Merchant interconnector projects by generators in the EU: Profitability and allocation of capacity

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ABSTRACT

When building a cross-border transmission line (a so-called interconnector) as a for-profit (merchant) project, where the regulator has required that capacity allocation be done non-discriminatorily by explicit auction, the identity of the investor can affect the profitability of the interconnector project and, once operational, the resulting allocation of its capacity. Specifically, when the investor is a generator (hereafter the integrated generator) who also can use the interconnector to export its electricity to a distant location, then, once operational, the integrated generator will bid more aggressively in the allocation auctions to increase the auction revenue and thus its profits. As a result, the integrated generator is more likely to win the auction and the capacity is sold for a higher price. This lowers the allocative efficiency of the auction, but it increases the expected ex-ante profitability of the merchant interconnector project. Unaffiliated, independent generators, however, are less likely to win the auction and, in any case, pay a higher price, which dramatically lowers their revenues from exporting electricity over this interconnector.

1. Introduction

The EU electricity market suffers from a severe shortage of cross-border transmission lines, called interconnectors, leaving the electricity networks of the national EU states insufficiently connected with one another (European Commission, 2007, p. 174; European Climate Foundation, 2010). Sufficient interconnector capacity is vital for the realization of one of the main objectives of the EU: the creation of a single EU market in electricity (Directive 96/92/EC). EU law allows two types of projects for building new interconnectors: a public and a private one. The public type of interconnector projects are regulated projects implemented by national Transmission System Operators (hereafter TSOs). The private type of interconnector projects are for-profit, merchant projects implemented by commercial investors (European Commission, 2009a).

Merchant interconnector projects will likely play a significant role in providing at least a part of the much needed transmission capacity between EU member states in the near future, as TSOs seem not to have the proper incentives to invest in interconnector capacity (Buijs et al., 2007; Brunekreeft, 2004; Brunekreeft and Newbery, 2006; de Hauteclouque and Rious, 2011). Also, new research shows that an important argument against merchant interconnector investment is likely less serious than believed previously. Whereas Joskow and Tirole (2005) previously showed that commercial investors have the incentive to build a suboptimally small line, Parail (2010) has recently shown that this effect is rather small in practice. This makes merchant interconnector investment a more viable option. Indeed, in the last few years three merchant interconnectors, NorNed, Estlink, and Campocologno-Tirano, have been built, and several other projects have been proposed in Italy, England, Belgium, and France (Italian Regulator, 2009; OFGEM, 2010). The last example, Campocologno-Tirano, concerns a merchant interconnector that was built by electricity generators. This paper will address this type of merchant interconnector projects: where electricity generators own a merchant interconnector. It is likely that in the near future more electricity generators may want to build merchant interconnectors that they would use to transport their own electricity (de Hauteclouque and Rious, 2011). Marseglia, an Italian generation company, is an example of such a case. Marseglia has requested permission to build two 500 MW merchant interconnectors that would connect Italy with Albania (Argus Power Europe, 19.02.2009).

EU law stipulates that when investors want to build a merchant interconnector, they must apply for permission from the national regulators (Regulation EC no. 714/2009). Regulators are to review such an application on a case-by-case basis and if they permit the project, set the conditions under which the merchant interconnection should operate. For example, the regulator usually limits the period for which the investors can collect the earnings from the interconnector and often obliges the investors to sell capacity in a non-discriminating auction.

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countries connected by the interconnector, then such a generator (hereafter, the integrated generator) can be expected to bid more aggressively. The aggressive bidding increases the profitability of the interconnector. While it also lowers the profitability of the integrated generator, the net effect (profits of interconnector plus generator) is positive. The more aggressive bidding biases the auction outcomes in favor of the integrated generator, thus lowering the allocative efficiency of the auction and lowering the expected profits of other generators that are not involved as investors.

The analysis presented here applies when capacity is allocated by explicit auctions, but not when allocated by implicit auctions. Explicit auctions are a much used form of allocating capacity on interconnectors (Helm, 2003; Newberry, 2003; Stern and Turvey, 2003; Yarrow, 2003). While there are interconnectors in the EU where implicit auctions are used for the day-ahead market, even there the long-term contracts for interconnector capacity (weekly, monthly, annual and multi-annual) are allocated by explicit auctions. For example, as the electricity markets of Belgium, France and the Netherlands have been coupled, the capacity of their interconnectors is said to be allocated by implicit auctions. This is, however, true for only 10% of the capacity; the other 90% is allocated by explicit auction (Commission for Energy Regulation, 2009, p. 18).

The remainder of this paper is organized as follows. In the next section I describe the setup of my model. Then I analyze first-price and second-price formats of the main auction model. To show the limits and robustness of the effects in my model, I also present models that employ the same setting but under the assumption of perfect information. In the conclusion, besides the usual summary, I suggest ways in which EU energy regulators could take into account the findings of this paper when dealing with new proposals for merchant interconnector projects by generators.

2. The model

2.1. Assumptions

In the main application of my model, an electricity generator bids to obtain capacity on an interconnector in order to sell electricity in the country on the other side of the connector. I will assume that the generator has enough spare capacity and has decided to generate below capacity in its home market. Interconnection thus gives the generator the option of selling more power to the foreign market, and the opportunity cost of doing so is the marginal cost of generation. The value of interconnection is therefore equal to the difference between the electricity price abroad and the marginal cost of generation. As generators have different marginal costs, they value interconnection differently. I will assume that a generator does not know its competitor’s marginal cost of generating electricity. In my model this implies that a generator knows its own value of interconnection, but not its competitor’s. When interconnection capacity is sold in an auction, such an auction is therefore a private value auction (for example, see Krishna, 2002). I will furthermore assume that values are independently and uniformly distributed on the interval [0,1]. As their values are drawn from the same value distribution, bidders are, at the outset, symmetrical.

In older models stemming from the time electricity generator markets were tightly regulated (Green and Newbery, 1993; von der Fehr and Harbord, 1993), it was usual practice to assume that marginal costs are common knowledge: however, since the electricity industry has become competitive, information on the cost structure of electricity generation has strategic value and is therefore carefully guarded (Léautier, 2001, 34). Parisio and Bosco (2008) add: “generators frequently belong to multi-utilities [integrated generators] providing similar services often characterized by scope and scale economies (Fraquelli et al., 2004, among others). The cost of generation therefore can vary across firms because firms can exploit production diversities in ways that are not perfectly observable by competitors.” In this line of thought, competitors can only make an estimate of each others’ marginal costs (Schöne, 2009).

One of the bidders is an integrated generator; a generator that owns (a part of) the merchant interconnector. I denote with parameter $\gamma$ the proportion of the interconnector firm that the integrated generator owns. I assume that interconnector capacity is sold as one indivisible good. As usual in auctions, the highest bidder wins the good, which reflects that the firm operating the interconnector capacity auctions does not favor the integrated generator. Given its value realization, the integrated generator $Y$ chooses its optimal bid $b_Y$. In line with the literature, I assume that there exists a continuously differentiable, strictly increasing bidding strategy $b_Y[\cdot]\) that maps the integrated bidder’s realized value $v_Y\in[0,1]$ onto its bid $b_Y[v_Y]$. The bidding strategy $b_Y[\cdot]$ has an inverse, $y[\cdot]$, such that $y[b_Y[v_Y]]=v_Y$. Analogously, the optimal bid of an independent generator $X$, $b_X$, is determined by its bidding strategy $b_X[\cdot]$ that maps its realized value $v_X\in[0,1]$ onto its bid $b_X[v_X]$. The strategy $b_X[\cdot]$ has an inverse, $x[\cdot]$, such that $x[b_X[v_X]]=v_X$.

2.2. The second-price auction

In second-price auctions, an integrated generator, when it loses, is not indifferent to the price for which the interconnector capacity is sold: it would like the capacity to be sold for as high a price as possible (see also Burkart, 1995). This gives the integrated generator an incentive to bid more aggressively. As Proposition 1 shows, this effect is relatively strong even when there is more than one independent generator competing.

**Proposition 1.** For any $n \geq 1$, in a second-price auction with $n+1$ bidders, one integrated bidder who receives a share $\gamma$ of the auction revenue and $n$ independent bidders, where values are distributed independently and uniformly on [0,1], the independent bidders bid their values, and the integrated bidder bids $b_Y[v_Y]=v_Y+\gamma((1-v_Y)/(\gamma+1))$. As a result, with increasing $\gamma$ for all $n \geq 1$:

(a) The expected auction revenue, $E[n^m[\gamma]]$, increases,

(b) The expected profit of $Y$, $\pi_Y^m[\gamma]$, increases,

(c) The expected profit of $X$, $\pi_X^m[\gamma]$, decreases for all $i$,

(d) Efficiency, $W^m[\gamma]$, decreases,

(e) The profit from optimizing total profits (bidder profit and $\gamma$ times auction revenue) increases relative to optimizing the profit of only the bidder $X$:

$$\pi_Y^{m_{\text{strategic}}}[\gamma] = \pi_Y^m[\gamma] - (\pi_X^m[0] + \gamma m^m[0]).$$

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1 See “Nomenclature”.

2 In line with the empirical evidence, I assume that, as transmission capacity is fixed and small relative to total demand, buyers cannot influence the final price in distant locations (see e.g. Consentec, 2004).


4 Generators are usually not symmetric, and transmission capacity is usually not sold as one indivisible good, but as multiple units. Also, an assumption of a uniform distribution of costs is a simplification. These simplifying assumptions serve to focus the analysis on the effect of an ownership share, and likely do not affect the qualitative results.

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Proof. See Appendix A.

The intuition for Proposition 1 is as follows. Independent generators bidding their own bid in a second-price auction is a standard result. The profit function for the integrated generator \( Y \) is given by

\[
\pi_Y^{(n)}(b_Y, v_Y) = \Pr(Y \text{ wins})[(v_Y - (1 - \gamma)E[\text{highest bid from n bidders}; Y \text{ wins}]) + \gamma \Pr(Y \text{ has 2nd highest bid}] b_Y + \sum_{i=1}^{n-1} \gamma \Pr(Y \text{ has ith highest bid}] \\
\times E[\text{2nd highest bid from n-1 bidders}; Y \text{ has ith highest bid}] 
\]

(1)

The parts in bold in this equation are the expected payments for each case. The first line gives the part of the profit in case \( Y \) wins; \( Y \) then receives its value \( v_Y \) minus the money it must pay that it does not receive back through its ownership of the interconnector; this is equal to \( 1 - \gamma \) times the highest expected bid from the \( n \) competing independent bidders. The expression in the second line gives the part of the auction revenue \( Y \) receives in case it has the 2nd highest bid. In this case, \( Y \) loses the auction and sets the price to be paid by the winner of the auction; \( Y \) thus receives the ownership share \( \gamma \) times its bid \( b_Y \). The expression in the third line gives the expression in case \( Y \) has a bid lower than the 2nd highest bid and thus \( Y \) loses the auction and does not set the price. When \( Y \) has the ith highest bid (with \( 3 \leq i \leq n \)), the expected payment by the winner is the 2nd highest bid from the \((n - i)\) bidders that have a higher bid than \( Y \). The total expected profit for \( Y \) in this case is thus its ownership share \( \gamma \) times the summation of the probability of \( Y \) having the \((i + 1)\)th highest bid times the expected 2nd highest bid from the \((n - i)\) bidders.

Having more independent bidders participating in the auction has opposing effects on the bidding function of the integrated bidder \( Y \). On the one hand, having more independent bidders lowers the risk for the integrated bidder \( Y \) to win the auction with a bid higher than its value (the first line in Eq. (1)), and thus gives \( Y \) an incentive to bid more aggressively. On the other hand, having more independent bidders lowers the probability that \( Y \) will be setting the price by having the 2nd highest bid (the second line in Eq. (1)), and thus gives \( Y \) an incentive to bid less aggressively. Interestingly, for values being independent and uniformly distributed the two opposite effects cancel out, and the integrated bidder \( Y \) chooses an identical bidding function for any number of competing independent bidders: \( b_Y[v_Y] = v_Y + \gamma(1 - v_Y) / \gamma + 1 \). Fig. 1 illustrates the bidding by the integrated bidder and the independent bidders.

As a result of its aggressive bidding, the auction revenue increases (Proposition 1a). Notably, for an auction with two bidders (thus with one competing independent bidder) and \( \gamma = 1 \), the auction revenue is equal to 11/24,6 which is different from the auction revenue in a first-price auction shown below. Also, the total profit of the integrated bidder (the profit of its generation activity plus its share of the auction revenue) is higher (Proposition 1b). The profit of each independent bidder \( X_i \) is now lower, \( X_i \) is less likely to win, and if it wins, it pays a higher price (Proposition 1c). The auction is now inefficient because there are some cases where \( Y \) wins without having the highest value. The more aggressively \( Y \) bids, the more often this happens, and thus efficiency decreases further (Proposition 1d). The last expression (Proposition 1e) shows that the strength of the incentive for \( Y \) to bid more aggressively increases in its ownership share \( \gamma \).7 The strength of this incentive, which I call the “strategic profit”, is the difference in profits between using a strategy of maximizing total profits (generator profits and \( \gamma \) times auction revenue) and of using a strategy (which I call the naive strategy) of maximizing the profit of only the generator. The strategic profit is thus given by \( \pi_Y^{(n)}(\text{strategy}) = \pi_Y^{(n)}(\text{naive}) + \gamma \sum_{m=0}^{n-1} \pi_Y^{(n)}(0) \). The first expression is its profit when maximizing total profits and the second part is its profit when maximizing only the profit of the generator.

Fig. 2 shows the effect of ownership share on auction outcomes when the integrated bidder competes with one independent bidder. The price of the interconnector capacity is strongly affected; it can increase by up to 37.5%. The gain for the integrated generator given by the strategic profit8 is also considerable; an integrated generator can, by bidding more aggressively, increase its profit by up to 16.7%. This is a mixed blessing. The increase of profitability makes a merchant interconnector project more attractive ex-ante, and this can thus be expected to boost investment in interconnectors, alleviating the severe shortage of interconnectors.

There is, however, also a considerable efficiency loss9 up to 6.25%. Moreover, the independent generators experience strong discrimination, both in the probability that they win the auction and in their expected profitability. As can be seen in Fig. 2 the probability of the independent bidder winning decreases by up to 50%. Not only do independent generators win less often, but when they win, they make less profit. Fig. 2 shows that the resulting decrease in expected profit can be up to 75%. Also at moderate levels of ownership integration discrimination is considerable; even with an ownership share of only 50%, the independent generator has a probability of winning that is lower by 35% and a profit that is lower by 56%. The ownership of the merchant interconnector thus leads to outcomes that violate the requirement of the regulator for the merchant interconnector to provide non-discriminatory allocation of capacity.

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7 This is an important indicator for external validity of the model; experimental evidence has shown that the strength of incentives is important for theoretical predictions to show in real settings (Hertwig and Ortmann, 2001; Smith and Walker, 1993).

8 The strategic profit percentage is calculated as \( \pi_Y^{(n)}(\text{strategy}) / \pi_Y^{(n)}(\text{naive}) \).

9 The efficiency loss percentage is calculated as \( (W[0] - W[\gamma]) / W[0] \), which is equal to \( 25\gamma^2 / (1 + 2\gamma) \).

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Fig. 3 shows that when the number of competing independent bidders goes to infinity all effects disappear, thus perfect competition in the generation markets would eradicate these effects. With more realistic numbers in the electricity market, however, effects are strong. The discrimination effect of integrated ownership is remarkably strong. Graph (a) shows the loss in expected probability of winning for each competing independent generator, which is high – between 39% and 29% – with as many as two or three competitors. As shown in Graph (b), with one competing generator the loss in expected profit can be as high as 75%. With two competing independent generators, each of them has a decrease in expected profits of up to 62.5%. Even with as many as three competing independent generators, a rather generous assumption as the markets for electricity generation are rather concentrated in the EU, each has a decrease in expected profits of up to 52%. Even for a moderate ownership share the discrimination effect is rather strong; for example when \( \gamma = 0.5 \), each independent generator experiences a decrease in expected profits of 34% with three competing independent generators, and 65% with one competing independent generator. Graph (c) shows the loss in efficiency, which represents a considerable social loss. Remembering that strategic profit is the extra expected profit over naïve profit derived from ownership, Graph (d) shows the strength of incentives for Y to bid more aggressively as given by the strategic profit as a percentage of the naïve profit. The incentive is considerable for reasonable values of the ownership share and the number of competing independent generators; when the ownership share is above \( \gamma = 0.5 \), and there are no more than two independent generators, then Y can increase its profit by 5.6% or more.

2.3. The first-price auction

In this section, I will analyze the effect of ownership integration in first-price auctions. When \( Y \) fully owns the interconnector, a general result can be established for first-price auctions. Remarkably, Proposition 2 shows that \( Y \) bids as if taking part in a second-price auction.

**Proposition 2.** When the values of \( X \) and \( Y, v_X \) and \( v_Y \), are independently distributed without any further restrictions on the possible distribution, then when the integrated bidder \( Y \), receives the full auction revenue such that \( \gamma = 1 \), \( Y \) bids its own value in a first-price auction.

**Proof.** See Appendix A.

To further analyze the bidding functions of \( X \) and \( Y \), I assume that the values of \( X \) and \( Y, v_X, v_Y \), are independently and uniformly distributed on \([0,1]\). In first-price auctions, the expected profit of \( Y \) is given by

\[
\pi_Y(b_Y) = \Pr(Y \text{ wins})[E(v_Y - (1 - \gamma)b_Y | b_Y > b_X)] + \gamma \Pr(X \text{ wins})[E(b_X | b_Y < b_X)].
\]

The first part of Eq. (2) is the probability that \( Y \) wins times its expected profit in that case; this profit is equal to the value of the good on auction minus its bid plus the part of the bid it “pays to itself” through its ownership of the merchant interconnector, altogether \( v_Y - (1 - \gamma)b_Y \). The second part is the probability that \( Y \) loses times its expected profit in that case; this profit is equal to the ownership share times the payment by \( X \), \( \gamma b_X \). \( Y \) wins the auction with bid \( b_Y \) when the bid of \( X \) is lower, \( b_X < v_X \). Applying the inverse bidding function \( x(b_X) \equiv b_X^{-1}[\cdot] \) on both sides of the equation gives \( v_Y = x(b_Y) \). Y thus wins for value realizations

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\( ^{10} \) The average Herfindahl–Hirschman Index (HHI) for the old (West-European) EU members in 2006 was equal to 3786, which is close to the case where three symmetrical firms compete (HHI=3313). The new (Central- and East European) EU members had in 2006 a HHI equal to 5558, which is closer to the case where two symmetrical firms compete (HHI=5000) (Van Koten and Ortmann, 2008).

\( ^{11} \) In a first-price auction the highest buyer wins and pays its own bid.

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of \( X \) with \( v_X < b_Y \). Eq. (2) can then be written as

\[
\pi_Y[b_Y] = \int_0^{b_Y} (v_Y - (1 - \gamma) b_Y) \, dz + \gamma \int_{b_Y}^{1} b_Y [z] \, dz. \tag{3}
\]

Solving the first integral and substituting \( v_X = x[b_Y] \) in the second integral and integrating by parts results in

\[
\pi_Y[b_Y] = x[b_Y](v_Y - (1 - \gamma) b_Y) + \gamma \left( b_Y [x[b_Y]] - \int_{b_Y}^{1} x[q] \, dq \right), \tag{4}
\]

where \( b \) is the maximum bid.

To determine the first-order condition for profit maximization for \( Y \), differentiate Eq. (4) with respect to \( b_Y \), set it equal to zero and substitute \( y[b_Y] = b_Y^{-1}[b_Y] \) for \( v_Y \):

\[
(y[b_Y] - b_Y)x'[b_Y] = (1 - \gamma)x[b_Y]. \tag{5}
\]

The profit maximization problem for \( X \) is identical to that for \( Y \) with the ownership share set to zero, i.e. \( \gamma = 0 \), therefore the first-order condition for profit maximization for \( X \) is

\[
x(x) - b_X y'[b_X] = y'[b_X]. \tag{6}
\]

When \( \gamma = 0 \), the problem is symmetrical for \( X \) and \( Y \) and both have bidding function \( b[v] = \frac{1}{2} v \). Under full ownership, when \( \gamma = 1 \), \( Y \) bids its value, and thus, using (5), \( X \) bids \( b_X[v_X] = \frac{1}{2} v_X \). The more aggressive bidding by \( Y \) has several interesting effects on price, competition, profits and efficiency. Proposition 3 summarizes the main effects.

**Proposition 3.** In a first-price auction with one competing independent bidder \( X \) and an integrated bidder \( Y \) who has full ownership, \( \gamma = 1 \), bids its value, while the independent bidder bids \( b_X[v_X] = 1/2 v_X \). As a result of the more aggressive bidding of \( Y \),

(a) The expected profit of \( Y \), \( \pi_Y[\gamma] \), increases,

(b) The expected auction revenue \( m[\gamma] \), increases,

(c) The expected profit of \( X \), \( \pi_X[\gamma] \), decreases,

(d) Efficiency, \( W[\gamma] \), decreases,

(e) The strategic profit – the extra profit that can be earned by bidding more aggressively increases relative to optimizing the profit of only the generator.

**Proof.** See Appendix A.

Quantitatively, with \( Y \) bidding its value, its profit is equal to the auction revenue. Furthermore, the auction revenue increases by 62.5% from 1/3 to 13/24, the profit of \( X \) falls by 50% from 1/6 to 1/24.
1/12, efficiency falls by 4.2% from 2/3 to 15/24, and the strategic profit increases from 0 to 1/24. Interestingly, the auction revenue when Y has full ownership is different in a first-price auction than in a second-price auction.

**Corollary 1.** Revenue equivalence between first and second-price auctions does not hold.

**Proof.** See Appendix A.

Outcomes for $\gamma < 0 < 1$ lie in between the extremes of no ownership, $\gamma = 0$, and full ownership, $\gamma = 1$. Eqs. (5) and (6) can be solved numerically for $x(b_Y)$ and $y(b_Y)$ for $\gamma: 0 < \gamma < 1$. Fig. 4 shows numerical approximations of the bidding functions for $0 < \gamma < 1$.13

The bidding functions in Fig. 4 demonstrate that a larger ownership share in the interconnector leads to Y bidding more aggressively. Y maximizes profits given by $Pr[Y\text{ wins}] b_Y (v_Y - \gamma b_Y) + Pr[X\text{ wins}] b_Y (v_Y b_Y)$. A higher ownership share, $\gamma > 0$, increases the gain of winning, $v_Y (1 - \gamma) b_Y$. This gives Y the incentive to sacrifice a part of this gain by bidding stronger and increasing its probability of winning. This incentive is partly countered by the income Y earns when it loses; the ownership share times the bid of X, $\gamma b_X$. All in all, Y bids stronger. The stronger bidding by Y lowers the profits of X, Pr[X wins $b_Y$] $(v_X - b_X)$, lowering the probability of Y winning the auction. This gives X the incentive to sacrifice part of its earnings by bidding stronger and increasing its probability of winning.

2.4. Perfect information

While I assumed that generators have private information about their values (allowing for a common value factor that is publicly known), it is useful to look at an idealized situation where generators can estimate the exact value of their competitor without error. Burkart (1995) analyzes such a setup for second-price auctions with one integrated and one independent bidder and notes that the integrated bidder mostly still overbids.

Remarkably, sealed-bid first and second-price auctions are efficient and the independent bidder has a fair chance to win the auction, and makes the same, “fair”, expected profit as when the other bidder was not integrated. The intuition for this result is as follows: To guarantee the existence of Nash-equilibria, assume that if both bidders make the same bid, then the auction is won by the bidder with the highest value (and in case of equal values the winner is chosen at random). When the price for interconnector capacity is equal to p, then bidder Y with ownership share $\gamma$ and value $v_Y$ receives $v_Y - (1 - \gamma) p = v_Y - p + \gamma p$ on winning, and $\gamma p$ on losing. From the relationship $p < v_Y \Leftrightarrow v_Y - p + \gamma p > \gamma p$, it follows that when the price is lower (higher) than its value, Y prefers to win (lose) the auction and receive $v_Y - p + \gamma p$. When $v_Y < v_X$, Y and X bid $b_X = b_Y = p$ for $p \in [v_Y, v_X]$, and Y wins and earns $\pi_Y = v_Y - (1 - \gamma) p$, while X loses. When $v_X > v_Y$, Y and X bid $b_X = b_Y = p$ for $p \in [v_Y, v_X]$. Y loses and earns $\pi_Y = \gamma p$, while X wins and earns $\pi_X = v_X - p$. Thus for every realization of values for X and Y, there is a continuum of Nash equilibria where X and Y choose any identical bid $p \in \text{MIN}(v_X, v_Y), \text{MAX}(v_X, v_Y)$, in all of which the bidder with the highest value wins the auction; all Nash equilibria are thus efficient. As the bidder with the highest value wins the auction, both bidders have equal probability to win the auction, 50% each, which indicates that there is no discrimination against the independent bidder concerning winning the auction. The profits of the independent and integrated bidders cannot be determined without further assumptions.

For second-price auctions, unique solutions for the profits can be determined with a trembling-hand refinement criterion for equilibria (Burkart, 1995). The independent bidder bids its value in these auctions and the integrated bidder then always matches the bid of the independent bidder, and thus, when its value is the highest, win and earn $\pi_Y = v_Y - (1 - \gamma) v_X$ and when its value is the lowest, lose and earn $\pi_Y = \gamma v_X$.14 The integrated bidder thus makes...

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13 To my best knowledge there exists no explicit analytical solution for the bidding function in first-price auctions with $\gamma: 0 < \gamma < 1$. Proposition 4 in the Appendix lays out the necessary restrictions that the bidding strategies must fulfill.

14 Its expected profit is thus equal to $\frac{1}{2} + \frac{1}{2} \gamma$ in auctions with one competing independent bidder.
the highest profit possible in these auctions; the independent bidder, on the other hand, makes zero profits.

The case of perfect information in second-price auctions can therefore lead to an outcome of perfect discrimination, where the integrated bidder appropriates all surpluses from the independent bidder. This shows that while some of the negative effects of integrated ownership—such as inefficiency—disappear, it is possible that, in second-price auctions, the independent generator is prevented from making a profit higher than zero, which is a form of discrimination far stronger than in the previous models.

3. Conclusion

My analyses suggest that an integrated generator, a generator that owns a merchant interconnector and thus receives the auction revenues of the capacity allocation, bids more aggressively. Consequently, the profit of the integrated generator increases at the expense of an independent generator, thus curbing competition and causing efficiency losses. The aggressive bidding also drives up the price of the interconnector capacity. The results are relevant for EU electricity markets when merchant interconnectors are allowed to keep the auction revenues in full, but are obliged to allocate the capacity non-discriminatory by explicit auction.15

There are a few possible solutions to remedy the negative results found in this analysis. Firstly, a regulator could set a cap on the amount of capacity the generator can win. This would make it impossible for the integrated generator to bid for capacity above its allotment and thus for such capacity the discrimination and inefficiency effects found above would not occur. It may, however, be difficult to determine the optimal cap. Secondly, a regulator could insist that all generators in a country participate in an auction. One integrated bidder thus prevents the discrimination and efficiency effects. In the light of the severe consequences of only the generator winning the auction and causing efficiency losses. The aggressive bidding also drives up the price of the interconnector capacity. The results are relevant for EU electricity markets when merchant interconnectors are allowed to keep the auction revenues in full, but are obliged to allocate the capacity non-discriminatory by explicit auction.15

Appendix A

Proposition 1. For any n ≤ 1, in a second-price auction with n + 1 bidders, one integrated bidder who receives a share γ of the auction revenue and n independent bidders, where values are distributed independently and uniformly on [0,1], the independent bidders bid their value, and the integrated bidder bids bγ, where pγ = pγ + (1 − pγ)/γ. As a result, with increasing γ for all n ≥ 1:

(a) The expected profit of Y, π[Y], increases,
(b) The expected auction revenue, m[γ][Y], increases,
(c) The expected profit of Xi, π[Xi][γ], decreases,
(d) Efficiency, W[γ], decreases,
(e) The profit of optimizing total profits (generator profits and γ times auction revenue) increases relative to optimizing the profit of only the generator.

Proof. Independent bidders bidding their own bid in a second-price auction is a standard result.16 The profit function for the integrated bidder Y is given by

\[\pi_Y = \mathbb{E}[\text{winnings}] - (1-\gamma) \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

The parts in bold in this equation are the expected payments of only the generator. The expected auction revenue is

\[\mathbb{E}[R] = \mathbb{E}[\text{winnings}] - \gamma \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

The expected auction revenue for the integrated bidder Y is

\[\mathbb{E}[R_Y] = \mathbb{E}[\text{winnings}] - \gamma \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

The expected profit of Y is

\[\mathbb{E}[\text{profit}] = \mathbb{E}[\text{winnings}] - \gamma \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

The expected profit of Xi is

\[\mathbb{E}[\text{profit}] = \mathbb{E}[\text{winnings}] - \gamma \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

In the first line, the probability of Y winning with bid b is equal to \(b_Y\), and the expected price is equal to \((1/b_Y)\), which is the probability distribution function of the highest value of the n independent bidders. In the second line, the probability of Y having the 2nd highest bid is equal to \(n b_Y^{n-1} (\gamma - b_Y)\), and the payment by the winner of the auction is the bid b of Y. In the third line, the probability of Y having the ith highest bid \((1 \leq i \leq n)\) is equal to \(n!/(n-i)!b_Y^{n-i} (\gamma - b_Y)\), and the expected 2nd highest bid of n − i bidders is equal to

\[\int_{b_Y}^{1} \frac{(1-z)(\gamma - b_Y)^{i-1}}{(1-b_Y)^{i-1}} dz\]

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Appendix B

Proof. Independent bidders bidding their own bid in a second-price auction is a standard result.16 The profit function for the integrated bidder Y is given by

\[\pi_Y = \mathbb{E}[\text{winnings}] - (1-\gamma) \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

The expected auction revenue is

\[\mathbb{E}[R] = \mathbb{E}[\text{winnings}] - \gamma \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

The expected profit of Y is

\[\mathbb{E}[\text{profit}] = \mathbb{E}[\text{winnings}] - \gamma \mathbb{E}[\text{2nd highest bid from n independent bidders}].\]

The expected profit of Xi is

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In the first line, the probability of Y winning with bid b is equal to \(b_Y\), and the expected price is equal to \((1/b_Y)\), which is the probability distribution function of the highest value of the n independent bidders. In the second line, the probability of Y having the 2nd highest bid is equal to \(n b_Y^{n-1} \gamma - b_Y\), and the payment by the winner of the auction is the bid b of Y. In the third line, the probability of Y having the ith highest bid \((1 \leq i \leq n)\) is equal to \(n!/(n-i)!b_Y^{n-i} (\gamma - b_Y)\), and the expected 2nd highest bid of n − i bidders is equal to

\[\int_{b_Y}^{1} \frac{(1-z)(\gamma - b_Y)^{i-1}}{(1-b_Y)^{i-1}} dz\]

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\[\int_{b_Y}^{1} \frac{(1-z)(\gamma - b_Y)^{i-1}}{(1-b_Y)^{i-1}} dz\]

where \(i \leq 1\) is the probability distribution function of the 2nd highest value of n − i independent bidders. Solving

15 The results may be relevant for certain regulated interconnector projects, as OGFEM (2010) has indicated to consider using incentives for these projects. If a TSO may keep a part of the profits of an interconnector and the TSO is still integrated with a generator company, then the same type of analysis as developed above applies.

16 See, for example, Krishna (2002).
the integrals in the first and third line, and collecting the elements multiplied with the ownership share \( \gamma \) gives the following expression:

\[
\pi_Y^{(n)}[b_Y,\nu_Y] = b_Y^n \nu_Y - \frac{n}{n+1} b_Y^{n+1} + \gamma \left( \frac{n}{n+1} b_Y^{n+1} + nb_Y^{n+1} (1-b_Y) \right) \\
+ \frac{n-1}{n+1} \left( 1-(n+1)b_Y^n + nb_Y^{n+1} \right)
\]

(A1)

where \((n)/(n+1)b_Y^{n+1}\) is the expected price \( Y \) must pay when it wins and \((1-n)/(n+1)(1-(n+1)b_Y^n + nb_Y^{n+1})\) is the expected payment when \( Y \) has a bid lower than the second highest bid (the third line in Eq. (A1)). Differentiating Eq. (A1) with respect to \( b_Y \), setting it equal to zero, and solving for \( b_Y \) results in a bidding function given by \( b_Y[\nu_Y,\gamma] = \nu_Y + \gamma((1-\nu_Y)/(1-\gamma)) \). Differentiating \( \pi_Y^{(n)}[b_Y,\nu_Y] \) twice and substituting \( b_Y \) with \( b_Y[\nu_Y,\gamma] \) gives:

\[
d^2 \pi_Y^{(n)}[b_Y,\nu_Y] \left( \frac{db_Y}{d\nu_Y} \right)^2 = -(1+\gamma)\nu_Y \left( \frac{1+\gamma}{1+\gamma} \right)^{-n-1} < 0
\]

which establishes that the found bidding function is a global optimum. The inverse bidding function \( Y[\cdot] \) such that \( Y[\nu_Y] = \nu_Y \) is given by \( \nu_Y = (1+\gamma)b_Y - \gamma \).

As a result, with increasing \( \gamma \), for all \( n \geq 1 \):

(a) The expected profit of \( Y, \pi_Y^{(n)}[\gamma] \), increases. The expected profit of \( Y \):

\[
\pi_Y^{(n)}[\gamma] = \frac{1}{(n+1)(1+\gamma)} \left( 1 + \gamma(n^2 + n - 1) \left( \frac{1}{(1+\gamma)^n} \right) \right)
\]

can be found by substituting \( b_Y \) with the optimal bidding function \( b_Y[\nu_Y,\gamma] = \nu_Y + \gamma((1-\nu_Y)/(1-\gamma)) \) in Eq. (A1), and integrating over the values of \( Y \) from 0 to 1:

\[
\pi_Y^{(n)}[\gamma] = \int_0^1 \left( \frac{2+\gamma}{1+\gamma} \right)^{n+1} \frac{n}{1+\gamma} \left( 1 + \gamma(n^2 + n - 1) \left( \frac{1}{(1+\gamma)^n} \right) \right) dz
\]

(b) The expected auction revenue, \( m_Y^{(n)}[\gamma] \), is equal to the bolded portion of the first line of Eq. (A1) (the case that \( Y \) wins the auction, in other words, equal to Eq. (A1) with \( \nu_Y = 0 \) and \( \gamma = 0 \)), substituting \( b_Y \) with the optimal bidding function \( b_Y[\nu_Y,\gamma] = \nu_Y + \gamma((1-\nu_Y)/(1-\gamma)) \), and integrated over the values of \( Y \) from 0 to 1:

\[
m_Y^{(n)}[\gamma] = \frac{1}{1+\gamma} \left( n \left( \frac{n}{n+1} b_Y^{n+1} \right) \right) dv_Y
\]

The expected payment by all independent bidders together is equal to the second and third line of Eq. (A1) (in other words, equal to Eq. (A1) with \( \nu_Y = 0 \) and \( \gamma = 1 \), substituting \( b_Y \) with the optimal bidding function \( b_Y[\nu_Y,\gamma] = \nu_Y + \gamma((1-\nu_Y)/(1-\gamma)) \)). The expected payment by a independent bidder \( i \) (\( 1 \leq i \leq n \), \( m_i^{(n)}[\gamma] \), is equal to this expression divided by the number of independent bidders, \( n \):

\[
m_i^{(n)}[\gamma] = \frac{1}{n} \int_0^1 \left( nb_Y^{n+1} (1-b_Y) + \frac{n}{n+1} \left( (n+1)b_Y^n + nb_Y^{n+1} \right) \right) dv_Y
\]

The expected auction revenue, \( m(n)[\gamma] \), is equal to these expected payments added for all participants, thus \( m(n)[\gamma] = nm_i^{(n)}[\gamma] = m_Y^{(n)}[\gamma] \), which is equal to:

\[
m(n)[\gamma] = \frac{1}{1+\gamma} \left( n \left( \frac{n}{n+1} b_Y^{n+1} \right) \right) dv_Y
\]

(c) The expected profit of \( X_i, \pi_{X_i}^{(n)}[\gamma] \), increases.

(b) The expected auction revenue, \( m(n)[\gamma] \), increases.

(c) The expected profit of \( X_i, \pi_{X_i}^{(n)}[\gamma] \), decreases.

Proposition 2. When the values of \( X \) and \( Y, \nu_X \) and \( \nu_Y \), independently distributed without any further restrictions on the possible distribution, then when the integrated bidder \( Y \), receives the full auction revenue such that \( \gamma = 1 \), \( Y \) bids its own value in a first-price auction.

Proof. When \( \gamma = 1 \), \( Y \) receives the full amount of any bid paid. Therefore \( Y \) does not have to take bidding costs into account, and regardless of its bid, earns at least min(\( \nu_Y, b_Y \)). Now an argument similar to that for truthful bidding in second-price auctions applies. Suppose \( Y \) has value \( \nu_Y \). If \( Y \) makes a bid lower than its value \( \nu_Y \), then with a positive probability \( X \) wins with a bid \( b_X \), which is higher than the bid of \( Y \) but lower than the value of \( Y \). \( b_Y < b_X < \nu_Y \). In this case \( Y \) can guarantee itself a higher profit at no cost by bidding its value, \( b_Y = \nu_Y \). A similar argument establishes that \( Y \) will not make a bid higher than its value. Hence, \( Y \) bids \( \nu_Y \) and earns max(\( \nu_Y, b_X \)).

Proposition 3. In a first-price auction with one competing independent bidder \( X \) and an integrated bidder \( Y \) who has full ownership, \( \gamma = 1 \), bids its value, while the independent bidder bids \( b_X = \infty \). As a result of the more aggressive bidding of \( Y \):

(a) The expected profit of \( Y, \pi_Y^{(n)}[\gamma] \), increases.

(b) The expected auction revenue, \( m(n)[\gamma] \), increases.

(c) The expected profit of \( X_i, \pi_{X_i}^{(n)}[\gamma] \), decreases.
Efficiency, \( W_Y \), decreases.

(e) The profit of optimizing total profits (generator profits and \( \gamma \) times auction revenue) increases relative to optimizing the profit of only the generator.

**Proposition 2.** Established that \( Y \) bids its own value, \( b_Y[v_Y] = v_Y \), and the inverse bidding function of \( Y \) is thus \( y[b_Y] = v_Y \). Substituting for \( Y \) in the first order condition as derived in Proposition 2, \( x[v_Y] = \frac{1}{2} v_Y \).

The inverse bidding function of the independent bidder \( X \) is \( x[b_X] = 2b_X \) and its bidding function is thus given by \( b_X[v_Y] = \frac{1}{2} v_Y \).

(a) The expected profit of \( Y \), \( \pi_Y[v_Y] \), increases. The case of no ownership, it is equal to \( \pi_Y[v_Y = 0] = \frac{1}{2} \). In the case of full ownership,

\[
\pi_Y[v_Y = 1] = \int_0^{1/2} v_Y \, d\nu_Y + \int_{1/2}^1 v_Y \, d\nu_Y + \frac{1}{2} v_Y \, d\nu_Y + \frac{1}{2} v_Y \, d\nu_Y = \frac{13}{24}.
\]

Once \( Y \) has a value higher than \( \frac{1}{2} \) it can be sure of winning as the highest bid of \( X \) is \( bx[1] = \frac{1}{2} \). The probability of \( X \) winning with value \( v_X \) is given by \( p_Y[v_X] = \frac{1}{2} v_X \) and its bidding function is \( b_X[v_Y] = 1 \) when \( v_Y > \frac{1}{2} \).

(b) The expected auction revenue, \( m^{(o)}[v_Y] \), increases. As \( Y \) bids and pays its realized value, auction revenue is equal to profit of \( Y \), \( m[v_Y = 1] = \frac{1}{2} \).

(c) The expected profit of \( X \), \( \pi_X[v_Y] \), decreases. In the case of no ownership the expected profit of \( X \) is given by \( \pi_X[v_Y = 0] = \frac{1}{2} \).

With full ownership, the profit is equal to

\[
\pi_X[v_Y = 1] = \int_0^{1/2} v_X(\frac{1}{2} v_X) \, d\nu_X + \int_{1/2}^1 v_X(\frac{1}{2} v_X) \, d\nu_X = \frac{17}{24}.
\]

(d) Efficiency, \( W_Y[\gamma] \), decreases. In the case of no ownership efficiency is equal to the expected value of the highest out of two signals which is equal to \( W_Y[\gamma = 0] = \frac{1}{2} \). In the case of full ownership, by \( W_Y[1] = \frac{1}{2} \) the efficiency is equal to the profits of \( X \) and \( Y \) together, that is, the full auction revenue is accounted for in the profit of \( Y \), and thus \( W_Y[\gamma] = \pi_Y[\gamma] + \pi_X[\gamma] = \frac{24}{24} + \frac{17}{24} = \frac{41}{24} = \frac{21}{12} \).

(e) The profit of optimizing total profits (generator profits and \( \gamma \) times auction revenue) increases relative to optimizing the profit of only the generator \( \pi_{Y_{\text{Strategic}}}[\gamma = 1] = \pi_Y[\gamma = 1] - \pi_{Y_{\text{Naive}}}[\gamma = 1] = \frac{12}{24} - \frac{12}{24} = \frac{24}{24} \).

**Proposition 4.** Given a value of the ownership share, \( \gamma \), \( 0 < \gamma < 1 \), the inverse bidding functions \( x[b] \) and \( y[b] \) and the maximum bid \( b \) for all bids \( b \) can be found by solving the following set of equations:

\[
(y[b] - b)x[b] = (1 - \gamma)y[b]; \quad (x[b] - b)y[b] = y[b]; \quad x[b] = y[b] = 1; \quad b = \frac{1}{2} + \frac{1}{\gamma} \int_{0}^{1} x[b] \, db.
\]

**Proof.** Eqs. (5) and (6) are the first-order conditions in Proposition 2. Eq. (7) states that a bidder only makes the maximum bid \( b \) when it has the highest possible value, which is one. This follows from the fact that it is a Nash equilibrium to bid equal or lower than the highest bid. Eq. (9) puts a restriction on the maximum bid that can be derived from the fact that a bidder with value 0 bids 0, \( x[0] = y[0] = 0 \), and the first-order conditions (5) and (6).

Rewriting (5) and (6) gives:

\[
(x'[b] - 1)y[b] - b = (1 - \gamma)x[b] - y[b] + b, \quad (y'[b] - 1)x[b] - b = y[b] - x[b] + b.
\]

Summing up (9) and (10) gives

\[
\frac{\partial}{\partial b}(x'[b] - 1)y'[b] + (y'[b] - 1)x'[b] - b = 2b - \gamma x[b] \Rightarrow \frac{\partial}{\partial b}(x'[b] - 1)y'[b] - ab = 2b - \gamma x[b]
\]

Integrating Eq. (11) over 0 to the maximum bid \( b \) gives

\[
(1 - b)(1 - b) = b^2 - \gamma \int_{0}^{1} x[b] \, db \Rightarrow b = \frac{1}{2} + \frac{1}{\gamma} \int_{0}^{1} x[b] \, db
\]

**Corollary 1.** Revenue equivalence between first and second-price auctions does not hold.

**Proof.** When \( Y \) has full ownership, \( \gamma = 1 \), then in a first-price auction \( Y \) and \( X \) have bidding functions \( b_Y[v_Y] = v_Y \) and \( b_X[v_X] = v_X \), while in a second-price auction they have \( b_Y[v_Y] = (v_Y/2) + \frac{1}{2} \) and \( b_X[v_X] = v_X \). The expected revenue in a first-price auction can be calculated using the formula derived in Proposition 3b, which results in \( \frac{24}{24} \).

Observe that such high auction revenue cannot be realized in a likewise second-price auction. The highest possible auction revenue is equal to \( \frac{1}{2} \) and can be realized only by \( Y \) bidding aggressively enough to win with probability one (e.g., by bidding one or higher for all its realized values), in which case \( X \) loses the auction with probability one and thus the expected second highest price, given by the expected value of \( X \), is equal to \( \frac{1}{2} \).

The expected revenue in a second-price auction is given by the formula derived in Proposition 1b in the Appendix, \( m_Y[v_Y] = (n/(n+1)(n+2))1^{n-1}((1+\gamma)^{n-2} - \gamma^{n+2}) \), and substituting \( n = 1 \) (one competing bidder) and \( \gamma = 1 \) (full ownership) results in a revenue equal to \( \frac{24}{24} \).
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Commission for Energy Regulation, 2009. SEM Regional Integration, a consultation paper.