

DGEC consultation on possible evolutions of the ARENH mechanism

■

EFET response – 30 March 2018

The European Federation of Energy Traders (EFET)¹ thanks the Direction Générale de l'Énergie et du Climat (DGEC) for this opportunity to provide feedback on their proposal of possible evolutions of the ARENH mechanism. As an organisation representing energy traders, our response below focuses on the functioning of the ARENH mechanism and its impact on the energy market. Hence, we do not respond to questions 1 to 3, which are only relevant for suppliers and generators.

Question 4: Do you have remarks concerning the proposed scheme for the evolution of ARENH gates?

The reform proposal of DGEC stems from the assessment by the Ministry that the current schedule of ARENH gates allows alternative suppliers to optimise their purchase of ARENH volumes depending on the evolution of energy market prices. In particular, DGEC gives the example of suppliers purchasing energy directly on the energy market when year-ahead wholesale prices are below the ARENH regulated price (EUR 42/MWh) to cover the needs of their end-customers over a given period, and then purchasing ARENH volumes for the same period when the year-ahead wholesale price has come above the ARENH regulated price. DGEC seems to consider this practice at odds with the objective of the ARENH mechanism. To remedy the situation, DGEC proposes to increase the number of ARENH gate to four and breakdown the available volumes throughout the year.

Before commenting on the DGEC reform proposal itself, we would like to come back on a number of points related to the rationale of DGEC's reasoning.

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We improve the operation of European wholesale energy markets and enhance the performance of traders and their support functions in those markets. We reinforce the markets' functionality and facilitate their liquidity and transparency.

1. Purpose of the ARENH mechanism

First, the purpose of the ARENH mechanism must be clear: the establishment of the ARENH mechanism is a direct consequence of the case SA.21918 (C 17/2007) opened by the European Commissions' DG Competition in 2007 with regard to the impact of state aid in the form of regulated retail tariffs on competition in the French market. In its decision of 12 June 2012², DG Competition considered the ARENH mechanism, enacted via the NOME Act of 2010, as a mitigation measure to favour competition on the French market.

Article 1 of the NOME Act states the purpose of the ARENH mechanism as “to ensure the freedom of choice of electricity supplier while granting the benefit of the competitiveness of the French electro-nuclear fleet to the attractiveness of the territory and all consumers”.

In a 2015 monitoring report of the ARENH mechanism³, the French Competition Authority notes that the main added value of the mechanism is to improve competition on the wholesale but especially the retail market. Though the Competition Authority flagged the risk of the mechanism widening the gap between the architecture of the French electricity market model with the energy-only market, it nonetheless supported the mechanism back in 2010 so as to improve competition on the French market.

The conclusions of the CRE report of 2018 on the mechanism are indeed similar, with a minor effect on wholesale energy prices, but a significant one on retail competition⁴.

It is clear for us, based on all the above, that the objective of the ARENH mechanism is to improve competition between market participants on the French retail market.

2. Market participants' approach to hedging price and volume risks

DGEC, and CRE in its 2018 report, consider that the ability for suppliers to source their electricity either on the energy market or ARENH, or both, constitute an unfair arbitrage opportunity.

In a liberalised market, market participants always try to buy energy at the lowest possible price, and sell it at the highest possible price. This basic principle of economics is the one that enables suppliers in particular to lower

² Communication C(2012) 2559 of the European Commission regarding its decision on state aid case N° SA.21918 (C 17/2007) (ex NN 17/2007) regarding regulated electricity tariffs in France, dated 12 June 2012, available at:

http://ec.europa.eu/competition/state_aid/cases/220576/220576_1380996_291_2.pdf.

³ Monitoring report on the ARENH mechanism, dated 18 December 2015, available at:

http://www.autoritedelaconcurrence.fr/doc/rapport_arenh.pdf.

⁴ Impact assessment of the ARENH mechanism between 2011 and 2017, dated 18 January 2018, available at: <http://www.cre.fr/documents/publications/rapports-thematiques/rapport-arenh/consulter-le-rapport>.

their electricity sourcing costs in order to offer the cheapest possible offers to their clients. This allows competition to take place between suppliers and ensures that end-customers benefit from low electricity prices. These two goals, competition and cost-effectiveness, are at the heart of both the NOME Act and European legislation applicable to electricity markets.

When suppliers conclude contracts with their clients for a specified volume and price, these elements are agreed upon in advance of delivery – except for dynamic price contracts indexed on spot markets. This constitutes an open short position on the side of the suppliers. Most suppliers would then hedge this position on the market in order to cover the related volume risk (i.e. the availability of electricity) and price risk (i.e. the fluctuation of wholesale electricity prices).

Hedging is not a static action whereby market participants solely close their open position through one transaction that ensures securing the desired volumes at an economically viable price. Hedging is a dynamic process where market participants constantly strive to improve the economic condition of their portfolio. This optimisation, which is under the strict supervision of both energy and financial regulators, has a number of advantages:

- The liquidity thereby created improves the ability for buyers and sellers to find a counterparty for the volume and price requested/offered;
- The extra benefits of optimisation, if not passed on to the customers with existing contracts with a fixed price, is used to lower the price of the next contracts offered by the market participant, thereby increasing competition on the market and lowering costs for end-consumers.

What is valid for the energy market is also valid when suppliers can source part of their volumes via the ARENH mechanism. In fact, it would be irresponsible, if not contrary to applicable competition rules, for alternative suppliers to collectively forego opportunities provided via ARENH to optimise their sourcing of electricity considering the fluctuations of the wholesale energy market.

Therefore, we consider that the reasoning of DGEC at the origin of their reform proposal of the ARENH mechanism is ill-advised. No in-depth “diagnosis” of potential ARENH design problems was made public by DGEC. ARENH was never designed as a mechanism that would preclude suppliers from optimising their electricity sourcing on the wholesale market in parallel. Forbidding suppliers to optimise their electricity sourcing via both the wholesale electricity market and the ARENH mechanism would go against established hedging practices encouraged by French and European legislation, and would contradict the very objective for which the ARENH mechanism was established, namely improving competition on the French market for the benefit of the end-customer.

3. Comments on the DGEC proposal

In the consultation document, DGEC proposes a modification of the number of ARENH gates with a cap on volumes offered at each gate. We propose an analysis of the different components of the proposal below.

a. Number of gates

The proposal foresees the replacement of the current gate in DY-1 by four gates evenly spread during the 2 years before the delivery year, with the objective to mimic the rhythm of contracting clients. For EFET, it is not realistic to have the ambition to model/assess the contracting rhythm. Given the fact that suppliers might have to wait until the last gate to know their final ARENH allocation and coming back once again to our considerations in point 2 of this document, a responsible supplier would not wait until the last minute to close their open short position linked to the electricity they have committed to deliver. This would put their financial viability for this contract at risk, and impede their ability to continue providing competitive offers in the future. Suppliers will instead manage their volume and price risks on the wholesale electricity market directly so as to not remain un-hedged. While this is fine as such, it empties the ARENH mechanism of its *raison d'être*.

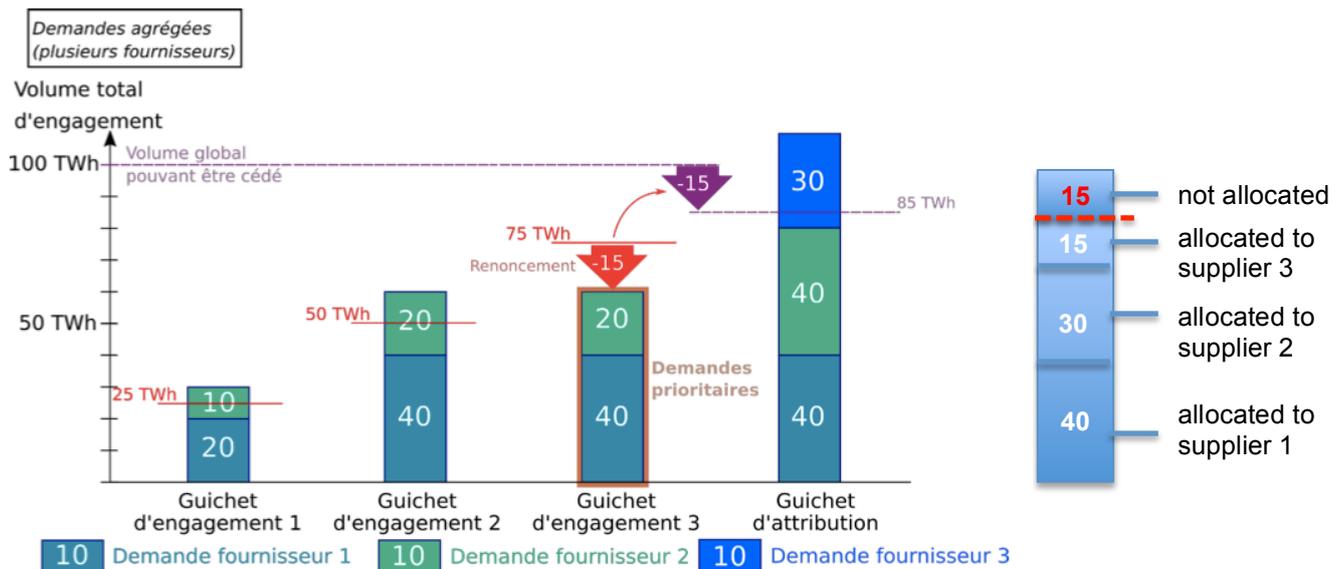
b. Volumes offered at each gate

The volume offered at the first gate will be 25 TWh, increased by an incremental 25 TWh at each of the subsequent gates. This could mean, in case the volume requested volumes by suppliers exceed the offered volume that suppliers would not know until the last gate the volume of ARENH they have succeeded in securing, while the electricity they have committed to deliver is in most cases based on annual or multi-annual contracts. Once again, referring to our point 3.a, we consider the reform proposal unrealistic in its attempt to model/forecast the contracting rhythm of suppliers. This rhythm widely varies from one market participant to the other, over time, and depending on the evolution of many endogenous and exogenous parameters.

c. Volumes allocated at each gate

The system proposed by DGEC is so that if the volumes requested at a specific gate are higher than the volume offered, no allocation takes place and market participants' offers are carried forward to the next gate. If the volumes requested at a specific gate are lower than the volume offered, the difference between the offered and requested volumes is deducted from the overall ARENH volumes to be allocated at the end of the year. The volumes requested at the last auction will be reduced pro-rata between the participants of this last auction if they are higher than the overall authorised ARENH volume (100 TWh or below if the volumes requested at one of the gates was below the offered volumes).

In the graph below (see Graph 1), DGEC presented a case where the requested volumes at the two first gates were higher than the offered one. Hence market participant offers were carried forward to the third gate. With no new market participant offers at the third gate, the total requested volume was lower than the total offered volume, thereby reducing the overall ARENH volume to be allocated that year from 100 TWh to 85 TWh. At the last gate, the volumes were attributed pro-rata to this gate's bidders as they exceeded the total of 85 TWh. We added a fifth column to show the final allocation of volumes.



Graph 1. Source: DGEC, complemented by EFET

This allocation proposal poses a number of problems:

- First, in case volumes requested are higher than the volumes of ARENH offered at a specific gate, then market participant offers are carried forward to the next gate three months later. DGEC does not mention a possibility for market participants to cancel or review the volume of ARENH they requested between the two gates. This would result in an obligation to trade a contract that will possibly be confirmed three months later, something unheard of in energy markets or even in centralised balancing mechanisms. This would create an additional and useless risk for alternative suppliers which would counter the very objective of the ARENH mechanism to improve competition on the French market;
- Second, in case volumes requested are lower than the volumes of ARENH offered at a specific gate, then the total volume of ARENH allocated for the year will be below the standard 100 TWh. This seems to us an uncanny circumvention of the commitment taken by the French government following the DG COMP decision. While both the NOME Act and the DG COMP decision foresee that the 100 TWh of ARENH is a maximum that suppliers can request, the total volume of ARENH made available to alternative suppliers should be reviewed in a governmental act based on the evolution of competition on the French market as article 1 of the NOME Act put it. This technical mechanism

reducing the amount of ARENH available to alternative suppliers based on quarterly demand does not seem to fulfil the conditions of the law, nor respect the spirit of the DG COMP decision.

- Third, the proposed allocation process would make the result of the ARENH auction at each gate dependent on the collective behaviour of market participants. This is a principle currently foreign to the functioning of energy markets in general. It is also not prone to favour competition in the French wholesale and retail markets, as it would increase the risk on individual alternative suppliers, which would reduce the attractiveness of the market for newcomers and existing alternative suppliers.

d. Conclusions on the DGEC proposal

It is our view that the DGEC proposal to reform the ARENH mechanism is not supported by a sound justification in coherence with the very purpose for which the mechanism was established. In addition, the technical changes proposed by DGEC risk render the mechanism ineffective.

4. Alternative and more pressing reform proposals

EFET expressed in the past its scepticism about the ARENH mechanism. However, much along the lines of the various opinions of the Competition Authority and its monitoring report of 2015, we supported the implementation of the mechanism for practical reasons, in order to support the objective sought after by the French government and the European Commission, i.e. improve competition on the French market for the benefit of the end-customer.

This being said, it does not mean that we are opposed to an evolution of the mechanism. Any reform, however, must be based on sound justification and must respect basic market-based principles.

According to the NOME Act, the Energy Ministry was supposed to publish back in 2015 a report on the functioning of ARENH, notably to analyse the impact of the mechanism on the wholesale and retail markets, and present it to the Parliament. To our knowledge, no such document has been made public. This document would have been ideal to conduct an in-depth impact assessment and propose possible reform avenues.

a. ARENH price

Our first piece of advice when it comes to reforms is the ARENH price itself. The NOME Act and DG COMP decision foresee that from 2013 onwards, the ARENH price should be established by CRE based on a methodology approved by governmental decree. Five years later, there is still no decree establishing the methodology for the ARENH price, which is set at EUR 42/MWh since 2012.

Coming back to the so-called “arbitrage opportunities” of suppliers between the ARENH mechanism and the wholesale electricity market that DGEC is concerned about, those are a natural market phenomenon when an administratively regulated price interacts with a dynamic market-based price. Part of the DGEC concerns would already be alleviated if a proper dynamic methodology for the establishment of the ARENH price was published, as requested by law for five years already.

b. Subscription mechanism

One interesting element presented by CRE in its consultation of 2015 on the mechanism⁵ is the proposal to move from a physical to a financial subscription. In this model, suppliers would source their electricity on the wholesale market directly and would be compensated for any difference between the ARENH price and the sourcing price. The ARENH mechanism would transform into a simple option mechanism, much like a feed-in premium for renewable energy support.

This solution poses the difficult question of the reference used to assess the sourcing costs of suppliers (as we have shown above, sourcing electricity is a dynamic process of cost optimisation over a long period of time). However, it would have two undeniable advantages:

- avoid withdrawing physical volumes from the wholesale electricity market, thereby restoring liquidity on the wholesale market;
- limit what DGEC seems to consider unfair rents from the mechanism without making a dent in the ability of market participants to trade and hedge themselves.

This option seems to be abandoned by CRE in its 2018 report following the lack of support of market participants for this option. Considering the current views of DGEC and CRE that prompted the present consultation document, it may be wise to revive the debate on the financial mechanism solution.

c. 2025 and beyond

In its 2015 monitoring report, the Competition Authority already called on French authorities to clarify their intentions about the existence of the ARENH mechanism beyond 2025. Once again, a thorough impact assessment by DGEC ought to present the evolution of the various criteria presented in article 1 of the NOME Act in order to give recommendations on possible reforms and on the existence or not of the mechanism beyond 2025. Such an indication of the Ministry’s intentions will be necessary by 2020 at the latest, some long-term OTC electricity contracts being concluded as far as five years in advance.

⁵ CRE consultation on the ARENH mechanism, dated July 2015, available at: <http://www.cre.fr/documents/consultations-publiques/dispositif-d-acces-regule-a-l-electricite-nucleaire-historique-arenh>.

Question 5: Do you think that taking into account the collective behaviour of alternative suppliers in this scheme would result in a clear and balanced market situation for all? In the event of a negative answer, please describe specific situations likely to raise competition concerns, as well as the foreseen difficulties.

As mentioned in our response to question 4 (point 3.c.), the proposed allocation process would make the result of the ARENH auction at each gate dependent on the collective behaviour of market participants. This is a principle currently foreign to the functioning of energy markets in general. It is also not prone to favour competition in the French wholesale and retail markets, as it would increase the risk on individual alternative suppliers, which would reduce the attractiveness of the market for newcomers and existing alternative suppliers.

Question 6: Does the visibility provided by this approach seem sufficient?

As mentioned in our response to question 4 (point 2), when suppliers conclude contracts with their clients for a specified volume and price, these elements are agreed upon in advance of delivery – except for dynamic price contracts indexed on spot markets. This constitutes an open short position on the side of the suppliers. Most suppliers would then hedge this position on the market in order to cover the related volume risk (i.e. the availability of electricity) and price risk (i.e. the fluctuation of wholesale electricity prices).

The reform proposal means that suppliers will not know until the end of the delivery year the volume of ARENH they have succeeded in securing, while the electricity they have committed to deliver is in most cases based on annual or multi-annual contracts. As a result, suppliers will hedge themselves primarily on the wholesale electricity market, the ARENH mechanism not serving as a competition improvement tool anymore.

Question 7: In your opinion, would the application of this new organisation of ARENH gates require specific adaptation of the ex-post control rules (determination of excess and excessive volumes and application of CP1, CP2)?

No comment.