

## Foreword

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While reading this text by Adrien de Hauteclouque, I began asking myself why contracts and contracting are so important to European energy market making. Twenty years ago, this thought would not even have crossed my mind, and I would certainly not have been able to expand upon it. This demonstrates quite how far economic thinking and applied policy making have moved away from the old, conventional wisdom of 20 years ago.

Paul Joskow (former Dean of the Department of Economics at MIT) and Oliver Williamson (Nobel Memorial Prize in Economic Sciences, 2009) started to tackle the issue in the early 1980s with Joskow's *Markets for Power: An Analysis of Electric Utility Deregulation*<sup>1</sup> and Williamson's *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*.<sup>2</sup> At the time, however, few were able to grasp the importance of these new findings. Williamson investigated how a market economy is built not just of markets (sometimes markets are not even the primary element), but how it brings together at least three types of governance mechanisms: markets, firms and contractual relationships, a typical one being a long-term contract to supply a commodity or infrastructure access. Joskow explored how these three basic mechanisms are closely intertwined in the electricity industry and how the organization and evolution of the governance structure of each mechanism is heavily affected by the governance structure of the others. This was also looked at by Williamson in a later book, *The Mechanisms of Governance*.<sup>3</sup> Joskow explained how integrated industries could use contractual partnerships as a substitute for company integration should company integration not be feasible, whether for economic, legal or political reasons. Williamson added that the complete disintegration of a formerly

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<sup>1</sup> Joskow and Schmalensee, *Markets for Power: An Analysis of Electric Utility Deregulation* (MIT Press, 1983).

<sup>2</sup> Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (Free Press, 1985).

<sup>3</sup> Williamson, *The Mechanisms of Governance* (Oxford University Press, 1996).

integrated industry into a completely open market was not always economically sound or feasible, as not all markets are able to efficiently manage all particular economic relations and interdependences.

After 1986, when the European Commission began to implement the Single European Act by creating a single market in all areas of economic activity, nobody really knew how it would work for electricity. In April 1990, the reform in England and Wales paved the way for change by creating a wholesale market. Was this new market just an ordinary market, or was it instead a complex network of contractual arrangements designed to mimic key parts of the previous vertical integration of operations? Was this market robust enough for new entrants to rely upon and to enter the CCGT<sup>4</sup> generation business? Or should they wait for the opportunity to sign long-term contracts with the regional electricity retail monopolies? Should access to the English and Welsh markets be granted to Scottish and French generators with long-term contracts signed by the operator of the existing interconnectors, or should access to the interconnectors be handed over to the newly set up Power Exchange? Should the Power Exchange have a monopoly over entry to specific market areas and should it be able to prohibit direct selling and bilateral contracting of long-term supply? All of these issues were unprecedented and the England and Wales Power Exchange arrangements had to be reviewed by the European Commission to check whether they would be compliant with EU competition policy.

It took a while to fully comprehend the fact that simply restructuring the industry would not be enough to allow new market and contractual relationships to work. The nadir was reached in 2000–2001 in California when an industry that was considered well restructured crashed in essence *because* of its market rules and the way its contractual partnerships were arranged. Professor Bill Hogan of Harvard University got to the core of the matter in few words: in the electricity industry, you should not delegate the design of market rules to market players. Bill pushed hard for some sort of standard market design in the US. The federal regulator, the FERC (Federal Energy Regulatory Commission), did all it could to try to implement a common market design in the US but to no avail – those unwilling had put in place political obstacles which proved impossible to overcome, and this put a complete stop to any attempt by the independent federal regulator to design a common US market.

There were similar obstacles in the European Union. The three liberalization packages from 1996 to 2009 were not successful in creating

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<sup>4</sup> Combined-Cycle Gas Turbine.

a comprehensive design for a common market. However, elements of market design have been implemented by regulation, such as the access regime to interconnections, and by consensus, for example through the Florence Forum. We will soon see how the measures introduced by the Third Package will address this need for design of a single market, especially the ENTSOs,<sup>5</sup> the introduction and expansion of network codes, and ACER.<sup>6</sup>

One particularly interesting feature of the European journey is the lack of federal regulatory power. Despite having no federal regulator, we Europeans are nevertheless slowly adding layers of design to the skeleton of our market. While in the US the competition authority in regulated industries is weak as the federal sector regulator remains in charge, in the EU the 'federal' competition authority takes precedence over existing energy regulators and sector-specific regulations. As the European Commission does not have the power to restructure the energy industry, Europe started liberalization although neither restructuring nor regulation could be easily achieved at EU level. EU competition policy remains strong but there is no detailed vision and there are no detailed guidelines, and powers are not detailed enough to make up for the lack of a comprehensive EU regulatory and restructuring structure. As a result, the EU works with an incomplete coordination of competitive market building, regulated market building, firms restructuring and contractual partnerships reframing. In addition, regulatory powers are allocated at European and national level, with national regulators and competition authorities, as well as strong governmental powers in the areas of competition and regulation.

The same is true for the EU gas industry, which has a vertical layer of long-term contracts between gas producers, gas suppliers and gas transmission networks plus a horizontal layer of market-based supply (gas hubs) and market-based grid access (either through explicit auctions, secondary markets or implicit auctions; that is, market coupling). It should also be remembered that the astounding wave of European investment into wind and solar electricity generation has been made possible mainly due to national schemes granting guaranteed long-term prices and unlimited demand priority access.

With all this in mind, we are ready to breach the issues dealt with in Adrien's book. Intricate economic and legal problems, such as those described above, are best analysed with specific case studies and in

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<sup>5</sup> European Network of Transmission System Operators.

<sup>6</sup> Agency for the Cooperation of Energy Regulators.

defined areas. In this case we are looking at long-term contracting for electricity. General theory cannot provide us guidance. To truly get to grips with this subject, we need someone with a theoretical background in both economics and law, as well as someone experienced enough to disentangle the known from the unknown, the feasible from the unfeasible, and the promising from the unpromising. Such individuals are few and far between and I have met only a handful of them at their PhD stage. Adrien, whom I met years ago at the European Summer School for New Institutional Economics, comes from a French business school and completed a PhD in Law in England. We have been discussing the subject of this book for years now, and I have learnt a lot from him, even when he was still working on his PhD as well as during his post-doctoral studies in Florence at the European University Institute. This dialogue has continued with his move to EU institutions.

A final anecdote – I learnt about transaction cost economics from Oliver Williamson when he was a visiting professor at La Sorbonne in Paris. I always asked him a lot of questions so he dedicated his 1985 book to me: *to Jean-Michel, who asks me hard questions and from whom I expect the right answers*. All readers of Adrien's book should share my optimism: there is no intellectual difficulty that cannot be overcome if we have the right people. Adrien is one of them. Enjoy the reading!

**Jean-Michel Glachant** (Holder of the Loyola de Palacio Chair  
and Director of the Florence School of Regulation at the  
European University Institute)