

General introduction

In the old era, European electricity markets were characterized by legal monopolies, geographic demarcation, vertical integration and cooperation both on the supply and demand sides.⁷ From the early 1990s onwards, the European Union has pursued a top-down reform process leading to the gradual implementation of a competitive market design within Member States. The new competition model of decentralized markets prescribed electricity generation to be vertically de-integrated as much as possible from retailing and not committed in long-term (supply) contracts with retailers or large consumers in order to allow entry and development of effective competition on wholesale and retail markets.⁸ In practice however, long-term contracts remain a pervasive feature of most European electricity markets despite the progress of liberalization which has not succeeded in much changing the traditional sales patterns.⁹

The current refining and harmonization of European market designs may be pointless if incumbents continue to use these contracts as devices to control markets.¹⁰ These contracts, indeed, frequently create anti-competitive effects when competition is imperfect and these effects are likely to be worsened in a slowly liberalizing market context where an oligopoly of super-dominant suppliers has been in place for decades. However, there is also growing acceptance that their positive impact on operations and investment makes them desirable as long as effective

⁷ Schaub, 'Liberalization of the European Energy Markets', in Bobdandy, Mavroidis and Meny (eds.), *European Integration and International Coordination: Studies in Transnational Economic Law in Honor of Claus-Dieter Ehlerman* (Kluwer Law International, 2002), 403–418.

⁸ Hunt, *Making Competition Work in Electricity* (Wiley, 2002).

⁹ DG Competition Report on Energy Sector Inquiry (Sector Inquiry), SEC(2006) 1724 of 10.1.2007.

¹⁰ Glachant and Lévêque, 'Electricity Internal Market in the European Union: What to do Next?', in Glachant and Lévêque (eds.), *Electricity Reform in Europe: Towards a Single Energy Market* (Edward Elgar, 2009); Hirschhausen and Neumann, 'Long-term Contracts and Asset Specificity Revisited – An Empirical Analysis of Producer–Importer Relations in the Natural Gas Industry', 32(2) *Review of Industrial Organization* (2008), 131–143.

competition on wholesale and retail markets has not developed.¹¹ Indeed, the main advantage of long-term contracting for individual firms is to hedge price and quantity risks in their input and output markets and therefore facilitate investment, operation and entry. The competition effects of long-term contracts are thus ambiguous and there is a need to weigh the efficiency-enhancing effects for individual contracting parties with the possible side effects on the opening of markets.

Competitive reforms in European electricity markets have led to an intense regulatory activity and European Commission (Commission) interventions on the content of contracts have been common under the EU antitrust laws.¹² Nowadays, Member States' antitrust authorities are also very active in the energy sector. As contracting parties take into account *ex ante* the regulatory framework applied to them when devising contracts, antitrust policy is a way to impact on the structuring of competitive behaviours and re-align private behaviour with social welfare. However, reaching a fine balance between freedom and coercion remains a constant challenge and the use of such an instrument to build markets creates specific problems.

Confronted by a new anti-competitive conduct, some of the main difficulties of antitrust authorities come from the fact that the instrument used to bring about more competition is a law which may only issue prohibitions with reference to economic concepts and whose application is constrained by judicial review. These economic concepts which became embodied in legal rules must be applied in completely new market settings and antitrust authorities must fight anti-competitive practices without always being able to firmly rely on past case law, an intimate knowledge of the market or even definite insights from economic theory. The problem indeed primarily lies in the speculative nature of economic analysis which might not provide straightforward answers to novel questions. Economic analysis suggests that antitrust enforcement is complex and requires a careful consideration of the market context in which the practices examined occur. This is even more complicated when short- and long-term efficiency criteria conflict, such as entry and investment, or when efficiency criteria must be weighted with non-economic goals, a likely occurrence in both cases in decentralized electricity markets. If the competition analysis of business conducts

¹¹ Finon and Roques, 'Financing Arrangements and Industrial Organization for New Nuclear Build in Electricity Markets', 3 *Competition and Regulation in Network Industries* (2008), 247–282.

¹² Bellantuono, *Contract Law and Regulation in Energy Markets* (Società editrice il Mulino, 2009).

necessitates taking into account non-economic variables or requires solving trade-offs for which economic analysis is ill-equipped or ambiguous, the economic accuracy of decisions becomes uncertain, and so does the eventual outcome of judicial review.

In addition, antitrust authorities must not only find an efficient solution from an economic point of view but also ensure legal certainty and limit regulatory costs.¹³ Legal certainty, and more generally the clarification of rules, is a particularly important goal of regulation in newly liberalized electricity markets as it facilitates both the entry of new competitors which already suffer from asymmetries of information compared with incumbents and investment in some high-fixed-cost technologies (e.g. nuclear) necessary for long-term security of supply. Legal certainty thus has a positive impact both on short- and long-term efficiency criteria, against which any competitive reform must be judged. Lastly, the deterrence potential of antitrust policy is associated with the predictability of enforcement and this predictability may itself be correlated with its simplicity. The complexity of economic analysis thus makes it a particularly inappropriate guide for the enforcement of the antitrust laws.

In view of these challenges, the suitability of antitrust policy as a market-building tool needs to be questioned. Are antitrust authorities able to tailor their decisions to the specifics of the new market context or will they tend to apply well-known analytical frameworks devised in completely different settings, thereby evidencing both the constraints of the legal and judicial process in which they operate and a form of path dependence in their patterns of enforcement? Do antitrust authorities strike the right balance between economic analysis and predictability or between entry in the short term and investment incentives in the longer term? Is antitrust enforcement optimally articulated with sector regulation? These are not secondary questions in view of the prominent role antitrust authorities are increasingly taking in certain regulatory regimes.

The problem of long-term contracts in decentralized electricity markets is a highly topical example of these difficulties. The Commission continues to emphasize the risks of anti-competitive effects inherent to long-term contracts, such as customer foreclosure, and pursue full market de-integration through secondary legislation in phase with the 'textbook' model for liberalization. Following the findings of the Sector Inquiry, long-term contracts even became a priority for review under the EU

¹³ Christiansen and Kerber, 'Competition Policy with Optimally Differentiated Rules Instead of "Per Se Rules vs Rules of Reason"', 2(2) *Journal of Competition Law and Economics* (2006), 215–244.

antitrust laws. For instance, after *Distrigaz*¹⁴ in late 2007 in the gas sector, the electricity incumbents EDF and Electrabel from France and Belgium have been under attack for their portfolios of long-term supply contracts with industrial customers.¹⁵ In view of the experience of electricity markets where full de-integration has been applied and the need for a massive round of highly capital-intensive investments which the European Union will face along with others in the coming years, the current position of the Commission encountered harsh criticisms from the industry, especially from energy intensive users and dominant generators. The Commission would in the critics' view take a dogmatic view on these contracts and prove incapable of adapting to the new realities of electricity markets, to the detriment of employment and competitiveness, and thus ultimately to the detriment of European citizens.

This book therefore aims, on the one hand, to conduct an assessment of the strategy of the Commission on long-term contracts, both within and across Member States, and consider possible improvements. This will require understanding how the technical and institutional conditions specific to the European Union impacted on the implementation of the theoretical economic model of competitive reform and framed the problem of long-term contracts in the new market context. An inductive approach will be used to reconstruct this strategy from antitrust cases and regulatory decisions. This strategy will then be assessed against the recent advances of economic theory and propositions will be formulated in the light of antitrust authorities' concerns for legal certainty and the limitation of regulatory costs.

This book will investigate, on the other hand, to what extent the outcome of EU antitrust enforcement is truly influenced by economic theory and to what extent it can be explained by the current dynamics of regulatory practice.¹⁶ Indeed, the outcome of EU antitrust enforcement in

¹⁴ *Distrigaz*: COMP/37.966, Decision of 11 October 2007, O.J. 15.1.2008, C 9/8.

¹⁵ EDF: COMP/39.386, Decision of 17 March 2010, O.J. 22.5.2010, C 133/5; Electrabel: COMP/39.387, Decision of 3 February 2011.

¹⁶ Long-term contracts could in theory be assessed against many of the Treaty articles concerning competition in a more general sense (e.g. the rules on free movement) but we focus on the antitrust laws (i.e. Art. 101 and 102 TFEU) for two reasons. First, the Commission has decided to proceed almost exclusively under these provisions. Secondly, with the modernization of EU antitrust law and its 'more economic' approach, the tensions between the use of more economic analysis and the limits of the instrument itself are exacerbated. However, in view of the recent long-term contract cases in Hungary (Commission Decision of 4 June 2008 in Case C 41/05, notified under document C(2008) 2223, O.J.

decentralized electricity markets may also be influenced by a variety of factors related to the nature of the legal tool itself or the personal agenda of the enforcer. The on-going process of modernization of EU antitrust law, largely independent of the concurrent liberalization of network industries, may, for instance, have consequences on enforcement in the electricity sector. Moreover, the institutional structure of the European Union does not give to the Commission the power to alter property rights in the different Member States and thus to carry out an aggressive policy of horizontal and vertical de-integration which would probably deliver better and faster results.¹⁷ As the Commission has announced it would use its antitrust power with constant strength in the energy sector,¹⁸ this book will carefully consider whether the politics of liberalization impacts on the way the law is enforced, that is, whether the Commission has a tendency to use the EU antitrust laws to pursue a political goal.

This book is divided into two parts. The first part (Chapters 1 and 2) aims to clarify the policy trade-offs created by long-term contracts in decentralized electricity markets and then understand the specificities of the problem in the European context. A second part (Chapters 3, 4 and 5) then pursues an assessment of the strategy of the Commission against two criteria: economic accuracy and enforcement predictability.

Chapter 1 will first introduce the theoretical economic models of competitive reform devised at the beginning of liberalization and how they are supposed to organize supply relationships in the new market

27.8.2009, L 225/53; joined cases T-80/06 and T-182/09 of 13 February 2012, *Budapesti Erõmu Zrt/Commission*, not reported) and Poland (Commission Decision of 25 September 2007, notified under document C(2007) 4319, O.J. 28.3.2009, L 83/1), an analysis under the EU state aid rules would also be interesting. See on this Hancher, 'Long-term Contracts and State Aid: A New Application of the EU State Aid Regime or a Special Case?', in Glachant, Finon and Hauteclouque (de) (eds.), *Competition, Contracts and Electricity Markets: A New Perspective* (Edward Elgar, 2011), 233–258.

¹⁷ Green and Newbery, 'Competition in the Electricity Industry in England and Wales', 13(1) *Oxford Review of Economic Policy* (1997), 27–46; Newbery, van Damme and von der Fehr, *Benelux Market Integration: Market Power Concerns*, Report of the Market Surveillance Committee, Dutch Competition Authorities (2003).

¹⁸ Monti, 'Applying EU Competition Law to the Newly Liberalized Energy Markets', Communication to the World Forum on Energy Regulation (2003), Rome; Sector Inquiry, 2007, *supra* note 9. See also Gauer and Kjolbye, 'Competition Policy in a New Regulatory Environment: Business as Usual?', in Glachant, Ahner and Hauteclouque (de) (eds.), *The EU Energy Law and Policy Yearbook 2011* (Claeys and Casteels, 2011), 77–94.

context. It will then review the relevant lessons learned from 20 years of electricity market restructuring worldwide and discuss how recent developments, in particular the California crisis of the early 2000s, led to the reconsideration of the role of long-term contracts. It will finally assess the recent advances of economic theory on long-term contracts and show that the immediate policy recommendations for antitrust authorities remain ambiguous.

Chapter 2 will study the legal and institutional parameters, which determined how the two dimensions of the European competition model, namely vertical de-integration and single market integration, have been implemented in the European Union. The evolution of the Commission's strategy in the face of the strong opposition of certain Member States will be particularly scrutinized. Chapter 2 will show that the problem of long-term contracts will have to be addressed in different ways *within* and *across* Member States, as their effects on competition diverge due to the necessity to match the analysis of long-term supply contracts with the analysis of long-term priority access rights to interconnectors in the latter case. It will also show that the two dimensions of the problem are related but that regulatory powers are not unified. A last section will depict the different strategies currently being implemented to support the transition, among which the enforcement of EU antitrust law is increasingly taking a more prominent role, as well as the on-going changes in the dynamics of EU energy regulation they represent.

Chapter 3 explores how the Commission is currently dealing with the problem of long-term contracts *within* Member States and what are the insights we may draw not only in terms of predictability for future enforcement but also on the drivers currently shaping its antitrust strategy. This chapter will also aim to assess the substantial content of the strategy currently emerging in the light of our findings of the first chapter, in particular the way the Commission articulates entry and investment. Finally, it will consider to what extent the 'more economic' approach, a cornerstone of the modernization of EU antitrust law, truly has an influence on the enforcement strategy of the Commission in electricity, and then reflect on the likely impact of the EU politics of energy liberalization on the Commission's patterns of antitrust enforcement.

Chapters 4 and 5 will undertake a competition analysis of long-term contracts *across* Member States. Chapter 4 will focus on how the associated long-term priority access rights on interconnectors are likely to be treated under both secondary EU law and the EU antitrust laws. It will also aim to assess whether a better management of capacity allocation will enable more long-term contracts to be signed or whether

an increase of the physical capacity of interconnection will be necessary to pursue that goal. Chapter 5, written with Dr Vincent Rioux, will assess the current strategy of the European Union for the development of interconnectors in light of the market players' need for longer-term access rights to the cross-border transmission network. It will focus on a recent and promising trend: the development of merchant transmission investments. Chapter 5 will argue that the European strategy on merchant transmission investment is misguided and largely influenced by the 'textbook' model of competitive reforms. It will then propose the opening of merchant transmission investments to those who have today the biggest incentives to undertake them: the dominant generators.