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Dear Mr Marlee

**Addressing market power concerns in the electricity wholesale sector – Initial policy proposals**

Consumer Focus strongly supports this initiative, which is long overdue. This letter summarises our key points and more detail is contained in Annexe One, which is attached.

The initial policy proposals document contains unambiguous evidence of abuse by generators to the detriment of customers, and this requires an urgent regulatory response. Costs have already been passed through to consumers--Ofgem has estimated that these may have been as high as £125mn in 2008-09 as a result of higher than necessary transmission constraint costs alone—and this position is set to continue and could deteriorate further.

We believe that the consultation sets out a timely and proportionate set of regulatory responses, and we support Ofgem's preference for a market power licence condition, backed up by changes to market rules.

The licence condition must not be too narrowly defined, as it needs to extend beyond situations involving transmission constraints. To help better manage perceptions of increased regulatory risk, the condition should be accompanied by suitably drafted guidelines and an appeals mechanism.

It is not obvious from the document why legislation is needed to deliver an appeal mechanism. If it is not needed to achieve this outcome, then we prefer the collective licence modification route on grounds of speed, as any referral to the Competition Commission would open up the prospect of an independent review of the market arrangements.

Our only point of real disagreement with the document is that we consider the proposed action on market rules should be an integral feature of the adopted solution and should not be discretionary or pursued to a different timescale. In our view many of the changes to market rules discussed in the document have merit in their own right to deal with identified deficiencies in the current arrangements. As Ofgem acknowledges in a number of places in the document, work underway or in progress will not fully address all the concerns that have been identified. These additional steps should also help mitigate the on-going and new market power concerns identified by Ofgem in the electricity sector.

Consumer Focus believes the package of measures could be improved in two important respects.

First, we do not prefer a regime based on ex ante screening because of its complexity and because of its lack of compatibility with the likely EU market abuse framework. However we believe that monitoring of the GB electricity market needs to be dramatically increased. The British market requires much more comprehensive monitoring *and* reporting of market activity and behaviour on a much more systematic basis than currently occurs. In turn increased market transparency will significantly complement the measures advocated by Ofgem and support current objectives to empower consumers.

Second Consumer Focus also believes that the market rules should be under-pinned by clear standards of participant behaviour, very much in concept along the lines of general aims that Ofgem has proposed as part of its draft retail remedies package in response to the price probe. These principles or aspirations could be included as a preamble in the generation licence and could be invoked in cases of enforcement. We also consider that market conduct rules associated with the BSC in particular could complement and enhance the proposals set out in the consultation.

Please let me know if you would like to discuss this response. I can be contacted on 020 7799 7936 or by email: [Robert.Hammond@consumerfocus.org.uk](mailto:Robert.Hammond@consumerfocus.org.uk)

Yours sincerely



**Robert Hammond**  
**Head of Regulated Industries**

## **Annexe One**

### **Addressing market power concerns in the electricity wholesale sector Initial policy proposals Response by Consumer Focus**

#### **CHAPTER: One**

#### **Question 1: Do you agree with our analysis of market power concerns in the GB wholesale electricity sector?**

Yes. Market power is a real and recurrent problem, and its exercise is aggravated by the limited scope for demand response and limited information made available to consumers on prices. The proposed remedial steps need to be taken urgently owing to the adverse impacts already being experienced by existing consumers. We concur with Ofgem's comments that the GB wholesale market is "increasingly vulnerable to undue exploitation of market power" and that the factors exacerbating the scope [for exercise] are likely to persist and potentially worsen in the short-to medium term" (pp9-10).

The various industry developments flagged by Ofgem in the document may reduce the scope for exercise of market power in some instances, but they will by no means eliminate the problems that Ofgem documents and which arise from the unique nature of electricity (and which is different to other commodities) and the current rules. The current rulebook means generators will often be called on irrespective of the cost, and they can also be compensated if the system requires them not to run. Further, the highly concentrated nature of the industry structure means that scale players will always be able to optimise their performance within any given set of rules, and based on the examples given by Ofgem there is clearly a fine line between testing the parameters of the rules and abusing them.

The current defects, which are inflating consumer bills probably by many millions of pounds more than the costs of constraints highlighted by Ofgem, arise from a range of causes. These include excessive market concentration, inappropriate market rules and limited surveillance, and all these areas need to be tackled. As Ofgem notes, the GB market is likely to be increasingly vulnerable to undue exploitation of market power, which will aggravate the other defects in the rulebook that have been identified.

#### **Question 2: To what extent should further policy intervention be progressed or are there alternative approaches that can be adopted for dealing with the concerns?**

Chapter 1 sets out several measures currently in process that should go some way towards mitigating the potential for undue exploitation of market power. They include actions by National Grid to address constraints costs (such as administered pricing of inter-trips and locational BSUoS) and change proposals arising from the transmission

access review. These proposals require careful consideration of the detail, and proper impact assessments should be carried out by Ofgem, but in principle we support the need to further evaluate these measures.

Consumer Focus believes the package of measures could also be improved in two important respects.

First, we believe that market monitoring needs to be dramatically increased. The British market requires much more comprehensive monitoring *and* reporting of market activity and behaviour on a much more systematic basis than occurs at present. There are unclear accountabilities within the market for surveillance. Current reporting is partial and haphazard. Increased market transparency will significantly complement the measures advocated by Ofgem and support important objectives to empower consumers. It would also help prospective new entrants. While either Elexon, National Grid or Ofgem could exercise this role, the natural ownership should be with Ofgem given the wider surveillance role it exercises.

Second we also believe that the market rules should be under-pinned by clear standards of behaviour. Development of market conduct rules associated with the BSC in particular would also complement the proposals set out in the consultation. Ofgem references Nord Pool, which already has market conduct rules and ethical guidelines that inter alia prohibit “market manipulation” and “inside trading”; the New Zealand electricity market has rules for dealing with “undesirable trading situations”.

Both these issues should be examined, and we would like to see this matter explored further in the autumn consultation. As we have explained in the covering letter we think standards of conduct should be introduced to the generation licence and possibly also in the major codes.

## **CHAPTER: Two**

### **Question 1: To what extent do you think that changes to SO and TO incentives and/or changes to other market arrangements are likely to be effective in addressing the concerns discussed in Chapter 1?**

It is clearly important on grounds of market efficiency to implement stronger incentives (and penalties where necessary) on the transmission licensees to manage better constraints that arise from their outages and to achieve network availability at least overall cost to the consumer. Ofgem cites a number of examples where the current relationships are dysfunctional. It is not clear to us, given this situation and the current licence obligations to operate networks efficiently, why transmission licensees have not brought forward change proposals to tackle inefficiencies under the current rules.

The options outlined in chapter 2 all appear to have merit and require fuller development and assessment. However we think the following proposals with regard to changes to TO-SO arrangements have particular merit, probably in combination:

- ensure there is proper engagement of the SO in setting the TOs' investment plans;
- make it mandatory for TOs to commit to fix the outage period that they have notified to the SO, with the imposition of penalties where the TO fails to do so;
- permit the SO to agree with TOs to adjust outage plans to help reduce constraint costs (we see this as complimentary, not an alternative as suggested at p22); and
- in doing so the parties could agree a share of an appropriate portion of the savings realised (i.e. a form of incentive scheme) provided they are real savings (that is, they are not a function of over-prudent forecasts).

Turning to the Balancing Mechanism and pricing, there are a range of aspects of the current operation of the physical market flagged in Ofgem's recent plan and strategy that also need to be considered in the context of mitigating constraints, including later contract notification and the possibility of shortening Gate Closure (both of which would tend also reduce imbalance risk, as well as removing rigidities under the current rulebook).

We would also like consideration of how representative indicative prices can be formulated to improve information to market participants on likely market conditions and potential supply bottlenecks. However, in response to Ofgem's specific question, we do not consider that introduction of a cleared auction of itself would help.

However as Ofgem implies these (and related) changes will not in isolation have a direct impact on the situations where generators can abuse their dominance compounded by the specific locational or timing requirements of the SO, although they may reduce incentives to behave in this way. Consequently they would only constitute one element of a complete solution.

Question 2: Are there any other changes to existing market arrangements that Ofgem should consider?

See our response to chapter 1, Q2 for our comments on increased market surveillance and market conduct standards. We have also flagged in this section of the response our initial thoughts on indicative prices.

## **CHAPTER: Three**

### **Question 1: To what extent do you think increased transmission investment is a feasible option and likely to be effective in addressing the problem?**

Over time increased transmission investment should help, provided it is properly targeted to address constraint issues, and consumers are of course already funding extensive network reinforcement programmes. However, over shorter time-horizons current bottlenecks on the transmission system are likely to continue. Furthermore congestion will always be a risk on some parts of the upgraded system at particular times as power flows change in response to fuel commodity prices shift, and increased investment of itself will not address shortcomings that arise under the market rules.

We conclude that increased investment will help, but this too needs to be part of a more wide-ranging solution.

### **Question 2: To what extent do you think that the other asset related options discussed are likely to be effective in addressing the problem?**

Industry concentration continues to be a problem in some areas, and Ofgem demonstrates this unambiguously for flexible plant in Scotland (pp25-26). It follows that greater competition in these problematic areas could mitigate this.

However Ofgem is right to point out there are times when low concentration can lead to opportunities for the exercise of market power. More generally remedies need to be framed that can be applied across the market. We also believe it is counter-intuitive to change industry structure to address problems that arise from defects under the market rules—unless of course changes to the market rules would create upheaval or significant off-setting detriments to consumers.

We conclude that physical or virtual divestment is not a proportionate response to address the defects.

### **Question 3: Are there other asset-related remedies that Ofgem should consider?**

Yes. We would like there to be full separation of transmission from generation in Scotland. We do not see any need for derogations under the third energy package, and clear ownership separation would pre-empt the need for further action.



## **CHAPTER: Four**

### **Question 1: Is a licence condition on generators appropriate? If so, do you have views on what form of condition is the most appropriate?**

Yes. Ofgem has explained why current powers available to it are insufficient and raise difficulties in application, and we consider that the ex post market power licence condition (MPLC) has considerable merit.

The MPLC needs to be broadly defined to pick up a wide range of potential behaviours but centring on the undue exploitation of market power (the high level obligation described on p29, not the licence condition with narrow scope). While an ex post arrangement has merit, though this should be in the context of more orderly disclosure of relevant information to the market.

### **Question 2: How important would a formal appeals mechanism be?**

To complement a high level obligation there would need to be a formal appeal mechanism for the proposed arrangements to work and be seen to work fairly.

In terms of possible vehicles, see chapter 5, Q1.

We support the proposal for an Information Retention and Disclosure Licence Condition (p30).

### **Question 3: Is an ex-ante price framework an effective tool? If so, do you have any views on what would be the most appropriate form?**

Yes, it could be, though it would represent a fundamental shift in sectoral regulation and the regulator's (and/or Elexon's) relationship with the market. It is not clear why Ofgem considers this approach might be less complex and intrusive owing to the need to develop an appropriate screening approach. Experience in North America shows that there are many ways in which screening methodologies can be developed and the associated mitigation methods that have to be defined. In contrast we would argue that an ex post approach such as an MLPC if it acts as the necessary deterrent could constitute a light touch.

At the same time we agree with the various down-side issues associated with an ex ante approach flagged by Ofgem (upfront development costs, inflexibility, deterrence of truly price responsive behaviour, heavily interventionist).

In conclusion, while an ex ante price framework might represent an improvement on the current arrangements, we prefer an ex post MPLC. It can and should be developed in further detail now, and implementation should not be contingent on any major policy review.

**Question 4: Are there other specific mechanisms that will effectively address the issues identified?**

No.

**CHAPTER: Five**

**Question 1: Do you have any views on the preferred mechanism for implementation?**

The changes should be pursued through a collective licence modification (CLM), though we suspect this will inevitably be referred through to the Competition Commission even in the absence of proposed structural remedies. Ofgem implies that an appeal mechanism might only be available if the arrangements were legislated for, but we cannot see why that should be.

On balance, while we would prefer early implementation, there is also merit in obtaining from the Competition Commission an independent view on the market arrangements. Consequently the CLM route also has merit provided that an appeals route can be satisfactorily be defined.

**CHAPTER: Six**

No question