

Introduction by Jan Horst Keppler, Scientific Director of the Chaire European Energy Markets (CEEM), to the Conference on “Long-Term Contracts”

Université Paris-Dauphine, 18 December 2013

Ladies and Gentlemen, Colleagues, Partners, Friends,

It is my great pleasure to welcome you today to the workshop on long-term contracts of the Chaire European Electricity Markets. We are proud having been able to assemble such a prestigious and knowledgeable panel of speakers on the crucial issue of long-term electricity supply contracts. It goes right to the heart of the functioning of European electricity markets and their ability to attract adequate investment and ensure security of supply.

In particular, I would like to welcome our two keynote speakers,

Inge Bernaerts, Head of Wholesale Markets at the EU Commission and David Newbery, Professor at Cambridge University and Head of its Electricity Policy Research Group (EPRG).

On the 18th of December this is indeed the last event of the CEEM in what was a rich year 2013. Among the many events, I would like to mention the workshops on renewable integration, capacity remuneration and demand-side management. Together with today’s workshop and the ones on distribution and investment in the first semester of 2014, they form the building blocks of a common theme that we are pursuing at the CEEM and that we refer to with only a touch of hyperbole as “Target Model 2.0”.

One of the speakers present today once remarked, **if everything goes well, we will have at the end of 2014 exactly the electricity market that we would have needed 10 years ago**. All of you are aware how much history has moved on since then. We no longer worry about organisational slack, gold-plating in inefficient monopolies overseen by lenient regulators and barriers to new entrants. This is also a credit to the reforms undertaken since then. Today our concerns are with a lack of investment incentives outside of the regulated part of the market for incumbents and entrants alike, due to high uncertainty and low electricity prices, as well as with risks to security of supply. Gas has to share its place as the marginal fuel increasingly with coal and, amazingly, on some low demand days with nuclear and renewables. Negative prices, peak-load prices below base-load prices – it has become a brave new electricity world.

Of course, our objective cannot be to agitate an alternative blueprint to an agenda of 20 years that has driven deep structural change on the ground. Rather we seek to contribute to an emerging paradigm that in an open, non-ideological and pragmatic fashion aims at preserving the strong points of a competitive, low-carbon European electricity sector while sustainably ensuring affordability and security of supply.

It is our conviction that long-term supply contracts have a major role to play in this context. Let us face it: if you discount coal-based capacity built on miscalculated

assumptions concerning the value of “free-entry allowances” (a sort of long-term contract in itself), the only capacity that is currently being added is doing so on the basis of long-term contracts. Feed-in-tariffs, contracts-for difference, capacity payments for strategic reserves, Mankala system, Arenh... you name it, behind every single power plant currently being built in Europe there is a long-term contract.

Tonight we will know whether this is a good or a bad thing. However, what is certainly regrettable is that these long-term contracts are grafted on a system that is not prepared for them in a wanton and haphazard manner driven by national prerogatives without any coherent integration at the level of the European system.

Long-term contracts have always had an ambiguous standing among economic theorists and I look forward to the presentations by Eric Brousseau and Anna Creti to learn more about this aspect. While their contribution to risk reduction and certainty for investors was always recognised, the fashion was a considerable period of time to emphasise their ability to serve as a proxy for vertical integration as well as their contribution to market foreclosure. “Contracts as a Barrier to Entry” was the paradigmatic title of a famous and influential paper by Aghion and Bolton in 1987. The underlying notion that a long-term contract with appropriate penalties for breach can keep out more efficient entrants has always struck me as somewhat simplistic. **The barrier of entry does not consist in the long-term supply agreement between an incumbent supplier and a distributor *per se*, but in the inability of the more efficient entrant to buy out the incumbent supplier at a price higher than the latter’s original benefits.**

There is a profound need for a more systematic exploration of this aspect. The question is not whether long-term contracts are good or bad. The question is whether they are tradable or not. The way to go is the creation of a European market for long-term electricity supply contracts. Long-term contracts with a common duration, standard conditions and an obligation of transparency would provide investment certainty without hampering competition or foreclosing markets. Electricity is and remains for the foreseeable future a non-storable good. Any short-term delivery is thus related to an investment decision taken years or decades ago with brutal directness, in the absence of any buffers that storage or smoothed consumption can provide. Long-term supply contracts can make that contrast between short-term consumption and long-term investment slightly less brutal.

In conclusion, let me just inform you that the Chaire European Electricity Markets has now completed its senior management team where next to Dominique Finon and Patrice Geoffron, Anna Creti has joined us as leader of the activity on quantitative studies and the econometrics of electricity markets. Much of the merit for organising this event, by the way, lies with Dominique Finon, Scientific Advisor and leader of the CEEM’s activity of market structure and regulation, and, of course, Fatoumata Diallo, most of you have already communicated with individually.

I wish you and us a day of high-quality discussion on the issue of long-term contracts that fairly assesses their benefits and shortcomings from a theoretical, an empirical and a legal perspective. We will thus gain a better understanding of the potential that their coherent and systematic integration into the existing market architecture could offer for the efficiency and security of the European electricity supply.

Thank you very much.