

# Regulatory Uncertainty and Inefficiency for the Development of Merchant Lines in Europe

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# Objective of the Paper

- Evaluates the current regulatory choices that may prevent a better development of the transmission network through merchant transmission investment in Europe
- Propose a simple and EU Regulatory policy ‘compatible’ improvement of regulation

# Outline

- I. The Strategy of the European Commission for the Development of the Transmission Network
- II. This Strategy is only a Third Best: a Second Best is Possible
  - Dominant Generators Should Be Allowed to Develop ML
- III. How to Regulate ML by Dominant Generators?

# I- The Strategy of the European Commission for the Development of the Transmission Network

- Theory: fully independent TSOs well regulated by an EU-wide Regulator is a First Best (Costello, 2001; Politt, 2007)
- The Strategy of the European Commission aims to get as close as possible to that first best:
  - Unbundling is due to set the right incentives to invest
  - ACER must allow a consensual approach best able to optimise the development of the transmission grid at the European level

# I- The Strategy of the European Commission - C<sup>ted</sup>

- BUT
  - Full ownership unbundling not achieved
  - No optimal regulation of transmission investment in Europe for the moment → no EU-wide regulator with discretionary powers
    - Rmq: Even perfectly unbundled TSO might not have the right incentives because of national tropism of regulators
- Improvement of regulation and full unbundling very complicated if not impossible due to the opposition of several members states (see current discussions around the 3rd package)

# I- The Strategy of the European Commission - C<sup>ted</sup>

- Consequences of the pitfalls of this strategy
  - Insufficient investment leads to growing interest for merchant lines
    - only effective and achievable way of developing the network with the current allocation of regulatory powers
- Who will be able to develop merchant lines?
- Strategy is emerging from recent decisions:
  - Gas Sector: no dominant allowed to develop ML
  - Grandfathering rights have been systemically considered abuses of a dominant position (Art 82 EC)
  - Long term Supply Contracts: limited for dominants

# I- The Strategy of the European Commission - C<sup>ted</sup>

- Overall: strong suspicion against former incumbents
- ML is currently emerging as a TSO business
  - Developed by TSOs (Britned) or independent ML business
  - With or without long term access contracts (open season)
- Conclusion: revived interest for ML but we stay in the same “1st best” paradigm

## II- Dominant Generators Should be Allowed to Develop ML

- ML as a TSO business is only a third best:
  - Known to lead to insufficient investment (Perez-Arriaga et al., 1995)
  - And Pareto-improvement is doubtful because:
    - possible substitution with regulated investments
    - Fuzzy incentives to manage network externalities to the benefit of social welfare
- A better solution could be to let generators make ML. why?

## II- Dominant Generators Should be Allowed - $C^{ted}$

- With high costs or just too small  $\rightarrow$  no interest to develop a ML...and no problem
- With low costs  $\rightarrow$  powerful incentives (Sauma & Oren, 2007)
  - price is higher than my cost in the destination market
  - incentive to export
    - Profit Function
    - $\text{Max PriceDestMkt} - \text{InvCostProd} - \text{MargCostProd} - \text{InvCostML}$
    - If no market power  $\rightarrow$   $\min \text{InvCostProd} + \text{MargCostProd} + \text{InvCostTrans} = \min \text{Total system cost}$
- Reintegration of investment decisions in Prod and Trans + no market power = problem of sub-optimal capacity Inv is ruled out
  - Pareto improvement compared to ML as a TSO business

## II- Dominant Generators Should be Allowed - C<sup>ted</sup>

- Other advantages should not be under-estimated:
- Information advantages of generators over TSOs on market conditions across borders
- Exempted network investments are realized sooner
- Would help secure investment in capital intensive technology when long term supply contracts (over 5 years) are not sure to be allowed if you are dominant in your domestic market: positive effect on fuel mix diversity from the society point of view
- Next Message: regulation must be tailored to the problem of market power and the needed tools already exist

# III- How to Regulate ML by Dominant Generators?

- 3 key conditions for market power mitigation:
  - strict imposition of UIOLI with transparency requirements to avoid pre-emptive investment and give access to third parties
  - no TPA exemption on reverse flows: you must take the full commercial risk
  - If you do not have a long-term supply contract (unlikely): must-offer provision on a limited part of the ML capacity, to avoid you use the ML to manipulate prices in the destination spot market
- This will require both the monitoring of transparency on free cross-border capacities and a least cost deterrence-based mechanism for self-enforcement

# III- How to Regulate ML by Dominant Generators?

- Our key Message:
  - True, the current EU regulatory framework has weaknesses
  - But, he also has strength
  - He can do the job. Why?
- UIOLI requires monitoring of transparency requirements on cross-border unused capacities → we will have ACER
- ACER will have weak decision power on substantial policy issues
- But ACER will help find common standards for the monitoring of transparency by regulators
- ACER could even monitor transparency requirements directly (most unlikely to be considered as a substantial policy issue in EU law)

### III- How to Regulate ML by Dominant Generators?

- How do we get self-enforcement by dominant generators at least cost?
- *Ex ante* regulation is weak in Europe at the federal level but antitrust policy is very strong and taking the lead: process of market building through antitrust today in the EU! See *E.ON* and all cases on long-term supply contracts (*Distrigaz...*)
- Antitrust can fine up to 10% of their turnover: strong deterrence
- Antitrust has already been applied to interco (UK-French submarine interco) - “essential facility” doctrine
- Monitoring of transparency requirements will provide data for court trial (complementarities *ex ante* / *ex post*)

## RECAP.

# How to mitigate market power through ML?

2 ingredients needed

Characteristics of the EU regulatory framework

*ex ante* monitoring of transparency requirements

ACER: low discretion but strong on technical issues – monitoring is part of them

*ex post* self-enforcement by dominant generators

*ex ante* regulation is weak but EU antitrust is strong (deterrence) and has already been applied successfully on interco

# Conclusion

- Today, the EU Commission seeks a first best but reaches a third best
- A second best is reachable by allowing ML for those who can do it
- Change in the technology mix (nuclear, wind) may increase price differentials and some firms have new incentives to build ML
- European regulation should use the current change of the energy mix and leverage on the few advantages of the current allocation of regulatory powers
- A robust, public and “smart” regulatory framework for ML is