

Competition Legislation

Competition Act 1998

Application in the Energy
Sector

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1. Introduction

- 1.1 The Competition Act 1998 as amended by SI 2004, No. 1261¹ ('CA98') gives the Office of Fair Trading ('OFT') and the sector regulators, including the Gas and Electricity Markets Authority ('the Authority') powers to apply and enforce Articles 81 and 82 of the EC Treaty ('Articles 81 and Article 82' respectively) as well as the Chapter I and II prohibitions of CA98 using their concurrent powers.
- 1.2 Article 81 and the Chapter I prohibition contained in section 2 (1) of CA98 prohibit agreements between undertakings, decisions by associations of undertakings and concerted practices ('agreements') which have the object or effect of preventing, restricting or distorting competition. Article 81 applies to agreements which may affect trade between Member States in the EU. The Chapter 1 prohibition applies to agreements implemented or intended to be implemented in the United Kingdom (or a part thereof), which may affect trade within the United Kingdom.
- 1.3 Article 82 and the Chapter II prohibition contained in section 18(1) of CA98 prohibit conduct by one or more undertakings which amounts to the abuse of a dominant position in a market ('conduct'). Article 82 applies to conduct within the common market in so far as it may affect trade between Member States. The Chapter II prohibition applies if the dominant position is held and the conduct in question that may affect trade within the United Kingdom (or a part thereof).
- 1.4 The competition law guideline *Application in the Energy Sector* ('the guideline') provides advice and information about the factors which the Authority will take into account when considering whether, and if so how, to exercise its powers under the CA98.² The Office of Gas and Electricity Markets ('Ofgem')

¹ The Competition Act 1998 and other Enactments (Amendment) Regulations 2004S.I 2004 No. 1261 entered into force on 1 May 2004 and were introduced inter alia to give effect to the EC regulation 1/2003 which requires national competition authorities and the courts of Member States to apply and enforce Articles 81 & 82.

² This guideline should be read in conjunction with the guidelines listed in the front cover.

exercises certain functions under the CA98 on behalf of the Authority in accordance with the Authority's Rules of Procedure. For the purpose of this document Ofgem and the Authority are used interchangeably unless specified otherwise. This guideline is not exhaustive. It will be necessary to consider the circumstances of each case on an individual basis, with reference to the guideline.

- 1.5 The guideline was originally published in March 2001 and this first revision is being made to reflect the modernisation of EC competition law and development of recent case law. The guideline will be updated from time to time, in the future, to take account of relevant developments in the energy sector. It will also need to take account of any changes in the other guidelines issued by the OFT and the Regulators and the development of relevant case law under the CA98 and under the EC Treaty. Consultation with interested parties, including the OFT and other sector regulators, will take place before making any changes to the guideline.³
- 1.6 Part 2 of the guideline sets out the legal context within which Ofgem will be operating. It explains Ofgem's powers under the CA98 and the relationship of these powers with other relevant legal provisions. Part 3 provides an economic analysis of the application of the CA98, with reference to the specific economic characteristics of the energy sector. The process for carrying out investigations, and in particular, how Ofgem intends to use its powers under the CA98, the Gas Act 1986 (as amended) and the Electricity Act 1989 (as amended) is discussed in Part 4. Part 5 describes Ofgem's approach to considering agreements covered by the transitional arrangements in Schedule 13 to the CA98.

³ The latest version of the guideline will be kept in the Ofgem library and will be available on Ofgem's web pages on the Internet at <http://www.ofgem.gov.uk> and OFT's web page on the Internet at <http://www.oft.gov.uk>.

2. Legal Context

The Competition Act 1998 as amended

2.1 The CA98 gives the Authority and other sectoral regulators concurrent powers to apply and enforce Articles 81 and 82 of the EC Treaty as well as the Chapter I and II prohibitions. These powers include the ability:

- to investigate suspected infringements;⁴
- to impose interim measures during the investigation;⁵
- to give directions to bring an infringement to an end;⁶
- to apply Article 81(3) to agreements which infringe Article 81(1) and section 9 to agreements which infringe Chapter I;
- to accept binding commitments which fully address competition concerns;⁷
- to impose financial penalties on undertakings of up to 10 per cent of an undertaking's worldwide turnover in the business year preceding the date of the decision.⁸

2.2 The CA98 also provides the OFT with powers to assist, or act on behalf of, the European Commission in connection with European Commission investigations regarding Articles 81 and 82. The OFT can also carry out an inspection on behalf

⁴ Sections 26, 27, 28 & 28A

⁵ Section 35

⁶ Section 32

⁷ Section 31A

of a national competition authority (NCA) of another Member State, if requested. The Authority does not have direct powers under CA98 to investigate suspected infringements on behalf of the European Commission or other Member States. However, Ofgem may assist fully in such investigations, which relate to the Ofgem's areas of jurisdiction and where Ofgem has expertise.

2.3 The jurisdiction of the Authority with regards to CA98 is set out in section 36A of the Gas Act 1986 and section 43 of the Electricity Act 1989 (Gas Act and Electricity Act respectively). Ofgem will consider upon a case-by-case basis whether the agreements or conduct in question relate to:

- commercial activities connected with the generation, transmission or supply of electricity⁹; or
- licensable activities or other activities (such as off-shore activity) which are ancillary to those subject to licences for transportation, shipping or supply of gas.¹⁰

Where an agreement or conduct has an impact upon competition in the markets regulated by the Authority, the case will be allocated to the Competition Authority best placed to act in accordance with the Competition Act 1998 Concurrency Regulations (SI 2004 No.1077) or the Modernisation Regulation (as appropriate).

When to apply EC Competition Law

⁸ Section 36 and Competition Act 1998 (Determination of Turnover for Penalties) Order 2000 as amended for more information refer to the competition law guideline ***OFT's guidance as to the appropriate amount of a penalty.*** (OFT423)

⁹ The provisions relating to the use of the electricity interconnector introduced by the Energy Act 2004 have not yet commenced.

¹⁰ For detail on the activities relating to gas licenced by the Authority see section 5 (1) of the Gas Act 1986. The provisions relating to the gas interconnector introduced by the Energy Act 2004 have not yet commenced.

- 2.4 Article 3(1) of Regulation 1/2003 (the Modernisation Regulation)¹¹ requires the national competition authorities of the Member States (including the Authority) to apply Articles 81 and 82 where they apply national competition law and when such legislation is applied to agreements or conduct which may affect trade between Member States. Therefore, where the Authority applies Chapter I and or II prohibitions, and there is an actual or potential effect on trade between Member States, it shall also apply Article 81 and/or 82 in accordance with Article 3(2) of the Modernisation Regulation (see section 2.9).
- 2.5 As a result, the Authority may be obliged to apply Articles 81 and/or 82 when carrying out duties under the Gas Act 1986, the Electricity Act 1989 ('Gas and Electricity Acts') or other relevant national legislation. This obligation applies to the extent that the provision is considered an application of national competition law to agreements or conduct within the meaning of Article 81 or 82, and which have an actual or potential effect on trade between Member States.¹² Where both these conditions are satisfied, the Authority must also apply Articles 81 and/or 82 in accordance with Article 3(2) of the Modernisation Regulation (see section 2.9). Where the Authority is exercising powers which pursue an objective different to that being pursued by Articles 81 and 82, it would not apply these articles.

The application of 'national competition law' with regard to the sector-specific Acts

- 2.6 When exercising statutory duties under the Gas and Electricity Acts, the Authority will consider whether in doing so it is applying national competition law within the meaning of Article 81 and/or 82. In order to reach a view, it will be necessary to consider the legal basis from which a duty stems and the predominant objective of the provision. To the extent that a duty arises from EC law (excluding the Modernisation Regulation), it will be considered an application of EC law and not an application of national competition law. Where a national provision pursues

¹¹ Council Regulation EC1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty 16 December 2002 OJ L1, 4.1.2003, p 1.

several obligations, it will generally not be considered national competition law, unless the predominant objective is consistent with that of Articles 81 and 82.

- 2.7 There are provisions of the Gas and Electricity Acts which predominantly pursue objectives different to that being pursued by Articles 81 and 82 and therefore would not be considered an application of national competition law. For example, the standard supply licence condition relating to the provision of gas and electricity to vulnerable customers¹³ would be considered to be pursuing a consumer protection objective. Similarly, the provisions for the supplier of last resort provisions or ensuring efficient use of gas and electricity would also be considered to be pursuing objectives to secure supply or to promote environmental standards respectively.¹⁴ In such cases the Authority's obligation to apply Articles 81 and/or 82 would not apply when exercising its statutory duties under the Gas and Electricity Acts.

Effect on inter-state trade

- 2.8 Where the exercise of a provision may be considered an application of national competition law within the meaning of Articles 81 or 82, the Authority will also consider whether the agreement or conduct has an actual or potential effect on inter-state trade. The Authority will act consistently with the principles developed by the European Court of Justice in interpreting this concept and will have regard to the notice issued by the European Commission ***Guidance on the effect on trade concept contained in Articles 81 and 82 of the EC Treaty*** (2004/C 101/07).

Applying Articles 81 and 82

¹² Refer to European Commission ***Guidance on the effect on trade concept contained in Articles 81 and 82 of the EC Treaty*** (2004/ C 101/07)

¹³ Standard Conditions 37 and 38 of the Electricity Supply Licence and standard conditions 37 and 37A of the Gas Supply Licence.

¹⁴ Standard Conditions 25 and 29 of the Electricity Supply Licence and of the Gas Supply Licence.

- 2.9 Where the criteria for applying Articles 81 and 82 are met and the Authority is applying national competition law, the Authority must apply such national competition law in accordance with Article 3(2) of the Modernisation Regulation. Article 3(2) prevents national competition authorities (including the Authority) from prohibiting agreements, decisions or concerted practices by undertakings which would be permitted under Article 81. UK Authorities (including the Authority) shall not prohibit agreements under national competition law which do not restrict competition under Article 81 (1), which fulfil the conditions of Article 81(3) or are covered by an EC block exemption regulation. However, the Authority may apply stricter national laws and prohibit or sanction unilateral conduct under national legislation even if that conduct would be permitted under Article 82.

Conforming with Community law

- 2.10 Article 16(2) of the Modernisation Regulation prevents national competition authorities (including the Authority) from taking decisions under Article 81 or 82 which would run counter to decisions by the European Commission decision on the same agreement or conduct. They must also avoid giving decisions which would conflict with a decision contemplated by the Commission.
- 2.11 Section 60 of the CA98 places an obligation on the UK authorities (including the Authority) to answer questions arising under Part I of CA98 (which includes the Chapter I and Chapter II prohibitions) in such a way as to ensure consistency with Community law. First, they must ensure that there is no inconsistency with either the treatment of corresponding questions arising in Community law, insofar as this is possible, having regard to any relevant differences between the provisions concerned. The competition law guideline *The modernised regime* (OFT400) contains further detail on how conformity with EC law will be ensured.

EC directives

2.12 There are two EC directives which are directly related to the electricity and gas industries. Other EC directives may also be relevant to the electricity and gas industries.

*EC Directive Concerning Common Rules for the Internal Market in Electricity*¹⁵

2.13 This directive provides a framework for EU Member States to open their electricity markets to competition. It addresses a number of issues, including:

- the role of public service obligations in a competitive market;
- the legal unbundling from generation and supply of transmission by 1 July 2004 and distribution by 1 July 2007;
- open, non-discriminatory and transparent rules of access to electricity networks;
- market opening for non-household customers by 1 July 2004 and for all customers by 1 July 2007;
- regulatory function to be established independent of the interests of industry.

*EC Directive Concerning the Common Rules for the Internal Market in Natural Gas*¹⁶

2.14 This directive provides a framework for EU Member States to open up their gas markets to competition. It addresses a number of issues, including:

- the role of public service obligations in a competitive market;

¹⁵ Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC.

- legal unbundling from upstream and supply activities of transmission by 1 July 2004 and distribution by 1 July 2007;
- transparent and non-discriminatory access to storage;
- conditions for natural gas undertakings and eligible customers to have access to upstream pipeline networks;
- market opening for non-household customers by 1 July 2004 and for all customers by 1 July 2007.

2.15 Consistent with the principle of subsidiarity, each EU Member State can determine how to implement these directives bearing in mind their particular circumstances.

2.16 Ofgem will take account of the provisions of the EC directives when applying the CA98.

The Enterprise Act 2002

2.17 Part 4 of the Enterprise Act 2002 empowers the OFT and certain Regulators (including the Authority) to make market investigation references to the Competition Commission (CC). The purpose of a market investigation reference is for the CC to inquire into markets where it appears that the structure of the market or the conduct of suppliers or customers is harming competition. The Market Investigation Reference provisions repeal the provisions of the Fair Trading Act 1973 on monopoly enquiries. Further details of the Authority's powers under Part 4 of the Enterprise Act 2002 are set out in the OFT guidance ***Market investigation references*** (OFT511).

¹⁶ Directive of the European Parliament and of the Council concerning the common rules for the internal

- 2.18 The Enterprise Act 2002 introduced a criminal offence for individuals who dishonestly participate in cartel arrangements. The criminal cartel offence will operate alongside the Chapter I prohibition of the CA98 and Article 81 of the EC Treaty. The Enterprise Act gives the OFT powers to investigate individuals suspected of having committed the criminal cartel offence. The Regulators (including the Authority) with concurrent powers under the CA98 *do not* have powers to investigate the criminal cartel offence. Further information on the criminal cartel offence is available in the OFT's guidance ***Powers for investigating criminal cartels*** (OFT513).
- 2.19 The Enterprise Act 2002 amends the Company Directors Disqualification Act 1986 to provide the OFT and certain Regulators (including the Authority) with the power to apply to the courts for orders disqualifying directors of undertakings which have committed a breach of Article 81, Article 82, the Chapter I prohibition and /or the Chapter II prohibition from acting as directors for a period of up to 15 years. Further information on this power is available in the OFT's guidance ***Competition disqualification orders*** (OFT510).
- 2.20 The Enterprise Act 2002 empowers the OFT and certain Regulators (including the Authority) to investigate super complaints, that is complaints by designated consumer bodies relating to a feature(s) of a UK market which appears to be significantly harming the interests of consumers. Further information on this power is available in the OFT's guidance ***Super- complaints*** (OFT514).

3. Economic Analysis

The importance of regulating dominant incumbents¹⁷

3.1 The scope of monopoly and of public ownership in the electricity and gas industries (and other utility sectors) prior to privatisation gave rise to patterns of activity that were not subject to normal market disciplines. Not only was there a lack of competitive pressures on cost and price levels, but products, services, marketing methods, etc, tended to be relatively standardised, and incentives to respond to the varied requirements of different electricity and gas customers were weak. The unbundling and separation of natural monopoly activities from the other parts of the industries facilitated the subsequent introduction of competition to parts of the supply-chain. This has enabled incumbents and new entrants alike to take advantage of the opportunities to better serve the interests of customers through:

- prices that reflect efficient costs;
- new tariff structures;
- new products and services;
- new combinations of products and services;
- the offering of alternative billing and payment methods; and
- new marketing methods.

¹⁷ Ofgem notes that incumbents may not necessarily be dominant as competition develops and new entrants erode their dominance. New entrants may develop a position of dominance over time.

- 3.2 Such measures have been important in the transition from statutory or *de facto* monopoly to effective competition in gas supply, electricity supply, electricity generation and a range of related services. In its application of the CA98, and in particular the Chapter II prohibition / Article 82, Ofgem will therefore continue to be particularly vigilant in seeking to ensure that the conduct of undertakings does not restrict the opportunities for others to address markets in innovative ways. This could occur, for example, by preventing the introduction of new products or services or by artificially restricting the profits that could be made by new entrants from the introduction of new products and services.

Characteristics specific to the gas and electricity sector

- 3.3 Application of the CA98 to the gas and electricity industries will raise a number of challenges associated with the specific economic conditions to be found in the sectors. It may take some time for the sector- specific case law to develop. The relatively advanced state of energy liberalisation in the UK compared with most other Member States of the EU means, however, that the UK is at the forefront of the application of competition law to competitive energy markets. Where appropriate, Ofgem will ensure that it applies its powers under the CA98 in a manner that is consistent with relevant EC jurisprudence on corresponding questions in relation to competition from other sectors, as far as is possible having regard to any relevant differences between any of the provisions concerned.

- 3.4 Ofgem believes that there is a range of characteristics of the gas and electricity industries which, when taken together, may be more relevant to an assessment of the energy sector as compared to other sectors in Great Britain. The relevant factors include:

- the existence of monopoly providers of gas transportation, and electricity transmission and distribution networks, which are unlikely to be replicated due to the cost conditions faced by any undertaking seeking to duplicate

such networks (including the high sunk costs associated with construction and other costs arising from planning and environmental constraints);

- the importance in the transition from monopoly to competition across a range of activities of ‘unbundling’ and ensuring effective separation of the network services from the potentially competitive parts of the supply chain;
- the extent of market power of dominant undertakings in parts of the gas and electricity industries, including supply, metering, connections and storage markets;
- the existence of price controls for gas transportation and electricity transmission and distribution, and in some other parts of the industries where market power is particularly strong;
- the low elasticity of supply and demand for electricity and gas, particularly over short periods and in specific locations. In part this results from the limited storability of electricity, and to a lesser extent gas, which limits the opportunities to substitute between time periods on either the supply side or the demand side;
- the significance of the relative complexity of and the mandatory adherence by market participants to the various rules, codes and agreements in the gas and electricity markets. These include codes that aim to keep the gas and electricity networks operating within a safe and efficient operational limits, and which govern customer transfers as well as the connection to and the use of electricity and gas systems;

- the economic linkages between different parts of gas and electricity supply chains; including horizontal and vertical linkages, between spot and forward markets, and between electricity and gas wholesale markets; and
- the relatively high levels of information required to compare competing offers.

3.5 All of these factors may not be relevant for every case that Ofgem considers under the CA98. For example, the limited storability of electricity, the low elasticity of demand for electricity particularly over short periods and the relative inelasticity of supply for electricity at some periods are likely to be factors that are highly relevant to an investigation of electricity generation activities. For cases regarding the supply of gas and electricity to domestic customers relevant factors are more similar to those considered by the OFT in relation to other markets.¹⁸

3.6 Ofgem will adopt approaches to applying the CA98 that are, as far as possible, consistent with those set out in other competition law guidelines. The particular characteristics of the energy sector identified above will, however, affect the emphasis that is placed on, and the weight given to, particular aspects of the analysis set out in other guidelines when assessing:

- market definition;
- market power¹⁹, and in particular the assessment of dominance;
- whether an abuse of a dominant position has occurred;
- whether a dominant undertaking is engaging in exclusionary behaviour;

¹⁸ Refer to the competition law guideline *Assessment of Market Power* (OFT415)

¹⁹ The concept of market power is not part of the statutory framework of the Act, but it is a useful tool in assessing potentially anti-competitive behaviour.

- agreements between undertakings, decisions by associations of undertakings and concerted practices under the Chapter I prohibition; and
- the exclusion from the CA98's prohibitions, for services of general economic interest, under Paragraph 4 of Schedule 3 to the CA98.

3.7 The remainder of this part of the guideline explains how Ofgem intends to approach these six issues when applying the CA98 to the specific combination of circumstances in the gas and electricity industries identified above.

Market definition

3.8 In considering whether one of the prohibitions of the CA98 has been infringed it is necessary to define a relevant market or markets, since European competition law has required this in similar cases. A market definition normally contains two dimensions, a product and a geographic area.

3.9 In defining markets, one of the standard procedures to identify the extent of substitutability between products is to ask whether it would be profitable for a hypothetical monopolist to sustain prices at a small but significant amount above competitive levels. As explained in the competition law guideline ***Market Definition*** (OFT403), this involves considering the following:

- the extent to which customers would switch to other products following the hypothetical price increase; as a rough rule of thumb the OFT considers the relevant period of time in which to assess switching behaviour to be one year, but states that the relevant time period may be shorter, for example, in markets where transactions are made more frequently;

- the ability of suppliers to enter the market quickly and have a competitive effect on prices;
- the effect of the timing of production and purchasing on a customer's ability to switch products; in particular the guideline mentions the non-substitution of peak and off-peak services with regards to electricity supply.²⁰

Duration

3.10 Due to limited storability of electricity and, to a lesser extent gas, one of the standard mitigating constraints on the abuse of very short-term market power – the ability of undertakings and their customers to substitute transactions in one time period with transactions in another time period - is largely absent. In addition the need to keep the gas and electricity networks within safe and efficient operational limits has resulted in the introduction of formal balancing arrangements in the wholesale markets for gas and electricity on a daily and half hourly basis respectively. For this reason trading and contract settlement occurs more frequently and in relation to shorter periods of time than in many other markets. As such, in certain circumstances, the appropriate definition of the market may be limited to a shorter duration than has generally been used for analysis in many other industries.

Magnitude

3.11 The competition law guideline ***Market Definition*** (OFT403) refers to tests based on whether a hypothetical monopolist could profitably sustain prices a small but significant amount above competitive levels. Normally a price 5 to 10 per cent above competitive levels will be considered a small but significant price increase. However, if a price increase of 5-10 per cent is not profitable, but a higher price

increase would be profitable, the undertaking could be considered to be sustaining prices above competitive levels. In electricity and gas markets the price ‘spikes’ that occur can be many times higher than these benchmark numbers, irrespective of their causes in particular instances (for example, demand and supply fluctuations or the exploitation of market power). Therefore, Ofgem may consider very high wholesale prices, even if they hold for only short durations, to have significant effects on customers and, since customers may include other rival companies, on future competition.

- 3.12 The consideration of hypothetical price increases where a dominant undertaking is present may be particularly difficult because of the problems of identifying clear competitive benchmarks. Hence, the process of defining a market cannot be carried out in isolation, but needs to be considered alongside other evidence on market power and the undertaking’s conduct.

The combined effect of duration and magnitude

- 3.13 The combination of inelastic supply and demand can provide significantly enhanced opportunities for the exploitation of market power, enabling parties with relatively low market shares to affect prices. Effects on customers and on competition of similar magnitudes can be caused either by large price increases that can be sustained only for a short period or small price increases that can be sustained for or repeated over a long period. It is appropriate, given the emphasis placed by the CA98 on economic effects that Ofgem takes into account the potential deviations from competitive levels and the likely duration such deviations can be sustained in defining the relevant market. This may particularly apply to markets for wholesale gas and electricity and to markets for capacity on gas and electricity networks.

Related markets

²⁰ Please see section 5 referring to temporal markets of the competition law guideline ***Market Definition***,

3.14 It is recognised in competition law that in many situations there may not be a single relevant market. An important class of cases concerns behaviour in one relevant market or market segment that may have anti-competitive effects in other related markets or market segments. Such cases are important in gas and electricity markets, bearing in mind the economic linkages between the different activities in the sectors. For example, a particular entry point on a transportation network may initially be defined as a relevant market because customers using that particular entry point are likely to have limited substitution possibilities. The effects of conduct at that entry point, however, are likely to have economic effects on other parts of the network and potentially impact on the traded gas and electricity markets. In such circumstances it is appropriate that any market definition exercise does not unduly restrict the scope of an investigation and that it takes fully into account all of the relevant economic effects.

3.15 As explained in the competition law guideline *Article 82 and Chapter II prohibition*, there will also be cases where undertakings dominant in one market may be able to leverage market power to commit an abuse in a different but closely associated market.²¹ In such cases it is not necessary to show that the abuse was committed in the market in which the undertaking dominates. Such cases may be important in gas and electricity markets as many gas and electricity suppliers are now active in the supply of both electricity and gas and of other products. Similarly conduct or agreements relating to electricity generation or gas production may have an impact on downstream supply markets.

3.16 Ofgem will therefore have regard to the actual or potential effects of a firm's conduct on different activities in deciding the scope of an investigation and in

(OFT403)

²¹ Case T-83/91 Tetra Pak v European Commission [1994] ECR II-755.

defining relevant markets. Often the behaviour of competitors will provide practical examples of the relevant activities to consider in an investigation.²²

The assessment of market power, and in particular, the assessment of dominance

3.17 Dominance has been defined by the European Court as “a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers”.²³ Dominance may involve more than one undertaking (‘joint dominance’). One important indicator of dominance on the supply side is to consider whether a firm or firms has or have the ability persistently to raise prices above competitive levels. In cases involving a potentially dominant buyer, the test is reversed by considering whether a firm or firms has or have the ability persistently to reduce prices below competitive levels.

3.18 When considering whether undertakings can act to an appreciable extent independently of their customers and competitors, Ofgem will look at a range of factors including:

- customers’ behaviour and options (for example, awareness of competition, the extent to which alternative providers are chosen, the extent to which substitutes are available);
- competitors’ behaviour and capacities (for example, their range of offers, their ability to increase output within the relevant time period);
- market operation (for example, the extent of barriers to entry and exit);

²² Ofgas’ investigation into the market for storage and related services in 1998 (‘*Review of the supply of gas storage and related services, The Director General’s final proposals*’, Ofgas, September 1999), showed the importance of considering all relevant markets when assessing market power. The investigation concluded that the conduct of BG plc, including its pricing, was affected by and could affect the related markets for spot and peak gas (‘swing’) and interruptible supply contracts.

- an undertaking's conduct in a market with regards to price setting as well as its financial performance (such as persistently earning an excessive rate of profit); and
- market share.

3.19 Consistent with the competition law guideline *Assessment of Market Power*, (OFT415) Ofgem considers that market share is an important factor but does not determine on its own whether an undertaking is dominant. Market share alone would not be considered sufficient evidence to determine whether an undertaking or group of undertakings is or are dominant, not least because the economic implications of any market share are likely to be heavily conditioned by a range of other relevant factors, including the magnitudes of demand and supply elasticity.²⁴ In general, Ofgem will seek, wherever possible, to assess both substitution possibilities and actual behaviour directly, rather than rely on proxies such as market share.

3.20 In developing the case law on dominance, the European Court has stated that dominance can be presumed, in the absence of evidence to the contrary, where an undertaking has a market share persistently above 50 per cent.²⁵ The OFT considers it unlikely that an undertaking will be individually dominant if its market share of the relevant market is below 40 per cent but considers that dominance could be established below this figure if there are other relevant factors.²⁶ In the Great Britain gas and electricity sectors, due to the particular economic characteristics to be found there (including inelasticity of supply and

²³ Case 27/76 *United Brands v EC Commission* [1978] ECR 207, [1978] 1 CMLR 429.

²⁴ In Case 85/76 *Hoffman-La Roche & Co. AG v Commission* [1979] ECR 461, [1979] 3 CMLR 211, and a number of other cases, the Court and the Commission have considered other factors as well as market share when determining dominance, including competitors' positions; barriers to entry; the resources, size and commercial superiority of the undertaking; and technical superiority and the possession of know-how and intellectual property.

²⁵ Case C62/86, *AKZO Chemie BV v the European Commission* [1993] 5 CMLR 215.

²⁶ Section 4 of CA98 Guidance "*Article 82 and chapter II prohibition*" OFT402

demand), there are circumstances where undertakings may have the ability substantially and persistently to influence prices, and therefore to act independently of customers and competitors, even though their market shares fall below normal thresholds for considering dominance. This may particularly apply to markets for wholesale gas and electricity and to markets for capacity on gas and electricity networks.

The assessment of whether an abuse of a dominant position has occurred

3.21 It is the abuse of, not the existence of, a dominant position that is prohibited by the CA98. Therefore, where an abuse of a dominant position is alleged or suspected and it is found that an undertaking or group of undertakings has the ability to act, to an appreciable extent, independently of its customers and competitors (as manifested, for example, by an ability to raise prices above competitive levels to an extent that can cause significant harm), Ofgem will investigate further, to determine whether or not any infringement has occurred. Such an investigation will focus on the commercial conduct of the relevant undertaking(s) and on the effects of that conduct, or agreements entered into by undertakings, on customers and on competition. Conduct by dominant undertakings that seeks to exclude or exploit actual or potential competitors is likely to breach Article 82 or the Chapter II prohibition.

The assessment of whether a dominant incumbent is engaging in exclusionary behaviour

3.22 One other example of exclusionary behaviour is predatory pricing. When considering whether behaviour is predatory, Ofgem will assess whether an undertaking is dominant and if so consider the following:

- the intentions of the undertaking alleged to be engaging in predatory pricing;

- the feasibility of the undertaking recovering the losses it incurs when engaging in predatory pricing; and
- the level of the undertaking's prices relative to its costs.

3.23 Bearing in mind the particular concerns about exclusionary behaviour in the gas and electricity industries, Ofgem considers that it will be appropriate in considering whether an undertaking is engaging in predatory pricing to apply a relatively strict cost-based test. Where prices are found to be below average variable cost and are a means of eliminating a competitor, the Authority is likely to presume this conduct abusive.²⁷ However, there are legitimate commercial reasons for pricing below average variable cost,²⁸ which may not constitute an abuse.

3.24 Ofgem may consider an *avoidable costs* test more appropriate in assessing conduct in some gas and electricity markets. This test includes elements of costs that are often described as fixed costs that would not be included in a variable cost test. In cases where the costs are unlikely to be similar (such as in the electricity generation market) the Authority may also consider pricing below avoidable cost an abuse if it is part of a plan to eliminate an actual or potential competitor from a market or markets.²⁹

The assessment of agreements between undertakings, decisions by associations of undertakings and concerted practices under Article 81 and the Chapter I prohibition

3.25 Article 81 and the Chapter I prohibition prohibit those agreements between undertakings, decisions by associations of undertakings, and concerted practices which prevent, restrict or distort competition, or are intended to do so and, in the

²⁷ Case C62/86, AKZO Chemie BV v the European Commission [1993] section 71.

²⁸ Refer to Aberdeen journals No.2 Aberdeen Journals Limited v The Office of Fair Trading [2003] CAT 11, paragraph 357.

case of Article 81, may affect trade between Member States. The CA98 includes a list of illustrative examples of agreements, decisions or practices, which:

- directly or indirectly fix purchase or selling prices or any other trading conditions;
- limit or control production, markets, technical development or investment;
- share markets or sources of supply;
- apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

3.26 There are a number of problems that arise in gas and electricity markets as a result of the statutory requirements for arrangements to ensure safe, secure and efficient operation of gas and electricity networks which are used by many market participants. These arrangements may involve restrictions on competition to achieve their objectives which relate to safety, security and efficiency.

3.27 As a result of their contribution to safety, security and efficiency, such agreements may qualify for exemption from Article 81 or the Chapter I prohibition. Any agreement that falls within Article 81(1) or the Chapter I prohibition but which satisfies all the conditions set out in Article 81(3) or section 9(1) respectively shall not be prohibited. It is the responsibility of the undertakings to assess their agreement's compatibility with Article 81(3) or section 9(1) and, if necessary,

²⁹ Case C62/86, AKZO Chemie BV v the European Commission [1993] section 71.

prove that all the conditions are satisfied. The conditions for Article 81(3) and section 9(1) are similar; these are that the agreement:

- produces an improvement in the production or distribution (of goods) or promotes technical or economic progress;
- provides a fair share of the benefits to consumers;
- does not impose restrictions which are not indispensable to obtaining the improvements; and
- would not result in a substantial elimination of competition.

3.28 The Authority may withdraw the benefit of an EC block exemption in respect of the United Kingdom or a part of it in a particular case from any agreements if the following conditions are met:

- the territory of the United Kingdom, or a part of it, has all the characteristics of a distinct geographical market, and;
- the agreements in question have effects that are incompatible with Article 81(3) in the territory of the United Kingdom or part of it.

3.29 Under section 5 of the CA98, the Authority retains the power to cancel an individual exemption granted before 1 May 2004 until their expiry date. After expiry, individual exemptions will not be renewed.³⁰

³⁰ The provisions for exclusions for agreements that were covered or would be covered by the RTPA within the gas and electricity industries are discussed in Part 5.

The exclusion from the CA98's prohibitions for services of general economic interest, under paragraph 4 of Schedule 3 to the CA98

- 3.30 Neither the Article 81, the Chapter I prohibition, Article 82 nor the Chapter II prohibition apply to an undertaking entrusted with the operation of *services of general economic interest* or having the character of a revenue-producing monopoly in so far as the prohibition would obstruct the performance, in law or in fact, of the particular tasks assigned to that undertaking. Ofgem will therefore be required to assess whether or not, in a particular case, this exclusion is applicable.
- 3.31 As explained in the competition law guideline ***Services of General Economic Interest*** (OFT421), the exclusion's application is particularly narrow, with undertakings seeking to benefit from the exclusion having to prove that they meet all the requirements of the exclusion. Amongst other requirements, the Authority will only consider undertakings that are able to show that they have been 'entrusted' with the operation of a service of general economic interest. The undertaking must show that the application of the prohibitions of the CA98 would obstruct the performance, in law or in fact, of the particular task entrusted to it.
- 3.32 For example, Transco may have previously been considered an undertaking entrusted with the operation of a service of general economic interest in its operation of the gas transportation system in Great Britain. However, the deregulation and introduction of competition into Transco's previously monopolised sector has resulted in independent gas transporters building and operating both extensions to Transco's existing network and constructing separate networks, reducing the likelihood that the general economic interest exclusion will apply to it.

4. Process for Investigation

Sector specific regulation

- 4.1 Unlike most sectors covered by the CA98, undertakings' behaviour in the gas and electricity markets, including that of dominant companies, is regulated by sector specific Acts of Parliament that have created a licensing regime. Among other things, these Acts and the licences regulate and aim to protect the interests of gas and electricity customers. This includes restrictions on some undertakings' level and structure of charges and the prevention of unduly discriminatory behaviour by network operators. The Gas and Electricity Acts set out the factors the Authority should consider when deciding whether to use its powers under these Acts to address anti-competitive behaviour. In particular, the Authority may not take enforcement action under the sector- specific Acts if it is satisfied that it would be more appropriate to address the issue under CA98³¹. In such cases, the Authority shall only take account of its duties under the Gas and the Electricity Acts to the extent that they are factors of which the OFT could take account when applying the CA98.
- 4.2 With regards to Articles 81 or Article 82, the Modernisation Regulation requires the national competition authorities of the Member States (including the Authority) to apply Articles 81 and/ or Article 82 when they apply sector -specific provisions. This applies to the extent that the sector-specific provisions predominantly pursue a national competition objective and are applied to agreements or conduct which have an actual or potential effect on trade between Member States. Where an undertaking may have committed an infringement of both Article 81 and/or Articles 82 and of the provisions of sector specific Acts, the Authority will, as a matter of policy, only take enforcement action under Articles 81 and/ or 82.

³¹ See section 28 of the Gas Act 1986 and section 25 of the Electricity Act 1989

- 4.3 The following part of this guideline is about how Ofgem will proceed with a complaint relating to Article 81, Article 82, Chapter 1 or Chapter II prohibitions. It also explains how the Authority intends to use its powers under the Gas and Electricity Acts, Part 4 of the Enterprise Act 2002 and CA98 to ensure that any anti-competitive behaviour is most effectively addressed without undertakings facing ‘double jeopardy’.³²

Decision on whether to commence a CA98 investigation

- 4.4 Once it has been decided that the Authority is responsible for a case³³, Ofgem will attempt as quickly as possible to determine whether the complaint falls within its administrative priority. As part of this process Ofgem will consider whether the case meets the requirements of section 25 of the CA98, that is, that there are reasonable grounds for suspecting that Article 81, Article 82, the Chapter I prohibition and/or the Chapter II prohibition of CA98 have/ has been infringed, and the potential economic effect (including the effect on trade in the case of Articles 81 / 82) of the agreement or conduct in the particular case. To the extent that it is relevant, Ofgem will use its existing knowledge of the issues to determine the nature of the complaint. Where it cannot be determined quickly whether a complaint falls within its administrative priorities, Ofgem may seek information informally from undertakings to decide whether to commence an investigation.
- 4.5 Where there are insufficient grounds for suspecting an agreement or conduct infringes Article 81, Article 82, the Chapter I prohibition and/or the Chapter II prohibition, Ofgem shall not commence a formal CA98 investigation. In such circumstances, Ofgem shall inform the parties bringing the complaint and those to whom the complaint relates of this decision in writing.

³² ‘Double jeopardy’ would occur where an undertaking faced the possibility of being subject to a penalty more than once for the same infringement.

³³ See the competition law guideline ***Concurrent Application to Regulated Industries*** (OFT405) and ***The modernised regime*** (OFT400) on case allocation within the network of the European Commission and between UK NCAs.

Information gathering

- 4.6 When investigating potential infringements under the CA98, the Gas and Electricity Acts or issues under Part 4 of the Enterprise Act 2002, Ofgem may need to seek information from various undertakings and other relevant persons. When requesting information, Ofgem will specify the potential infringement it is investigating and the legal instrument under which the questions are posed. Where more than one of the Authority's powers (Article 81, Article 82, the Chapter I prohibition or the Chapter II prohibition or sector specific powers) is considered to be potentially appropriate, Ofgem may make separate information requests under each of these legal instruments. This will enable Ofgem to decide which specific power(s) are likely to be the most appropriate to address the suspected infringement or non-compliance.
- 4.7 If it becomes clear to Ofgem when conducting its investigation that a particular power is no longer appropriate to the particular case, it will cease to request information under the respective power and will inform the undertaking concerned. Also, where possible, Ofgem will inform an undertaking if a new infringement is suspected after the investigation has commenced, which may affect the powers Ofgem considers could be appropriate to address the suspected infringement(s).
- 4.8 Where information has been gathered using powers under CA98 or sector specific powers Ofgem may use information gathered to investigate other matters under the CA98, the Gas and Electricity Acts, or Part 4 of the Enterprise Act 2002, subject to and in accordance with the provisions of these various Acts. However, where information has been received from the European Commission or an NCA in another Member State, article 12 of the Modernisation Regulation applies. Ofgem may only use this information for the following purposes:

- the application of Article 81 or 82 in relation to the subject matter for which it was collected; or
- the parallel application of national competition law to a case which is being considered under Article 81 or 82 and will lead to the same outcome.

Making representations

- 4.9 Section 31 of the CA98 requires the Authority, if it proposes to make a decision that Article 81, Article 82, Chapter I or Chapter II prohibition has been infringed, to give written notice to the person or persons likely to be affected by the proposed decision and to give that person or persons an opportunity to make representations.

Enforcement action

- 4.10 As early as possible in the course of an investigation where infringements of more than one provision are under consideration, Ofgem will determine the most appropriate power(s) to remedy the competitive concerns identified.
- 4.11 Section 28 of the Gas Act 1986 and section 25 of the Electricity Act 1989 provide that the Authority shall not make a provisional or final order, or confirm a provisional order under either sector- specific Act, if it is satisfied that the CA98 is the most appropriate way of proceeding to address the issue. Section 30A(2) of the Gas Act 1986 and section 27A(2) of the Electricity Act 1989 prevent the Authority levying a financial penalty in a matter where it is satisfied that it is more appropriate to proceed under CA98. The Authority will therefore not levy a financial penalty under the Gas or Electricity Act where a financial penalty under CA98 has already been levied.

4.12 With regards to Articles 81 and 82, the Modernisation Regulation requires the Authority to apply these provisions as well as national competition law (as noted in section 2). It is possible that certain provisions of the Gas and Electricity Acts could be deemed an application of national competition law and could relate to agreements or conduct which have an actual or potential effect on trade between Member States. Therefore, as a matter of policy, where the Authority is satisfied that Articles 81 and/or 82 apply, Ofgem will not take enforcement action under the Gas and Electricity Acts. However, the Authority retains its discretion to choose between taking enforcement action under the Gas and Electricity Acts and under competition law (to the extent that Articles 81 and/ or 82 do not apply).

Accepting Commitments

4.13 Under CA98 as amended, the Authority may accept binding commitments from undertakings suspected of infringing Article 81, Article 82, Chapter I or Chapter II prohibitions. The Authority is required to have regard to the OFT's guidance when considering whether to accept commitments offered.³⁴ The Authority is only likely to accept commitments in cases where the competition concerns are readily identifiable and where the concerns are fully addressed by the commitments offered. The Authority may accept commitments in respect of some of its competition concerns and continue its investigation in respect of other concerns arising from the same agreement or conduct.

4.14 In conformity with the guidance, the Authority will not, other than in exceptional circumstances, accept binding commitments in cases involving secret cartels between competitors which include:

- price-fixing;
- bid-rigging;
- establishing output restrictions or quotas;
- sharing markets; and/or

³⁴ See competition law guideline *Enforcement* (OFT407) section 4 for further information.

- dividing markets;
- nor in cases of a serious abuse of a dominant position.

Imposition of penalties

- 4.15 The Authority is required to have regard to the OFT's guidance on the appropriate level of a penalty, prepared under Section 38 of the CA98, when setting a penalty in respect of an infringement of Article 81, Article 82, the Chapter I prohibition and/or the Chapter II prohibition. In accordance with the methodology in the OFT's guidance, the Authority will take into account penalties imposed under the Chapter I or II prohibition when setting a penalty under Articles 81 or 82 in respect of an agreement or conduct that infringes both Articles 81 or 82 and the Chapter I or II prohibition. The Authority will also take into account penalties imposed by the European Commission, or by a Court or an NCA in another Member State, when setting the amount of penalty with regard to an agreement or conduct which infringes Articles 81, Article 82, the Chapter I prohibition or the Chapter II prohibition.
- 4.16 In accordance with section 30A(2) of the Gas Act 1986 and section 27A(2) of the Electricity Act 1989, the Authority will not impose a penalty under these Acts if a penalty is being imposed under CA98. As a result, the Authority will not have the ability to take into account its duty under the Gas Act 1986 and the Electricity Act 1989 to have regard to the ability of licensees to finance their activities, since this is not a factor to which the OFT could have regard when applying the CA98.
- 4.17 When publishing any decisions following investigations, Ofgem will have regard to market sensitive information when deciding on the timing of announcements, as is currently the case for some announcements, for example, price control proposals. This is in accordance with Ofgem's voluntary agreement with the London Stock Exchange.³⁵

³⁵ The voluntary agreement was published by the London Stock Exchange on 2 January 1996.

Compliance

- 4.18 When setting penalties, in accordance with the OFT's guidance, Ofgem will consider the extent to which the undertaking has taken reasonable steps, bearing in mind its resources, to put in place programmes to ensure compliance with the requirements of the CA98. The OFT has produced a range of material to assist companies in developing compliance programmes.³⁶
- 4.19 Ofgem expects companies within the gas and electricity sectors to have implemented corporate compliance programmes. Ofgem expects that such programmes will minimise the risk of infringing the prohibitions by systematically ensuring that all relevant employees are sufficiently knowledgeable about the provisions of the law, and that they will put that knowledge to good effect.
- 4.20 The details of compliance programmes are likely to vary between companies, particularly with regard to their resources. A minimum programme might be expected to comprise at least four elements, with the depth with which each element is covered being dependent on a company's resources. The four elements are described below:
- support and personal commitment from senior management, both visible and continuous, will be essential to ensure that compliance is treated with the importance it deserves and to ensure acceptance by other employees who will be more receptive to an initiative which is seen to be applied equally to senior managers;
 - appropriate compliance policy and procedures will include a clear policy commitment to comply with the legislation by not engaging in anti-

³⁶ These can be obtained directly from the OFT.

competitive behaviour or condoning such behaviour in other parties. This policy could feed through into personal development performance objectives, contracts and disciplinary arrangements. Procedures could include a framework within which employees can check whether or not a particular contract or deal is in breach of the law. This might involve a nominated expert or compliance officer. An effective mechanism to communicate the policy and procedures supported by a review process is a necessity, part of which is likely to be a manual or handbook provided to all relevant staff;

- training will form an essential aspect of any compliance programme. It should be designed to ensure that all relevant staff are given proper training on both the law and the company policy and procedures. It will not be sufficient to limit training to the implementation phase. It must be offered on a regular basis to reinforce and update the message. Such training is likely to be an essential element of any induction programme for new staff; and
- evaluation of the effectiveness of the overall compliance programme is the final essential ingredient. This might include informal feedback at an individual level and perhaps as part of individual performance appraisal. At a broader level formal audits, both with and without warning, could be undertaken. A transparent approach to the correction of any revealed infringements would serve as a constant reminder to employees that their business dealings are subject to review and will thereby deter complacency.

Informal Guidance and Opinions

- 4.21 Following a request from an undertaking, Ofgem may give informal confidential advice on the application of Article 81, Article 82, the Chapter I or Chapter II

prohibitions with regards to specific cases. Ofgem will only give advice to the extent it is able to do so based on the information provided. Where information is insufficient to give advice on certain aspects of a request, Ofgem may decide not to give advice or to only give advice on the general principles of CA98 as opposed to issues raised by the specific case. Any views expressed will be confidential and will not be legally binding.

- 4.22 Where a case raises novel or unresolved questions about the application of Article 81, Article 82, Chapter I or Chapter II prohibition, Ofgem may agree to publish a non-legally binding opinion. Ofgem will only publish such an opinion where there is insufficient precedent in EC or UK case law, decisions or guidance; and where a wider audience would benefit from a published opinion. An opinion would not bind the Authority in any subsequent assessment of the issues raised. Ofgem will follow the approach to giving opinions set out in competition law guideline *The modernised regime* (OFT400).

5. Transitional Arrangements

- 5.1 Provisions for the transition from pre- CA98 competition law to the CA98 (relating to the Chapters I prohibitions) are set out in Schedule 13 to the CA98 and *The Competition Act 1998 (Office of Fair Trading's Rules) Order 2004 S.I XXX*³⁷ (OFT's Rule's). Further details are provided in the competition guideline *The modernised regime* (OFT400). Certain provisions in Schedule 13 to the CA98 relate particularly to provisions of the Gas Act 1986 or the Electricity Act 1989. There were no transitional periods available in respect of the Chapter II prohibition, which applied to the behaviour of dominant undertakings immediately from 1 March 2000.

Agreements benefiting from the transitional periods

- 5.2 Schedule 13 to the CA98 provides for transitional periods for particular agreements in the electricity and gas industries. In summary, arrangements under the Restrictive Trade Practices Act will be retained till 2005, in that these agreements will be exempt from the application of that Act as will similar agreements reached before 2005.
- 5.3 There are three categories of agreement that benefit from the transitional periods in the gas and electricity industries:
- agreements which on 1 March 2000 were exempt from the Restrictive Trade Practices Act by virtue of section 100 of the Electricity Act 1989 or section 62 of the Gas Act 1986 respectively. These agreements received a five year transitional period from 1 March 2000;
 - agreements made during the five year period beginning on 1 March 2000 which are of a type that would have been exempt from the Restrictive

³⁷ OFT Rules are still to be laid before Parliament.

Trade Practices Act had it not been repealed. These agreements receive a transitional period applying from the date that the agreement is made and for the remaining part of the five year period; and

- agreements specified in transitional orders by the Secretary of State. These will receive a transitional period applying from the date specified in the order and, again, apply for the remaining part of the five year period beginning on 1 March 2000.

5.4 The benefit of these transitional periods will be lost if the agreement is varied in such a way that it ceases to be one to which the Restrictive Trade Practices Act would not have applied or one to which a transitional order applies.

5.5 The question of whether or not the Restrictive Trade Practices Act does or does not apply to an agreement requires, in some instances, an assessment by the Authority of the extent to which an agreement is likely to have a significant effect in preventing, restricting or distorting competition.³⁸ In making such assessments during the transitional period the Authority will, to the extent appropriate, take into account matters addressed in this guideline.

Extending or terminating the transitional period

5.6 The Authority may extend for up to six months the transitional period during which the Chapter I prohibition will not apply to an agreement. The Authority may do so either on application by one of the parties to the agreement or under the Authority's own initiative. More details of the procedures in relation to the extension of transitional periods are given in the ***OFT's Rules***.

³⁸ For example, The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996, SI 385/96 or the Electricity (Restrictive Trade Practices Act 1976) (Exemption) Order 1993, SI 912/93.

- 5.7 It is unlikely that an agreement, which the Authority considers would infringe the Chapter I prohibition of the CA98, would be granted an extension unless there are good reasons why an extension is required – for example, the agreement is being re-negotiated or is due to expire shortly after the end of the unextended transitional period. In deciding whether to extend the transitional period the Authority will apply the approach described above and set out in the competition guideline *The modernised regime* (OFT400).
- 5.8 The Authority may by direction terminate the transitional period in relation to any agreement if either:
- the Authority has required any party to that agreement to give it such information about that agreement as it may require and, at the end of the period specified in the *OFTs Rules* for providing such information, any party has failed, without reasonable excuse, to do so; or
 - if the Authority considers that the agreement would, but for the transitional period, infringe the Chapter I prohibition.
- 5.9 Any direction terminating a transitional period is subject to revocation, before it takes effect, either by the Authority or the Secretary of State.

