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Dear Ian,

**ADDRESSING MARKET POWER CONCERNS IN THE ELECTRICITY  
WHOLESALE SECTOR – INITIAL POLICY PROPOSALS**

Thank you for the opportunity to respond to your consultation dated 30 March which set out Ofgem's concerns about the GB wholesale electricity sector and discussed three broad approaches for possible regulatory action.

At the outset, we think it is helpful to assess whether there is a market failure which needs addressing. The most important piece of evidence in this would be to look at the level of prices and consider whether they are consistently above new entry levels, as they were in England and Wales during the late 1990s when the issue of a Market Abuse Licence Condition was initially proposed.

In fact, the evidence could not be clearer. While there have been brief periods where the spark spread (taking account of marginal carbon costs) has reached the level of around £15/MWh needed to justify new entry, on average they have been well below that figure. The current forward curve is signalling a spark spread of £5 to £6/MWh which is not in our view any evidence of exploitation of market power. Indeed, the persistent weakness of spark spreads gives us concerns that there will be insufficient investment to meet demand, should the current recessionary reduction in demand reverse.

The other possible area of market failure indicated by Ofgem relates more specifically to constraints on the transmission circuits between Scotland and England. In our view, the problems here have arisen because of the slower than anticipated increase in the capacity of these circuits since BETTA, and the increased importance of renewable Scottish generation in contributing towards UK environmental targets. The focus here should be on measures to bring forward the required transmission investment as quickly as possible rather than on changes to the regulatory regime for generators impacted by the shortfall in transmission investment. We believe that generators in Scotland (in common with their other competitors in the GB market) are entitled to respond to market signals for the provision of the balancing services that are needed to manage the situation pending the necessary upgrades, subject of course to the rules imposed by competition law.

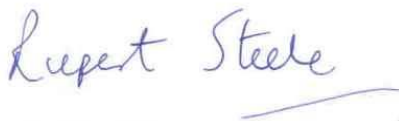
Accordingly, we are not persuaded that there is a market failure which needs addressing. We also believe that the specific proposal of a Market Power Licence Condition applied to generators would be contrary to customers' interests, because it would put a significant question mark on investment. A commodity-only market will tend to trade close to short run marginal cost in periods of adequate or over-supply, with significant spreads opening out only in periods of tightness. The area under these spikes must be perceived by investors as sufficient to remunerate the capital, if new plants are to proceed.

The proposed condition would (if it is to have any effect at all) restrict behaviours that were otherwise permissible under competition law. This would be perceived by investors as restricting the ability of plant to earn in the spikes and therefore a disincentive to investment in a situation where spreads are already below entry cost and investment is dependent on a perception that they would grow. We do not think investors will understand how Ofgem would be able to differentiate between a "good spike" and a "bad spike" and consider that they are more likely simply to send their capital elsewhere. This would not be an outcome that is in consumers' interests.

The Competition Commission concurred with the view that such a licence condition was not appropriate in its 2001 decision report on Ofgem's proposed Market Abuse Licence Condition where they stated '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'.

Attached is a paper giving our more detailed comments on the matters you have raised and responses to the specific questions raised in the consultation document. I hope that you will find these comments useful; we would welcome the opportunity to discuss these issues and if you have any questions please contact me using the details printed on the previous page.

Yours sincerely,

A handwritten signature in blue ink that reads "Rupert Steele". The signature is written in a cursive style and is positioned above a horizontal line.

**Rupert Steele**  
Director of Regulation

## **Addressing Market Power Concerns in the Electricity Wholesale Sector - Initial Policy Proposals**

### **ScottishPower Response**

#### *General Comments*

We believe that there is no general problem of excessive pricing in the GB market and that any issues arising from congestion in the Scotland/England interconnector should be resolved by increasing the capacity of that link as soon as possible. We do not think that Ofgem's preferred option of a Market Power Licence Condition on generators is appropriate for the following reasons:

- Firstly, we believe that existing enforcement provisions available to Ofgem, including the competition law prohibitions, are adequate to deal with anti-competitive behaviour by generators.
- Secondly, we believe that it would be detrimental to the operation of the competitive UK market, recognised as amongst the most competitive in Europe and globally, through discouraging innovation and the offering of new competitive services by existing generators or new entrants.
- Thirdly, we believe it would discourage investment, if the UK's regulatory regime were to move further out of step with the regimes elsewhere in Europe, at a time when generation investment in the UK is vital.

We consider that it would be more appropriate to await the outcome of the current European initiatives rather than take action on a national level which could undermine the development of the internal market.

The Competition Commission concurred with the view that such a licence condition was not appropriate in its 2001 decision report on Ofgem's proposed Market Abuse Licence Condition where they stated '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'.

This latest proposal following on from Ofgem's closed Competition Act investigation into ScottishPower and Scottish and Southern Energy suggests that Ofgem is attempting to define undue exploitation of market power for the electricity wholesale market on a different basis to case law in relation to the Competition Act. The Competition Act has been used successfully by Ofgem, and upheld on appeal by the Competition Appeals Tribunal, in the electricity industry to deal with abuse of a dominant position and should be the basis for deciding whether an organisation has unduly exploited market power. If under the Competition Act an organisation is not found to have unduly exploited market power then a licence condition should not be introduced which deems the organisation to have done so.

The scope of the proposed licence condition is not sufficiently clear to allow industry to reach an informed decision on its merits. In particular, limited information is given in terms of the types of behaviour that would constitute "undue exploitation". It would have been beneficial if the consultation paper had given specific examples of behaviour that would be caught by the proposed licence condition.

Ofgem is concerned that the shortage of transmission capacity may adversely impact trading in the GB market but there is no evidence that constraints are significantly impacting the GB wholesale price. It is important to recognise the downward competitive pressures on the GB wholesale price from Scottish generation being able to fully compete commercially in the GB market. The current arrangements for dealing with constraints do not distort this competition.

Ofgem has stated in the consultation document that they recognise that high prices at times are necessary and efficient market signals for generation investment in both baseload and peaking plant and play an important role in delivering security of supply. However, there is no clear basis given which would enable investors and generators to understand when such prices would be considered acceptable. Moreover in practice there have been occasions when Ofgem and National Grid have queried some periods of high prices and suggested there is no justification for the price level. It has only been when a fuller investigation has been carried out and more information has been provided by generators that the price levels have been seen to be justifiable. It is essential that decisions on the need for changes in the regulatory regime are not made on the basis of unsubstantiated views of unjustifiable price levels.

#### *Response to Specific Questions Raised*

### **CHAPTER 1 INTRODUCTION**

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

The analysis recognises that price spikes play an important role in delivering security of supply and at times of overall shortage are a necessary and efficient market response providing important signals for generation investment in both baseload and peaking plant. We agree with the statement that there could be situations in which price spikes could be the result of undue exploitation of market power through non-economic dispatch decisions but only when these decisions are considered over the long term and cannot be explained by technical reasons. We refute any suggestions that ScottishPower has dispatched or withheld plant where it has been non-economic to do so, taking into account relevant considerations.

It is important to recognise, however, that any such non-economic dispatch situations by a dominant operator would be covered by the Competition Act and Article 82 of the EC Treaty of Rome. It is also important to recognise that, irrespective of whether the market is constrained or not, economic dispatch cannot be regarded as undue exploitation of market power.

In relation to current concerns in the GB market, the first factor identified by Ofgem as the shortage of transmission capacity between Scotland and England & Wales is key, given the slower than anticipated increase in the capacity of these connecting circuits since BETTA and the increased importance of renewable Scottish generation in contributing towards GB environmental targets. Ofgem is concerned that this may adversely impact trading in the GB market but there is no evidence that constraints are significantly impacting the GB wholesale price. It is important to recognise the downward competitive pressures on the GB wholesale price from Scottish generation being able to fully compete commercially in the GB market. The current arrangements for dealing with constraints do not distort this competition.

In relation to the recent Competition Act investigation into ScottishPower and Scottish & Southern Energy, which Ofgem closed in January 2009 after 9 months of investigation,

the document does not give any indication of the full extent of Ofgem's investigation into dominance and abuse of a dominant position nor of the full co-operation from the companies being investigated. It thus does not come across clearly that after a full investigation, with the companies concerned providing all the information requested, Ofgem's conclusion was there was unlikely to be any case to answer under the Competition Act.

It is not clear how Ofgem has arrived at its estimate of £125m for 2008/09 for the worst case scenario of the potential direct costs attributable to undue exploitation of market power. We believe this estimate to be grossly overstated. Economic dispatch cannot be regarded as undue exploitation of market power and thus compensation payments for 'lost profit' from being unable to run economically cannot be regarded as undue exploitation of market power. Constraints between Scotland and England & Wales are forecast at £153m for 2008/09 and given that this includes offer payments to English generators we do not see how £125m could be attributed to exploitation by Scottish generators.

The analysis of historical trends in constraint costs shows that for 2008/09 the average price of actions in Scotland at £47.5/MWh was lower than the average price of actions in England & Wales at £51.3/MWh. We fail to see how this can be regarded as evidence of undue exploitation of market power by Scottish generators.

**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?**

Ofgem's analysis shows that in 2008/09 the forecast volume of constraint actions in Scotland is over 8 times the volume in England & Wales while the average price of actions to resolve the constraints was lower in Scotland. The major concern must therefore be in relation to the volume of constraints but approaches for reducing the price of actions should also be considered. It is important that any actions to reduce the volume or price of constraints do not distort the GB competitive market.

The current and forecast volume of constraints between Scotland and England & Wales is evidence that the required investment in the transmission network has not been made. Further action is required to ensure the necessary investment is made as soon as possible. While planning delay is an issue for other parts of the GB network it cannot be cited as the main reason for delayed investment in the circuits connecting Scotland and England & Wales.

The lower cost of constraint actions in Scotland is evidence of the use of other options cheaper than balancing mechanism bids and offers to resolve constraints and more use should be made of these options within the increasingly competitive market through contracting forward for a longer period for options such as intertrip and capping contracts.

**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?**

We agree that there is scope for improvements in the alignment of SO and TO incentives which could reduce the frequency and severity of constraints on critical circuits and could facilitate more investment on the transmission network. The SO should be aware of the increase in constraint costs which would result from an extension to a transmission outage and the reduction in costs achievable from shortening the outage and could therefore incentivise the TO to shorten the outage or ensure it does not overrun.

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

We believe there is scope within the current market arrangements for incentivising the SO to enter more into long term contracts for alleviating constraints, particularly recognising the increase in availability of generators capable and willing to provide such services. Under the current SO incentive scheme the SO may be reluctant to enter into significant long term contracts for alleviating constraints for fear that a post audit of the effectiveness of such contracts with hindsight identifies more economic alternatives resulting in financial penalties to the SO. There could be benefits in separating out such contracts from the SO incentive scheme. In general, if the SO is encouraged to plan ahead in conjunction with generators rather than manage the constraints at the last minute, it is likely that the costs will be lower as more efficient options and more providers may be available.

**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?**

Increased transmission investment is the key to resolving the constraints issue. While the Transmission Price Control Review and the Transmission Investment for Renewable Generation processes have resulted in increased investment in the transmission system this has not happened early enough or to a sufficient extent. It is essential that all options are investigated which could alleviate the network capacity shortfall as soon as possible. We do not agree with the statement in the document that “building our way out” of the problem is unlikely to be a viable solution in the medium term. It is precisely the solution that is needed.

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

We do not consider that physical or virtual divestment of flexible generation plant in Scotland will be effective in addressing the constraints issue. Large flexible plant is bound to be more attractive to the SO for alleviating constraints and the two flexible plants in Scotland with large units are already separately owned. It would not be feasible to split ownership on a physical or a virtual basis within each of the large stations.

We do not consider that changing the split between SO and TO roles in Scotland or unbundling transmission ownership networks in Scotland would be effective in addressing the constraints issue. The Scottish TOs have been pro-active in promoting investment in transmission networks which would reduce constraints and without their actions the shortage of transmission capacity in Scotland and between Scotland and England & Wales would be even more severe than it is at present.

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

We do not consider that there are other asset-related remedies that would be effective in addressing the constraints issue.



## **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?**

We do not think that Ofgem's preferred option of a Market Power Licence Condition on generators is appropriate for a number of reasons. Firstly, we believe that existing enforcement provisions available to Ofgem, including the competition law prohibitions, are adequate to deal with anti-competitive behaviour by generators. Secondly, we believe that it would be detrimental to the operation of the competitive UK market, recognised as amongst the most competitive in Europe and globally, through discouraging innovation and the offering of new competitive services by existing generators or new entrants. Thirdly, we believe it would discourage investment, if the UK's regulatory regime were to move further out of step with the regimes elsewhere in Europe, at a time when generation investment in the UK is vital. We consider that it would be more appropriate to await the outcome of the current European initiatives rather than take action on a national level which could undermine the development of the internal market.

The Competition Commission concurred with the view that such a licence condition was not appropriate in its 2001 decision report on Ofgem's proposed licence condition targeted at tackling market abuse where they stated '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'.

This latest proposal following on from Ofgem's closed Competition Act investigation into ScottishPower and Scottish and Southern Energy suggests that Ofgem is attempting to define undue exploitation of market power for the electricity wholesale market on a different basis to case law in relation to the Competition Act. The Competition Act has been used successfully by Ofgem in the electricity industry and should be the basis for deciding whether an organisation has unduly exploited market power. If under the Competition Act an organisation is not found to have unduly exploited market power then a licence condition should not be introduced which deems the organisation to have done so.

The more broadly any licence condition is drafted the greater the uncertainty facing the licensee and a potential investor on what would constitute a breach of the condition and the greater the stifling of innovative competitive initiatives in the market. We do not believe that it would be possible to significantly reduce this level of uncertainty through the publication of guidelines, no matter how comprehensively drafted.

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

A formal appeals mechanism would be essential for any licence condition and it would need to operate on a similar basis to appeals to the Competition Appeals Tribunal under the Competition Act. In the absence of any specific appeals mechanism for this licence condition, we believe that the scope of appeals which currently exists for breaches of licence conditions under the Electricity Act 1989 (as amended) is narrower than that available in respect of the Competition Act 1998. We do not consider it appropriate that a licence condition should be introduced the scope of which would be wider than existing competition law provisions whilst at the same time reducing the rights of appeal in respect of that behaviour.

**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?**

We do not consider that a US-style ex-ante regulation framework would operate successfully in the GB market. The fully competitive GB wholesale and retail markets are significantly different to the equivalent US markets where wholesale competition is limited, retail competition is minimal and the state and federal regulatory framework is significantly different.

As stated above we believe that it is important for the continued development of the internal market in Europe that the regulatory regimes which exist in the different Member States do not unnecessarily become further out of step with each other. We believe that it would be prudent to await the outcome of the current work being undertaken by the European Commission in this area in order to avoid unduly deterring foreign investment in our national markets.

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

We believe significant reductions in constraint costs could be achieved in some situations where it is recognised well in advance that constraints will be an issue and forward contracts are put in place, within the competitive contracting framework, to alleviate these constraints.

**CHAPTER 5 POTENTIAL MECHANISMS FOR IMPLEMENTATION**

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

Given the previous rejection of this concept by the Competition Commission, we doubt whether there will be significant support for Ofgem's preferred option of a Market Power Licence Condition. If more than 20% of the licensed generators responding to this consultation are opposed to such a licence condition then we do not believe Ofgem should proceed with this option.

We also do not believe it would be appropriate for Ofgem to make a Market Investigation Reference to the Competition Commission. Significant investment is required by generators in renewable and environmentally beneficial generation in the near future and the prolonged detailed investigation of the market as a whole that the Competition Commission would undertake following such a reference would introduce considerable uncertainty in the market at a time of important investment decisions.