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Draft Energy Guidelines under the Competition Act

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Note:

On 16 June 1999, the former regulatory offices, Ofgas and OFFER, were renamed the Office of Gas and Electricity Markets (Ofgem). References in the text to documents and events before this date use the name of the original regulatory office.

1. Introduction

The substantive provisions of the Competition Act 1998 ('the Act') come into force on 1 March 2000. The Office of Fair Trading ('OFT') and the sector regulators, including the Office of Gas and Electricity Markets ('Ofgem'), will enforce the Chapter I and II prohibitions using their concurrent powers. Chapter I prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices which have the object or effect of preventing, restricting or distorting competition in the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom ('the Chapter I prohibition'). Chapter II prohibits conduct by one or more undertakings which amounts to the abuse of a dominant position in a market in the United Kingdom (or a part thereof) which may affect trade within the United Kingdom ('the Chapter II prohibition').

In accordance with Section 52 of the Act, the OFT and the sector regulators have developed advice and information about the application of the Chapter I prohibition and the Chapter II prohibition, and the enforcement of those prohibitions ('the guidelines'). The guidelines set out in this document ('the energy guidelines') provide advice and information as to how the Act will be applied to the energy sector,¹ bearing in mind its specific characteristics. These guidelines should be read in conjunction with:

- the other guidelines produced by OFT and the sector regulators;
- the guidance as to the appropriate level of penalties under the Act being produced by the Director General of Fair Trading ('DGFT') under Section 38 of the Act;

¹ In this context, the 'energy sector' covers those activities for which Ofgem has concurrent powers with the OFT under the Gas Act 1986 (as amended by the Gas Act 1995) and the Electricity Act 1989. Ofgem has concurrent powers in relation to activities for which Subsection 3 of Section 36A of the Gas Act 1986 applies (including the transportation, shipping, supply and storage of gas, and metering, meter reading and connection services), and under the Electricity Act 1989 in relation to any commercial activities connected with the generation, transmission or supply of electricity. Throughout this guideline the terms energy sector and gas and electricity industries are interchangeable.

- the set of rules being produced by the DGFT under Section 51 of the Act explaining the process that will be followed when applying the Act ('the Director's rules'); and
- the concurrency regulations being produced by the Secretary of State for Trade and Industry ('the Secretary of State') under Section 54 of the Act.

The energy guidelines provide advice and information about the factors which the Director General of Gas and Electricity Markets ('the DGGEM')² may take into account when considering whether, and if so how, to exercise his powers under the Act. However, the DGGEM cannot fetter his future discretion and there may be circumstances where Ofgem considers it appropriate not to apply its powers under the Act in accordance with these guidelines. In such circumstances, Ofgem would explain why it had chosen to apply the Act in such a way.

The guidelines will need to be updated from time to time to take account of relevant developments in the energy sector.³ The guidelines will also need to take account of any changes in the other guidelines and the development of relevant case law under the Act and under the EC Treaty. Consultation with interested parties will take place before making any changes to these guidelines.⁴

Section 2 of the guidelines explains Ofgem's powers under the Act and their relationship with other relevant legal provisions. Section 3 explains Ofgem's proposed approach to economic analysis under the Act, with reference to the specific economic characteristics of the energy sector. Again bearing in mind the circumstances in the energy sector, the process for carrying out investigations, and in particular, how Ofgem intends to use its combined powers under the Act, the Gas Act 1986 (as amended by the Gas Act 1995) and

² The duties of the DGGEM comprise the duties of the DGGS and the DGES under the Gas Act 1986 and the Electricity Act 1989 respectively.

³ Ofgem expects that the first revision of the energy guidelines will be required when the Utility Bill becomes law and the New Electricity Trading Arrangements are implemented. These changes should not affect the principles that are applied, but will affect the relevant market circumstances.

⁴ The latest version of the guidelines will be kept in the Ofgem library and will be available on Ofgem's web pages on the internet at <http://www.ofgem.gov.uk>.

the Electricity Act 1989 is discussed in Section 4. Section 5 describes Ofgem's intended approach to considering agreements covered by the transitional arrangements in Schedule 13 of the Act.

2. Legal Context

2.1 *The Competition Act 1998*

The Act replaces the anti-competitive practices provisions of the Competition Act 1980, and the Restrictive Trade Practices Acts ('RTPA') 1976 and 1977, and the Resale Prices Act 1976. The Chapter I and II prohibitions of the Act are based on the provisions of Articles 81 and 82 of the Treaty of Rome. The Act gives the DGGEM and the other sector regulators new concurrent powers with the DGFT. These new powers include the ability to impose financial penalties of up to 10% of turnover on undertakings infringing a prohibition in the Act.

Paragraphs 3 and 4 of Schedule 10 of the Act amend the Gas Act 1986 and the Electricity Act 1989 so that the DGGEM may have regard to his duties under the Gas Act 1986 and the Electricity Act 1989 when applying the Act, only if they are factors that the DGFT could have regard to when applying the Act.

a) EU Jurisprudence

Section 60 of the Act sets out certain principles with a view to ensuring that the UK authorities (including the DGGEM) handle cases in such a way as to be consistent with EC law, so far as that is possible. Under that section the DGGEM is required to ensure that his determination of questions relating to the prohibitions under Chapter I and II of the Act is consistent with principles laid down by the EC Treaty and the European Court. He is also required to have regard to any relevant decision or statement by the Commission.

The OFT's guideline on the major provisions of the Act contains further detail on how Section 60 of the Act will be applied.⁵

b) EC Directives

There are two EC directives which are directly related to the gas and electricity industries, which Ofgem must have regard to when exercising its functions.

⁵ "The Major Provisions", Office of Fair Trading 400, 1999.

i) EC Directive Concerning Common Rules for the Internal Electricity Market⁶

This directive provides a framework for EC member states to open up part of their electricity markets to competition. It addresses a number of issues, including:

- the interaction of electricity networks across the EC;
- the role of public service obligations in a competitive market;
- open, non-discriminatory and transparent rules of access to electricity networks; and
- transparency of vertically integrated electricity transmission or distribution companies (For example, through separate accounts).

ii) EC Directive Concerning the Common Rules for the Internal Market in Natural Gas⁷

This directive provides a framework for EC member states to open up part of their gas markets to competition. It addresses a number of issues, including:

- the role of public service obligations in a competitive market;
- open, non-discriminatory and transparent rules of access to gas networks;
- transparency of vertically integrated electricity transmission or distribution companies (For example, through separate accounts); and
- the opportunity to make special provisions for undertakings adversely affected by long term take or pay contracts when competition is introduced.

⁶ Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity.

⁷ Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning the common rules for the internal market in natural gas.

Consistent with the principle of subsidiarity, each EC member state can determine how to implement these directives bearing in mind their particular circumstances. Broadly, the UK has taken the view that the liberalisation of its gas and electricity markets so far, has ensured that the directives have been implemented.

c) The Competition Act 1998 Guidelines

The OFT and the sector regulators are producing guidelines setting out advice and information about the factors they may take into account when considering whether, and if so how, to exercise their powers under the Act.

The DGFT is required to produce guidance as to the appropriate level of penalties under Section 38 of the Act, which the DGGEM is required to apply when setting a penalty. In accordance with Section 51 of the Act, the DGFT is producing a set of rules ('the Director's Rules') on the process to be followed when applying the Act, which the DGGEM is required to follow when applying the Act. The Director's rules will be brought into force by an order laid before parliament by the Secretary of State.

There are published guidelines on how concurrent powers will operate in practice.⁸ Moreover, the Secretary of State is producing regulations on the application of concurrent powers under Section 54 of the Act,⁹ which the DGFT, and the sector regulators, including the DGGEM, will have to follow. These regulations will set out how the performance of certain functions under the Act, which are exercisable concurrently by sector regulators or the OFT will be co-ordinated.

2.2 The Fair Trading Act 1973

Investigations under the Fair Trading Act 1973 can still be undertaken following the introduction of the Act. Complex or scale monopolies can be examined by the DGFT or the DGGEM under his concurrent powers. A reference may be made to the Competition Commission in order to establish whether a monopoly situation operates, or may be

⁸ "Concurrent Application to Regulated Industries", Office of Fair Trading 405, March 1999.

⁹ These regulations will be given a binding legal effect by a Statutory Instrument of Parliament.

expected to operate, against the public interest. Further details of the DGGEM's powers under the Fair Trading Act 1973 are set out in the guideline on the major provisions.¹⁰

¹⁰ "The Major Provisions", Office of Fair Trading 400, 1999.

3. The Application of the Competition Act 1998 to the Energy Sector – Economic Analysis

3.1 The Requirements of the Competition Act 1998

When investigating potential infringements under the Act, Ofgem will take into account the guidelines listed in the back cover. It will also be necessary under Section 60 of the Act to ensure that any decisions under the Act are consistent with relevant European jurisprudence so far as is possible, have regard to European Commission statements, as explained in Section 2.1(a), and any are consistent with relevant case law that develops as a result of the application of the Act in the UK.

3.2 The Importance of Regulating Incumbents in the Energy Sector

The scope of monopoly and of public ownership in the electricity and gas industries prior to privatisation gave rise to patterns of activity that were not subject to normal market disciplines. As a consequence there was relatively little innovation in these industries. Innovation is central to discovering how resources can be better used to serve the varied interests of electricity and gas consumers. The relatively recent privatisations and the subsequent introduction of competition to parts of these industries has enabled participants to take advantage of the opportunities to innovate that were not taken during the periods of monopoly and public ownership.

Given the particular importance of innovation in the gas and electricity industries due to the recent introduction of competition, in its application of the Act Ofgem will be particularly vigilant in seeking to ensure that the conduct of incumbent undertakings does not have an anti-competitive effect by restricting the opportunities for others to innovate. This could occur, for example, by preventing the introduction of new products or services or by artificially depressing the returns that are available from them.

3.3 Characteristics Specific to the Energy Sector

Application of the Act to the energy sector will raise a number of challenges associated with the specific economic conditions to be found in the sector. It may take some time for the

energy sector case law to develop. In addition to energy sector case law, Ofgem will also have to ensure that it applies its powers under the Act in a manner that is consistent with relevant EC jurisprudence from other sectors, so far as is possible. However, the relatively advanced state of energy liberalisation in the UK compared to most other member states of the EC may mean that the UK is at the forefront of the application of competition law to competitive energy markets.

Ofgem believes that there are a range of characteristics of the gas and electricity industries, which, when taken together, affect how the Act is applied to the energy sector as compared to other sectors in Great Britain. The relevant factors include:

- the importance of 'unbundling', business separation, divestment and structural change more generally in the transition from monopoly to competition across a range of activities;
- the existence of monopoly providers of transportation, transmission or distribution networks, which are unlikely to be replicated, due to the cost conditions faced by any undertaking seeking to replicate the networks (including the costs arising from planning and environmental constraints);
- the extent of incumbent market power in parts of the gas and electricity industries, including supply, metering, meter reading, connections and storage markets;
- the limited storability of electricity, and to some extent gas, which has the effect of segmenting the market into short time periods;
- the low elasticity of demand for electricity and gas, particularly over short periods;
- the relative inelasticity of supply at some periods, in particular in electricity;

- the complexity of the Pool¹¹ rules for determining wholesale prices in electricity; and
- the significance and complexity of the various codes and agreements that govern connection to and use of electricity and gas systems, which are required to ensure the safe, secure and effective operation of those systems, eg. the Master Connection Use of System Agreement for electricity transmission and the Network Codes for gas transportation and shipping.

Ofgem believes that in enforcing the Act these specific economic conditions will give rise to a particular emphasis on certain issues connected with predation by dominant incumbents; the time dimension of dominance; the effects of agreements covering the use of networks; and the effects of conduct in relation to one activity or market on other related activities or markets.

These economic conditions and issues will affect at least five main aspects of the application of the Act:

- market definition;
 - the assessment of market power, and in particular, the assessment of dominance, including joint dominance;
 - the assessment of whether an undertaking is engaging in predatory pricing;
 - the assessment of the effects of inter-company agreements on competition;
- and

¹¹ The electricity pool of England and Wales is the mechanism that sets the prices generators receive and the prices suppliers pay for electricity, subject to their ability to agree contracts that hedge the risk of pool price fluctuations.

- the exclusion from the Act prohibitions, for services of general economic interest, under Schedule 3, Paragraph 4 of the Act and for compliance with legal requirements under Schedule 3, Paragraph 5.

Sections 3.4 to 3.8 explain how Ofgem intends to approach these five issues when applying the Act to the specific combination of circumstances in the gas and electricity industries, identified above.

3.4 Market Definition

European competition law requires that, in cases involving the possible restrictive effects of inter-firm agreements and cases of a possible abuse of dominance, the relevant market or markets should be defined.

a) Duration

In defining markets, one of the standard procedures to identify the extent of substitutability between products is to ask whether prices could profitably be sustained at levels significantly above competitive levels for a non-transitory period. By convention, as set out in the guideline on market definition,¹² non-transitory has tended to be interpreted as a duration of a year or more. The time segmentation of the electricity and gas markets, associated with a relative lack of storability, coupled with the supply and demand inelasticities noted above, imply that much shorter durations may be appropriate when considering market definition and market power.

As discussed in the market definition guideline, time is one dimension of a market definition, along with product and geography. Inelastic supply and demand, coupled with variations in levels of supply and demand, imply that both electricity and gas wholesale prices can be relatively volatile. Such volatility does not in itself raise problems. However, it is also the case that the combination of inelastic supply and demand can provide significantly enhanced opportunities for the exploitation of market power. This is particularly likely since limited storability means that one of the standard mitigating constraints on very short-term market power – the ability of firms and their customers to

¹² "Market Definition", Office of Fair Trading 403, 1999.

substitute transactions in one time period with transactions in another time period – is largely absent. The absence of a substitutability constraint means that, in certain circumstances, the appropriate definition of the market may be limited to a much shorter duration than is standard in many other industries.

b) Combined Effect of Duration and Magnitude

The market definition guideline¹³ refers to tests based on hypothetical price increases of 5 or 10 per cent. In electricity and gas markets, however, the potential price spikes that could be caused by the exercise of market power can be many times higher than these benchmark numbers. Very high wholesale prices, even if they hold for only short durations, can cause significant harm to customers and can, since customers include other companies, give rise to significant anti-competitive effects. As discussed in the market definition guideline, the consideration of hypothetical price increases where a dominant firm is present may be particularly difficult because of the lack of a competitive benchmark. Therefore, the process of defining a market could not be carried out in isolation, but would need to be considered alongside other evidence on market power and the undertaking's conduct.

Ofgem therefore considers that, in defining markets, it is appropriate to take account of the combined effects both of the magnitude of potential deviations of prices from competitive levels and, simultaneously, of the likely duration for which such deviations can be sustained. Effects on customers and on competition of similar magnitudes can be caused either by large price increases that can be sustained only for a short period or small price increases that can be sustained for a long period. It is appropriate, given the emphasis placed by the Act on economic effects, that market assessments reflect this fact in the specific circumstances of gas and electricity markets.

c) Absence of Sequencing

Ofgem also considers that the question of whether prices could profitably be raised above competitive levels for a non-transitory period can be best answered by considering the effects or expected effects of alleged anti-competitive behaviour at the outset, rather than

¹³ "Market Definition", Office of Fair Trading 403, 1999.

defining a market as the first step in a sequential investigation. One of the functions of market definition is to identify the scope of the potential issues that will need to be addressed by an investigating agency that may not have detailed and specialist knowledge of the relevant activities. Given Ofgem's continuing supervision of the energy market, it will often not be necessary to define a market as a first step in a case to determine the scope of an investigation.¹⁴ Although Ofgem will define the relevant market or markets during the course of such an investigation.

Further, while Ofgem recognises that the hypothetical monopolist test and the other procedures that are most frequently used to define a market, may usefully contribute to analysis under the Act, the information required to define markets, which relates largely to demand and supply side substitutability, is also required to assess dominance. Therefore, in assessing dominance, Ofgem will simultaneously be addressing the market definition issue. Any differences from the approaches adopted in other sectors should, therefore, be ones of timing and sequencing rather than of substance.

d) *Related Markets*

In many situations, it is recognised in competition law that there may not be a single, relevant market. An important class of cases concerns behaviour in one relevant market or market segments that may have anti-competitive effects in other, related markets or market segments. Such cases may be particularly important in energy markets. For example, a particular entry point on a transportation network may initially be defined as a relevant market because customers using that particular entry point have limited substitution possibilities. However, the effects of conduct at that entry point are likely to have economic effects on other parts of the network. In such circumstances it is appropriate that any market definition exercise does not unduly restrict the scope of an investigation and

¹⁴ There may be cases that relate to issues on which Ofgem does not have detailed and specialist knowledge, which may require specific work to define the scope of the investigation, before any assessment of market power or whether an infringement has occurred, can commence.

that it takes fully into account all of the relevant economic effects.¹⁵

When defining markets and assessing dominance, Ofgem will therefore have regard to the actual or expected effects of a firm's conduct on different activities, in deciding the scope of an investigation. Often the behaviour of competitors will provide practical examples of the relevant activities to consider in an investigation.¹⁶

3.5 Assessment of Market Power, and in Particular, the Assessment of Dominance, Including Joint Dominance

Dominance has been defined by the European Court in terms of the ability of a firm to behave, to an appreciable extent, independently of its competitors and its customers.¹⁷

Dominance may involve more than one undertaking ('Joint Dominance'). The simplest test for such conditions is to consider whether a firm or firms has the ability persistently to raise prices above competitive levels. Consistent with the Court's definition, Ofgem will place considerable emphasis on this test.

Such a test will not be applicable to situations where there is suspected to be a dominant buyer. Consistent with the guideline on the assessment of market power, Ofgem will carry out a careful analysis of vertical relationships on a case by case basis, where an abuse of buyer power is suspected.

In developing the case law on dominance, the European Court and the European Commission have, in cases to date, tended to assume that a dominant firm will be the

¹⁵ Ofgas' investigation in 1997 into BGT's Goldfish credit card joint venture ("Goldfish: British Gas Trading's credit card joint venture, A Decision Document", Ofgas, October 1997) is an example of a case where the leveraging of market power in one market into another has been considered. Ofgas concluded that, while the 'Goldfish' credit card constituted a discount on BGT's gas bills, which might persuade customers to stay with BGT, it was a strategy that rivals could in principle, and if they so wished, also choose to adopt. Ofgas concluded that the ability to redeem points accrued against a final BGT gas bill was an important safeguard against a potential tie-in of the customer, and therefore required BGT to explain this facility on its gas bills.

¹⁶ Ofgas' investigation into the market for storage and related services in 1998 ("Review of the supply of gas storage and related services, The Director General's final proposals", Ofgas, September 1999), showed the importance of considering all relevant markets when assessing market power. The investigation concluded that the conduct of BG plc, including its pricing, was affected by and could affect the related markets for spot and peak gas ('swing') and interruptible supply contracts.

¹⁷ *United Brands Co. v Commission* case 27/76 [1978] 1 CMLR 429, para.65.

largest firm (or group of firms) operating in a particular sector.¹⁸ Market share indicators have also played an important, although not decisive part, in the assessment of dominance. The guideline on the assessment of market power states that market share is an indicator but not a definer of market power.¹⁹

However, in the GB energy sector, due to the particular economic characteristics to be found there and due to some of the price setting rules, there are circumstances where firms may have the ability substantially and persistently to influence prices, and therefore to act independently of customers and competitors, even though they are not the largest firm in the market and even though their market shares fall well below normal thresholds for considering dominance.

Ofgem has recently published proposals to address certain types of inappropriate behaviour, associated with the exercise of market power, by some generators in the electricity wholesale market.²⁰ In this market the combination of the price-setting rules, inelastic demand, inelastic supply at some times of the year, and the non-storability of the product, can confer substantial market power on generators with a relatively small market share.

When considering whether undertakings are dominant (ie. can act to an appreciable extent independently of their customers and competitors), Ofgem will therefore look at a range of factors in assessing the effects of undertakings actions, including:

- customers' behaviour and options (eg. awareness of competition, the extent to which alternative providers are chosen, the extent to which substitutes are available);
- competitors' behaviour and capacities (eg. their range of offers, their ability to increase output within the relevant time period);

¹⁸ Joint dominance may not involve the largest firm in a market.

¹⁹ "Assessment of Market Power", Office of Fair Trading 415, 1999.

²⁰ "Rises in Pool Prices in July, A Decision Document", Ofgem, October 1999.

- market operation (eg. the extent of barriers to entry and exit); and
- market share.

Consistent with the guideline on the assessment of market power, Ofgem considers that market share on its own will only be an indicator of dominance, but would not be considered sufficient evidence on its own to determine whether an undertaking or group of undertakings are dominant, not least because the economic implications of any market share are likely to be conditioned by other relevant factors. In general, Ofgem will seek to assess both substitution possibilities and actual behaviour directly, rather than rely on proxies, such as market share, which can only be indicators of market power.

It is the abuse of, not the existence of, a dominant position that is prohibited by the Act. Therefore, where an abuse of dominant position is alleged or suspected and it is found that an enterprise or enterprises have the ability to act, to an appreciable extent, independently of its customers and competitors, (as manifested for example by an ability to raise prices above competitive levels to an extent that can cause significant harm) Ofgem will investigate further, to determine whether or not any infringement has occurred. Such an investigation will focus on the commercial conduct of the relevant enterprise(s) and on the effects of that conduct or agreements entered into by undertakings on customers and on competition. The guidelines on the Chapter I and II prohibitions of the Act, discuss the types of agreements or conduct that may breach the prohibitions.²¹ Ofgem's approach to considering predatory pricing, which is one possible infringement, is set out in Section 3.6.

As noted earlier, unlike many sectors in the UK, the energy sector is characterised by the presence of incumbent dominance or market power, which is being eroded in some cases through the development of competition. Ofgem, will therefore, pay particular attention to the possibility of pre-emptive behaviour by incumbents, designed to affect adversely the development of competition. For example, in the relatively newly opened domestic gas and electricity markets. Pre-emptive behaviour may also occur through actions in related

²¹ "The Chapter I Prohibition", Office of Fair Trading, 1999 and "The Chapter II Prohibition", Office of Fair Trading, 1999.

markets, eg. distributors or transporters may use their dominance in these markets to restrict, distort or prevent competition in the provision of metering, meter reading, connections or storage services. This again highlights the importance of considering the effect of actions across all the potentially affected activities.

3.6 Assessment of Whether an Undertaking is Engaging in Predatory Pricing

As indicated in the guideline on the assessment of individual agreements and conduct²², Ofgem considers the specific circumstances found in the gas and electricity industries will in some cases require an alternative approach to assessing predatory pricing to that set out in that guideline.

Generally, Ofgem will suspect predatory pricing if prices do not cover the avoidable costs that can be directly attributed to the group of customers to which they relate. However, predation may also occur where prices are set at the same level as, or above, attributable avoidable costs. Whether prices are predatory is best judged against the result that they are designed to achieve, which will necessarily depend on the circumstances at the time. This is consistent with the guideline on the assessment of individual agreements and conduct which considers amongst other factors the intention of an undertaking suspected of predatory pricing²³.

3.7 Assessment of the Effects of Inter-Company Agreements on Competition

Chapter 1 of the Act prohibits those agreements among undertakings, decisions by associations of undertakings, and concerted practices which prevent, restrict or distort competition, or are intended to do so. The specific examples listed in the Act are agreements, decisions or practices, which:

- directly or indirectly fix purchase or selling prices or any other trading conditions;

²² "Assessment of Individual Conducts and Agreements", Office of Fair Trading, 1999.

²³ Ofgas has applied this approach in a number of cases, including its review of BGT's proposed ValuePlus tariff in 1997, its review of BGT's tariffs in 1998 and its assessment of BGT's 'dual fuel' offer in 1999.

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

In addressing such agreements, Ofgem will follow the guideline on the Chapter I prohibition.²⁴ There are, however, a number of particular problems that arise in electricity and gas markets as a result of the requirements for arrangements to ensure safe, secure and efficient operation of electricity and gas systems that are used by many market participants. Such arrangements take the form of network codes, balancing and settlement codes, use of system agreements, and connection agreements.

As a result of their contribution to safety, security and efficiency, such agreements may qualify for exemption from the Chapter I prohibition. When exemption issues arise, Ofgem will apply the criteria for exemption set out in Section 9 of the Act. Consistent with the Chapter I prohibition guideline, Ofgem will pay particular attention to the question of whether any resulting restrictions of competition are indispensable to achieve the desired effects ('the indispensability test'). Only where this test is passed, will exemption be merited. More specifically, since a variety of different types of agreement may serve to achieve safety, security and operational efficiency objectives, and since different agreements may have different implications for competition, simply demonstrating that a particular agreement will achieve the stated objectives will be insufficient to warrant exemption. The agreement should constitute the least restrictive means of achieving its aims.

²⁴ "The Chapter I Prohibition", Office of Fair Trading, 1999.

In the first instance, Ofgem will make use of the 'indispensability' test when considering modifications to existing agreements. In the longer term, consideration will also need to be given to the continuing indispensability of provisions in existing agreements, not least because both electricity and gas markets continue to be subject to rapid structural change and aspects of the agreements that may have been considered to have relatively benign effects on competition in the past may come to have more restrictive effects, in later, changed circumstances. Agreements that met the 'indispensability' test at one point in time, cannot be assumed to meet the test in the future.

3.8 Exclusion from the Competition Act 1998 Prohibitions, for Services of General Economic Interest, under Schedule 3, Paragraph 4 of the Competition Act 1998 and for Compliance with Legal Requirements Under Schedule 3, Paragraph 5

Neither the Chapter I prohibition nor the Chapter II prohibition of the Act applies to an undertaking entrusted with the operation of "*services of general economic interest*" or having the character of a revenue-producing monopoly in so far as the prohibition would obstruct the performance, in law or in fact, of the particular tasks assigned to that undertaking.²⁵ Ofgem will therefore be required to assess whether or not, in a particular case, this exclusion is applicable.

As explained in the guideline²⁶ on this matter, for the exclusion to apply, the undertaking must have been *entrusted* with the relevant task by a public authority -- mere approval will not be sufficient. Ofgem will apply this first test strictly. This is consistent with EC jurisprudence.

The second test that Ofgem will apply in addressing the issue, concerns the extent to which a restriction on competition is *necessary* in order to be able to perform the task of general economic interest. If it is not necessary, for example, because the task could be performed in another, non-restrictive way at an acceptable cost, then the relevant conduct is not

²⁵ These provisions are contained in Paragraph 4, Schedule 3 of the Act.

²⁶ "Services of General Economic Interest", Office of Fair Trading, 1999.

excluded from the prohibition. Again, Ofgem will take a strict approach to the question of necessity.

The operation of the exclusion in respect of services of general economic interest is distinct from the exclusion from the prohibitions for 'agreements to the extent to which [they] are made in order to comply with a legal requirement' and 'conduct to the extent to which it is engaged in in order to comply with a legal requirement'.²⁷ Again, Ofgem will apply this exclusion strictly so that agreements or conduct will only receive this exclusion if they are the least restrictive way of meeting the legal requirement.

²⁷ These provisions are contained in Paragraph 5, Schedule 3 of the Act.

4. The Application of the Competition Act 1998 to the Energy Sector – Process for Investigation

4.1 The Requirements of the Competition Act 1998 and the Guidelines

As required by the Act, Ofgem will apply the various provisions of the Act relating to investigating and enforcing the Act, including provisions relating to the disclosure of information. In addition to the provisions of the Act, Ofgem will follow ‘the Director’s Rules’, developed by the DGFT under Section 51 of the Act. General guidance on the process to be followed when applying the Act is set out in the guideline on enforcement.²⁸

4.2 Characteristics Specific to the Energy Sector

Unlike most sectors covered by the Act, undertakings’ behaviour in the gas and electricity markets, including that of dominant companies, is regulated by sector specific Acts of Parliament that have created a licensing regime, as explained in Appendix 1. These Acts and the licences regulate and attempt to prevent various types of anti-competitive behaviour that may have detrimental effects on gas and electricity customers. This includes restrictions on some undertaking’s level and structure of charges and the prevention of unduly discriminatory behaviour by network operators and dominant suppliers.

Ofgem believes that the provisions of these forms of regulation are generally consistent with the Act and Ofgem will continue to use these forms of regulation to regulate and reduce market power, in conjunction with the Act. When applying the Act the DGGEM can only take account of his duties under the Gas Act 1986 and the Electricity Act 1989 to the extent that they are duties that the DGFT could take account of when applying the Act.

Section 4.3 explains the DGGEM’s view as to how Ofgem will distinguish between complaints that are trivial and non-trivial in nature. It also explains how the DGGEM intends to use his powers under the Act, the Gas Act 1986, the Electricity Act 1989 and the

²⁸ “Enforcement”, Office of Fair Trading, 1999.

Fair Trading Act 1973 to ensure that any anti-competitive behaviour is most effectively addressed without undertakings facing 'double jeopardy'.²⁹

4.3 Guidance for the Energy Sector

a) Trivial or Non-Trivial Complaints

Once it has been decided that Ofgem is responsible for a case,³⁰ Ofgem will attempt as quickly as possible to determine whether the complaint is trivial or non-trivial in nature. To the extent that it is relevant, Ofgem will use its existing knowledge of the issues to determine the nature of the complaint. If there is a doubt about whether the complaint is trivial or non-trivial in nature that cannot be resolved quickly by Ofgem, it may seek information from undertakings to determine whether to commence an investigation.

b) Information Gathering

When investigating potential infringements under the Act, the Gas Act 1986, the Electricity Act 1989 or issues under the Fair Trading Act 1973, Ofgem may need to seek information from various undertakings.

When requesting information, Ofgem will specify the infringement it is investigating and the power(s) it will use to address the suspected infringement. Where more than one of the powers explained in Chapter 2 or Appendix 1 are considered to be potentially appropriate, it is likely that Ofgem will specify all the potentially relevant powers. It may not be possible for Ofgem to decide which specific power(s) are likely to be the most appropriate to address the suspected infringement at the commencement of an investigation. When more than one power could be used because infringements under more than one provision are suspected, Ofgem may use the strongest information gathering powers available.

If it becomes clear to Ofgem when conducting its investigation that a particular power is no longer appropriate to the particular case, it will cease to request information under the

²⁹ "Double jeopardy" would occur where an undertaking faced the possibility of being punished more than once for the same infringement.

³⁰ Ofgem will follow the Secretary of State for Trade and Industry's regulations on concurrency under Section 54 of the Competition Act 1998, when determining whether it, the OFT, or another sectoral regulator will be a responsible for a case.

respective power and inform the undertaking concerned. Also, Ofgem will inform an undertaking if a new infringement is suspected after the investigation has commenced, which may increase the powers Ofgem considers could be appropriate to address the suspected infringement(s).

Where information has been gathered using powers under one of the Acts described in Chapter 2 or Appendix 1, Ofgem may use information gathered to investigate other matters under the Act, the Gas Act 1986, the Electricity Act 1989 or the Fair Trading Act 1973, subject to and in accordance with the provisions of these various acts.³¹

c) Consultation

Ofgem will follow the rules set out in the Director's rules when deciding whether or not to consult on decisions made under the Act. Where the Director's rules do not state whether a consultation is required or provide discretion as to whether or not to consult, Ofgem would normally expect to consult interested parties on decisions following non-trivial complaints, own initiative investigations or notifications of agreements, irrespective of whether it is found that one of the prohibitions has been infringed and a penalty is proposed.³²

When exercising powers under the Gas Act 1986 and the Electricity Act 1989, Ofgem would expect to consult on decisions and in some cases is required to do so. For example, if amendments to electricity or gas licences are proposed, it would be necessary to conduct a statutory 28 day consultation period.

d) Enforcement Action and the Imposition of Penalties

As early as possible in the course of an investigation where infringements of more than one provision are under consideration, Ofgem will determine the most appropriate power to remedy the anti-competitive behaviour identified and to punish the infringing undertaking. Section 28 of the Gas Act 1986 and Section 25 of the Electricity Act 1989 authorise the

³¹ Before the proposed Utilities Bill becomes law, Ofgem may not be able to use information gathered under the Gas Act 1986 to consider matters under the Electricity Act 1989, and vice versa. Where this issue arises, Ofgem will consider its powers in that particular case.

³² Ofgem will use its usual mailing lists to identify interested parties, publish consultations on its website and list the consultations in the OFT's weekly gazette on the Act.

DGGEM not to make a provisional or final order or confirm a provisional order under either sector specific act, if he is satisfied that the Act is the most appropriate way of proceeding to address the issue.

Ofgem would not use powers that had not been specified to the undertaking during the investigation. While an undertaking will not be fined twice for the same infringement, it is possible that remedies could include action under more than one of the powers set out in Chapter 2 or Appendix 1. However, as explained above, Ofgem is required not to use its Gas Act 1986 or Electricity Act 1989 licence enforcement powers if its powers under the Act would be more appropriate to address the issue.

When setting penalties under the Act, the DGGEM will not have the ability to have regard to his duty under the Gas Act 1986 and the Electricity Act 1989, to have regard to the ability of licensees to finance their activities, to the extent that this is not a duty to which the DGFT could have regard when applying the Act. However, the DGFT's guidance on the appropriate level of a penalty, prepared under Section 38 of the Act, will allow the DGGEM to consider the financial strength of an undertaking when setting a penalty. Ofgem is required to have regard to this guidance when setting penalties, after an undertaking has been found to have infringed the Act.

When setting penalties, in accordance with the DGFT's guidance, Ofgem will consider the extent to which the undertaking has taken reasonable steps, bearing in mind its resources, to put in place programmes to ensure compliance with the requirements of the Act. The OFT has produced a range of material to assist companies in developing compliance programmes.³³

When publishing any decisions following investigations, Ofgem will have regard to the need to maintain propriety with regard to market sensitive information, when deciding on the timing of announcements, as is currently the case for some announcements, eg. price

³³ These can be obtained directly from the OFT.

control proposals. This is in accordance with Ofgem's voluntary agreement with the London Stock Exchange.³⁴

³⁴ The voluntary agreement was published by the London Stock Exchange on 2 January 1996.

5. Transitional Arrangements

Provisions for the transition from existing competition law to the Act are set out in Schedule 13 to the Act. Those provisions are described further in the guideline on transitional arrangements.³⁵

Certain provisions in Schedule 13 to the Act relate particularly to provisions of the Gas Act 1986 or the Electricity Act 1989. Furthermore, the DGGEM has power, concurrently with the DGFT, to exercise the following functions under Schedule 13:

- publication of advice and information explaining the provisions of Schedule 13;
- dealing with applications for guidance in respect of agreements subject to transitional arrangements; and
- extending or terminating the transitional period during which the Chapter I prohibition does not apply to an agreement.

Nothing in Schedule 13 to the Act operates so as to prevent the Chapter II prohibition applying from the day on which Section 18 of the Act comes into force.

5.1 Section 100 of the Electricity Act 1989 and Section 62 of the Gas Act 1986

These sections (described in this section as the RTPA sections) provide that the RTPA 1976 does not apply to certain types of agreements described in those sections. Agreements of major importance to the energy sector, such as the Gas Network Codes and the Electricity Master Connection and Use of System Agreement are exempt from the RTPA by virtue of these provisions.

³⁵ "Transitional Arrangements", Office of Fair Trading 406, 1999.

Schedule 13 to the Act provides for a transitional period in respect of these agreements, which will run for five years from the date on which the Chapter I prohibition comes into effect. The Chapter I prohibition of the Act will not apply to these agreements during the transitional period.

The Chapter I prohibition of the Act will also not apply for the duration of the same transitional period in the following circumstances:

- where an agreement is made during that transitional period and that agreement is one to which, had the RTPA not been repealed, it would not have applied by virtue of the RTPA sections;
- where an agreement (whenever made) is varied so as to become one to which, had the RTPA not been repealed, it would not have applied by virtue of the RTPA sections; or
- where an agreement to which the Chapter I prohibition does not apply during the transitional period because of the provisions of Schedule 13 relating to the RTPA sections is varied, so long as following the variation it remains one to which, had the RTPA not been repealed, it would not have applied by virtue of the RTPA sections.

In contrast, where an agreement to which the Chapter I prohibition of the Act does not apply during the transitional period, because of the provisions of Schedule 13 of the Act relating to the RTPA sections, is varied so that, had the RTPA not been repealed, the RTPA would now apply to it, then the Chapter I prohibition of the Act will apply to it from the date of variation.

The question of whether or not the RTPA does or does not apply to an agreement requires, in some instances, an assessment by the DGGEM of the extent to which an agreement is

likely to have a significant effect in restricting, preventing or distorting competition.³⁶ In making such assessments during the transitional period the DGGEM will, to the extent appropriate, take into account matters addressed in these guidelines. In particular, the issues raised in Section 3.1(c)(iii).

The Secretary of State may by order provide for a transitional period, during which the Chapter I prohibition of the Act will not apply to specified agreements relating to the gas and electricity sectors.

5.2 Extending or Terminating the Transitional Period

The DGGEM may extend the transitional period during which the Chapter I prohibition will not apply to an agreement. He may do so either on application by one of the parties to the agreement or on his own initiative. More details of the procedures in relation to the extension of transitional periods are given in the guideline on transitional arrangements.³⁷

In deciding whether to extend the transitional period the DGGEM will bear in mind the issues set out in the guideline on transitional arrangements and the issues discussed in Section 3.1(c)(iv). In particular, Ofgem will consider the expected future effect of each particular agreement on competition and customers before deciding whether to extend the transitional period. It is unlikely that an agreement, which the DGGEM considers would infringe the Chapter I prohibition of the Act, would be granted an extension unless there are good reasons why an extension is required – for example, the agreement is being re-negotiated, the agreement is due to expire shortly after the end of the unextended transitional period, or the parties have a legitimate need for more time to prepare a notification.

³⁶ For example, "The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996, SI 385/96" or the "Electricity (Restrictive Trade Practices Act 1976) (Exemption) Order 1993, SI 912/93.

³⁷ "Transitional Arrangements", Office of Fair Trading 406, 1999.

The DGGEM may by direction terminate the transitional period in relation to any agreement if either:

- he has required any party to that agreement to give him such information about that agreement as he may require and, at the end of the period specified in the Director's Rules for providing such information, any party has failed, without reasonable excuse, to do so; or
- if he considers;
 - that the agreement would, but for the transitional period, infringe the Chapter I prohibition; and
 - that he would not be likely to grant the agreement an unconditional individual exemption.

Any direction terminating a transitional period is subject to revocation, before it takes effect, either by the DGGEM or the Secretary of State.

The DGGEM will bear in mind the guideline on transitional arrangements³⁸ and the issues discussed in Section 3.1(c)(iii) when deciding whether to terminate the transitional period for an agreement. In particular, Ofgem will give some consideration to the need to terminate the transitional period where it is concerned that an agreement may be having an appreciable effect on competition, such that it is appropriate to review it under the Chapter I prohibition immediately rather than wait for the transitional period to run its course.

³⁸ "Transitional Arrangements", Office of Fair Trading 406, 1999.

Appendix 1 Energy Sector Regulatory Law

This appendix sets out the DGGEM's duties and powers under the Gas Act 1986 and the Electricity Act 1989. It also explains how these duties and powers are expected to be amended if the proposed Utility Bill becomes law during the current parliamentary session.

A1.1 Electricity Act 1989

The general duties of the Director General of Electricity Supply ('the DGES') are set out in section 3 of the Electricity Act 1989, and his functions are set out in sections 1 and 47 to 50. The DGES must exercise his functions in a manner he considers is best calculated to secure that all reasonable demands for electricity are met, that licence holders are able to finance their activities, and to promote competition in the generation and supply of electricity.

Subject to these primary duties, the DGES also has a duty to exercise his functions in the manner he considers is best calculated to protect the interests of customers, to promote efficiency on the part of transmission and supply licence holders and the efficient use of electricity. In doing so, he has to take into account the effect on the environment of activities connected with the generation and supply of electricity, as well as the health and safety of those employed in the electricity industry.

The DGES has the power to obtain information from licensees and others in relation to potential breaches of licence, under Section 28 of the Electricity Act 1989. However, the DGES cannot require information to be produced, which the holder of that information would not be required to produce in civil proceedings in court. A person who refuses to comply with a notice requiring information to be furnished to the DGES is liable on conviction to face a fine and a court order to provide the information.

A1.2 The Gas Act 1986

The general duties of the Director General of Gas Supply ('the DGGS') are set out in Sections 4 and 4A of the Gas Act 1986 (as amended by the Gas Act 1995). The DGGS must exercise his functions in the manner he considers is best calculated to secure that all

reasonable and economic demands for gas are met, to secure that license holders can finance their licensed activities and to secure effective competition in gas shipping and supply.

Subject to these primary duties, the DGGS also has a duty to exercise his functions in the manner he considers is best calculated to protect the interests of gas customers in terms of price, service and continuity of supply, to promote efficiency and economy on the part of licence holders and to secure effective competition in new connections and the laying of pipes and in activities ancillary to the shipping and supply of gas. In doing so, he shall take into account the effect on the environment and to protect the public from the dangers of supplying gas.

The DGGS has the power to obtain information in relation to potential breaches of licence under Section 38 of the Gas Act 1986. However, the DGGS cannot require information to be produced, which the holder of the information would not be required to produce in civil proceedings in court. A person who refuses to comply with a notice requiring information to be furnished to the DGGS is liable on conviction to face a fine and a court order to provide the information.

A1.3 The Electricity Act 1989 Licensing Regime

The Electricity Act 1989 provides for the licensing of transmission operators, generators and suppliers of electricity (subject to some limited exemptions in the case of generators and suppliers).³⁹ These licences impose a number of obligations on their holders.

Where the DGES is satisfied that a licensee is contravening, or is likely to contravene, a licence condition, the Electricity Act 1989 requires him (except in certain specified circumstances) to issue an enforcement order against the licensee. Failure to comply with the order can expose the licensee to action (including a claim for damages) by any person who suffers loss or damage as a result of that failure.

³⁹ 1st Tier PES Electricity licences cover both distribution and supply functions, while 2nd Tier Electricity licences only cover supply functions.

The Electricity Act 1989 empowers the DGES to modify the conditions of a licence with the licensee's consent (and after consultation). The DGES may also refer to the Competition Commission questions as to whether any matters relating to a licence operate or may be expected to operate against the public interest. In certain circumstances the DGES may, following a report from the Competition Commission, modify that licence.

The transmission, generation and supply licences include conditions requiring the licensees to provide information requested by the DGES to fulfil his duties under the Electricity Act 1989 and to enforce the requirements of the licences.

A1.4 The Gas Act 1986 Licensing Regime

The Gas Act 1986 provides for the licensing of public gas transporters, shippers and suppliers of gas. These licences impose a number of obligations on their holders.

Where the DGGS is satisfied that a licensee is contravening, or is likely to contravene, a licence condition, the Gas Act 1986 requires him (except in certain specified circumstances) to issue an enforcement order against the licensee. An enforcement order may include a requirement for the licensee to pay a monetary penalty of an appropriate amount. Failure to comply with the order can expose the licensee to action (including a claim for damages) by any person who suffers loss or damage as a result of that failure. The Gas Act 1986 empowers the DGGS to modify a licence with the licensee's consent (and after consultation). The DGGS may also refer to the Competition Commission questions as to whether any matters relating to a licence operate or may be expected to operate against the public interest. In certain circumstances the DGGS may, following a report from the Competition Commission, modify that licence.

The transportation, shipping and supply licences include conditions requiring the licensees to provide information requested by the DGGS to fulfil his duties under the Gas Act 1986 and to enforce the requirements of the licences.

A1.5 The Proposed Utility Bill

Under the Government's proposed new utility legislation, the duties of the DGGS and DGES will be combined and the position of DGGEM will be formally created. The Utility Bill is expected to place a primary duty on the DGGEM to protect the interests of consumers, where possible through the promotion of competition. In performing this duty, the DGGES will need to take account of the ability of licensees to finance their licensed activities. The Government has also indicated its intention to enable the DGGEM to impose financial penalties on companies found to have been or who are in breach of their licence. The electricity licensing regime will be changed to introduce separate licenses for distribution and supply activities, and to prevent the holding of both types of licence by the same company.

The DTI expects that the Utility Bill will receive royal assent in the summer of 2000.