

April 2000

**The market abuse licence condition for
generators**

A decision document

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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). Reference in the text to documents and events before this date use the name of the original regulatory office.

1. Introduction

The purpose of this document

- 1.1 This document sets out Ofgem's decisions following the publication in December 1999¹ of a document setting out formal notification of Ofgem's intention to introduce a new market abuse condition into the licences of seven generators.² Five of these generators have now accepted the proposed licence modification. Two generators have not yet accepted and the document confirms Ofgem's intention to refer the matter to the Competition Commission in respect of two generators who have not consented.
- 1.2 The document confirms the appointment of, and the procedures for, the Advisory Body, which will hear appeals under the market abuse condition. It re-states Ofgem's policy on the criteria for determining coverage of the market abuse condition under the existing wholesale trading arrangements and under the New Electricity Trading Arrangements (NETA) that are due to be implemented later this year.³

The process so far

- 1.3 In July 1999, in response to a number of complaints from customers and suppliers, Ofgem published a consultation document on causes of the very high level of electricity prices set in the wholesale electricity market in England and Wales, the Pool, in July 1999⁴. Ofgem concluded that the high prices were the result of two factors. First, the two major price-determining generators, National Power and PowerGen increased the prices at which they offered their coal-fired plant into the Pool, raising energy prices. Second, the capacity element of the Pool price was very high.
- 1.4 Following a consultation on the findings of the investigation into Pool prices in July, Ofgem published a decision document in October⁵. Ofgem concluded that the history of the Pool had demonstrated the continuing market power of a number of generators and their

¹ 'Pool Prices in July: Statutory Consultation on Proposed Licence Amendments', Ofgem, December 1999.

² The seven generators were AES, British Energy, Edison Mission Energy, Magnox Electric plc, National Power, PowerGen and TXU Europe.

³ 'The New Electricity Trading Arrangements: Ofgem/DTI conclusions document', Ofgem/DTI, October 1999.

⁴ 'Ofgem Consultation on Rises in Pool Prices in July', Ofgem, July 1999.

willingness to exercise that market power at the expense of customers. Ofgem therefore proposed the introduction of a modification to the licences of generators whom Ofgem believes are likely to have substantial market power in determining wholesale electricity prices. In the October document, Ofgem set out its criteria for determining the coverage of the licence. On this basis, Ofgem proposed introducing the condition into the licences of seven generators.

1.5 The proposed 'market abuse' condition would allow Ofgem to take action if a generator were found to be abusing a position of substantial market power. In the document, Ofgem consulted on the text of the proposed licence condition, draft guidelines on enforcing the condition and the proposed coverage of the condition.

1.6 In the light of responses to our October proposals Ofgem continued to support the introduction of a licence condition to address the potential abuse of substantial market power by generators. The majority of respondents endorsed this view and believed that the licence modification would help to protect customers and prevent market abuse. Ofgem's December document set out our intention to introduce the new condition into the licences of seven generators. Ofgem did, however, take the concerns of the generators very seriously. To reflect these concerns, Ofgem revised the text of the licence condition and the guidelines on enforcement of the licence condition. The document indicated that if any of the licensees did not consent to the modification, Ofgem intended to make a reference to the Competition Commission.

Developments since Ofgem's December document

1.7 In the light of responses to Ofgem's December document, Ofgem amended the guidelines and made minor changes to the licence condition itself⁶. The final guidelines and licence text were published on the 31 January 2000⁷. On the same day Ofgem wrote to the seven generators seeking their formal consent to the proposed licence modification.

⁵ "Rises in Pool Prices in July: A Decision Document", Ofgem, October 1999.

⁶ The full text of the revised condition is set out in Appendix 1.

⁷ "The Prevention of Wholesale Market Abuse: Guidelines for Generators", Ofgem, January 2000.

a) Consents received to date

- 1.8 Of the seven generators to whom the market abuse condition was originally proposed to apply, two companies, Magnox Electric plc and TXU Europe, consented immediately. On 22 March, Ofgem announced that another generator, Edison Mission Energy, had also consented to the modification. On the same day, Ofgem announced that National Power had been issued with a new generation licence that included the market abuse condition. National Power had applied for the licence as part of the restructuring necessary before its proposed de-merger of its international and UK businesses. On 6 April, Ofgem announced that National Power⁸ and PowerGen had consented to the modification.
- 1.9 On 12 April 2000, Ofgem modified all of the licences of BNFL Magnox, Edison Mission Energy, National Power, PowerGen and TXU Europe to include the new market abuse condition. The licence modifications took immediate effect. A list of the generation licences modified to include the market abuse condition is set out in Appendix 1.
- 1.10 British Energy and AES have, to date, not consented to the modification.

b) Consent from other generators

NRG

- 1.11 In February 2000, National Power gave consent on behalf of NRG, who were in the process of purchasing National Power's 650MW gas-fired, Killingholme power station, to modify the licence of Nitrogen Ltd, the company that owned the plant within the National Power group. At the time, NRG was also negotiating to acquire National Power's 1200MW coal-fired, Blyth power station. The combined capacity of the generating plant would have fulfilled Ofgem's criteria for indicating the possibility of possessing substantial market power. On 29 March 2000, NRG completed its purchase of the Killingholme plant but has subsequently withdrawn from negotiations to purchase Blyth from National Power. As a result, NRG does not fall within the criteria for modifying the licence and Ofgem does not intend to include the market abuse condition in NRG's licence at this time.

⁸ National Power holds four generation licences: npower, National Power plc, Nitrogen Two Ltd and National Power Cogeneration Trading Ltd. National Power consented to the introduction of the market abuse condition into the remaining three licences.

London Electricity/EdF

- 1.12 On 17 March 2000, Ofgem issued a consultation paper on London Electricity's proposed acquisition of Enron's 790MW gas-fired Sutton Bridge power station. Ofgem consulted on whether to seek to introduce the market abuse licence condition into the licence of London Electricity given that London Electricity and its parent company, EdF, have a combined market share of approximately 4.5% of the England and Wales generation market and have a price-setting role through EdF's use of the UK-France interconnector. In the light of the responses, Ofgem proposed the inclusion of the condition into London Electricity's licence and London Electricity gave its consent.
- 1.13 Ofgem is therefore proposing to modify the licence of London Electricity (Sutton Bridge Ltd) under Section 11 of the Electricity Act 1989, which provides for modification of a licence with the licensee's consent. The Notice of the modification is set out in Appendix 3.

Ofgem's policy on the inclusion of the market abuse condition in additional licences

a) Market abuse condition under existing trading arrangements

- 1.14 There have recently been a number of announcements of plans to divest generation assets and as a result, the ownership of plants and market shares of a number of generators has changed rapidly. The prospect of further restructuring raises the issue of existing companies applying for new generation licences prior to disposal and of inclusion of the market abuse condition in the licences of companies following acquisitions.
- 1.15 Before the introduction of NETA, Ofgem will determine whether or not to include the market abuse condition in a new generation licence on the basis of a generators' share of total output and the frequency with which it has set the energy price (System Marginal Price) under the existing trading arrangements (i.e. the criteria set out in Ofgem's October 1999 decision document). In assessing a generator against these criteria, Ofgem will take into account all generation assets in which the company in question holds a controlling interest, even if the generation assets are in separately licensed companies.

- 1.16 If a generator who meets these criteria applies for a new generation licence as part of say, a corporate restructuring, Ofgem will include the market abuse condition if a new licence is issued.
- 1.17 If following a plant acquisition, a generator meets the criteria, Ofgem will seek to introduce the market abuse condition into any generation licences held by the generator.

b) Market abuse under NETA

- 1.18 Ofgem believes that although NETA will fundamentally alter the trading environment for generators and suppliers, it cannot eliminate all opportunities for potentially damaging, exploitation of substantial market power that derive from the underlying operational and economic characteristics of electricity systems. Ofgem therefore believes it is necessary to introduce a prohibition on market abuse as a standard licence condition to provide an effective means of tackling abuse, if it occurs.
- 1.19 In the Ofgem/DTI consultation in February⁹, Ofgem reaffirmed our view and stated that we would initiate a further consultation on the market abuse condition following any Competition Commission reference. Subject to this consultation, Ofgem intends to recommend to the Secretary of State that he introduces, as a standard condition, a market abuse licence condition applying to all generation and supply licences, subject to any Competition Commission findings.

Ofgem clarification on market abuse

- 1.20 In discussions with Edison Mission Energy, PowerGen and National Power, Ofgem was able to clarify a number of areas of the application of the market abuse condition in accordance with the licence condition and the guidelines.
- 1.21 Specifically, Ofgem confirmed that:
- ◆ Market abuse is not concerned with price spikes that are a consequence of underlying market conditions which are necessarily a feature of a properly functioning markets. This includes price spikes which are caused by events which are outside of a generator's

⁹ 'The New Electricity Trading Arrangements: Proposed licence conditions', Ofgem/DTI, February 2000.

reasonable control or those which are responsive to demand. Ofgem is only concerned with excessive price movements that are a consequence of generator's abusing positions of substantial market power;

- ◆ Withdrawals of generation capacity that are a result of legitimate technical unavailability or, in certain circumstances, poor trading conditions are not an abuse, even where the generator concerned is found to have substantial market power;
- ◆ Licensees subject to the condition can propose modifications to the guidelines on what constitutes abuse under the condition; and
- ◆ In determining what constitutes abuse, Ofgem will have regard to the general principles which have arisen from the application of competition law, taking into account the specific economic characteristics of the wholesale electricity market.

1.22 Ofgem also clarified the following aspects relating to the Advisory Body and the appeals process under the market abuse condition:

- ◆ Ofgem has created a *de facto* independent appeal route through the establishment of the Advisory Body and its terms of reference. Under the law as it stands, no more formal appeals process can be created;
- ◆ Ofgem will take into account any advice given by the Advisory Body, will in practice expect to follow any advice and will publish reasons for any departure from its advice; and
- ◆ Ofgem recognises that any decisions taken under the licence condition are susceptible to Court challenge through judicial review.

The Advisory Body

1.23 Ofgem has now appointed an Advisory Body consisting of Professor Richard Whish, who will chair the Body, Sir Bryan Carsberg, John Flemming, Richard Smethurst and Professor Michael Waterson. The Advisory Body will advise Ofgem in the event that Ofgem considers taking action under the new licence condition.

Modification to the guidelines

- 1.24 Following the clarification given to licensees, Ofgem is proposing to modify the guidelines issued in January to allow licensees to propose amendments to the guidelines. Ofgem does not believe that it will be necessary to change the guidance notes on procedures of the Advisory Body because they already provide for the Director General to seek written advice from the Advisory Body on any proposed changes to the guidelines.
- 1.25 Under the procedures we have established, any modification proposed to the guidelines will be subject to a decision by Ofgem, having consulted the Advisory Body. In seeking to modify the guidelines, we intend to follow this process. Ofgem is therefore minded to accept the proposed amendment to allow licensees to propose changes and would issue revised guidelines shortly after the consultation ends.

Competition Commission reference

- 1.26 To date, two generators, AES and British Energy, have not consented to a licence modification to introduce the market abuse condition into their licences. In respect of these licences, Ofgem intends to refer the matter to the Competition Commission under Section 12 of the Electricity Act 1989.
- 1.27 Ofgem will review the market abuse condition in the light of any findings or recommendations by the Competition Commission. It will, if appropriate, discuss any proposals to modify the condition following receipt of a report from the Competition Commission with those companies who are subject to the condition.

Outline of this document

- 1.28 Chapter 2 sets out the relevant provisions of the Electricity Act 1989 and associated generation licences. Chapter 3 sets out Ofgem's decisions in the light of developments since Ofgem's December document, provides more detail on the clarification issued to generators and the proposed modification to the guidelines and sets out the role of the Advisory Body, which Ofgem has established to hear appeals under the market abuse condition. Appendix 1 lists the generation licences that have been modified to date to include the condition and sets out the text of the condition. Appendix 2 sets out the

procedures of the Advisory Body. Appendix 3 gives Notice of our intention to modify the licence of Sutton Bridge Ltd to include the market abuse condition.

Views invited

- 1.29 Ofgem is seeking representations or objections relating to the proposed licence modification of the London Electricity's licence. Ofgem is also seeking views on the proposed amendment to the guidelines. Views, representations or objections need to be received by 11 May 2000. Responses should be sent to:

Dr Eileen Marshall CBE

Deputy Director General, Competition and Trading Arrangements

Office of Gas and Electricity Markets

Stockley House

130 Wilton Road

London

SW1V 1LQ.

Electronic responses can be sent to: lorraine.ladbrook@ofgem.gov.uk

- 1.26 Respondents are free to mark their responses as confidential although we would prefer, as far as possible, that responses can be placed in the Ofgem library. If you have any queries concerning this document Stephen Smith (0207 932 5927) or Sonia Brown (0207 932 6312) will be pleased to help.

2. Regulatory Framework

The Electricity Act 1989

- 2.1 The statutory duties of the Director General are set out in section 3 of the Electricity Act 1989 ('the Act'). The Director General 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.
- 2.2 Subject to these primary duties, the Director General also has a duty to exercise his functions in the manner he considers is best calculated to protect the interests of consumers in respect of price, continuity and quality, 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 Electricity Act licensing regime

- 2.3 The Act provides for the licensing of generators, transmission operators and suppliers of electricity (subject to some limited exemptions in the case of generators and suppliers). These licences impose a number of obligations on their holders.
- 2.4 Unless covered by an exemption, all electricity generators generating electricity in Great Britain are required to have a generation licence. Generation licences in respect of generation in England & Wales obliges the holder, among other things, to comply with the Grid Code, be a member of the Pool and comply with the Pooling and Settlement Agreement¹⁰ and submit relevant generating sets for central despatch.
- 2.5 Standard conditions in the generators' licences do not include any conditions intended to address the acceptability, or otherwise, of generators' behaviour in the Pool. However, a special licence modification, condition 9A, was made to the licences of PowerGen,

National Power and Nuclear Electric¹¹ in 1992 following a Pool price inquiry by OFFER. The new condition was aimed at preventing anti-competitive behaviour by generators. The licence condition seeks to ensure that available generation capacity is offered into the Pool by obliging the generators to publish information on plant availability, and to establish arrangements to discover whether other operators would be willing to buy stations that the licence holder intends to close.

Modifying licences by consent

2.6 Under section 11 of the Act, the Director General can modify the conditions of a licence if the holder of the licence consents to the modifications. Before making modifications under section 11, the Director General shall give notice:

- a) stating that he proposes to make the modifications and setting out their effect;
- b) stating the reasons why he proposes to make the modifications; and
- c) specifying the period (not being less than 28 days from the date of publication of the notice) within which representations or objections to the proposed modification may be made

and shall consider any representation or objections which are duly made and not withdrawn.

Referrals to the Competition Commission

2.7 The Director General may, under section 12 of the Act, refer a licence to the Competition Commission. Any such reference must be framed so as to require the Competition Commission to investigate and report on the following questions:

- a) whether any matters specified in the reference, relating to the generation, transmission or supply of electricity by a licensee, operate, or may be expected to operate, against the public interest; and

¹⁰ The Pooling and Settlement Agreement is the trading contract between generators and suppliers that governs the Pool.

b) if so, whether the effects adverse to the public interest which those matters have or may be expected to have could be remedied or prevented by modifications of the conditions of the licence.

2.8 In determining whether any particular matter operates, or may be expected to operate, against the public interest, the Competition Commission shall have regard to the Director General's statutory duties under the Act.

2.9 Section 14 of the Act states that where a report of the Competition Commission:

a) includes conclusions that any of the matters specified in the reference operate, or may be expected to operate, against the public interest;

b) specifies effects adverse to the public interest which those matters have or may be expected to have;

c) includes conclusions to the effect that those effects could be remedied or prevented by modifications of the conditions of the licence; and

d) specifies modifications by which those effects could be remedied or prevented,

the Director General shall make such modifications of the conditions of that licence as appear to him requisite for the purpose of remedying or preventing the adverse effects specified in the report. In doing so, the Director General shall have regard to the modifications set out in the Competition Commission's report.

2.10 Before making any such modifications, section 14 of the Act requires the Director General to consult interested parties and consider any representations or objections that are duly made and not withdrawn. The procedure for doing so mirrors that of section 11 when seeking to modify a licence by consent (see 2.6 above).

¹¹ Following nuclear privatisation, the condition now appears in the licences of both British Energy and Magnox Electric.

The Pooling and Settlement Agreement (PSA)

- 2.11 The Director General's powers in relation to the PSA are limited. A decision by Pool Members on a resolution can be appealed to the Director General, who can decide that the resolution should stand or fall: he cannot alter its wording.
- 2.12 Clause 6.11 of the PSA¹² provides that the Director General can refer a matter, in writing, to the Pool Executive Committee (PEC). The PEC is then obliged to consider the matter and report back to the Director General. It is not obliged to take any other action on his suggestion.

¹² Clause 6.11 says:-

"At the Director General's request, the Executive Committee shall:- give due and prompt consideration to any matter referred to it in writing by the Director; advise the Director in writing of any decision or action of the Executive Committee in relation to such matter; provide the Director in writing with an explanation with reasonable detail of the reasons for such a decision or action; and if reasonably requested by the Director (having regard, in particular, to the resources available to the Executive Committee), in relation to any proposal by the Director for a change to any provision of this Agreement provide or procure the provision of advice and assistance to the Director as soon as reasonably practicable as to the implications of the change and the actions necessary to implement it (including any relevant feasibility study).

3. Developments since the December document

Generators' consent to the market abuse licence condition

- 3.1 In the light of responses to Ofgem's December document, Ofgem amended the guidelines (and also made minor changes to the licence condition) and published the final version on 31 January 2000. On the same day Ofgem wrote to the seven generators seeking their formal consent to the proposed licence modification.
- 3.2 Initially, two companies, Magnox Electric plc and TXU Europe, consented to the modifications being made to their licences. In March, Edison Mission Energy consented to the modification. In April, PowerGen and National Power consented to the modification. These consents followed discussions with Ofgem of its approach under the "market abuse" clause and the manner in which Ofgem intends to exercise its powers. The proposed licence amendments and guidelines remain unchanged.
- 3.3 In March 2000, Ofgem decided to seek to introduce the condition into the licence of London Electricity because, following its acquisition of Sutton Bridge from Enron, it met the criteria we had set out for including the condition in a generation licence. London Electricity consented to the modification. Subject to consultation, this modification will be made in May. The notice of the proposal to modify the licence of Sutton Bridge Ltd is set out in Appendix 3.
- 3.4 National Power gave consent on behalf of NRG to modify the licence of Nitrogen Ltd (Killingholme) to include the market abuse condition. However, NRG subsequently withdrew from negotiations to purchase Blyth and as a result, no longer meets the criteria for inclusion of the condition in its licence.
- 3.5 The modifications to all of the licences of BNFL Magnox, Edison Mission Energy, National Power, PowerGen and TXU Europe were made on the 12 April 2000.
- 3.6 To date, AES and British Energy have not consented to the inclusion of the market abuse condition in their licences. Ofgem expects to refer the matter in respect of these licences to the Competition Commission.

Ofgem clarification on market abuse

3.7 Ofgem was able to clarify a number of areas of the application of the market abuse condition in accordance with the licence condition and the guidelines in discussions with Edison Mission Energy, PowerGen and National Power.

3.8 In particular, Ofgem made clear that:

- ◆ Market abuse is not concerned with price spikes that are a consequence of underlying market conditions which are necessarily a feature of a properly functioning markets. This includes price spikes which are caused by events which are outside of a generator's reasonable control or those which are responsive to demand. Ofgem is only concerned with excessive price movements that are a consequence of generator's abusing positions of substantial market power;
- ◆ Withdrawals of generation capacity that are a result of legitimate technical unavailability or, in certain circumstances, poor trading conditions are not an abuse, even where the generator concerned is found to have substantial market power;
- ◆ Licensees can propose modifications to the guidelines to generators on what constitutes abuse under the condition; and
- ◆ In determining what constitutes abuse, Ofgem will have regard to the general principles which have arisen from the application of competition law, taking into account the specific economic characteristics of the wholesale electricity market.

3.9 Ofgem also clarified the following aspects relating to the Advisory Body and the appeals process under the market abuse condition:

- ◆ Ofgem has created a *de facto* independent appeal route through the establishment of the Advisory Body and its terms of reference. Under the law as it stands, no more formal appeals process can be created;
- ◆ Ofgem will take into account any advice given by the Body and will in practice expect to follow any advice and will publish reasons for any departure from its advice; and
- ◆ Ofgem recognises that any decisions taken under the licence condition are susceptible to Court challenge through judicial review.

Guidance on bidding strategies

- 3.10 Ofgem accepted the desirability of reducing uncertainty at the outset, and offered on a voluntary, confidential basis, to allow licensees to submit details of bidding and capacity strategies. Ofgem would on the basis of these submission, be willing to identify, in advance, any behaviour that appeared likely to be problematic and could, also in advance, indicate its views to the licensee.
- 3.11 Ofgem made clear that it would not be possible to identify all possible issues in advance; this is a major part of the rationale for the shift in the balance between prescriptive, ex-ante regulation and application of the abuse principle. In particular, informal guidance cannot (as under the Competition Act and the FSA's proposed market abuse regime) be treated as equivalent to an 'exemption'.
- 3.12 Ofgem therefore agreed to give informal guidance on any plans that are, on a voluntary basis, submitted to Ofgem. Such guidance may be conditional. For example, it might be indicated that the relevant behaviour would generally be unproblematic but that it could give rise to issues of abuse in the event that certain specified circumstances materialised.
- 3.13 Where any generator has sought informal guidance on strategies, and where Ofgem has indicated that the proposed behaviour does not appear to raise issues of market abuse, any change in Ofgem's view of the likely effects of the relevant behaviour will be communicated to the company. Similarly, Ofgem would expect generators to notify us in the event of changes in circumstances, known to them, that they might reasonably expect would affect Ofgem's views on the likely effects of the behaviour (e.g. because its impacts on prices or competition were materially changed).
- 3.14 Where informal guidance has been given, Ofgem will not take retrospective action in respect of behaviour initially indicated as likely to be unproblematic in the relevant circumstances, provided information had been given fully and fairly by the generator. Ofgem reserves the right to take action in respect of behaviour which, although originally accepted by Ofgem as likely to be unproblematic, subsequently turns out to cause problems, from the time at which Ofgem indicates to the generator its new assessment of the position.

- 3.15 Ofgem cannot guarantee that we will be able to indicate to a generator that all proposed strategies are in fact without problems. Any correspondence between Ofgem and generators will be placed on file and made available to the Advisory Body in the event that the Body is asked to consider any subsequent disputes.

Capacity withdrawal and market abuse

- 3.16 Ofgem made clear its views on the framework for how it would assess whether capacity withdrawal constituted market abuse in a letter to generators. The contents of the letter were published as part of an Ofgem statement on prices in Electricity Futures markets on 6 April 2000.
- 3.17 In the letter to generators, Ofgem confirmed that withdrawals of capacity as a result of legitimate technical unavailability are not an abuse, even where the generator concerned is found to have substantial market power.
- 3.18 The position in relation to 'poor market conditions' is slightly more complicated. In such circumstances, it is likely that there is excess capacity in the market, and it may very well be the case that, as a result, the generator concerned does not have substantial market power during the relevant period. If that is the case there is no issue of potential abuse to consider.
- 3.19 Where, notwithstanding the market conditions, the generator does possess substantial market power in the relevant period, there is clearly the potential for abuse of that market power, including by withdrawal of capacity. Whether or not capacity withdrawal is an abuse will then depend upon its effects on prices, and hence on customers and competition. If prices were not materially affected, the behaviour would be unproblematic, even if the generator had substantial market power. On the other hand, if the effect of the withdrawal is a substantial increase in prices, Ofgem would need to give careful consideration to the circumstances of the case.
- 3.20 By way of illustration, if (a) the poor market conditions were expected to persist in the longer term, (b) the generator decided that it was no longer economic to keep plant open, and (c) the effect of closure was to move prices back towards a longer-term equilibrium level, the behaviour would amount to no more than a normal competitive reaction. On the other hand, if (a) the poor market conditions were expected to be temporary, (b) the capacity withdrawal was likewise temporary, and (c) the effect was to prevent market prices

reflecting costs in situations of temporary excess capacity, then, depending on its other effects (on customers and competition), the behaviour might be problematic.

- 3.21 In summary, Ofgem recognises that when market conditions are poor and prices are low, generators may legitimately consider temporarily withdrawing plant from the system. If a generator with substantial market power withdraws plant and the decision can be economically justified, on the basis of expectations of price and the avoidable costs of the plant over the relevant period, this would not constitute market abuse. Generators should not be compelled to operate plant at a loss (based on avoidable costs) and in these circumstances it would not be right for Ofgem to intervene.
- 3.22 However, where a generator possesses substantial market power in the relevant period, there is clearly the potential for abuse of that market power by the temporary withdrawal of capacity. Whether or not capacity withdrawal is an abuse will depend upon its effects on prices, and hence on customers and competition.

Modification to the guidelines

- 3.23 Following the clarification given to licensees, Ofgem is proposing to modify the guidelines issued in January to allow licensees to propose amendments to the guidelines. Ofgem does not believe that it will be necessary to change the guidance notes on procedures of the Advisory Body because they already provide for the Director General to seek written advice from the Advisory Body on any proposed changes to the guidelines. Ofgem believes that this will cover any changes proposed by a licensee to the Guidelines.
- 3.24 Under the procedures we have established, any modification proposed to the guidelines will be subject to a decision by Ofgem, having consulted the Advisory Body. In seeking to modify the guidelines, we intend to follow this process. We are therefore consulting on whether to introduce the change, and would invite views on whether to introduce an amendment to the guidelines to allow licensees to propose modifications. Subject to consultation, Ofgem is minded to accept these changes and would issue revised guidelines shortly after the consultation ends.

The Advisory Body

- 3.25 Ofgem has now appointed an Advisory Body consisting of Professor Richard Whish, who will chair the Body, Sir Bryan Carsberg, John Flemming, Richard Smethurst and Professor Michael Waterson. The Advisory Body will advise Ofgem in the event that it considers taking action under the new licence condition.
- 3.26 An Enforcement Order issued under the Electricity Act in relation to a breach of the market abuse condition would be subject to the statutory right of appeal under Section 27 of the Electricity Act. This provides that a licensee subject to an Order may, within 42 days of the issue of the Order, apply to have the Order or part of it quashed on grounds that:-
- ◆ Ofgem has acted outside its powers in making or confirming the Order; or
 - ◆ Ofgem has not followed the procedure under the Act for issuing or confirming Orders and the licensee's interests have as a consequence been substantially prejudiced.
- 3.27 The role of the Advisory Body is not provided for in the procedure under the Act for issuing or confirming Orders and Ofgem will not be under a legal obligation to follow its advice. However, the advice of the Advisory Body will be published and will form an important part of the context within which the reasonableness of Ofgem's decision would need to be assessed. Ofgem recognises, therefore, that a decision to impose an Enforcement Order under the market abuse condition might be open to challenge under the appeals mechanism if the Director General disregarded a report of the Advisory Body.
- 3.28 As discussed above, Ofgem considers that licensees subject to the market abuse condition should be able to seek guidance from Ofgem as to whether particular conduct is liable to be considered as an abuse of substantial market power. Such guidance would not have any formal status. However, Ofgem recognises that a decision to make an Enforcement Order would also be liable to challenge under Section 27 of the Act on grounds of irrationality, if it was inconsistent with positive informal guidance previously given to a licensee (in the absence of a material change of circumstances or other factor justifying a change in position).
- 3.29 As noted above, Ofgem has now established the Advisory Body, comprising distinguished experts in competition policy and financial markets, which will help ensure that there are

no major departures from best practice in other public policy areas when Ofgem applies the prohibition of abuse principle to the relevant activities. Ofgem attaches great importance to the role of the Advisory Body, and considers that the skills, authority and independence of its members send a clear signal of the care and seriousness with which Ofgem intends to tackle any relevant issues that might arise.

- 3.30 The Advisory Body will have access to the evidence considered by Ofgem and any other directly affected third parties. Its conclusions will be published. Ofgem cannot, legally, be bound to follow the advice of the Advisory Body but we would in practice expect to do so and to publish reasons for any departure from its advice. We consider that the Advisory Body will add significantly to the authority and transparency of the decision making process. Fuller details of the Advisory Body and its procedures are set out in Appendix 2.

Views invited

Proposal to modify the licence of Sutton Bridge Ltd

- 3.31 Ofgem is proposing to modify the licence of London Electricity (Sutton Bridge Ltd) under Section 11 of the Electricity Act 1989, which provides for modification of a licence with the licensee's consent. The Notice of the modification is set out in Appendix 3.
- 3.32 Ofgem is seeking representations or objections relating to the proposed licence modification of the London Electricity's licence.

Proposed amendment to the guidelines under the market abuse condition

- 1.30 Following the clarification given to licensees, Ofgem is proposing to modify the guidelines issued in January to allow licensees to propose amendments to the guidelines. Ofgem does not believe that it will be necessary to change the guidance notes on procedures of the Advisory Body because they already provide for the Director General to seek written advice from the Advisory Body on any proposed changes to the guidelines.
- 3.33 Under the procedures we have established, any modification proposed to the guidelines will be subject to a decision by Ofgem, having consulted the Advisory Body. In seeking to modify the guidelines, we intend to follow this process. Ofgem therefore invites views on the proposed modification to the guidelines.

Appendix 1 List of generation licences modified to include the market abuse condition

On 12 April 2000, under Section 11(1) of the Electricity Act, the Director General made modification to introduce the market abuse condition into the following licences:

- ◆ PowerGen plc;
- ◆ National Power plc;
- ◆ National Power (Cogeneration Trading Ltd);
- ◆ Nitrogen Two Ltd
- ◆ Eastern Merchant Generation Ltd;
- ◆ Anglian Power Generators Ltd;
- ◆ Peterborough Power Ltd;
- ◆ Citigen Ltd;
- ◆ Magnox Electric;
- ◆ Edison First Power Ltd;
- ◆ Lakeland Power Ltd; and
- ◆ First Hydro Company.

On 22 March 2000, pursuant to Section 6(1)a of the Electricity Act, the Director General issued a licence to npower that included the market abuse condition.

A copy of the text of the market abuse condition is provided below.

The Market Abuse Licence Condition

1. The Licensee shall not engage in conduct, whether alone or with one or more other undertakings, which amounts to an abuse of a position of substantial market power in the determination of wholesale prices for electricity under the relevant trading arrangements.

2. For the purpose of this Condition conduct may, in particular, constitute such an abuse if the Licensee, whether alone or with one or more other undertakings:
 - (a) acts in such a way as materially to prejudice the efficient and economical balancing of the transmission system;
 - (b) without good cause limits generation or capacity availability in such ways as materially to increase wholesale prices for electricity; or
 - (c) pursues discriminatory pricing policies by determining wholesale prices for electricity that differ unduly between times when market demand and cost conditions are otherwise similar.

3. For the purpose of this Condition:
 - (a) "relevant trading arrangements" shall mean the arrangements from time to time in force for the sale and purchase of electricity under the Pooling and Settlement Agreement and any arrangements for the sale and purchase of electricity as may supersede them; and
 - (b) the Licensee shall be regarded as having a position of substantial market power in the determination of wholesale prices for electricity under the relevant trading arrangements if the Licensee (or the Licensee together with its affiliates and related undertakings) has the ability to bring about, independently of any changes in market demand or cost conditions, substantial changes in wholesale electricity prices.

4. Whether any conduct is prohibited by this Condition shall be determined having regard to any guidelines on the application of this Condition issued from time to time by the Director after consultation with the Licensee and any other person who may have a relevant interest in the same.
5. This Condition shall cease to have effect on the first anniversary of the coming into effect of trading arrangements which supersede the arrangements for the sale and purchase of electricity under the Pooling and Settlement Agreement (the disapplication date) unless at any time before the disapplication date the Director makes a reference to the Competition Commission under Section 12 of the Act relating to modification of the Condition.
6. If the Competition Commission makes a report on a reference made by the Director under paragraph 5 relating to the modification of this Condition and such report does not include a conclusion that the cessation of this Condition operates or may be expected to operate against the public interest, this Condition shall cease to apply 30 days after the publication of such report by the Director in accordance with Section 13 of the Act.
7. This Condition shall not limit or affect in any way the Licensee's obligations arising under any other Condition of this Licence.

Appendix 2 The Advisory Body - Guidance notes on procedures

Introduction

- 1.1 The Director General of Electricity Supply ("the Director") has established an Advisory Body ("Advisory Body") to advise him on the application of the Market Abuse Condition in licences granted to licensees under the Electricity Act 1989 ("Act"). These guidance notes set out the procedures of the Advisory Body.
- 1.2 The meaning of Market Abuse Condition and other terms contained in these guidance notes are defined in paragraphs 1.36 to 1.47 of these notes.
- 1.3 The Director will consult the Chairman of the Advisory Body and such other persons as he considers appropriate before modifying these guidance notes. The Director will publish any changes and, where appropriate, submissions in respect of those changes.
- 1.4 The Advisory Body may at any time propose changes to these guidance notes.
- 1.5 These guidance notes cannot be legally binding on the Director. Nevertheless he intends to follow them and to give his reasons if he departs from them.

Membership of the Advisory Body

- 1.6 The Advisory Body shall consist of a Chairman, and at least four other Members, each of whom shall be suitably qualified and have relevant experience.
- 1.7 Each matter brought before the Advisory Body shall be considered by a panel of at least three Members selected by the Chairman. A panel will normally include the Chairman among its members. No Member of the Advisory Body shall be involved in consideration of a matter in respect of which he has a conflict of interest.
- 1.8 If the Chairman is not available, the Members of the Advisory Body shall select another Member of the Advisory Body to act as chairman for the purposes of giving advice on a particular matter referred to it.

Appointment and removal of members

- 1.9 The Chairman and Members shall be appointed by the Director.
- 1.10 The terms and duration of appointment for each Member, including the Chairman, shall be those agreed with the Director from time to time.
- 1.11 The Members of the Advisory Body, including the Chairman, may resign by giving one month's notice in writing to the Director, or earlier if the Director agrees.
- 1.12 The appointment of a Member of the Advisory Body may be terminated by the Director only on the ground of incapacity or misbehaviour.

Purpose and function of the Advisory Body

- 1.13 The function of the Advisory Body shall be to advise the Director in writing on the application of the Market Abuse Condition.
- 1.14 Where
 - (a) the Director makes a Provisional Order or gives notice under section 26(1) of the Act of his intention to make a Final Order in relation to a breach of the Market Abuse Condition by a licensee; and
 - (b) that licensee has requested that the Director refer the matter to the Advisory Bodythen the Director will ask the Advisory Body to advise him in relation to the confirmation of the Provisional Order or the making of a Final Order and will publish his request.
- 1.15 In considering whether to confirm a Provisional Order or make a Final Order in respect of which the Director has received advice from the Advisory Body, the Director will take into account that advice. Further information on the Director's decisions and their relationship to orders made under section 25 of the Act can be found in the Guidelines.
- 1.16 The Director may, at any time, ask the Advisory Body to advise him on any other matter, whether general or particular, relating to the application of the Market Abuse Condition. The Director shall seek written advice from the Advisory Body on any proposed changes to the Guidelines.

Procedures of the Advisory Body

- 1.17 Any request by the Director to the Advisory Body for advice shall be in writing, specify the time and date by which the advice is sought and be published.
- 1.18 All information provided by the Director to the Advisory Body shall be passed to the Advisory Body through a secretariat appointed by the Director.
- 1.19 The secretariat shall notify those Members of the Advisory Body selected to consider a specific matter of the Director's request for advice.
- 1.20 All deliberations of the Advisory Body and any of its Members shall be held in private and shall be treated as confidential by those Members.
- 1.21 Following deliberation, the Advisory Body shall nominate one of its number selected to consider the matter to be responsible for drafting the written report containing the advice to the Director.
- 1.22 The draft written report shall then be considered by those Members of the Advisory Body selected to consider the matter.
- 1.23 Wherever possible the report should be agreed unanimously by those Members of the Advisory Body selected to consider the matter. In the absence of unanimity and where there is an even number of Members the Chairman shall have a casting vote in addition to his own vote.
- 1.24 Should any of the Members of the Advisory Body selected to consider the matter disagree with the written report to the Director, or any material part of it, that Member shall be entitled to append a notice of dissent to the written report indicating those parts of the written report with which he or she disagrees together with reasons for his or her dissent.
- 1.25 Before publishing the report the Director may consult the licensee and complainant on any matters that he should exclude from the published report, being matters of a kind mentioned in section 57 of the Act. Such matters shall include any matter which relates to the affairs of an undertaking where the publication of that matter would or might, in the opinion of the Director, seriously and prejudicially affect the interests of that undertaking.

- 1.26 The Director will publish the report of the Advisory Body and any appended notices of dissent, excluding such matters referred to in 1.25 above as he may consider appropriate. Where the report relates to a specific case involving one or more licensees the Director shall send those licensees and any complainant a copy of the report including any excluded matters that relate exclusively to the recipient of the copy of the report. Subject thereto, all excluded matters shall remain confidential to Members of the Advisory Body and to the Director and his staff.

Information to be considered by the Advisory Body

- 1.27 The Advisory Body shall base its advice on material provided by the Director through the secretariat. It shall receive evidence and information through the Director.
- 1.28 The Director shall make available to the Advisory Body all material relevant to the matter under contemplation supplied to the Director by the licensee or all material supplied by the complainant.
- 1.29 The Director may recommend that the Advisory Body decline to consider material submitted to him after he has completed his final consultation with the licensee prior to issuing a Final Order or confirming a Provisional Order where, in his opinion, such material should reasonably have been supplied to him, if at all, at an earlier stage and, because it was not then so supplied to him, the consequential delay in its consideration by the Advisory Body would cause undue delay in the work of the Advisory Body and would thereby prejudice the efficient administration by the Director of his duties.
- 1.30 The Advisory Body shall also normally have access to all correspondence to the complainant and the licensee. Such correspondence shall include a copy of the Director's notification to the licensee setting out reasons for which it appears that the Condition may be being, or may have been, breached and details of any relevant matters of fact or law.
- 1.31 The Director will provide to the Advisory Body all factual market information, relevant to the matter under contemplation, available within OFGEM.
- 1.32 The Advisory Body would normally have access to internal OFGEM memoranda and to advice sought by OFGEM.

- 1.33 The Advisory Body may exclude from its consideration any material referred to above on which the licensee or complainant has not had a reasonable opportunity to make comments for consideration by the Advisory Body if and to the extent that consideration of such material by the Advisory Body would or might be unfairly prejudicial to the licensee or complainant.
- 1.34 The Advisory Body may recommend to the Director that the Director obtain further information or advice in respect of matters that it is considering.
- 1.35 The Director shall obtain further information or advice for the Advisory Body where, in his opinion, it is appropriate to do so. If and to the extent that the Director, having been recommended by the Advisory Body to seek such information or advice, does not do so the Advisory Body may note that fact in its written report.

Meaning of expressions

- 1.36 "Advisory Body" means the Advisory Body established by the Director to provide advice to him in connection with the Market Abuse Condition.
- 1.37 "Market Abuse Condition" means the condition in licences granted under section 6(1)(a) of the Act prohibiting abuses of substantial market power in the determination of wholesale prices for electricity.
- 1.38 "Director" means the Director General of Electricity Supply.
- 1.39 "the Act" means the Electricity Act 1989.
- 1.40 "Chairman" means the Chairman of the Advisory Body, as appointed by the Director or the Member appointed to act as such under paragraph 1.8 of these guidance notes.
- 1.41 "Final Order" means an order under whose terms the Director makes such provision as is requisite for securing compliance with a licence condition, in accordance with section 25 of the Act.
- 1.42 "Provisional Order" means an order under whose terms the Director makes such provisions as appear to him to be requisite for the purpose of securing compliance with a licence condition, being made, confirmed or modified in accordance with section 25 of the Act.

- 1.43 "Member" means any person appointed to the Advisory Body by the Director.
- 1.44 "Guidelines" means any guidelines on the application of the Market Abuse Condition issued from time to time by the Director as referred to in paragraph 4 of the Market Abuse Condition.
- 1.45 References to "Member" shall include "Chairman", and "Members" or either of these unless otherwise specified.
- 1.46 "secretariat" means a body of the Director's staff appointed by the Director to provide administrative services to the Advisory Body.
- 1.47 "excluded matters" means matters which, pursuant to paragraphs 1.25 and 1.26, are excluded from a report of the Advisory Body as published.

Terms and conditions of appointment of members

General

- 1.48 The terms of appointment and termination for each Member shall be those agreed with the Director from time to time.

Conflicts of interest

- 1.49 A Member shall immediately inform the Director should there be grounds to believe that there is a conflict of interest between the Member's duties on the Advisory Body and his or her other interests (including employment, consultancy or other remunerated work).
- 1.50 Should a Member inform the Director that he or she has a conflict of interests, the Director may either terminate the Member's appointment or suspend his or her involvement for as long as the conflict subsists either generally, or in relation to any matter.

Members' interests

- 1.51 The Members of the Advisory Body shall not buy or deal in shares or other forms of securities in any company subject to regulation by the Director, or in any company of which they have received share-price sensitive information whilst they are Members and for one year following termination of appointment, in their own names or as trustees.

- 1.52 On appointment, every Member shall ensure that any shares or securities of the type referred to in 1.51 above, that they already own or have an interest in, are placed in a "blind trust" whilst they are Members and for one year following termination of appointment.
- 1.53 The prohibition on shareholdings in 1.51 and 1.52 above does not extend to the spouse or children of a Member unless the Member is actually or effectively controlling the investment policy of his or her spouse or children including in the capacity of trustee or other comparable position.
- 1.54 A Member shall not advise or assist others in the dealing of shareholdings or other securities (as referred to in 1.51 and 1.52 above) whilst a Member of the Advisory Body and for one year following the termination of appointment.

Political activities

- 1.55 Members of the Advisory Body shall not serve as officers carrying out executive duties in any political party.
- 1.56 The Chairman and the Members shall abstain from controversial political activity.

Release of confidential information

- 1.57 The Members of the Advisory Body shall be subject to the constraints on the release and disclosure of information contained in the Official Secrets Act 1911 and 1989; section 101 of the Act; and section 133 of the Fair Trading Act 1973.
- 1.58 These constraints may be amended as necessary to reflect relevant changes to the applicable legislation.

Indemnities

- 1.59 The Director shall indemnify Members who have acted honestly, reasonably and in good faith and without negligence so that such a Member will not have to meet out of his or her own personal resources any personal civil liability which is incurred in execution or purported execution of his or her function as a Member of the Advisory Body.

Restrictions following termination of appointment

- 1.60 Following the termination of their appointments, Members will not, without the prior written permission of the Director, directly or indirectly disclose to any person or make use of any information received in confidence in the course of their appointment, whether orally or in writing. This obligation of confidentiality shall not apply to any information which subsequently comes into the public domain other than as a result of a breach of this obligation.
- 1.61 Following the termination of their appointments, for a period of one year, Members may not enter employment or undertake consultancy or other remunerated work in relation to the energy industry where it is apparent or likely that conflicts of interests could arise as a result of their previous Membership of the Advisory Body. A reduction in the one-year period of this restriction or exceptions for specific work may be made with the written agreement of the Director.

Appendix 3 Notice of Proposal to Modify the Licence of Sutton Bridge Ltd

NOTICE

ELECTRICITY ACT 1989

Section 11(2)

Notice of proposal to modify the conditions of the Electricity Generation Licence granted under Section 6 of the Electricity Act 1989 to Sutton Bridge Power Limited.

The Director General of Electricity Supply ("the Director"), pursuant to Section 11(2) of the Electricity Act 1989 ("the Act") hereby gives notice as follows:-

- 1 The Director, pursuant to Section 11(1) of the Act, proposes to make modifications ("the proposed modifications") to the conditions of the Electricity Generation Licence granted under Section 6 of the Act to Sutton Bridge Power Limited by inserting a new Condition 3A (Prohibition of abuse of substantial market power in the determination of wholesale electricity prices).

- 2 The effect of the proposed modifications is to prohibit the Licensee from engaging in conduct which amounts to an abuse by the Licensee, either alone or with other undertakings, of a position of substantial market power in the setting of wholesale prices for electricity under the Pooling and Settlement Agreement and any arrangements for the sale and purchase of electricity as may supersede them.

- 3 The reason why the Director proposes to make the proposed modifications is that they will better protect the interests of electricity consumers in respect of prices charged by prohibiting such abuses.

A consultation document entitled "Pool Prices in July, Statutory Consultation on the Proposed Licence Amendments", published on 23 December 1999, describes in more detail the effects of and reasons for the modifications proposed to 15 other licences: the proposed

modifications to the licence referred to herein are substantially the same and proposed for the same reasons as those referred to in the consultation document. This document and the proposed modifications are published on the Office of Gas and Electricity Markets website (at www.ofgem.gov.uk). A copy can also be obtained free of charge from the Office of Gas and Electricity Markets. Representations or objections with respect to the proposed modifications may be made on or before 11 May 2000 and should be sent to the address below, marked for the attention of Lorraine Ladbrook:-

The Director General of Electricity Supply
The Office of Gas and Electricity Markets
Stockley House
130 Wilton Road
London SW1V 1LQ



.....

Stephen Smith
Director, Trading Arrangements

Authorised in that behalf by the
Director General of Electricity Supply

12 April 2000