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Market Power in Electricity: A Comment on Ofgem's Consultation Document 30/09

An Expert Report for EDF Energy

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Executive Summary

On 30 March 2009, Ofgem issued a consultation document setting out initial policy proposals for new measures aimed at addressing market power in the wholesale electricity market. Ofgem says in that document that it is "minded to" adopt a new licence condition which (although accompanied by "guidance" on enforcement) would be "broad and applicable to all generators". In doing so, Ofgem appears to be repeating mistakes that led the Competition Commission (CC) to reject of the "Market Abuse Licence Condition" (MALC) in 2001.

Ofgem's own review of the CC report from 2001 considers the discussion of electricity market conditions and the likelihood of anti-competitive behaviour. However, the CC did not only conclude that the MALC was *unnecessary*, given the state of competition law and likely future developments in the electricity market. The CC also considered the MALC to be *detrimental to competition*. Ofgem's review of the CC's report does not give any weight to that strand of the argument.

Part of Ofgem's rationale for preferring to introduce broad powers rests on the difficulty of applying the Competition Act 1998. However, Ofgem has not established a need for such broad powers, because a number of available powers have yet to be exploited. Changing the market rules to deal with specific problems is still likely to be the best solution. Here, market rules can be interpreted widely to include, not just the trading arrangements, but also potentially a bidding code that defines specific forms of conduct by generators as acceptable or abusive, allowing objective appraisal of their actual conduct. The provision for market investigations also seems to be applicable to conditions in the electricity market.

Some of the evidence that Ofgem quotes in favour of "broadly defined powers" refers in fact to broadly defined powers *to specify detailed rules*. These examples do not therefore indicate any consensus that there is a gap in the applicable law that would be filled by giving Ofgem broadly defined powers *to intervene in markets*. This distinction is important, because the CC commented at length in 2001 on the detrimental effects of the MALC, due to the broad or undefined nature of the abuses it was intended to prohibit.

The CC identified two distinct problems with the MALC: (1) abuses would be difficult to define and to identify; and (2) uncertainty over interpretation of the licence condition would limit market conduct in a way that was detrimental to competition. These problems apply to any broadly defined licence condition and neither has diminished over time.

Hence, if Ofgem is to avoid the kind of arbitrary and unpredictable interventions that are detrimental to competition in electricity markets, it would have to work on narrowing down any broadly defined powers. The creation of broadly defined powers would not save on the upfront implementation costs, but would merely replace them with ad hoc implementation costs in each case. In the meantime, the supposed "flexibility" of broadly defined powers would only create uncertainty and harm competition.

Thus, Ofgem has not established the need for any new powers, as many available powers remain unexploited, particularly the ability to change the rules of the market. In any case, new powers should be defined in a manner that is capable of predictable and objective implementation by any competition authority. Only then will the benefits of restricting abuse outweigh any potentially detrimental effect of deterring competitive behaviour.

1. Introduction

On 30 March 2009, Ofgem issued a consultation document with initial policy proposals for measures aimed at addressing market power in the wholesale electricity market.[1] Ofgem says that it is "minded to" adopt a new licence condition which (although accompanied by "guidance" on enforcement) would be "broad and applicable to all generators".[2]

EDF Energy has asked me to write an expert report reviewing this consultation document, drawing on my experience of past attempts to regulate abuses in wholesale electricity markets in Britain and elsewhere. I have found that Ofgem's "minded to" decision appears to be repeating the mistakes that led about ten years ago to the design – and eventual rejection – of the "Market Abuse Licence Condition" (MALC).

The consultation document recognises that Ofgem is reviewing a problem (and some solutions) first considered in discussions of the MALC. The Competition Commission (CC) rejected that licence condition on appeal.[3] Ofgem's latest consultation document therefore reviews the CC's arguments to see whether conditions have changed (or have not changed in the manner anticipated by the CC), to see if there might now be a case for a measure such as a new "Market Power Licence Condition". Ofgem has not reached any definitive conclusions as to the need for, or possible form of, any such new measures but has indicated a preference for new, broadly defined powers.

It is notable that Ofgem's review of the CC report from 2001 reviews only one part of the CC's arguments, namely the discussion of electricity market conditions and the likelihood of anti-competitive behaviour. However, the CC did not only conclude that the MALC was *unnecessary*, given the state of competition law and likely future developments in the electricity market. The CC also considered the MALC to be *detrimental to competition*, but Ofgem's review of the CC's report does not give any weight to that strand of the argument.

By failing to appreciate the nature of arguments on the harmful effects of the MALC, Ofgem is in danger of proposing new measures which, although different from the MALC in some ways, would also be detrimental to competition and undesirable from the point of view of consumers' interests.

In chapter 0 below, I review Ofgem's rationale for further action. Chapter 3 discusses measures available to Ofgem that have not yet been fully exploited and that Ofgem has not considered. I have reviewed the CC's 2001 report to draw out the second major strand in its argument, namely the harmful aspects of the MALC. In chapter 4, I show that Ofgem's latest consultation document has not properly reflected this aspect of the CC's 2001 report.

Chapter 5 summarises my conclusions that would be applicable to any future measures proposed by Ofgem.

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1 Ofgem (2009), *Addressing Market Power Concerns in the Electricity Wholesale Sector: Initial Policy Proposals*, Ofgem reference 30/09, 30 March 2009. This report addresses question 2 in chapter 1, among others.

2 Ofgem (2009), paragraph 6.7.

3 CC (2001), *AES and British Energy: A report on references made under section 12 of the Electricity Act 1989*, Competition Commission, London, January 2001.

2. Ofgem's Rationale for Further Action

The nub of Ofgem's reasoning is set out in chapter 1 of Ofgem (2009), under the heading "Rationale for further action" and in paragraph 1.35 in particular. Ofgem's rationale has two elements:

- Other electricity markets have led various authorities to identify or to express concern about potential competition problems and to adopt special rules on market manipulation;
- Ofgem foresees "difficulties in applying CA98 legislation in the wholesale electricity context".

To illustrate its rationale, the consultation document discusses Ofgem's investigation of an incident involving Scottish generator companies in 2008, which it cites as a case that demonstrates the difficulty of applying the Competition Act 1998 (CA98) to some market power concerns. The discussion of the case in Appendix 2 to the consultation document includes a broad overview of Ofgem's concerns, but also reports that:

> "Ofgem closed the investigation into SP and SSE on 19 January 2009, noting that the likelihood of making an infringement finding under CA98 was low, and that other actions were available which could be more effective in addressing the issues raised on a forward-looking basis."[4]

It therefore appears that Ofgem's policy proposals in the consultation document are motivated by fear of a potential enforcement gap in the CA98, i.e. that the electricity wholesale sector might exhibit market power concerns not captured by the CA98.

However, an enforcement gap in the CA98 does not constitute a "rationale for further action", in the sense of action to create additional powers to intervene in the electricity market, if at least one of the following conditions is satisfied:

- Authorities charged with oversight of the electricity wholesale sector already have powers to deal with malfunctioning of that sector, which have not yet been exploited in the cases identified by Ofgem;
- The decision of legislators (as interpreted by the courts) to limit Ofgem's powers to intervene in wholesale electricity markets was taken for good reason, because such interventions would worsen outcomes.

Ofgem has not considered either of these possibilities, which means that it is premature to decide that new powers are needed. Moreover, it appears that not only one, but both of the two conditions listed above are indeed satisfied. Accordingly, the creation of new powers is unnecessary and/or undesirable for two independent and individually sufficient reasons, as explained below.

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[4] Ofgem (2009), Appendix 2, paragraph 1.15.

3. Available (But Unexploited) Powers

Ofgem has expressed a preference for creating new powers, but does not explain why new powers are necessary, given the availability of existing powers that have yet to be fully exploited. Two examples of such existing powers merit further consideration: market rule changes; and market investigations.

3.1. Market Rule Changes

In this context, the definition of the "changing the market rules" would certainly include modifications to the Balancing and Settlement Code (BSC), but it would also cover changes to other market Codes (such as the Connection and Use of System Code, CUSC), new codes of practice applicable to generators (similar to the Supply Code which applies to all retail suppliers of energy), and new licence conditions that have the same effect.

Ofgem does not always have a formal power to propose modifications to the BSC or other codes. However, Ofgem has shown that it is possible to induce others to propose modifications. In particular, Ofgem obliged National Grid to raise certain modifications to the Gas Network Code, as a condition of its 2005 sale of gas distribution networks. Ofgem imposed the obligation to raise appropriate modifications through a narrowly worded licence condition and a similar mechanism could be adopted for future modifications to any other code.[5]

For some cases, it might be most appropriate for Ofgem to create a new Code for generators, outside the BSC, which sets down new rules governing their interaction with the market. For instance, in the latest example featuring the Scottish generators, Ofgem may have had some view as to what form of bidding was acceptable and what was not, contingent perhaps on a set of market conditions. In order to identify and punish any such abuse, Ofgem would in any case need to explain how a generator's actual conduct differed from what was acceptable, so some codification of conduct will always be necessary. Ex ante codification would minimise uncertainty.

Ofgem refers to several such codes in US electricity markets.[6] An example that operates within the context of general European competition law is to be found in Ireland.[7] The bidding code for the "Single Electricity Market" (SEM) sets down how generators should bid into the market. The SEM operates in some ways like the old England and Wales Electricity Pool, in that it sets a market clearing price and makes a capacity payment to all available generation capacity. However, ESB has a very large market share in generation. The bidding code therefore has a clear statement of objectives:

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[5] In the end, the Competition Commission rejected Ofgem's decision to approve the licence changes, but for reasons connected with the quality of the analysis behind the rule change. That outcome did not weaken Ofgem's ability to oblige licence holders to enact rules, although it did redefine and raise the standard of analysis required for such rules to be accepted. See E.ON UK plc v GEMA on Energy Code Modification UNC116, Appeal under section 173 Energy Act 2004, case number CC02/07.

[6] Ofgem (2009), paragraphs 4.11-4.13.

[7] All-Island Project (2007), *The Bidding Code of Practice: A Response and Decision Paper*, AIP-SEM-07-430, 30 July 2007.

"This Code aims to facilitate the efficient operation of the Single Electricity Market by ensuring that:

- in combination with the Capacity Payment Mechanism established under the Single Electricity Market Trading and Settlement Code, generators are appropriately compensated for making available their generation sets or units (as appropriate) and for generating electricity in the Single Electricity Market;
- generators cannot exercise market power in the generation of electricity on the island of Ireland or any part thereof; and
- the Power Procurement Business cannot exercise market power by virtue of generation sets or units contracted to it under long term power purchases agreements in Northern Ireland, in respect of which it has been appointed an Intermediary."[8]

Given this context, the Regulatory Authorities set out previously the requirement for generators to bid short run marginal costs (to avoid double payment for capacity and to mitigate market power) and why that policy will work in the SEM. According to the bidding code, "When calculating the Short Run Marginal Cost of a generation set or unit in respect of a Trading Day, constituent cost-items are to be valued at their Opportunity Cost." The bidding code then (1) defines the concept of opportunity cost; (2) explains the principles to be adopted in recovering start-up and no-load costs; (3) sets out the principle to be adopted when a generator's output is limited by energy, emissions or time constraints; (4) defines opportunity cost for co-generators; and (5) refers to the applicable change management procedure.

Ofgem has noted, correctly, that applying this rule universally would not facilitate competition or competitive entry in the current British electricity market, since it does not have a capacity payment (the "missing money" problem). However, it shows the level of detail at which ex ante guidance can be set out. Any ex post review of generator conduct would, of course, have to address precisely the same issues on an ad hoc basis. Chapter 4 of this report considers in more detail the relative advantages of ex ante and ex post codification of acceptable and abusive behaviour.

3.2. Lessons Learnt from Overseas Experience

When discussing the "rationale for further action", Ofgem refers to some additional powers to combat market manipulation that were recently granted under the Energy Policy Act 2005 (EPA 2005) to the US Federal Energy Regulatory Commission (FERC).[9] The CC also commented on FERC's new powers in its 2008 review of its 2001 decision on the MALC.[10] However, it is worth reviewing the actual text of the EPA 2005 to see what these new powers entail. In practice, they do not grant FERC powers like those which Ofgem is minded to adopt.

The relevant section of EPA 2005 states:

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[8] All-Island Project (2007), Annex A, paragraph 4.

[9] Ofgem (2009), paragraph 1.35.

[10] CC (2008), paragraph 4.71.

> "It shall be unlawful for any entity (including an entity described in section 201(f)), directly or indirectly, to use or employ, in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b))), in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of electric ratepayers." [11]

Several points emerge from a close reading of this clause. First, these powers draw upon existing definitions of a "manipulative or deceptive device or contrivance" as used in the Securities Exchange Act of 1934. Second, the ban on market manipulation is not a general one, but only applies if traders contravene "such rules and regulations as the Commission may prescribe". As the CC noted, "The Energy Policy Act 2005 (EPAct) allows the FERC *to issue rules* to bar market manipulation in wholesale power and gas markets (italics added)."

In other words, although the EPA 2005 awards FERC some broadly defined powers, it appears that FERC can only exercise those powers (1) in relation to conduct defined by previous legislation and case law and (2) after setting down more specific "rules and regulations". Assuming this interpretation is correct, the EPA 2005 does *not* award FERC the right *to apply broadly defined powers*, merely a broadly defined power *to specify detailed rules*. Ofgem does not seem to have considered whether it already possesses similar powers to set down rules, or how such a power might be defined.

3.3. Market Investigations

Market power concerns that fall outside the scope of the CA98 are not specific to the electricity wholesale sector, but can also arise in other industries and markets. For that reason, presumably, the UK competition policy regime extends beyond the CA98, to include in particular the market investigation provisions of the Enterprise Act 2002.

As consultation document mentions, Ofgem already has the option of making a market investigation reference (MIR) to the CC. If the CC is asked to undertake a market investigation, it must consider whether there are "adverse effects on competition", assessed by reference to features of the market that prevent, restrict or distort competition.

The purpose of the market investigation regime was described by Peter Freeman, Chairman of the CC, as follows:

> *"In investigating markets we are trying to assess whether conditions in a given market are enabling some providers, or acquirers, of goods or services to get, hold and exercise a degree of market power to such an extent that competition is restricted, consumers are harmed and some intervention is justified.*

[11] Public Law 109–58, 8 August 2005, Section 1283.

People sometimes say—what is the point of this? Surely Articles 81 and 82 cover all the things that should be covered? Well, the kinds of situation that market investigations can cover, and which a prohibition system might miss, include:[12]

1. *Unilateral effects: The need to improve the operation of a market dominated by one or more players, who are not themselves 'abusing' that position (particularly where incumbents are protected by high natural or strategic entry barriers that impede self-correcting entry).*
2. *Coordinated effects: Non-collusive oligopoly behaviour falling short of illegal conspiracy, of the form economists would regard as tacit coordination leading to prices approaching the collusive (or monopoly) level.*
3. *Vertical effects: Issues of market structures in vertical cases with parties operating at different levels of the supply chain where some 'unbundling' is perhaps needed to correct distortions in competition or actual or perceived discrimination;*
4. *Inefficient equilibria: Where the market arrives at a 'bad' equilibrium from which no individual firm has an incentive unilaterally to deviate.*
5. *Government barriers to entry: Where government policy creates 'artificial' barriers to entry that may distort competition (often motivated by legitimate public policy considerations).*
6. *Informational failure: Where consumers lack the information to make informed choices or (perhaps more controversially) where they may not use that information to make good choices.*

This is a substantial list of matters, which suggests that there is considerable utility in the market investigation régime, and indeed, the increasing volume of cases bears that out."[13]

Some of these conditions are particularly relevant to electricity markets, but electricity markets are not the only cases where these conditions arise. The UK competition policy regime therefore appears to recognise that the CA98 by itself may not be sufficient to address all relevant market power concerns. Instead, law makers have made explicit provision for measures intended to capture issues of market operation that fall outside the scope of the CA98.

It is unclear why Ofgem rejects this route for dealing with market power concerns that are not captured by the CA98, even though it is the standard approach in all other sectors of the economy. In particular, the reasons cited by Ofgem, i.e. time/resource intensiveness[14] and

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[12] Footnote in original text reads: "This formulation owes much to Dr Mark Williams of NERA."

[13] Peter Freeman, *'A Wise Man Proportions His Beliefs to the Evidence': Scepticism and Competition Policy*, lecture at a meeting of the David Hume Institute in the Royal Society of Edinburgh on 3 May 2007.

[14] Although Ofgem is correct in stating that the CC can take up to two years to reach recommendations on remedies in a market investigation, the CC now aims, where appropriate, to complete future market investigations in 18 months or possibly an even shorter period in the case of smaller markets (see CC news release 17/09 of 8 April 2009). Moreover, the long gestation of such recommendations may be evidence of due care being taken, when a quicker approach would imply a propensity to make errors and to overlook evidence. A faster outcome is not always a better one.

uncertainty,[15] are intrinsic features of the market investigation regime (with corresponding benefits, such as an independent view and detailed investigation) and therefore do not explain why the standard approach is not suitable for the electricity wholesale sector. As discussed in chapter 4, other measures would in any case require a similar investigation of the market and so would not avoid problems of resource intensiveness or uncertainty.

3.4. Summary

Part of Ofgem's rationale for further action rests on the difficulty of applying the Competition Act 1998. Ofgem is currently "minded to" fill this apparent gap by introducing a new licence condition is "broad and applicable to all generators".[16] However, Ofgem has not established a need for such broad powers, because a number of available powers have yet to be exploited.

The CC suggested in 2001 that changing the market rules was likely to offer the best solution to many of the abuses feared by Ofgem. In this context, the "market rules" encompasses not only the trading arrangements, but also specific constraints on the conduct of generators, such as a bidding code that would set out how generators should deal with the market in defined conditions. The provision for market investigations also seems to be applicable to conditions in the electricity market. There are therefore many possible routes by which Ofgem or other regulators could exercise a degree of control over energy markets and Ofgem has by no means exhausted them.

Moreover, some of the evidence that Ofgem quotes in favour of "broadly defined powers" in practice refers only to broadly defined powers *to specify detailed rules*. These examples do not indicate any consensus that there is a gap in the applicable law to be filled by giving Ofgem broadly defined powers *to intervene in markets*.

Indeed, the focus on creating detailed rules in other regimes is consistent with the second strand of the CC's 2001 analysis of the MALC, which focused on the detrimental aspects of broadly defined (or undefined) powers. I turn to that strand of the CC's argument in the next chapter.

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[15] Ofgem (2009), paragraph 5.3.

[16] Ofgem (2009), paragraph 6.7.

4. Constraints on the Design of New Powers

Despite the existence of unexploited existing powers, Ofgem seems to favour the creation of new powers that would allow Ofgem to intervene in electricity markets or to punish electricity companies for undesirable forms of behaviour.[17] However, in discussing such powers, Ofgem has taken no account of the possibility that the supposed gap in current powers (with regard to competition policy cases against individual oligopolists) may represent a deliberate choice by legislators. In particular, Ofgem does not seem to have considered the possibility that creating new powers to deal with oligopolistic electricity markets would be counter-productive because:

1. Anti-competitive conduct by oligopolists cannot be separated from acceptable oligopolistic conduct; and
2. Powers to punish oligopolists for poorly defined or undefined forms of conduct are detrimental to efficient competition.

In Chapter 4 of the Consultation Document, Ofgem considers both a general "licence condition on generators" (without specifying what the licence condition would say) and "ex ante regulation" (with reference to some of the specific rules used in the US). However, the appraisal of these two approaches is partial and does not take full account of the criticisms levelled at the MALC by the CC in 2001.

4.1. Partial Appraisal

Ofgem notes that ex ante rules would take time to develop and might not cover all eventualities.[18] Ofgem also notes that explicit constraints on bidding have to ensure that generators are able to recover their costs, particular investment costs (the "missing money" problem). There is no doubt that defining rules will take time and that the rules may have to be updated in the light of experience.

However, these problems would apply equally to any ex post application of any "broadly drafted licence condition". Ofgem would still need to define what type of conduct was acceptable or competitive and how a particular company had deviated from it. In doing so, Ofgem would have to ensure that its definition of acceptable or competitive conduct did not create the "missing money" problem (e.g. by persistently shaving away all the price rises needed to cover investment costs).

Thus, the disadvantages that Ofgem ascribes to ex ante regulation are common to ***both*** ex ante regulation ***and*** a "broadly defined licence condition" applied ex post. In fact, the disadvantages may be greater for the broad definition, since Ofgem would have to describe acceptable conduct and the nature of the abuse in each case, raising the possibility of unpredictable or inconsistent definitions arising in different cases.

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[17] Ofgem (2009), paragraph 6.7.

[18] Ofgem (2009), paragraph 4.15.

The Market Abuse Licence Condition that Ofgem proposed in 1999-2000 was also a broadly defined power (albeit Ofgem tried to set out guidelines for its implementation). Ofgem's consultation document quotes from the CC's 2001 report on the MALC, but selectively, leaving out important lessons.

The CC's reasons for rejecting the MALC can be divided into two broad categories:

1. conditions in the electricity market that make the MALC unnecessary; and
2. intrinsic problems with the form of the MALC that make it undesirable.

Ofgem has considered the first of these reasons and whether conditions in the GB electricity market have changed, or have not developed in the manner anticipated by the CC, since 2001. However, Ofgem has not considered any of the second category of criticisms, even though the CC's comments on this aspect of the MALC would be important for appraising the options in Ofgem's current consultation.

4.2. CC's Conclusions in 2001

The CC analysed the effect of the MALC on the public interest. The CC concluded not only that concerns about the abuse of market power did not justify implementation of the licence condition, but also that the MALC would be counter to the public interest because it would deter competitive behaviour. The CC's views are well summarised in the following extract (emphasis added):

> "We have not identified adverse effects which need to be addressed by the inclusion in the licences of AES and British Energy of a broadbased condition prohibiting abuse of market power. **Moreover, we think that such a prohibition would cause uncertainty, because of the difficulty of distinguishing between abusive and acceptable conduct, and would risk deterring normal competitive behaviour (see paragraphs 2.258 and 2.259).** Competition should be given the opportunity to work in the new circumstances of NETA, and with a less concentrated generation sector, without the introduction at this stage of new broadly-framed regulation. **We consider that, besides promoting competition in generation, the absence of such additional regulation is also likely to be the best means of protecting the interests of consumers of electricity**."[19]

Ofgem has not indicated in the consultation document how any alternative licence condition would overcome "the difficulty of distinguishing between abusive and acceptable conduct" or why such a licence condition would not "risk deterring normal competitive behaviour". Ofgem is currently arguing that a gap in competition law justifies the introduction of broadly defined powers, but the CC stated specifically in 2001 that the *absence* of such additional regulation offered the best protection of consumers' interests.

[19] CC (2001), page 69, paragraph 2.329.

The CC therefore concluded that the mere possibility of generators manipulating markets was not sufficient justification for introducing broadly defined powers, given the uncertainty that such powers would create. The adoption of new rules was a better method of protecting the public interest than trying to prohibit the manipulation of existing rules:

> "We see manipulation of the market as conduct for which a sufficient remedy would in principle be the modification of market rules or mechanisms. The wholesale electricity market is intrinsically vulnerable to such conduct because of the need for rule-based arrangements to govern the balancing of the supply system. The Pool, as a rule-based trading arrangement governing the whole market, has magnified this inherent problem.
>
> Beyond that, the DGES may be right to predict that manipulation will be a continuing problem because no workable set of rules could eliminate the possibility. But in view of the uncertainties we cannot form an expectation that manipulation by AES or British Energy will occur, with adverse effects for the public interest. **We are also mindful of the disadvantages of a broad, effects-based prohibition such as the MALC—as mentioned in paragraph 2.329 in the context of market power—and our view that such a prohibition would not be suitable for dealing with manipulation of market rules.** If, in the light of experience, manipulation of market rules proves to be a significant problem under NETA and cannot be satisfactorily dealt with by rule modification, it will be open to the Secretary of State to consider using his powers under the Utilities Act to introduce new licence conditions to address the problem."[20]

The disadvantages of a "broad, effects-based prohibition" have not diminished over time. Moreover, Ofgem has not fully explored or exhausted the possibilities offered by rule modification. According to the CC, therefore, it would be premature to apply Utilities Act powers to address the problem.

4.3. The Difficulty of Identifying Abuses

In 2001, the DGES claimed that four types of abusive behaviour were present in the market and the CC assessed the degree of uncertainty surrounding each one.[21] Below, I quote extracts from this discussion.[22] These extracts illustrate the difficulty of defining even the generic types of abuse that Ofgem wished to prevent through the MALC, and wishes to prevent today:

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[20] CC (2001), page 70, paragraphs 2.330-2.331.

[21] CC (2001), page 26, paragraph 2.253.

[22] The full text of the paragraph is set out in Appendix A. Several of the excisions here merely concern cross references to other paragraphs. The public version of the report substitutes "[!]" for the name of a company.

> "The degree of uncertainty resulting from the MALC, or any other broad prohibition of substantial market power, depends to a large extent on the difficulty or otherwise of distinguishing between abusive and acceptable conduct. It is useful to consider this issue in relation to the four examples of different types of conduct listed by the DGES …
>
> **(a) Capacity withholding**. Experience with the Edison and [!] cases in summer 2000…indicates that the avoidable cost test is useful in distinguishing normal commercial behaviour from conduct which may be an exploitation of market power.…The test is not always straightforward to apply: in some circumstances there can be considerable room for argument about which costs and revenues should be taken into account. There are potentially many individual factors—such as a limit on the amount of time which a genset can operate for, as a result of emission restrictions—which would have to be taken into account in deciding whether a generator had good cause for withdrawing capacity.…
>
> **(b) Bidding strategies.** In contrast we have not identified any principle which would be of great use in determining whether a particular bidding strategy is abusive.…We note in this connection the view of Professor Wolak, Chairman of the Market Surveillance Committee of the California Independent System Operator, who in a submission to us said that, although detecting the exercise of market power was a well-defined exercise, assigning the blame to specific participants in a market where several generators operated was a virtually impossible task. The DGES maintained that it was possible to detect egregious cases of abusive price discrimination but in the absence of a clear criterion for doing so we did not find his argument persuasive.
>
> **(c) Manipulation of complex rules.** We have already commented, in the context of rule modification, that manipulation of rules is not something that is necessarily straightforward to identify…Various examples of possible manipulation under NETA have been put forward but some of these would be contrary to the rules (for example, in the Grid Code and the Balancing and Settlement Code) and it is not possible to foresee to what extent the kinds of conduct identified will arise in practice.
>
> **(d) Influence of contractual positions**. It seems to us that this is not a further type of manipulation but rather a means by which a generator would profit from one of the other three types of conduct."[23]

The CC therefore concluded that abuse would be impossible to define (or difficult to define objectively) and that some of the conduct identified by Ofgem (the DGES) as abusive was already prohibited or infeasible.

The CC also concluded that it would be difficult to identify the party responsible for a change in the price level (and abusing its market position) in any oligopoly conditions (and that it would be even harder under NETA than it was under the pool system):

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[23] CC (2001), page 43, paragraph 2.199.

> "Moreover, as we have noted, it will often be difficult to attribute a movement in market prices to any particular participant. This problem is difficult enough under the Pool, where a single market-clearing price is set in a rule-based system: it will be yet harder in the more fluid circumstances of NETA."[24]

As mentioned in the extract above, the CC discussed this problem with Professor Frank Wolak, who had observed closely the (then recent) events in California. The CC set out the following summary of Professor Wolak's views (emphasis added):

> "Professor Wolak told us that his 1999 paper[[25]] illustrated how a firm's ability to exercise market power depended crucially on the strategies pursued by its competitors. Therefore, **it was extremely dangerous to attempt to single out one firm as having exercised market power,** because without the behaviour of other firms in the market, presumably also trying to exercise their market power, it would not be possible for this firm to exercise as much or any market power…Professor Wolak referred us to a study which he and others had undertaken that estimated the extent of market power in the Californian market over the period June 1998 to September 1999…Professor Wolak emphasized that, **although the study was able to quantify the extent to which market prices deviated from the perfectly competitive ideal (its measure of the extent of market power exercised), it was unable to determine which market participant caused those deviations**."[26]

These extracts illustrate how the definition of the supposed abuses listed by Ofgem is not objective, straightforward or predictable – either then or now. Penalising one party among several who might be responsible would be arbitrary (or possibly even discriminatory).

The CC commented in 2001 that the introduction of NETA would only make this problem more difficult than under the Pool. However, these difficulties are not specific to any particular market arrangements. Nothing has changed since 2001 to make the definition or identification of such electricity market abuses any easier or more transparent.

4.4. CC Comments on Regulatory Uncertainty

The cornerstone of the CC's argument against the adoption of the MALC was the regulatory uncertainty associated with a poorly defined rule. Such uncertainty would deter competitive behaviour by power generators, so the rule would be anti-, rather than pro-competitive.

Essentially, the problem is as follows. If a rule is poorly or vaguely defined, generators will be required to make their own interpretation of it, in order to decide whether a particular form of conduct is "acceptable" or "abusive". This requirement has two adverse effects: (1) generators may avoid some forms of conduct which would be acceptable forms of competition, but which they fear Ofgem would punish; and (2) different generators may adopt different interpretations, so that competition between them is distorted by the

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[24] CC (2001), page 56, paragraph 2.257.

[25] F. A. Wolak (1999), *An Empirical Analysis of the Impact of Hedge Contracts on Bidding Behaviour in a Competitive Electricity Market*, mimeo, Stanford University.

[26] CC (2001), pages 207-8, paragraphs 8.191 and 8.195.

differences between their interpretations. Either outcome represents a deviation from the competitive outcome.

In the case of the MALC, the CC identified the lack of a clear benchmark price as a key source of regulatory uncertainty. The CC specifically discredited the DGES's proposal to compare the change between two wholesale prices:

> "It is true that the DGES has produced an apparently precise definition of what he means by a substantial change in wholesale electricity prices (a key element in his definition of substantial market power): in effect, an increase of £30 million in market prices (see paragraph 2.182). But the benchmark from which the price increase has to be measured is unclear. The technique of comparing prices in two different periods does not provide a basis for saying that the price in either period is in some sense correct." [27]

This passage indicates a problem that is common to ***all*** such rules, not just a problem with the MALC, namely the difficulty of identifying an acceptable level of prices in an oligopolistic market over a short time frame.

The CC also pointed out the impact of this regulatory uncertainty on the behaviour of market participants:

> "We consider, therefore, that the problem of uncertainty, both for generators and for other market participants, over the interpretation of a prohibition of substantial market power is substantive. This view is supported by experience in the Edison and [!] cases….Because of the difficulty of distinguishing between abusive and acceptable conduct, there is a risk that such a prohibition will deter normal competitive behaviour and thus inhibit the operation of the market. A dampening of price volatility, for example, could reduce the effectiveness of price signals and inhibit the development of more flexible responses from both the supply and demand sides.
>
> Moreover, at a time when the structure of the generation sector is much improved and a new market design, intended to get away from the problems experienced with the Pool, is shortly to be introduced, there is a danger that the introduction of a prohibition of substantial market power would amount to over-regulation. This could deter investment and new entry, with harmful effects on consumers in the longer term. We believe that competition should be given the opportunity to work in the new circumstances without the introduction at this stage of new broadly-framed regulation."[28]

The CC therefore concluded that poorly defined rules would have an anti-competitive effect and that excessive threats of intervention could deter investment.

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[27] CC (2001), page 56, paragraph 2.257.

[28] CC (2001), page 57, paragraphs 2.258-2.259.

Ofgem continues to regard excessive pricing as a problem which cannot be addressed fully under CA98.[29] If Ofgem adopted a new broadly defined licence condition as its preferred solution, it would still be necessary to the problems attributed to the MALC, by defining a benchmark for acceptable pricing. This pricing benchmark would require a consistent definition that avoids the "missing money" problem, whether Ofgem defined it ex ante or case-by-case. Hence, adopting a broadly defined rule does not avoid the time and effort ("upfront implementation costs") needed to define clear criteria for separating abusive from acceptable conduct – it merely postpones the task and raises the possibility of case-specific differences and inconsistencies.

Ofgem refers to the "flexibility" of a broadly defined power as an advantage. However, such flexibility only means uncertainty over the case-by-case application of such a power.[30] This uncertainty is detrimental to competition. A broadly defined approach therefore offers no advantage over ex ante regulation, in which such a benchmark would be defined in advance.

4.5. The CC's 2008 Review of its 2001 Decision

In 2008, the CC reviewed a number of its previous decisions, including its decision on the appeal by AES and BE against the MALC. Ofgem quoted the following extract from this review in support of its proposal for a new licence condition:

> "In summary, the CC's decision not to support the introduction of the MALC in 2001 seems well-justified by subsequent market developments in Great Britain. Equally, however, Ofgem's view that such powers can be necessary in some circumstances also seems to be supported by subsequent developments overseas."[31,32]

In fact, this section of the CC's 2008 report provides little direct support for the introduction of a new licence condition. The CC's review of past cases (from which Ofgem extracts the quotation above) indicates that the CC is far from convinced that "developments overseas" (mostly the California energy crisis) would justify the MALC or similar prohibitions. It is worth quoting in full the paragraphs on either side of the extract quoted by Ofgem (which is shown in italics):

> "The CC investigation and decision concluded before the problems in California (which have affected attitudes to electricity regulation worldwide) came to light. It is interesting to speculate on whether its decision would have been different if the example of California had been before it. That example does seem to provide strong evidence that in extremis, powers similar to those

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[29] Ofgem (2009), paragraph 1.35.

[30] Note that broadly defined laws are often considered undesirable until a defined procedure for analysing the potential abuse has emerged from a series of cases. Such is the case with the prohibition on abuse of a dominant position, where any affected parties can anticipate a discussion of the scope of the relevant market, defined forms of abuse, etc.

[31] Ofgem (2009), page 5

[32] Competition Commission (2008), *Evaluation of the Competition Commission's Past Cases*, Final Report, January 2008, page 49, paragraph 4.83.

> of a MALC are in the public interest (or at least that competition law is not enough). In effect, California exemplified Ofgem's nightmare scenario, made real.
>
> In summary, *the CC's decision not to support the introduction of the MALC in 2001 seems well-justified by subsequent market developments in Great Britain. Equally, however, Ofgem's view that such powers can be necessary in some circumstances also seems to be supported by subsequent developments overseas.*
>
> We cannot conclude on whether there is a case for a MALC 'today' or as a reserve power for Ofgem to retain 'just in case'. For one thing, it is not clear whether such powers are needed in circumstances that are less extreme than the Californian crisis, but more problematic than the British market over the last seven years. Possibly, operation of the US EPAct will provide clues about this in future."[33]

Thus, overall, the CC thought that conditions in California were not relevant to Britain. I have commented on the "EPAct" in section 3 above, as to how it is not an example of broadly defined powers to intervene in markets.

The CC did not therefore make any case for the MALC 'today', even as a reserve power. Indeed, the CC expressed some doubt as to whether such powers would ever be needed in conditions that were "less extreme than the Californian crisis, but more problematic than the British market over the last seven years". These conclusions appear to apply equally to any MALC-like licence condition that is subject to similar concerns about practicality and objectivity.

4.6. Summary

In its 2001 decision to reject the MALC, the CC relied on two major strands of argument: (1) conditions in the electricity market that made the MALC unnecessary; and (2) intrinsic problems with the form of the MALC that made it undesirable. Ofgem's consultation document gives some consideration to the former argument (whether conditions in the electricity market have changed). However, Ofgem overlooks the CC's criticisms of intrinsic flaws in the MALC, some of which apply to any broadly defined licence condition.

The CC identified two distinct problems with the MALC: abuses would be difficult to define and to identify objectively; and uncertainty over interpretation of the licence condition would limit market conduct in a way that was detrimental to competition. These problems apply to any broadly defined licence condition and neither has diminished over time.

Indeed, although Ofgem refers to overseas experience as a justification for new powers, it is notable that the main examples of such experience do not create broadly defined powers of the type that Ofgem appears to be seeking. Regarding the US example quoted by both

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[33] CC (2008), paragraphs 4.82-4.84.

Ofgem and the CC, it appears the EPA 2005 does *not* award FERC the right *to apply broadly defined powers*, but only a broadly defined power *to specify more detailed rules.*

In practice, Ofgem would always need to specify detailed rules that defined acceptable conduct and the form of any abuse. Ex ante regulation would require this work to be done once (and updated in the light of experience); ex post regulation would require precisely the same work to be done on a case-by-base basis. The outcome of case-by-case definitions would be unpredictable, although they might build up into a set of precedents over a long period, as with competition law.

In sum, to avoid arbitrary and unpredictable interventions that are detrimental to competition, Ofgem would have to narrow down any broadly defined powers. Therefore, creating broadly defined powers would not save on the "upfront implementation costs", [34] but would merely replace them with ad hoc implementation costs for each case. In the meantime, the supposed "flexibility" of broadly defined powers[35] would create uncertainty and harm competition.

[34] Ofgem (2009), paragraph 4.15.

[35] Ofgem (2009), paragraph 6.5.

5. Conclusion

Ofgem's latest proposals for regulation of electricity markets are motivated by fear of a potential enforcement gap in the CA98, i.e. that the electricity wholesale sector might exhibit abuses of market power not captured by the CA98. However, an enforcement gap in the CA98 does not constitute a "rationale" for Ofgem's preferred solution, namely additional broadly defined powers to intervene in the electricity market, if at least one of the following conditions is satisfied:

- Authorities charged with oversight of the electricity wholesale sector already have powers to deal with the malfunctioning of that sector, which have not yet been exploited in the cases identified by Ofgem;

- The decision of legislators (as interpreted by the courts) to limit Ofgem's power to intervene in wholesale electricity markets was taken for good reason, because such interventions would worsen outcomes.

Ofgem has not fully considered either of these possibilities, which means that it is premature to decide that new powers are necessary.

A number of available powers have yet to be exploited, specifically changes in market rules (both the trading arrangements and, potentially, other market rules such as bidding codes). The provision for market investigations also seems applicable to conditions in the electricity market.

Moreover, some of the evidence from overseas that Ofgem quotes in favour of "broadly defined powers" in fact refers only to broadly defined powers *to specify detailed rules*. This evidence undermines the case for giving Ofgem broadly defined powers *to intervene in markets*.

Ofgem's consultation document reviews the CC's 2001 discussion of electricity market conditions, but overlooks the intrinsic flaws in the MALC some of which apply to any broadly defined licence condition.

The CC identified two problems with the MALC: abuses would be difficult to define and to identify; and uncertainty over interpretation of the licence condition would be detrimental to competition. These problems apply to any broadly defined licence condition and neither has diminished over time.

If Ofgem is to avoid arbitrary and unpredictable interventions that are detrimental to competition in electricity markets, it will be necessary to define powers in a manner that is capable of predictable and objective implementation by any competition authority. Meeting this condition ensures that the benefits of restricting abuse outweigh any potentially detrimental effect of deterring competitive behaviour.

Appendix A. CC (2001) on Defining Abuse

Paragraph 2.253 of CC (2001) reads as follows:

> "The degree of uncertainty resulting from the MALC, or any other broad prohibition of substantial market power, depends to a large extent on the difficulty or otherwise of distinguishing between abusive and acceptable conduct. It is useful to consider this issue in relation to the four examples of different types of conduct listed by the DGES (see paragraph 2.113):
>
> (a) Capacity withholding. Experience with the Edison and [!] cases in summer 2000 (see paragraphs 2.206 to 2.220) indicates that the avoidable cost test is useful in distinguishing normal commercial behaviour from conduct which may be an exploitation of market power. We note that [!] generators accepted it in principle. The test is not always straightforward to apply: in some circumstances there can be considerable room for argument about which costs and revenues should be taken into account. There are potentially many individual factors—such as a limit on the amount of time which a genset can operate for, as a result of emission restrictions—which would have to be taken into account in deciding whether a generator had good cause for withdrawing capacity. Provided the test is appropriately defined and applied, however, we agree that it is the correct criterion for determining whether a withdrawal of capacity is—or would be—abusive. (This is not to say that a regulation based on the avoidable cost test is necessarily required: if the market was sufficiently competitive, there would be no grounds for regulatory intervention at all because capacity withholding by one generator would create opportunities which others would seize.)
>
> (b) Bidding strategies. In contrast we have not identified any principle which would be of great use in determining whether a particular bidding strategy is abusive. The DGES saw price discrimination between different periods when demand and cost conditions were similar as an important guiding principle in this regard. It appears to us, however that the difficulties of applying this principle are such that it is of little practical value (see paragraph 2.196). The risk is that, if this principle were used as a test, it would significantly inhibit normal competitive activity. We note in this connection the view of Professor Wolak, Chairman of the Market Surveillance Committee of the California Independent System Operator, who in a submission to us said that, although detecting the exercise of market power was a well-defined exercise, assigning the blame to specific participants in a market where several generators operated was a virtually impossible task. The DGES maintained that it was possible to detect egregious cases of abusive price discrimination but in the absence of a clear criterion for doing so we did not find his argument persuasive.
>
> (c) Manipulation of complex rules. We have already commented, in the context of rule modification, that manipulation of rules is not something that is necessarily straightforward to identify (see paragraph 2.246). It is possible to think of examples that would be clear-cut: the Powergen strategy in 1991 of declaring capacity unavailable one day and redeclaring it as available the next, which enabled the company to make substantial additional profits, is one such. Other Pool cases have been less clear and the DGES has not drawn our attention to any examples of this

kind of conduct since the winter of 1998/99. Various examples of possible manipulation under NETA have been put forward but some of these would be contrary to the rules (for example, in the Grid Code and the Balancing and Settlement Code) and it is not possible to foresee to what extent the kinds of conduct identified will arise in practice.

(d) Influence of contractual positions. It seems to us that this is not a further type of manipulation but rather a means by which a generator would profit from one of the other three types of conduct."

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