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FAO Ian Marlee
Director, Trading Arrangements
Ofgem
9 Millbank
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8th May 2009

Dear Ian,

Addressing Market Power Concerns in the Electricity Wholesale Sector – Initial Policy Proposals

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. We are pleased to have this opportunity to respond to Ofgem's consultation regarding proposals to address market power in the electricity wholesale sector.

The consultation document states that Ofgem is concerned that the wholesale electricity sector is vulnerable to undue exploitation both: (a) when there are constraints on the electricity transmission system (which limit the amount of electricity that can flow between certain locations); and (b) more generally at times of system tightness. In our view these two concerns are quite different. In the first case, where a party enjoys a position of market power as a result of its ability to act independently of its competitors and customers in a narrowly defined market, then it is quite appropriate for the regulator to apply its competition law powers in the case of anticompetitive conduct (EC and/or UK as appropriate). In the second case, we note that it is normal in any competitive market for prices to rise where demand exceeds supply (e.g. where the system is tight / close to gate closure). If, however, such conduct is contrary to, or a manipulation of, the rules governing the market, Ofgem already has significant enforcement powers or can propose that the rules be modified to prohibit such manipulation. We would be opposed to any regulation which would seek to dampen normal and rational commercial behaviour.

Our full response to the specific questions highlighted by Ofgem can be found in Appendix 1 to this letter. However, we would like to highlight the following points:

1. Companies currently operating in the GB electricity market are aware of, and subject to, competition legislation. Competition law is now well developed as a matter of law and economics and can be enforced by the European Commission as well as Ofgem and the OFT. Competition law has been, and can be, tested in the courts; most importantly, companies can reasonably take a view as to what is considered "acceptable behaviour" and, therefore, lawful under such legislation. Ofgem's proposals to introduce a Market Power Licence Condition, along with previous attempts to introduce a Market Abuse Licence Condition ("MPLC"), suggests that Ofgem has a different view to that of other competition authorities as to what constitutes market dominance and abuse. Drax believes that it is not necessary to develop such novel regulatory obligations in the light of the prevailing market context in Great Britain and that enforcement should, rather, be made under the appropriate and accepted competition law powers.

2. With regards to the issues surrounding Scottish boundary constraints, Ofgem appear to have been unable to take an infringement decision under competition law (abuse of dominance), perhaps due to either (a) an abuse not having occurred, or (b) Ofgem failing to gather the required evidence or undertake the appropriate analysis. If the former is true, then these proposals give the impression that Ofgem does not consider the Competition Act to be fit for purpose, in which case Ofgem needs to present convincing evidence of the need for regulatory change; we do not think Ofgem's consultation presents this evidence. However, if it was the

latter, Ofgem need to consider how such investigations should be more effectively pursued; this may, for example, involve working more closely with the OFT. Like the OFT, Ofgem has a broad discretion as to the cases it chooses to investigate from time to time. We are not, however, aware that these prioritisation criteria extend to excluding the application of the Chapter II prohibition to the wholesale electricity market. We accept that electricity has different characteristics from other products. However, all products are distinct in some way; electricity is not so different to be placed outside the scope of the normal application of competition law.

3. It is the nature of GB electricity markets that prices remain volatile; swings from high to low prices occur from one half-hour period to the next as prices follow changes in demand. A large proportion of these periods do not provide significant margin to cover fixed costs, meaning that high price / high margin periods are essential to create an effective market; capping high prices by formula whilst ignoring low prices would be a dangerous position for Ofgem to take.

4. Save for a single footnoted reference, it is clear from the proposals in the consultation document that Ofgem considers market abuse only takes place when generators demand high prices for their commodity; however, competition law takes a much more rounded, and in our view a much more reasonable, position recognising that abuse can be seen in low priced periods, i.e. parties selling generation below cost and forcing out competition.

5. It is notable that the proposals ignore the role of vertical integration and, in particular, do not consider the buy side of a market as a potential source of abuse. The increasing concentration in the retail market is a much greater threat to market liquidity and, in the long term, consumer prices.

6. The introduction of a Market Abuse Licence Condition was attempted in 2000 and was subsequently rejected by the Competition Commission. Not long after the decision, a large number of generating plants were hit by financial difficulties; given the majority of such plants were independent generators, it appeared that the Competition Commission was justified in making its decision. It is worth noting that only one vertically integrated company collapsed at that time (TXU); the other parties survived, managing to purchase the independent generation businesses at greatly reduced prices. A proposed MPLC would likely impact on non-vertically integrated operators disproportionately due to their inability to use retail margins as a way of mitigating regulatory risk at the generation level.

In summary, Ofgem already has very broad enforcement powers under competition law. It appears that a licence modification is sought because of difficulties in its investigation of the Scottish generators. However, there does not appear to be any evidence of more widespread problems of anticompetitive behaviour in the market (other than speculation regarding market developments exacerbated by transmission issues). We therefore oppose any attempt to introduce a MPLC by way of licence modification, particularly one which is drafted in sufficiently broad terms to encapsulate future forms of *"market abuse"* which are so remote they have not yet been identified by Ofgem.

We look forward to viewing both the industry's and Ofgem's response to this consultation. In the meantime, please do not hesitate to contact me should you wish to discuss our views.

Yours sincerely,

By email

Stuart Cotten

Regulation
Drax Power Limited

Appendix 1: Drax response to the consultation document questions

1: Introduction

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

No, it has not been adequately demonstrated that the exercise of market power is a problem in the wholesale electricity sector. The consultation document is conspicuously lacking in any detailed evidence to the effect that there is a problem with *"market power"* in the GB wholesale sector. The consultation document notes Ofgem's concern that the GB wholesale electricity market is *"increasingly vulnerable"* to undue exploitation of market power; however, the only concrete domestic example is the recent Competition Act investigation into Scottish Power ("SP") and Scottish & Southern Energy ("SSE"). The remaining concerns, which appear to relate to anticipated developments in the market (including an increasingly overburdened transmission system), are largely speculative and uncertain in scope. Drax is unsure of how the arguments in favour of a Market Power Licence Condition are any more convincing now than they have been on previous occasions in which Ofgem has sought to introduce similar regulatory provisions.

The consultation document refers to a review undertaken by the Competition Commission ("CC") into, amongst other things, its 2001 report rejecting the proposed Market Abuse Licence Condition ("MALC").[1] The CC's evaluation report is quite clear that the decision to reject the MALC was the correct one in the circumstances. The CC's evaluation report discusses in some detail how the market has developed in the period since 2001 by reference to prices, market concentration and the views of Ofgem, and concludes (at paragraph 4.31) that "*it seems reasonable to conclude that the electricity wholesale market in England and Wales has been significantly more competitive since 2000*". Moreover the CC notes that the MALC was designed to operate when generators had the ability and incentive to exercise market power but "*it seems likely that opportunities for doing so have been scarcer since 2000 than they were before it*".

The consultation document describes the wholesale market as currently being increasingly vulnerable to market power issues and Ofgem appear to be attempting to "fix" a market power issue. It is acknowledged that there are issues with transmission constraints in GB. However, no convincing argument has been presented by Ofgem to suggest that the wholesale generation market has deteriorated in the period since the CC's evaluation report (i.e. January 2008) to such an extent that an additional layer of wide-ranging and heavy handed intervention in the form of a MPLC is required. The absence of a right of appeal on the merits would also be of concern given the potentially grave implications of a breach of a licence condition for operators.

On the contrary, the evidence presented in the consultation document points towards a specific problem that may exist in relation to transmission constraints between England/Wales and Scotland. This was the focus of Ofgem's now closed investigation into SP and SSE. Indeed, it is suggested in the consultation document that the examples of undue exploitation of market power which are given are particularly (although not exclusively) likely to arise in the context of constraints on the GB transmission system (pages 8-9 of the consultation document). To the extent that there are problems in the market that stem from transmission issues and/or the characteristics of the market in Scotland, we believe that, while generally unhelpful to UK generation, these problems are not reflective of more endemic or systematic market power concerns on the wholesale market.

We believe that any specific regulatory action can be targeted more effectively where problems arise. In this regard Ofgem already holds concurrent Competition Act enforcement powers and the Chapter II prohibition in the Competition Act already prohibits the "abuse" of a "dominant position" by undertakings in the UK.

"Dominance" for the purposes of competition law is a well known concept characterised as a position of economic strength enjoyed by an undertaking, which enables it to prevent effective competition being

[1] Evaluation of the Competition Commission's past cases, Competition Commission, January 2008: http://www.competition-commission.org.uk/our_role/analysis/evaluation_report.pdf.

maintained on a relevant market, by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers.[2]

The notion of an "abuse" of dominance is subject to a great deal of legal and economic precedent. Behaviour such as excessive pricing, refusals to supply and pricing discrimination are accepted categories of abuse. It is important to note, however, that the notion of an "abuse" is flexible enough to cover potentially anticompetitive behaviour in the wholesale electricity market. Ofgem has now successfully invoked the Chapter II prohibition in its decision imposing fines on National Grid in respect of metering services. Similarly, the European Commission enforces Article 82 EC in the electricity sector where appropriate. In November 2008 the European Commission accepted binding commitments from E.ON as to its future behaviour following concerns that E.ON had abused its dominant position by withdrawing available generation capacity with a view to raising electricity prices to the detriment of consumers. The European Commission has also carried out inspections at EDF in respect of its alleged behaviour on the French wholesale electricity market. These cases demonstrate that competition law alone can be an effective tool to address market power concerns in the electricity sector.

We would therefore argue that an additional concept of *"undue exploitation of market power"* is entirely unnecessary. To the extent that there are concerns regarding the exercise of market power in specific circumstances, Ofgem, the OFT and in some instances the European Commission already have an effective enforcement power in the form of Article 82 EC / Chapter II of the Competition Act 1998. As the CC noted in 2001, Ofgem is in effect required to apply competition law if it is the most appropriate way of proceeding. To the extent that the MPLC constitutes a quasi-Chapter II prohibition operating at a lower threshold and/or to different standards, we consider it to be a disproportionate regulatory intervention which is unnecessary in the circumstances of the market. Moreover, given that the problems identified by Ofgem stem from transmission constraints, the proposed MPLC is arguably misdirected and liable to discourage market entry thereby ultimately leading to higher prices for consumers.

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?

If Ofgem believes that there is, or has been, potential for the abuse of market power in the GB wholesale electricity market, we consider that the most appropriate means of enforcement is via existing competition enforcement powers. As we have set out above the concept of abuse of dominance is well established in both law and economics. It is also operative across all sectors of the economy, including sectors featuring 'bottleneck' issues and complex markets (e.g. telecoms). These factors confer greater legal certainty on operators in the GB market and maintain, to a degree, a level playing field with competitors across Europe who are also subject to competition law.

In this regard we note that the CC evaluation report of January 2008 addresses and rejects the argument that conventional competition law enforcement powers are in some way not well-suited to dealing with the abuse of market power in the electricity sector. The CC states that "*as an economic proposition, there would be no difficulty in arguing that a small generator might have substantial market power at peak times*". By analogy it must be the case that a generator can have market power within the meaning of the Chapter II prohibition in narrow circumstances, such as when the system is constrained or at certain times of the day.

Moreover, the CC addressed the argument that competition enforcement is too slow. The CC noted that this factor was present across all markets but is reflective of the fact that Chapter II is enforced ex post "*and might therefore be expected to have beneficial effects principally through deterrence*". This deterrent effect takes the form of potentially large fines as well as the ability of the regulator to impose binding undertakings as to future behaviour and/or structural remedies (see for example E.ON's commitments to the European Commission). Furthermore, third parties are able to claim damages in the Competition Appeal Tribunal in "follow on" actions for losses incurred as a result of anticompetitive conduct.

[2] See the European Commission's *Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings* at paragraph 10.

We are likewise unconvinced that conventional competition law enforcement is inadequate in the electricity sector. In our view, problems of abuse of market power can be addressed through the judicious use of Ofgem's investigatory and enforcement powers (whether alone or in conjunction with the OFT). The difficulties of applying the Chapter II prohibition in one specific case, namely against SP/SSE, which may have involved case specific issues, should not undermine Ofgem's application of competition law powers more generally to the GB electricity sector.

In our view, the industry would be better served by policy intervention focusing on (a) dealing with transmission constraints as a matter or priority, (b) increasing transparency and liquidity, (c) requiring companies to produce regulatory accounts, (d) reducing the level of concentration at the retail level, and (e) related to that, reducing the level of vertical integration in the market.

As an aside, we would note that non-vertically integrated operators are likely to be affected disproportionately by the proposed MPLC as the vertically integrated operators may well be able to make use of their retail margins instead of exposing themselves to regulatory risk at the generation level.

Chapter 2: Changes to existing market arrangements

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?

Drax supports the general principle of initiatives that aim to align SO and TO incentives in order to ensure network outages are planned in a way that helps to minimise constraint costs; however, the SO and TOs may be in a better position to comment on what they currently do to ensure that they reduce costs and what could be done to improve this process.

With regards to changes to other market arrangements, we believe that administered prices would dangerously interfere with the concept of a competitive market and would meddle with the signals that such markets must give in order to encourage investment (whether this is the traded market or the Balancing Mechanism). Any proposal for price capping under an administered prices regime should be accompanied with a proposal for protection against low prices, in order to afford protection to all areas of the market.

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

No comment.

Chapter 3: Changes to existing assets and/or ownership of assets

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

The introduction of BETTA has ultimately lead to the constraint cost issues affecting the Cheviot boundary, where the volume of TEC sold exceeds the network's capability to export across the boundary; this is an accident of history. Ultimately, the solution would be to invest in network upgrades to increase the export capability across this boundary to an "optimum level", i.e. where National Grid believes that there is the correct balance between infrastructure built and economical constraints.

However, as identified in the consultation document, wider network upgrades do take considerable time to plan, gain consents and then build. The most frustrating element appears to be the planning consent process, which delays the process considerably, although this issue is currently in the process of being rectified by the Government via the introduction of the IPC.

It may be an idea to review National Grid's incentives to ensure that they have the ability to take a more pro-active approach to network infrastructure construction. Whilst this will not provide a short-term resolution to the constraint issues created under BETTA, it may help to ensure that similar situations do

not occur elsewhere in the future, particularly with the introduction of an Interim Connect and Manage scheme.

In the meantime, Ofgem should focus its enforcement priorities on this sector and take decisions under Chapter I and/or Chapter II, as required, to ensure deterrence. We do not consider that competition law enforcement should be set aside because it is difficult to apply in the electricity sector, as this would undermine the effectiveness of Ofgem's concurrent competition enforcement powers.

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

It is unclear as to whether physical or virtual divestment would help the situation in Scotland. Whilst divestment would increase the number of parties behind the constraint, the number of parties would not increase significantly due to the fact that there is only a small number of large power plants behind the Cheviot boundary; i.e. it would all depend on (a) the plant that is divested, (b) the size of the plant (in MW), and (c) how many new competitors are introduced.

Plus, a question would have to be raised over the demand by other parties to buy ageing plant in an area that could potentially be subject to initiatives such as price capping (with no protection against low prices), should constraint costs not lower significantly after divestment has occurred.

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

If Ofgem wish to make it easier to detect and monitor potential abuse, they should concentrate on simplifying the market through effective separation of licensed activities. This could involve licence conditions that either (a) prohibit vertical integration, or (b) at the very least prevent cross-subsidy between generation and retail businesses.

Chapter 4: Specific mechanisms for addressing market power concerns

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

Drax does not believe that a new licence condition is necessary or appropriate, as parties that behave abusively in the market are subject to Ofgem's competition law enforcement powers. Moreover, we consider that there are likely to be significant impediments to the imposition of a new licence conditions in the form of the MPLC. We note the following:

a) The CC rejected the proposals for a Market Abuse Licence Condition in 2001 on the basis that the MALC was unnecessary in the light of impending market developments. The CC concluded that the MALC "*would cause uncertainty, because of the difficulty of distinguishing between abusive and acceptable conduct, and would risk deterring normal competitive behaviour*";

b) It is our understanding that Ofgem attempted a second MALC proposal that was ruled out by the, then, DTI;

c) The CC's review of the MALC inquiry referred to above has confirmed that the CC had been correct in rejecting the MALC in 2001. The CC notes that Ofgem itself considers that the GB electricity market is more competitive than it was. In addition, the EU sector inquiries into gas and electricity markets refer to GB as one of the more competitive electricity markets.[3] There is no indication in the CC's evaluation report (as of January 2008) that there have been any changes in the market that would warrant further regulatory intervention.

As we have noted above, we do not consider that the consultation document demonstrates sufficient justification for a revised attempt to impose a new licence condition given the previous findings of the CC.

[3] See paragraph 4.30 of the CC's report.

We are particularly concerned about the potential imposition of a wide ranging licence condition which goes beyond the limited concerns identified by Ofgem in the consultation document. This is particularly the case given that the consultation document does not highlight any concrete market power concerns other than relating to the England/Wales and Scotland transmission constraint. The real concern appears to be the perceived need to regulate any other (as yet unspecified) issues that may or may not arise in the future.

In addition, the current proposals are lacking in clarity. For example, there is uncertainty as to what amounts to "market power" under the MPLC, and particularly whether this measure is intended to operate at a lesser level than, or in different circumstances to, the conventional measure in competition law of dominance. As an economic concept, dominance is characterised as an ability to act independently of its competitors, suppliers and customers on the market. It is traditionally accepted that market power is synonymous with dominance and we would be concerned by any departure from this well established standard.

The concept of *"undue exploitation"* is, as far as we can determine, entirely novel and unclear. It is doubtful, for instance, whether it is possible to exploit market power in a manner that is not *"undue"*. As we have noted above, competition law already provides a broad and flexible notion of "abuse", which has been used to good effect by EC and UK competition authorities and courts to sanction anticompetitive behaviour for many years. The examples of undue exploitation provided at paragraph 1.5 of the consultation document (i.e. price spikes which (a) differ unduly between times in which market demand and costs are similar, and/or (b) are due to non-economic dispatch decisions) only add further uncertainty.

A particular concern arises given that generators are frequently called upon to make short term and rapid decisions on how to react in the market whereas enforcement will take place *ex post* and over a longer period. Although Ofgem currently proposes to enforce the MPLC *ex post*, generators will have to ensure compliance *ex ante*. There is clearly a concern that (i) legitimate commercial responses might not be taken due to enforcement risk, and (ii) decisions taken quickly and in good faith could be reviewed with an excessive degree of hindsight. It is not possible to determine at this time how effective Ofgem's proposed guidelines, or the use of pivotality thresholds, would be.

In our view, these problems will not be conducive to promoting investment incentives in the GB electricity markets at a time when it is needed.

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

Should a licence condition be introduced, it would be very important to ensure that the correct checks and balances were in place. As such, there would have to be some form of appeals mechanism given our concern over the potentially serious consequences for a generator being found in breach of licence conditions.

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?

With regards to the *"structural screening"* proposal, it should be recognised that market power could be demonstrated at any time; it will depend on the circumstances in the market at a given time, i.e. was the generator that placed the high price the only generator that could offer a price at that particular point in time. Therefore, it is unclear how a position of market power would be identified *ex ante* as it would depend upon market conditions at the time.

The *"conduct-and-impact"* screening process could potentially be a very complex method, given that (once again) in order to judge if a generator has demonstrated market power in a particular period, the pre-defined reference level that approximates competitive bidding would have to take into account (subsequent) market conditions.

It appears that the devil will be in the detail; therefore, further information would be required as to how Ofgem envisage such a process would work in the GB power market before we were able to make a judgement on the methodology.

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

No comment.

Chapter 5: Potential mechanisms for implementation

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

As we have indicated above, we do not agree with Ofgem that any additional regulatory intervention imposed on all generators is necessary in the light of market circumstances. Clearly, to the extent that there is a problem with transmission capacity and/or with Scottish power generators, Ofgem's enforcement priorities should be pointed in that direction.

We think it is unlikely that Ofgem will be able to introduce a standard licence condition by consent via a collective licence modification route. If Ofgem proceeds by way of either a licence modification reference or market investigation reference to the CC, we see no reason why the outcome will be any different to the last time this issue was extensively reviewed in 2000/01, given the very recent support for that outcome in the CC's evaluation report in January 2008.