

Market power mitigation by contracts

Bert Willems

EU-Electricity Liberalization

- Started by EU-directive 1996
- ‘Unbundling’ of different activities in electricity sector
- **Network Services:** Transmission and Distribution
 - = Natural monopoly, remains regulated
- **Generation and Retail**
 - = Competition

- Now: 10 years after opening of market

Healthy Competition?

- Lack of effective competition in generation
 - Characteristics of electricity
 - Lack of harmonization (not in directive!)
 - Bad market structure (not in directive!)
 - Weak regulators (scope is national, not generation)
 - Merger policy too lax
 - Politics: National Champions

- Competition authorities are worried
 - Potential abuse of market power
- Which remedies can we take?

Overview of Talk

- **Standard tools** of anti-trust policy are important but **insufficient** in electricity markets
 - Ex-post competition policy
 - Structural remedies
- **Sector-specific regulation** is needed
 - Market power mitigation = part of market design
- How to design regulation
 - Not: Sun spot regulation
 - Not: Price caps in spot market
 - But: Contract regulation, *cf. banking sector*
 - Oblige firms to sign (medium term) contracts

Problems with direct application of Art 82

- Slow process & hard to undo transfers (distributional effects)
- Hard to prove abuse with general competition rules
 - **Small players** might be dominant
When demand is high, every player has market power
 - Abuse is not related with bundling, price discrimination, but **excessive pricing**, or **withholding** (= taking too much time for maintenance)
 - Abuse might be consequence of **market rules**
- Few cases went to court
- **Regulation needed**

Problems with structural remedies

- Structural remedies are irreversible: What if markets become more competitive in future?
 - Large uncertainty of effects
 - Relation market structure → market prices is not clear
 - We cannot solve temporal and local problems
 - Even small firms might have market power
 - Decrease economies of scale
 - Political pressure!
- Behavioral remedies are important

Current EU-Policy

| | | Economic Instruments | | | |
|---------------|------------|----------------------|-------------------------------|----------------------------|-----------------------|
| | | Structural Remedy | Behavioural Remedy | | |
| | | | <i>Spot Market Regulation</i> | <i>Contract Regulation</i> | <i>Monitoring</i> |
| Legal Instrum | Regulation | | | | “sun-spot” regulation |
| | Art 82 | Real Divestitures | | Virtual Divestitures | |

- Virtual divestitures (behavioral instruments)
 - Effect? = not clear, crowding out of existing contracts
- Sun-spot regulation = non-binding pseudo-regulation
 - Regulators defines relevant markets, measures of dominance, abuse etc..
 - Legal uncertainty: will judge follow reasoning of regulator
 - Focus too much on short term indicators, not underlying market
- Regulation of generation market does not exist

Solution: increase role of regulator

- What: regulation of
 - Generation
 - Market rules (= power exchanges)
- Provision of two public goods:
 - Security of supply
 - Reduction of market power
- Why?
 - It can react faster than competition policy
 - Lower burden of proof, as rules are specified ex-ante
 - It can adjust market design
- Use behavioral remedies

Spot market regulation?

| | | Economic Instruments | | | |
|---------------|------------|----------------------|-------------------------------|----------------------------|-----------------------|
| | | Structural Remedy | Behavioural Remedy | | |
| | | | <i>Spot Market Regulation</i> | <i>Contract Regulation</i> | <i>Monitoring</i> |
| Legal Instrum | Regulation | | Price Caps | | “sun-spot” regulation |
| | Art 82 | Real Divestitures | | Virtual Divestitures | |

- Used extensively in the U.S.!
- Price caps destroy incentives
 - Consumers will not reduce consumption
 - Generators not available during peak demand
 - Too little investment – Too many black-outs
- Requires regulations of maintenance decisions, production, investments
- I predict failure

Better: Contract Regulation

| | | Economic Instruments | | | |
|---------------|------------|----------------------|-------------------------------|-------------------------------|-----------------------|
| | | Structural Remedy | Behavioural Remedy | | |
| | | | <i>Spot Market Regulation</i> | <i>Contract Regulation</i> | <i>Monitoring</i> |
| Legal Instrum | Regulation | | Price Caps | Contracting Incentives | “sun-spot” regulation |
| | Art 82 | Real Divestitures | | Virtual Divestitures | |

- Regulate contracts between generators and retailers
- Contracts change incentives of generators
 - Hedged position: less reasons to increase prices on spot market
- Superior to spot market regulation
 - No distortion in incentives for production and pricing
 - Can replicate effects of bid cap
 - More certainty for generators

Implementation

- Penalty for risk taking by firms (cf. banking sector)
 - Capital requirement for firms
- Market power shifts from spot market to contract market
- Contract market is competitive
 - By (threat) of entry in contract market
 - Time lag between adjustment of contract requirement
- Danger
 - If too long-term contracts: foreclosure
 - Suboptimal risk management of firms

Conclusion

- Regulation of contracts and risk exposure
 - = extra tool for regulators
 - Important for security of supply and market power
- Regulator needs to get more authority
 - Regulation of generation
 - Regulation of power exchanges
 - Cross-border trade
- Regulation of contracts is NOT the solution for market power in EU
 - Market structure is bad
 - Market design is not sufficient