



## Viewpoint

## Windfalls and other profits

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## ABSTRACT

“Windfall profits” again is a popular term, but mostly the term is used inappropriately. This short article discusses why, and proposes a more complete taxonomy of profits. There exists little ground and need for policy to act against genuine windfalls, while the contrary holds for other excessive earnings. Very few windfalls, freely fallen down from winds in the sky, occur after observed excessive profits are stripped from deliberate man-made interventions. That is why clear identification and correct language are needed.

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## 1. Introduction

Addressing climate change risks and sustainable development are interrelated, both intertwined with more equal distributions of wealth and income (WCED, 1987; IPCC, 2007). But statistics show inequalities are growing (Milanovic, 2007). Rising inequalities are partly due to the amassing of excessive profits by OECD-based large businesses, in particular in the energy sector. Significant excessive profits are intertwined with energy and climate policies and generally called “windfalls”. Dealing with the phenomenon of excessive profit making is of high political interest because citizens are but willing to contribute to the common good of climate protection when they perceive the burdens and advantages to be distributed fairly over all participants. But before launching policy instruments and submitting bills for taking back (part of) the excessive profits we should work harder on an accurate identification of the big chunks of money appropriated by big companies. The windfall label is applied too quickly and may function as a cover of less innocent practices.

## 2. Taxonomy of profits

The increase in oil prices sets “windfall profits” high on the agenda again. “Venezuela’s parliament passed a law obliging oil companies to give in to the government 92 cents for every extra dollar when the world prices are above \$70 a barrel and 97 cents when they are above \$100 a barrel”.<sup>1</sup> This is far stronger than the famous US Crude Oil Windfall Profit Tax in 1980, attracting new interest since oil prices took off since 2005. Other “windfall profits” are signalled in the EU Emission Trading Scheme (ETS)

permitting some companies, mainly power generators, to reap billions of euros extra profits (PointCarbon, 2008), in the Clean Development Mechanism CDM (Wara and Victor, 2008) and in Green Certificate Systems (Verbruggen, 2007).

Windfall profit definitions differ. The best I found is “a sudden unexpected profit uncontrolled by the profiting party”.<sup>2</sup> Other sources extend this definition with the additional characteristic of being “unearned”.<sup>3</sup> The essence of windfall—unexpected, uncontrolled, unearned—questions whether profits in the oil business by shifting market conditions and profits in the politically structured flexible mechanisms ETS, CDM and green certificate systems, are truly windfalls. A more extended taxonomy for profits is required (Fig. 1).

A private entrepreneur’s Profit is equal to Revenues minus Expenses. Revenues are what customers pay for delivered goods and services. Expenses are the returns to capital, land and labour (interest, rent and wages).<sup>4</sup> Non-privately owned natural resources are considered by neoclassical economists as free heritages charging no price.

Enlarging the scope from private agents to public interests, public and welfare economics shift the terminology to Welfare as Benefits minus Costs. The latter both “encompass markets goods and services but should also include everything that is of value to people” (Nordhaus, 2007, p. 13). Differences are significant in e.g. the oil business: private expenses to supply oil are small but public costs in using oil are high; the differences are unpaid externalities such as climate change. The benefits in using oil exceed the revenues, by far when sales prices are modest. The double margin between benefits and expenses consists partly of rents and partly of unpaid externalities. That margin is shared by

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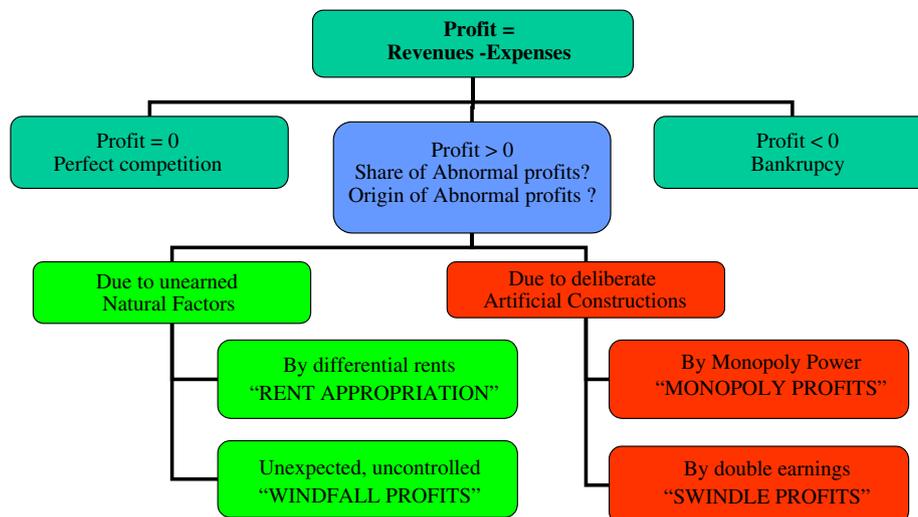


Fig. 1. Taxonomy of profits.

oil companies (profits), governments (taxes) and end-users (surplus of benefit above price paid).

Private profits can be zero, positive or negative. Along neoclassical economics profits equal zero when competition is perfect, because expenses include a return to invested capital. When profit is negative the company cannot reward the production factors and will go bankrupt. In practical life, accountants do not straightforwardly follow economic theory for including all capital as a production factor. In accounting, capital is split in borrowed capital and in shareholder capital. The interest on the former is included in the cost accounts, but the reward for the latter is published as the bottom line, mostly showing positive profits but occasionally losses. When declared profits are sufficient to reward shareholder invested capital and risks at normal rates, profits are normal. Some business cycles are erratic and some engage huge capital funds that may give rise to dazzling profit (loss) numbers above (and below) the bottom line, without therefore stigmatizing them excessive or abnormal. Because the size of stakeholder capital is known and risks by activity are also documented, it is feasible to assess the level of normal profits within acceptable ranges of accuracy.

When profits exceed normal levels, one questions the origin of the excesses. The figure shows a bifurcation between abnormal profits due to unearned natural factors and abnormal profits due to deliberate artificial constructions. Differential rents were identified by Ricardo in 1815. Some entrepreneurs have the fortune to live on fertile land, while others have to labour on less productive plots. Some sites are more apt for installing wind turbines than other sites. The former obtain a larger margin on their investments and efforts than the latter. Property rights and tax policies are decisive in distributing fortunes and in appropriating the rents. Rents can be transferred to the public interests by taxing natural resource use. When appropriated by private companies they show up as extra profits, but not as windfalls because they do not arise suddenly.

Windfalls are a rather exceptional type of profits because sudden unexpected fortunes in real life are scarcer than Hollywood fantasy suggests. Very few windfalls occur after observed excessive profits have been peeled down from the three other driving factors. There exists little ground and need for policy to act against genuine windfalls, while the contrary holds for the other excessive earnings. That is why clear identification and correct language are needed.

### 3. Deliberately constructed profits

Most abnormal profits result from deliberate actions by their beneficiaries. Well known are monopoly profits: companies with market power charge prices higher than marginal costs, further maximizing the reaping by price discrimination set-ups (Phlips, 1983). The electricity-intensive industries argued in 2004 that “in the absence of real competition in the power market, power companies will charge the extra cost linked to EU ETS regardless of whether the power purchased is from a source with CO<sub>2</sub> emissions or not. This pricing mechanism will lead to exorbitant windfall profits for power companies ...”.<sup>5</sup> Indeed the power companies cash huge profits covered up by the EU climate policy. These abnormal profits are labelled “windfalls” but do result from deliberately exercising monopoly power, as the above quote by the intensive industries opens with. When perfect competition in power markets would reign, charging customers for fictive costs (free emission allowances) would be impossible. Monopolists continuously being scrutinized by their customers and by regulators, love good pretexts to cover up excessive profits. Participating in the “global carbon market to fight climate change” is a wonderful pretext to hide monopoly profits.

Economists state “in principle and in line with economic theory, a company is expected to add the costs of CO<sub>2</sub> emission allowances to its other marginal (variable) costs when making (short-term) production or trading decisions, even if the allowances are granted for free” (references quoted in Sijm et al., 2006, p. 50). While this statement may be in accordance with first-hand interpretation of the economics textbook principle of pricing at short-run marginal costs, two main caveats are in order, because the case can also be considered as a textbook illustration of “tail wags dog”.

First the prices that apply on the free given permits are not prices for actual emissions happening. They rather represent some type of penalty (fine) on only the tons of emissions exceeding the freely supplied quota to the companies. Does economic theory state that companies should add to their short-run marginal cost the full price of a ticket they can get when violating particular regulations? One step further, the same monopoly

<sup>5</sup> Power-intensive industries object to windfall profits from Emissions Trading, 11 March 2004.

companies can argue that the fine announced by the EU Commission for shortfalls in allowances (€40/ton CO<sub>2</sub> emitted in the first trading period, and €100/ton in the second trading period) should be added to the short-run marginal cost price of electricity and of other carbon-intensive goods and services. The argument that the price of an allowance “represents an opportunity cost regardless of whether the allowances are allocated for free or purchased at an auction or market” (Sijm et al., 2006, p. 50) is debatable in this case. There are no costs made, perhaps even no single participation in any market, but the opportunity to profit by swindle, covered up by monopoly power, is taken. But as well the EU as the Member States argue that the distribution of free permits is necessary for a normal economic functioning of the industrial activities. When this assignment is realised in an appropriate way, the “opportunity” for trade is very thin.

Secondly, economic theory on the optimality of pricing electricity at short-run marginal cost is based on the assumption of equilibrium in the composition of the electric power generation systems. Only at that equilibrium applies the principle of income from short-run marginal cost prices perfectly covering the full costs of power generation including investments and other fixed costs (often called long-run marginal costs for extending capacity and running it). Setting price at the true short-run marginal costs (above or below the equilibrium value) is the shortest path for restoring equilibrium, contingent on the assumption markets run unfettered. These arguments have been developed by Boiteux since 1949 for a public monopoly company (recovered in Nelson, 1964), and can be carried over to a perfect competitive electricity market. But reality forces to point to some caveats again.

First, the actual state of the electricity markets in being competitive, or oligopolistic, or monopolistic, ... is to be taken into account. Sijm et al. (2006, p. 51) state “in a competitive environment generators ‘add-on’ the opportunity costs of CO<sub>2</sub> allowances to the power price (...). However, in a liberalized market, prices are ultimately determined by a complex set of market forces.” Is the reality not the contrary of the first statement? Only by monopoly power can electricity companies charge the fictive costs of freely assigned permits. The second statement points to the necessity of further exploration of the “complex set”. Thomas (2003) and Domanico (2007), among others, illustrate that the EU electricity market is likely to fall short of the economists’ ideal of free market functioning.

Secondly, electricity is priced very rarely at the short-run marginal costs of power generated and supplied. The overwhelming majority of power is traded in bilateral contracts that use some formula of expected average cost assessment that particular bulk customers or retail customer classes will cause.

Thirdly, the regulatory inroads of the ETS in the power generation systems of Europe are uneven by country and system. The over-assignments increase the volatile and speculative character of the penalty prices that would be applied on the eventual excess emissions that power companies would cause above their assigned permit quota. The unbalanced National Allocation Plans and adaptive political interventions by the EU Commission rather disturb than improve the converging to market equilibriums in power generation systems. But recall that the attainment of such equilibrium underpins the validity of short-run marginal cost pricing.

Non-electricity companies and exchange traders gain profits by the EU ETS through permit deals with colleague companies and other traders. Such profits are also called windfalls but “swindle” profits is a more correct name because they are achieved through cunning and guile. Double-dealings are easy and successful by flaws in the ETS, by lobbying for free permit assignments by authorities not capable and experienced for governing complex permit systems and by deceptive practices (charging fictive costs). Swindle profits

differ from monopoly profits. Swindle profits are made by selling “hot air” (UK, 2007), where monopoly profit making is a re-allocation of real values (rents) from customers to suppliers.

In the CDM excessive profits have been noted for project developers and particular countries. “Payments for HFC-23 abatement by refrigerant manufacturers in China, the Chinese government and to carbon market investors by governments and compliance buyers will in the end total approximately €4.7 billion while estimated costs of abatement are likely less than €100 million” (Wara and Victor, 2008, p. 12). In 2004, the ill-constructed Flemish Green Certificate system has lost 45 per cent of its turnover in swindle profits cashed by free-riders on the system (Verbruggen, 2007, p. 306). The source of such swindle profits is mostly flawed and weak regulation by political authorities. Many problems arise from well-intended policy initiatives to save the climate or to promote highly estimated values (such as more global fairness). The initiatives often miss understanding of real markets and fall short in co-ordinating policies over various issues, sectors and levels.

The many examples show there is ground for a more complete taxonomy and analysis of observed, excessive profits.

#### 4. Conclusion

Public policy and regulation are there to address rent skimming by private companies, monopoly profits and swindle profits. Instead of trying to level the excessive gains by ex-post and ad-hoc measures, preventing their mushrooming by improved regulation and design of policy instruments for climate protection is more effective and efficient. When targeting the roots of the excessive profits, putting the right name on the various types is a good start. The faulty use of the windfall concept is confusing and analysts and commentators should try to avoid this. It involves two tasks. The first task is splitting observed profits in normal and excessive parts. The second task is finding out how the excessive profits are composed. Often the blend of rent skimming, monopoly profits and swindle profits will be difficult to distillate. But done successfully one will find very little real—unexpected, uncontrolled, unearned—windfall residuals. This bottoming in the large profit barrel may be left to the lucky finder.

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