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## France's New Electricity Act: A Potential Windfall Profit for Electricity Suppliers and a Potential Incompatibility with the EU Law

*The NOME Act will achieve neither the aim of maintaining the benefit to consumers of France's past choice to go nuclear, nor the aim of avoiding a windfall effect. In spirit, it also disregards the principle of non-segmentation of markets and betrays the principle of free movement of goods within the European Union.*

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In December 2010, France passed a law to reform the organization of electricity markets and prices. The new Electricity Act introduces numerous economic changes, in particular eliminating current regulated retail tariffs for business while giving Electricité de France's rivals access to a portion of the electricity generated by EdF's nuclear power plants.

In other words, EdF's rivals in electricity supply to final

consumers in France would be eligible to tap into electricity generated by EdF's nuclear power plants at an administered wholesale tariff and compete with EdF to supply business customers in a then free retail market. The nuclear fleet, owned by the incumbent utility, is equated with an essential facility, access to which must be opened to downstream competition, which would otherwise only be able to develop on the margins.

This substitution of a regulation on the retail market for business by a wholesale regulation presents two major drawbacks that will likely give the new law a short life. First, electricity suppliers will enjoy a windfall profit. The cost advantage of current nuclear power generation will be passed on to suppliers instead of, as today, to industrial consumers. Second, the new regulation is likely to be incompatible with European law. It contains a destination clause so that it is impossible for a company located across the border in Germany or in Belgium to enjoy the same conditions of supply, in particular prices, as its counterparts in France. Before addressing these two issues, this article provides a brief overview of the new Act, titled "New Organization of Markets in Electricity" (NOME).

## I. Regulated Access to EdF's Power Generation in a Nutshell

To achieve the access to EdF's nuclear power generation, the Act introduces a cumbersome regulation of volumes and prices, which is supposed to remain in effect until 2025.

Let's start with the volumes. The NOME Act<sup>1</sup> imposes an overall ceiling of 100 TWh per year. Beyond this limit, EdF's rivals in supply will have to count on their own power generation or on purchase from the wholesale market. The Act stipulates also

that this amount is reserved for consumers located in France. To enforce that clause, the Energy Regulation Commission is empowered to regulate the volume subject to the tariff. It will calculate, then notify, the quantity to which each supplier is entitled based on its portfolio of customers and the estimated growth of that portfolio in France. In order to correct errors and avoid cheating, the Act provides for an

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adjustment mechanism, or penalty, in the form of a surcharge on top of the regulated access tariff. Suppliers that are allocated volumes in excess of what their customers in France actually consume will have to pay for every excess MWh received, an amount at least equal to the difference in value between the administered access tariff and the market price.

Regarding the regulated access tariff to historic nuclear power (hereafter, ARENH, the abbreviation in French for *Accès Régulé à l'Electricité Nucléaire Historique*), the Act stipulates it should reflect the costs (that is,

operating costs, plus investment, plus the provisional costs of dismantling the nuclear power plants and managing the waste, plus interest). The Act does not, however, ascribe a specific detailed methodology to calculate the tariff, nor give a figure. Both were to be set in decrees issued in the Council of State at the beginning of 2011. According to the rapporteur of the bill<sup>2</sup> to the National Assembly, the initial ARENH tariff is supposed to be between €38 and €42 per MWh. That may appear to be a fairly small range. It should be borne in mind, however, that a difference of one euro per MWh for this price represents plus or minus €100 million in annual revenues for EdF. The ARENH tariff will be revised each year. It will depend on the evolution of EdF's costs as reviewed by the Energy Regulation Commission. It will also depend on the political agenda because the tariff is not set by the independent regulator but by the government. The Energy Regulation Commission only issues a proposed tariff.

Finally, the Act schedules the elimination of retail tariffs for business customers. It will start once the new law will enter into force with the end of so-called TaRTAM.<sup>3</sup> This tariff set in 2006 offered a way for industrial consumers that had switched to the market to return to regulated pricing. Although TaRTAM is roughly 20 percent higher than the regulated tariffs they had left, it is lower than the market price. In 2009, 3,500 sites representing a

consumption of 72 TWh benefited from the TaRTAM. The other regulated retail tariffs for business, so-called green and yellow historical tariffs, should be phased out by December 2015, according to the Act.

## II. Competitive Equilibrium in Industrial Consumer Market<sup>4</sup>

Over the next years, competition can be expected to be strong in this market.

In the segment of ex-TaRTAM consumers, alternative suppliers, buying electricity at the ARENH tariff, will be able to challenge EdF's position. Their market share, currently around 38 percent, would increase further. It would reach at least 50.1 percent (i.e., 28.8 TWh) fairly quickly if EdF decides to position itself, like many incumbents before it, under the threshold of half the market, so that it is no longer *prima facie* considered to have a dominant position. Drawing lessons from liberalization in telecommunications, EdF will probably not seek to hinder entry by offering lower prices than competitors for the same services, which the French competition authority could consider to be an anti-competitive practice.

Competition is also likely to expand rapidly beyond that consumer segment. On Dec. 31, 2009, the Energy Regulation Commission identified 748,500 sites, representing total consumption of 69 TWh, which

were already supplied through market offerings. There is no public information about these offerings, but it can be assumed that they are more advantageous than TaRTAM. Otherwise, customers would have switched to TarTAM, as they are entitled to do. The price level of market offerings for base load must therefore be at least slightly below the regulated access tariff. A significant share of that segment

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*The yellow and green integrated retail tariffs are likely to increase over the next years.*

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could however become open to challenge fairly soon. Many of these contracts, in particular EdF's market offerings, expire in 2010. Moreover, the European Commission recently forced the incumbent utility to reduce the length of contracts it signs with industrial consumers. EdF undertook to put 60 percent of total volumes under contract back on the market every year.<sup>5</sup> EdF's share of this segment of market offerings accounts for 86 percent of consumption. Falling below 50 percent for the benefit of alternative suppliers would lead to consumption of an ARENH-priced volume of around 30 TWh.

Lastly, the yellow and green integrated retail tariffs are likely to increase over the next years. According to the Act, these historical tariffs have to be aligned with the level of the ARENH wholesale tariff before they will have to be phased out by December 2015. This increase of yellow and green tariffs would further expand the size of the market accessible to alternative suppliers. The segment represents a volume of 157 TWh, of which EdF's rival suppliers currently supply 2 TWh, or 1.2 percent. If their share rose to 10 percent in 2015, the corresponding need for ARENH-priced volume would be around 15 TWh.

By adding the three market segments, suppliers' needs for volume at the ARENH tariff would total just over 70 TWh in 2015. Their total market share for all volumes of electricity consumed by large consumers would be 29 percent, compared with 13 percent now. That rate of growth in five years requires a very high pace and level of effort by EdF's competitors. It is probably worth it because, as we shall see now, the final elimination of regulated tariffs and the reaching of the ceiling of 100 TWh can cause a windfall effect which will be all the more beneficial to alternative suppliers as they will have a high market share.

For the sake of simplicity, let's assume that total demand for ARENH by alternative suppliers to serve both their business and residential customers will reach

100 TWh on the date that regulated retail tariffs for business are eliminated (i.e., Dec. 31, 2015). Let's also assume that the authorities decide not to raise the ceiling in response to higher demand. If that were not the case, the reasoning below would remain the same except that it would only apply from a later date, after retail tariffs are eliminated and the final ceiling is reached. For it is the combination of those two events that is worth analyzing.

If the ceiling is reached while retail tariffs still exist, there will not be any upheavals. By design, sale tariffs must reflect the costs of supplying the electricity. There is nothing to stop the regulator from factoring into its calculations the fact that the needs of alternative suppliers' customers have exceeded 100 TWh. The regulator will alter yellow and green tariffs by taking into account that a smaller proportion of their supply will be obtained at the regulated access tariff and a larger proportion at the market price. If, for example, the needs of alternative suppliers' customers can only be 70 percent covered at the ARENH tariff, compared with 80 percent when the ceiling was not reached, and if the wholesale market price is 20 percent higher than the ARENH tariff, the retail tariff must increase by 2 percent. If it rises by more, alternative suppliers' margins will be inflated; if it rises by less, EDF's marketing arm will be favored. In other words, the reaching of the ceiling does not stop the regulator from

continuing to control suppliers' margins and enable industrial consumers to benefit from prices close to costs.

The elimination of yellow and green tariffs alone does not cause major change either. The market price offered to industrial consumers after 2015 should be fairly close to the former administered retail tariffs. Industrial consumers are informed buyers. They are aware

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*If the ceiling is reached while retail tariffs still exist, there will not be any upheavals.*

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of the ARENH tariff, peak prices on wholesale and capacity markets and network prices. They also have a fairly accurate idea of suppliers' marketing costs and know how to play them off against each other. Consequently, suppliers are unlikely to get away with prices that include a high margin. A supplier that decides to set a price much higher than the sum of the costs above would lose its customers and therefore its entitlement to the ARENH tariff. The loss of that entitlement is costly for the supplier even though it is allocated free of charge. As the French competition authority stresses,<sup>6</sup> under the Act

alternative suppliers are only charged for the use of nuclear electricity; the access right itself is free. In other words, the ARENH tariff has no fixed term, independent of the nuclear electricity extracted by the supplier; it has only a variable component that depends on the amount of energy purchased. Once demand from alternative suppliers exceeds the ceiling of 100 TWh, access becomes a scarce resource and acquires value because demand exceeds supply.

That shortage explains intuitively<sup>7</sup> why, once the ceiling is reached and retail tariffs are eliminated, the price paid by large consumers to purchase electricity will leap to a level close to the electricity price on the wholesale market.<sup>8</sup> All consumers, representing a need of around 240 TWh (300 TWh  $\times$  0.8 allocable by ARENH), will want to be supplied from the 100 TWh quota. But how can this cheap quantity, accounting for little over one-third of demand, be allocated other than through competition between consumers? And therefore resulting in a price close to that of alternative supply, i.e., the wholesale market. All industrial consumers will buy their electricity at the wholesale market price plus the variable cost of marketing. In other words, if the ARENH tariff is set at, say, €45/MWh, large consumers will buy their electricity at a market price that will be much higher, say, €90/MWh. This creates a windfall effect for the alternative suppliers that share the 100 TWh quota.

Thus, once administered tariffs are eliminated and the ceiling is exceeded, companies located in France will no longer obtain their electricity more cheaply than their counterparts in Germany or Belgium, while alternative suppliers' profits will increase substantially. The Act thus leads to a situation for industrial consumers that is similar to a lack of upstream regulation of access and a sharing of a portion of the nuclear rent that benefits alternative suppliers. In this market segment, the NOME Act will achieve neither the aim of maintaining the benefit to consumers of France's past choice to go nuclear, nor the aim of avoiding a windfall effect.

Of course, as we draw close to the ceiling and to the date for the elimination of yellow and green tariffs, it is likely that the government, anticipating an increase in the price of electricity for industrial customers and in suppliers' profits, will intervene to counter it. The government could, for example, amend the Act or even pass new legislation on regulation of the electricity market. The Act that has just been passed is not necessarily immutable for the next 15 years.

### III. The Risk of the NOME Act Being Incompatible with European Union Law

The uncertainty about the Act's compatibility with European

energy and competition law is another source of instability. An incompatibility will obviously shorten the life of the new French Electricity law. As Senator Philippe Marini pointed out, "The first decisive factor in the success [of the NOME Act] is its conformity with EU law. If it does not conform, [it] will be useless and will soon need to be reworked."<sup>9</sup>

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*The juxtaposition of national markets, each competitive but relatively independent from one other, is not the ultimate aim pursued.*

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There is no doubt that the NOME Act overlooks some major principles of European energy and competition law. However, it is not dead certain that it infringes any particular article and could be deemed partly incompatible with the Union Treaty. Let us draw a distinction here between betrayal of the spirit and infringement of the letter of the law.

As we briefly mentioned, the ARENH tariff for nuclear electricity can only benefit consumers in mainland France. To simplify, suppliers purchasing a volume of, say, 100 MWh of this cheap electricity must prove that their customers located in France

consume 100 MWh. The NOME Act is designed so that it is impossible for a company located across the border in Germany or Belgium to enjoy the same conditions of supply as its counterparts in France.

That territorial restriction goes against the construction of the internal market wanted by European law on energy, and against market integration, one of the aims of European competition law.

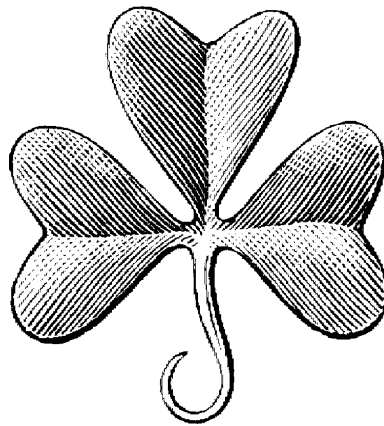
The electricity sector was first opened to competition in 1996 with the adoption of the first European directive on energy. The directive not only sought to liberalize the markets, i.e., to promote competition in electricity generation and supply. The long-term objective is to create a broad European market in electricity and gas common to member states. The juxtaposition of national markets, each competitive but relatively independent from one other, is not the ultimate aim pursued. The necessity of integration is reiterated in the Directive of July 13, 2009.<sup>10</sup> Its first article stipulates that the common rules for the businesses of the electricity sector that apply to all member states are established "with a view to improving and *integrating* [emphasis by the author] competitive electricity markets in the Community." The NOME Act, on the contrary, isolates part of the French electricity market from the European wholesale market. It removes volumes from that market, which had gradually

expanded, and increases the volumes bought and sold within a strictly national framework.<sup>11</sup>

Similarly, European competition law does not only seek to protect competition by combating collusive and exclusionary practices. It also seeks to contribute to the establishment of an internal market by combating practices by firms that segment national markets and actions by member states' aid for national firms that distorts competition at the expense of firms from other member states. The Commission has on several occasions cited competition law to denounce destination clauses in contracts between producers and suppliers. These territorial restrictions, which limit the use of the good purchased, in particular its resale, have been condemned on many occasions in the gas sector. As we shall see, it is not dead certain whether the legislation that results in firms in Germany or Belgium being unable to benefit indirectly from the ARENH tariff can be considered a destination clause or state aid. In spirit, however, the NOME Act definitely disregards the principle of non-segmentation of markets. It also betrays the principle of free movement of goods within the European Union. However, it is not 100 percent sure they are condemnable in terms of export restrictions.

Indeed, the NOME Act does not expressly prohibit the suppliers that buy electricity at the ARENH tariff from supplying customers outside France with the volumes

they purchase. It simply removes the incentive to do so by adding a surcharge. If they exceed the volume they were allocated on the basis of their portfolio of domestic customers, they will have to pay the difference between the ARENH tariff and the market price. This surcharge eliminates the profit on sales to other markets. In fact, it could even



dissuade suppliers rather than simply making them indifferent between the two options. The NOME Act stipulates that the surcharge shall be *at least equal* to the difference between the administered tariff and the market price. The degree of dissuasion for suppliers that exceed their volume will only be known in the beginning of 2011 when the Council of State decree setting forth the method for calculating the surcharge is issued. Moreover, the Act provides for a specific penalty mechanism in the event of abuse of the access right. A supplier that buys a quantity of electricity substantially higher than it needs to supply its French customers

can be fined up to 8 percent of its revenues. In short, there is no explicit destination clause, but the combination of the allocation of volumes based on customers in France, the prior and subsequent verification by the Energy Regulation Commission of the allocated volumes, the surcharge and the fine creates a de facto territorial restriction.

Is the Act likely to be invalidated by EU institutions?

From the European Commission, the guardian of the treaties, the risk appears to be limited. The French government has taken pains to inform and communicate in advance with the commissioners in charge of competition and energy. In a letter to Neelie Kroes dated Sept. 15, 2009 (copied to Andris Piebalgs), the French prime minister, François Fillon, explains the system of regulated access and the phasing out of retail tariffs for large consumers. He provides a detailed description of the surcharge mechanism, gives a figure for the ceiling of the accessible volume (namely 100 TWh), and sets out the stages and schedule. The prime minister stresses that the access mechanism would be open without discrimination to all European operators, that it does not prohibit resale and does not limit exports. In her reply, co-signed by the commissioner for energy, Neelie Kroes indicates that the general principles of regulated access seem to comply with EU law and that, in theory, the terms on which retail tariffs

for large consumers will be maintained transitionally until 2015 are compatible with the treaty's provisions on state aid. The Commissioner for Competition nevertheless refrains from giving the French government a blank cheque. She insists several times on the need to respect fully the principles and commitments that the prime minister mentions in his letter and the problems of conformity with EU law that the technical terms of their implementation could raise, particularly with regard to the rules on free movement of goods. According to rumor this prudence

is dictated by purely institutional considerations: a political agreement between the French government and the Commission has apparently been reached, ensuring that Brussels will not bring action against France over the Act before the European Court of Justice.

**B**ut the Court of Justice could become involved in other ways. A supplier that feels it has been underserved in access rights or an electricity-intensive firm that does not benefit from a comparable price to its main rival in France could, of course, lodge a complaint.

In particular, the plaintiffs could claim an infringement of Article 35 or Article 101 of the Treaty on the Functioning of the European Union (TFEU). Article 35 prohibits quantitative restrictions on exports and all measures having equivalent effect. It refers to "all trading rules enacted by member states which are capable of hindering, directly or indirectly, actually or potentially, intra-community trade."<sup>12</sup> The plaintiff could argue here that the Act creates a de facto clause that restricts exports and therefore infringes Article 35. It should be noted, however, that the



*In particular, the plaintiffs could claim an infringement of Article 35 or Article 101 of the Treaty on the Functioning of the European Union.*

Treaty authorizes export restrictions for reasons of public order or public security.<sup>13</sup> The French government could claim before the European judge that the surcharge and other factors restricting the resale of electricity are essential to ensure security of supply to consumers in France. If alternative suppliers sell all the electricity they purchase at the ARENH tariff to customers outside France and continuously saturate exports, there may not be enough of the 100 TWH left to meet domestic demand. The argument could prevail because energy security, like the choice of energy mix, comes under national sovereignty.

The plaintiff could also claim an infringement of competition law via Article 101 of the TFEU. Paragraph 1 of the article prohibits agreements which have as their object or effect the distortion of competition within the internal market, in particular through restrictions on resale. The success of such a claim is not certain, however. Theoretically, the article refers to agreements between undertakings that have willingly entered into a relationship and signed a binding contract. The contracts for the sale of electricity at the ARENH tariff signed between the historic monopoly and alternative suppliers are imposed on EdF. In addition, neither of the parties negotiates the tariff – which is set by the minister – or the volume – which is set by CRE. Case law only deals with settings where the undertakings had freely

negotiated and signed agreements from which they could have refrained. Moreover, Paragraph 3 of Article 101 provides for exemptions under certain conditions. A restriction on the resale of electricity purchased at the ARENH tariff could meet those conditions since they are essential to the development of competition on the French market, which represents an economic progress that benefits consumers.

To sum up, the NOME law was basically enacted<sup>14</sup> to maintain the benefit of the nuclear generation cost advantage for all consumers and to guarantee a long-term legal stability for the sector to increase investments. None of these goals is likely to be achieved.■

#### Endnotes:

1. Loi n° 2010-1488 Portant Nouvelle Organisation du Marché de l'Electricité, Official Journal, Dec. 8, 2010.
2. Report No. 2557 of May 26, 2010, by Jean-Claude Lenoir on behalf of the Economic Affairs Commission of the National Assembly, at 47 and 96.
3. This is the acronym for Tarif Réglementé Transitoire d'Ajustement au Marché ("Regulated Transitional Market Adjustment Price").
4. For the sake of convenience, this section uses the figures on non-residential consumers as issued by the Energy Regulation Commission. Note, however, that this category is not exactly the same as the category of industrial consumers because it includes small businesses, including those eligible for regulated blue tariffs. By volume, those small consumers represent roughly 30 TWh of annual consumption, which is around 10 percent of

non-residential consumption. Note that, unlike yellow and green tariffs, blue tariffs are not phased out by the NOME Act.

5. See the European Commission's press release dated March 17, 2010, IP 10/290.
6. Opinion of the Autorité de la Concurrence, No. 10-A-08 of May 17, 2010.
7. See Vincent Maillard, *Le Projet de Loi NOME, un Echec Programmé*, Médiapart, May 22, 2010, at <http://www.mediapart.fr/club/blog/vm/030510/le-projet-de-loi-nome-un-echec-programme>.
8. For a more detailed analysis, see Lévêque et Saguan, *Analyse Critique de l'Impact de la Loi NOME*, Document de Travail 2010-09, CERNA, June 2010.
9. Report of the Senate No. 617 of July 6, 2010, Opinion presented by Philippe Marini on behalf of the Finance Commission.
10. Directive 2009/72/EC of the European Parliament and Council of July 13, 2009, concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC, OJEC L 211 of Aug. 14, 2009, at 55–93.
11. See EPEX, *Impact de l'ARB sur la Liquidité et les Prix de Gros de l'Electricité en France*, EPEX report, May 2010.
12. CJEC, July 11, 1974, case 8/74, Dassonville, Reports of Cases before the Court, CJEC, at 837.
13. "The provisions [of Article 35] shall not preclude prohibitions or restrictions on imports, exports or goods in transit justified on grounds of public morality, public policy, or public security, protection of health [...]". TFEU, Article 36.
14. For a comprehensive presentation of the objectives of the NOME Act and an in-depth analysis whether they could be achieved, see François Lévêque, *France's New Electricity Act: A Barrier against the Market and the European Union*, EPRG Working Paper, Univ. of Cambridge, Jan. 2010.