, and requiring a departure from the often-cited motivation of reform (i.e. to introduce competition).

- Alternatives such as capacity requirements or capacity mechanisms suffer the weaknesses that they are intended to remedy (and others).

- A more tolerant approach to integration, sober assessment of the role of contracting, and pragmatic approach to retail competition is likely to provide a natural and self-sustaining approach to supporting both investment and competition in decentralised systems.
Thank You – Any Questions?