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FORMAL CONSULTATION DRAFT

Competition Legislation

Competition Act 1998

Application to the Energy
Sectors

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Contents

	Page
1. Introduction	2
2. Legal Context	4
3. Economic Analysis	8
4. Process for Investigations	25
5. Transitional Arrangements	32
Appendices	
1. Energy Sector Regulatory Law	36

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

- 1.1 The substantive provisions of the Competition Act 1998 ('the Act') came 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').
- 1.2 This guideline ('the energy guideline') provides advice and information about the factors which the Director General of Gas and Electricity Markets ('the DGGEM')¹ will take into account when considering whether, and if so how, to exercise his powers under the Act². This guideline is not exhaustive. It will be necessary to consider the circumstances of each case on an individual basis, with reference to the guideline.
- 1.3 The guideline will need to be updated from time to time to take account of relevant developments in the energy sector³. They will also need to take account of any changes in the other guidelines issued by OFT and the sector regulators and the development of relevant case law under the Act and under the EC Treaty.

¹ 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. It is expected that when the Utilities Bill becomes law the DGGS and DGES will be replaced by an authority.

² These guidelines should be read in conjunction with the guidelines listed in the front cover.

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.

Consultation with interested parties, including the OFT and other sector regulators, will take place before making any changes to the guidelines⁴.

- 1.4 Part 2 of the guideline sets out the legal context within which Ofgem will be operating. It explains Ofgem's powers under the Act and the relationship of these powers with other relevant legal provisions. Part 3 provides an economic analysis of the application of the Act, with reference to the specific economic characteristics of the energy sector. The process for carrying out investigations, and in particular, how Ofgem intends to use its powers under the Act, the Gas Act 1986 (as amended by the Gas Act 1995) and the Electricity Act 1989 is discussed in Part 4. Part 5 describes Ofgem's approach to considering agreements covered by the transitional arrangements in Schedule 13 to the Act.

⁴ The latest version of the guideline 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> and OFT's web page on the Internet at <http://www.oft.gov.uk>.

2. Legal Context

The Competition Act 1998

- 2.1 The Act replaces or amends legislation, including the Restrictive Trade Practices Act 1976, the Resale Prices Act 1976 and the majority of the Competition Act 1980. The Chapter I and II prohibitions of the Act are based on the provisions of Articles 81 and 82 of the EC Treaty. The Act gives the DGGEM and the other sector regulators new concurrent powers with the Director General of Fair Trading. These new powers include the ability to impose financial penalties of up to 10 per cent of turnover on undertakings infringing a prohibition in the Act, for every year of the infringement up to a maximum of three years.
- 2.2 The Act amends the Gas Act 1986 and the Electricity Act 1989, so that, while Ofgem should continue to have regard to its sectoral duties when carrying out its utility functions, Ofgem should not do so when exercising concurrent powers under the Act. Ofgem may, however, have regard to matters covered by its sectoral duties provided they are matters to which the Director General of Fair Trading could have regard in exercising his powers under the Act. Appendix 1 sets out Ofgem's statutory duties under the Gas Act 1986 and the Electricity Act 1989.

Community law – section 60

- 2.3 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 ensure consistency with Community law.
- 2.4 The Act therefore places a dual obligation on the UK authorities (including the DGGEM) in considering and dealing with the application of the Chapter I and Chapter II prohibitions. First, they must ensure that there is no inconsistency with

either the principles laid down by the EC Treaty and the European Court or any relevant decision of the European Court. Secondly, the UK authorities (including the DGGEM) must have regard to any relevant decision or statement of the European Commission. The obligation to ensure consistency applies only to the extent that this is possible, having regard to any relevant differences between the provisions concerned.

- 2.5 The Competition Act guideline *The Major Provisions* contains further detail on how Section 60 will be applied.

EC directives

- 2.6 There are two EC directives, which are directly related to the gas and electricity industries. There may also be other EC directives, which are relevant to the gas and electricity industries.

EC Directive Concerning Common Rules for the Internal Electricity Market⁵

- 2.7 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

⁵ *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.*

- transparency of vertically integrated electricity transmission or distribution companies (for example, through separate accounts).

*EC Directive Concerning the Common Rules for the Internal Market in Natural Gas*⁶

2.8 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 gas transportation companies (for example, through separate accounts); and
- the possibility of making special provisions for undertakings adversely affected by long term take or pay contracts when competition is introduced.

2.9 Consistent with the principle of subsidiarity, each EC member state can determine how to implement these directives bearing in mind their particular circumstances.

2.10 Ofgem will take account of the provisions of the EC directives when applying the Act.

The Fair Trading Act 1973

⁶ *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.*

- 2.11 The Fair Trading Act 1973 allows scale or complex monopolies to be examined by the United Kingdom authorities (including the DGGEM). A reference can be made to the Competition Commission in order to establish whether a monopoly situation exists, and if so, whether it operates, or may be 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 Competition Act guideline *The Major Provisions*.

3. Economic Analysis

The importance of regulating dominant incumbents

3.1 The scope of monopoly and of public ownership in the electricity and gas industries (and other utility sectors) prior to privatisation gave rise to patterns of activity that were not subject to normal market disciplines. Not only was there a lack of competitive pressures on cost and price levels, but products, services, marketing methods, etc, tended to be relatively standardised, and incentives to respond to the varied requirements of different electricity and gas customers were weak. The subsequent introduction of competition to parts of these industries has enabled incumbents and new entrants alike to take advantage of the opportunities to better serve the interests of customers via a range of innovative activities, including:

- lower costs and prices;
- new tariff structures;
- new products and services;
- new combinations of products and services;
- the offering of alternative billing and payment methods; and
- new marketing methods.

3.2 Such innovations are particularly important in the transition from statutory or *de facto* monopoly to effective competition in gas and electricity supply and a range of related services. In its application of the Act, and in particular the Chapter II prohibition, Ofgem will therefore be particularly vigilant in seeking to ensure that

the conduct of dominant incumbent undertakings does not have an anti-competitive effect by restricting the opportunities for others to address markets in innovative ways. This could occur, for example, by preventing the introduction of new products or services or by artificially restricting the profits that could be made by new entrants from the introduction of new products and services.

Characteristics specific to the gas and electricity sector

3.3 Application of the Act to the gas and electricity industries 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 sector specific case law to develop. The relatively advanced state of energy liberalisation in the UK compared with most other member states of the EC may, however, mean that the UK is at the forefront of the application of competition law to competitive energy markets. Where appropriate, Ofgem will ensure that it applies its powers under the Act in a manner that is consistent with relevant EC jurisprudence on corresponding questions in relation to competition, from other sectors.

3.4 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 gas transportation, and electricity transmission and distribution networks, which are unlikely to be replicated due to the cost conditions faced by any undertaking seeking to duplicate such 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 existence of price controls for gas transportation and electricity transmission and distribution, and in some other parts of the industries where market power is particularly strong;
- the limited storability of electricity, and to some extent gas, which limits the opportunities to substitute between time periods on either the supply side or the demand side;
- 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 Pool⁷ rules for determining wholesale prices in electricity;
- the economic linkages between different parts of the networks, which imply that the existence of market power in one set of activities or markets can have substantial effects on other (related) activities or markets; and
- the significance and complexity of the various codes and agreements, which govern connection to and use of electricity and gas systems, which are required to ensure the safe, secure and effective operation of those

systems, for example, the Master Connection Use of System Agreement for electricity transmission and the Network Codes for gas transportation and shipping.

- 3.5 All of these factors may not be relevant for every case that Ofgem considers under the Act. For example, the limited storability of electricity, the low elasticity of demand for electricity, particularly over short periods, the relative inelasticity of supply for electricity at some periods and the complexity of the Pool rules for determining wholesale electricity prices are likely to be factors that are highly relevant to an investigation of electricity generation activities. A different mix of considerations would apply in cases focused on the supply of gas to domestic customers.
- 3.6 Ofgem will not adopt approaches to applying the Act that are different from those set out in other Competition Act guidelines. The particular characteristics of the energy sector identified above, will, however, affect the emphasis that is placed on, and the weight given to, particular aspects of the analysis set out in other guidelines.
- 3.7 Ofgem considers that, in enforcing the Act, the specific economic conditions of the energy sector (including the relatively recent introduction of competition into many of the markets) will give rise to a particular emphasis on certain issues connected with:
- pre-emptive behaviour by dominant incumbents;
 - the time dimension of dominance;
 - the effects of agreements covering the use of networks; and

⁷ The electricity Pool of England and Wales is the mechanism which sets the wholesale prices generators receive and the prices suppliers pay for electricity, subject to their ability to agree contracts that hedge the

- the effects of conduct in relation to one activity or market on other related activities or markets.

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

- market definition;
- the assessment of market power⁸, and in particular, the assessment of dominance, including joint dominance;
- the assessment as to whether an abuse of a dominant position has occurred;
- the assessment of whether a dominant incumbent is engaging in pre-emptive behaviour;
- the assessment of agreements between undertakings, decisions by associations of undertakings and concerted practices under the Chapter I prohibition; and
- the exclusion from the Act's prohibitions, for services of general economic interest, under Paragraph 4 of Schedule 3 to the Act.

3.9 The remainder of this part of the guideline explains how Ofgem intends to approach these six issues when applying the Act to the specific combination of circumstances in the gas and electricity industries, identified above.

risk of pool price fluctuations.

Market definition

3.10 In considering whether one of the prohibitions of the Act has been infringed it is necessary to define a relevant market or markets, since European competition law has required this in similar cases. A market definition normally contains two dimensions, a product and a geographic area.

Duration

3.11 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. As explained in the Competition Act guideline ***Market Definition***, ‘non-transitory’ has generally been interpreted as a duration of a year, but could be shorter where appropriate.

3.12 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, which may infringe the prohibitions of the Act. This is particularly significant since limited storability means that one of the standard mitigating constraints on the abuse of very short-term market power – the ability of firms and their customers to substitute transactions in one time period with transactions in another time period – is largely absent. The absence of substitutability constraints 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.

Combined effect of duration and magnitude

⁸ The concept of market power is not part of the statutory framework of the Act, but it is a useful tool in assessing potentially anti-competitive behaviour.

- 3.13 The Competition Act guideline *Market Definition* refers to tests based on hypothetical price increases of 5-10 per cent. In electricity and gas markets the price ‘spikes’ that occur can be many times higher than these benchmark numbers, irrespective of their causes in particular instances (for example, demand and supply fluctuations or the exploitation of market power). Very high wholesale prices, even if they hold for only short durations, can have significant effects on customers and, since customers may include other rival companies, on future competition. As discussed in the Competition Act guideline *Market Definition*, the consideration of hypothetical price increases where a dominant firm is present may be particularly difficult because of the problems of identifying clear competitive benchmarks. Hence, as explained in that guideline, the process of defining a market cannot be carried out in isolation, but needs to be considered alongside other evidence on market power and the undertaking’s conduct.
- 3.14 For reasons that are also explained in that guideline, Ofgem 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.

Sequencing in the analysis

- 3.15 At an early stage of any investigation under the Act, and on the basis of the information then available, Ofgem will arrive at a preliminary view of the scope of the economic issues involved and of the analysis that will need to be done. It will then proceed to more detailed consideration of the various conditions of

demand and supply that are relevant both to assessing competitive pressures on the undertaking(s) concerned and to evaluating the effects of the relevant conduct, including the appreciability of those effects. In the course of the investigation, as the detailed analysis proceeds, it may be appropriate to revisit the question of the scope of the economic issues involved.

- 3.16 Among the factors that will be considered during the investigation will be the demand and supply side substitution possibilities that are relevant in defining markets. Since these substitution possibilities are also directly relevant to the analysis of market power, market definition and the assessment of dominance will be overlapping exercises in Chapter II cases. New information obtained during the investigation about, say, demand conditions, might potentially affect the final conclusions reached in either or both of these exercises, for example.
- 3.17 Evaluation of the economic effects of the conduct of concern will also be undertaken as the investigation proceeds. In Chapter II cases, however, only after the market definition and assessment of dominance exercises have been completed, and only if the undertaking or undertakings has or have been found to be dominant, will conclusions be reached on whether or not the prohibition has been breached, that is, whether a dominant position has been abused.

Related markets

- 3.18 It is recognised in competition law that in many situations there may not be a single relevant market. An important class of cases concerns behaviour in one relevant market or market segment that may have anti-competitive effects in other related markets or market segments. Such cases are likely to be particularly important in gas and electricity markets, bearing in mind the economic linkages between the different activities in the sector. 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 are likely to have limited substitution

- possibilities. The effects of conduct at that entry point, however, 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 that it takes fully into account all of the relevant economic effects.
- 3.19 As explained in the Competition Act guideline *The Assessment of Individual Agreements and Conduct*, there will also be cases where undertakings may be able to leverage market power in a relevant market or markets to abuse their dominance in another market. Again, such cases are likely to be particularly important in gas and electricity markets. The incumbent gas and electricity suppliers are now active in the supply of other products, for example⁹.
- 3.20 Ofgem will therefore have regard to the actual or potential effects of a firm's conduct on different activities, in deciding the scope of an investigation and in defining relevant markets. Often the behaviour of competitors will provide practical examples of the relevant activities to consider in an investigation¹⁰.

The assessment of market power, and in particular, the assessment of dominance, including joint dominance

⁹ 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.

¹⁰ 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.

3.21 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 customers¹¹. Dominance may involve more than one undertaking ('joint dominance'). The simplest test for dominance on the supply side is to consider whether a firm or firms has or have the ability persistently to raise prices above competitive levels. In cases involving a potentially dominant buyer, the test is reversed by considering whether a firm or firms has or have the ability persistently to reduce prices below competitive levels.

3.22 When considering whether undertakings are dominant (that is that they can act to an appreciable extent independently of their customers and competitors), Ofgem will look at a range of factors in assessing the effects of undertaking's actions, including:

- customers' behaviour and options (for example, awareness of competition, the extent to which alternative providers are chosen, the extent to which substitutes are available);
- competitors' behaviour and capacities (for example, their range of offers, their ability to increase output within the relevant time period);
- market operation (for example, the extent of barriers to entry and exit);
and
- market share¹².

¹¹ Case 27/76 *United Brands Co. v Commission* case [1978] ECR 207, [1978] 1 CMLR 429.

¹² In Case 85/76 *Hoffman-La Roche & Co. AG v Commission* [1979] ECR 461, [1979] 3 CMLR 211, and a number of other cases, the Court and the Commission have considered other factors as well as market share when determining dominance, including competitors' positions; barriers to entry; the resources, size and commercial superiority of the undertaking; and technical superiority and the possession of know-how and intellectual property.

- 3.23 Consistent with the Competition Act guideline *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 is or are dominant, not least because the economic implications of any market share are likely to be heavily conditioned by a range of other relevant factors, including the magnitudes of demand and supply elasticities. In general, Ofgem will seek, wherever possible, to assess both substitution possibilities and actual behaviour directly, rather than rely on proxies, such as market share.
- 3.24 In developing the case law on dominance, the European Court and the European Commission have tended to assume that a dominant firm will be the largest firm (or group of firms) operating in a particular sector¹³. In the Great Britain gas and electricity 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 below normal thresholds for considering dominance. This may particularly apply to markets for wholesale gas and electricity and to markets for capacity on gas and electricity networks.

The assessment of whether an abuse of a dominant position has occurred

- 3.25 It is the abuse of, not the existence of, a dominant position that is prohibited by the Act. Therefore, where an abuse of a dominant position is alleged or suspected and it is found that an enterprise or group of enterprises has the ability to act, to an

¹³ Joint dominance may not involve the largest firm in a market.

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 Competition Act guideline *The Chapter II Prohibition*, discusses the types of conduct that may breach the prohibition. Ofgem's approach to considering predatory pricing, which is one possible infringement, is set out below.

- 3.26 As noted earlier, unlike many sectors in the UK, the gas and electricity sector is characterised by the widespread presence of historic incumbent dominance or market power, which previously was promoted as a matter of public policy, but is now, in many cases, being eroded through the development of competition. Ofgem, will therefore, pay particular attention to the possibility of pre-emptive¹⁴ behaviour by incumbents, designed adversely to affect the development of competition in, for example, the relatively newly opened domestic gas and electricity markets. Pre-emptive behaviour may also occur through actions in related markets, for example, electricity distributors or gas transporters may use their dominance in these markets to prevent, restrict or distort 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.

The assessment of whether a dominant incumbent is engaging in pre-emptive behaviour

¹⁴ 'Pre-emptive behaviour' describes abuses by dominant incumbents in markets that are being opened to competition or are relatively newly opened to competition, which are designed to adversely affect the development of competition.

3.27 The incumbent suppliers of gas and electricity have reacted to the recent introduction of competition by introducing a range of initiatives, including new payment methods, the offering of ‘dual fuel’ supply and the linking of other products to the supply of gas and electricity. Many of these initiatives have improved customers’ choice. Bearing in mind incumbent suppliers’ possible dominance, however, it is important for Ofgem to consider whether these initiatives are merely a response to competition that could be expected in any industry and which will benefit customers, or pre-emptive behaviour designed to prevent competition developing or continuing to develop, and to prevent new entrants establishing themselves in the market. It is necessary to consider incumbents’ behaviour in each individual case, bearing in mind the circumstances of the initiative.

3.28 One example of such pre-emptive behaviour is predatory pricing. Ofgem will follow the approach set out in the Competition Act guideline *Assessment of Individual Agreements and Conduct*, when assessing whether a dominant undertaking is engaging in predatory pricing. That guideline explains that in considering predatory behaviour, three factors will be considered:

- the intentions of the undertaking alleged to be engaging in predatory pricing;
- the feasibility of the undertaking recovering the losses it incurs when engaging in predatory pricing; and
- the level of the undertaking’s prices relative to its costs.

3.29 Bearing in mind the particular concerns about pre-emptive behaviour in the gas and electricity industries, Ofgem considers that it will be appropriate in considering whether an undertaking is engaging in predatory behaviour, to apply a relatively strict cost-based test. Ofgem will follow the approach set out in the

Competition Act guideline *Assessment of Individual Agreements and Conduct*, paying particular attention to whether undertakings are covering their *avoidable costs*, which include elements of costs that are often described as fixed costs that would not be included in a variable cost test.

The assessment of agreements between undertakings, decisions by associations of undertakings and concerted practices under the Chapter I prohibition

3.30 Chapter I of the Act prohibits those agreements between undertakings, decisions by associations of undertakings, and concerted practices which may affect trade within the United Kingdom and which prevents, restricts or distorts competition, or are intended to do so. The Act includes a list of illustrative examples of agreements, decisions or practices, which:

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

3.31 There are a number of problems that arise in gas and electricity markets as a result of the statutory requirements for arrangements to ensure safe, secure and efficient operation of gas and electricity networks 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. These agreements may involve restrictions on competition to achieve their objectives in relation to safety, security and efficiency.

- 3.32 As a result of their contribution to safety, security and efficiency, such agreements may qualify for exemption from the Chapter I prohibition. The criteria for exemption are set out in section 9 of the Act. All of these must be satisfied. The agreement must not impose on the parties restrictions which are not indispensable to achieving the desired effects ('the indispensability test'). More specifically, since a variety of different types of agreement may serve to achieve safety, security and 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.
- 3.33 Ofgem can consider agreements involving 'dominant' undertakings under the Chapter II prohibition, subject to any exclusions that may apply.
- 3.34 Under section 5 of the Act, the DGGEM can cancel an individual exemption, or vary or remove any condition or obligation of an individual exemption, or impose additional conditions or obligations of an individual exemption if¹⁵:
- the DGGEM has reasonable grounds for believing that there has been a material change in circumstances since the individual exemption was granted; or

¹⁵ The provisions for exclusions for agreements that were covered or would be covered by the RTPA within the gas and electricity industries are discussed in Part 5.

- the DGGEM has a reasonable suspicion that the information on which the decision to grant an individual exemption was made, was incomplete, false or misleading in a material particular.

The exclusion from the Act's prohibitions for services of general economic interest, under paragraph 4 of Schedule 3 to the Act

- 3.35 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. Ofgem will therefore be required to assess whether or not, in a particular case, this exclusion is applicable.
- 3.36 As explained in the Competition Act guideline ***Services of General Economic Interest***, for the exclusion to apply the undertaking must have been *entrusted*¹⁶ with the relevant task by a public authority - mere approval¹⁷ will not be sufficient. Ofgem will apply this first test strictly. This is consistent with EC jurisprudence.
- 3.37 The second test that Ofgem will apply in addressing the issue is whether the application of the prohibition would obstruct the performance of those tasks. This will be assessed by 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 because, for example, the task could be performed in another, non-restrictive way at an acceptable cost, then the relevant conduct is not excluded from the prohibition. Again, Ofgem will take a strict approach to the question of necessity.

¹⁶ Case 127/73 BRT v SABAM [1974] ECR 313, [1974] 2 CMLR 238.

¹⁷ Case IV/30.717 Uniform Eurocheques Commission Decision [1985] 3 CMLR 434.

4. Process for Investigation

Sector specific regulation

- 4.1 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. Among other things, 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 undertakings' level and structure of charges and the prevention of unduly discriminatory behaviour by network operators and dominant suppliers. The Gas Act 1986 and the Electricity Act 1989 set out the factors the DGGEM should consider when deciding whether to use his powers under these Acts to address anti-competitive behaviour. In particular, the DGGEM may not take enforcement action under the sector specific Acts if he is satisfied that it would be more appropriate to address the issue under the Competition Act 1998.
- 4.2 Ofgem believes that the provisions of the sector specific forms of regulation are generally consistent with the Act and Ofgem will continue to use them to fulfil its statutory duties and obligations under the Gas Act 1986 and Electricity Act 1989. When applying the Competition Act 1998 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 factors of which the Director General of Fair Trading could take account when applying the Competition Act 1998.
- 4.3 The following part of this guideline sets out 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 Gas Act 1986, the Electricity Act 1989, the Fair Trading Act 1973 and the Competition Act 1998 to ensure that any

anti-competitive behaviour is most effectively addressed without undertakings facing ‘double jeopardy’.¹⁸

Guidance for the gas and electricity sector trivial or non-trivial complaints

4.4 Once it has been decided that Ofgem is responsible for a case¹⁹, Ofgem will attempt as quickly as possible to determine whether the complaint is trivial or non-trivial in nature. As part of this process Ofgem will consider whether the requirements of section 25 of the Act, that is, that there is a reasonable grounds for suspecting that one of the prohibitions has been infringed, has been met and the potential economic effect of the agreement or conduct in the particular case. 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 that cannot be resolved quickly by Ofgem, it may seek information from undertakings to determine whether to commence an investigation.

Information gathering

4.5 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 potential 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 part 2 of this guideline (competition law powers) or Appendix 1 (sector specific powers) are considered to be potentially appropriate, it is likely that Ofgem will specify all the 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.

¹⁸ ‘Double jeopardy’ would occur where an undertaking faced the possibility of being punished more than once for the same infringement.

¹⁹ See the Competition Act guideline *Concurrent Application to Regulated Industries*.

- 4.6 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 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 affect the powers Ofgem considers could be appropriate to address the suspected infringement(s).
- 4.7 Where information has been gathered using powers under one of the Acts described in part 2 (competition law powers) or Appendix 1 (sector specific powers), 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 acts²⁰.

Consultation

- 4.8 *The Director General of Fair Trading's Procedural Rules* set out the procedures to be followed when deciding whether or not to consult on decisions made under the Act. In addition, section 31 of the Act requires the DGGEM to consult affected parties when he intends to make a decision that one of the prohibitions has been infringed. In any event, Ofgem would normally expect to consult interested parties on decisions following non-trivial complaints, own initiative investigations or notifications of agreements²¹.

Enforcement action and the imposition of penalties

²⁰ 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.

- 4.9 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 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.
- 4.10 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 part 2 or Appendix 1 of this guideline. As explained above, however, 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.
- 4.11 The DGGEM is required to have regard to the Director General of Fair Trading's guidance on the appropriate level of a penalty, prepared under Section 38 of the Act, when setting a penalty, after an undertaking has been found to have infringed the Act. When setting penalties under the Act, the DGGEM will not have the ability to take into account 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 factor to which the Director General of Fair Trading could have regard when applying the Act. However, the Director General of Fair Trading's guidance includes a number of steps that the DGGEM will have to follow when setting a penalty. It may be appropriate to consider the financial strength of an undertaking at Step 3, which considers 'other factors' relevant to setting the penalty.

²¹ 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.

- 4.12 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, for example, price control proposals. This is in accordance with Ofgem's voluntary agreement with the London Stock Exchange²².

Compliance

- 4.13 When setting penalties, in accordance with the Director General of Fair Trading'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 programmes²³.
- 4.14 Ofgem expects companies within the gas and electricity sector to implement corporate compliance programmes if they do not already have them. Ofgem expects that such programmes will minimise the risk of infringing the prohibitions by systematically ensuring that all relevant employees are sufficiently knowledgeable about the provisions of the law, and that they will put that knowledge to good effect.
- 4.15 The details of compliance programmes are likely to vary between companies, particularly with regard to their resources. A minimum programme might be expected to comprise at least four elements, with the depth with which each element is covered being dependent on a company's resources. The four elements are described below:

²² The voluntary agreement was published by the London Stock Exchange on 2 January 1996.

²³ These can be obtained directly from the OFT.

- support and personal commitment from senior management, both visible and continuous, will be essential to ensure that compliance is treated with the importance it deserves and to ensure acceptance by other employees who will be more receptive to an initiative which is seen to be applied equally to senior managers;
- appropriate compliance policy and procedures will include a clear policy commitment to comply with the legislation by not engaging in anti-competitive behaviour or condoning such behaviour in other parties. This policy could feed through into personal development performance objectives, contracts and disciplinary arrangements. Procedures could include a framework within which employees can check whether or not a particular contract or deal is in breach of the law. This might involve a nominated expert or compliance officer. An effective mechanism to communicate the policy and procedures supported by a review process is a necessity, part of which is likely to be a manual or handbook provided to all relevant staff;
- training will form an essential aspect of any compliance programme. It should be designed to ensure that all relevant staff are given proper training on both the law and the company policy and procedures. It will not be sufficient to limit training to the implementation phase. It must be offered on a regular basis to reinforce and update the message. Such training is likely to be an essential element of any induction programme for new staff; and
- evaluation of the effectiveness of the overall compliance programme is the final essential ingredient. This might include informal feedback at an individual level and perhaps as part of individual performance appraisal. At a broader level formal audits, both with and without warning, could be undertaken. A transparent approach to the correction of any revealed

infringements would serve as a constant reminder to employees that their business dealings are subject to review and will thereby deter complacency.

5. Transitional Arrangements

5.1 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 Competition Act guideline *Transitional Arrangements*. Certain provisions in Schedule 13 to the Act relate particularly to provisions of the Gas Act 1986 or the Electricity Act 1989. There are no transitional periods available in respect of the Chapter II prohibition, which applies to the behaviour of dominant undertakings immediately from 1 March 2000.

Agreements benefiting from the transitional periods

5.2 Schedule 13 to the Act provides for transitional periods for particular agreements in the electricity and gas industries. In summary, the existing arrangements under the Restrictive Trade Practices Act will be retained for a further five years from the starting date, in that agreements currently exempt from the application of that Act and similar future agreements will benefit from transitional periods excluding them from the Chapter 1 prohibition during that period.

5.3 There are three categories of agreement that will benefit from the transitional periods in the gas and electricity industries:

- agreements to which, immediately before 1 March 2000, the Restrictive Trade Practices Act does not apply by virtue of section 100 of the Electricity Act 1989 or section 62 of the Gas Act 1986 respectively, or orders made thereunder. These agreements will receive a five year transitional period from 1 March 2000;
- agreements made during the five year period beginning on 1 March 2000 which are of a type such that, even if the Restrictive Trade Practices Act had not been repealed, it would not have applied to them because they

would have been like those agreements in the category above, and agreements, whether made before or after the starting date, that are varied to become of that type in the five year period. These will receive a transitional period applying from the date that the agreement or variation is made and for the remaining part of the five year period; and

- agreements of a description specified in a transitional order by the Secretary of State. These will receive a transitional period beginning at such time as is specified in the order and, again, applying for the remaining part of the five year period beginning on 1 March 2000.

5.4 The benefit of these transitional periods will be lost if the agreement is varied in such a way that it ceases to be one to which the Restrictive Trade Practices Act would not have applied or one to which a transitional order applies.

5.5 The question of whether or not the Restrictive Trade Practices Act 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 preventing, restricting or distorting competition²⁴. In making such assessments during the transitional period the DGGEM will, to the extent appropriate, take into account matters addressed in these guidelines, and particularly, the issues raised in paragraphs 3.27 – 3.29 above.

Extending or terminating the transitional period

5.6 The DGGEM may extend for up to six months 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

²⁴ 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.

transitional periods are given in the Competition Act guideline *Transitional Arrangements*.

- 5.7 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 or 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. In deciding whether to extend the transitional period the DGGEM will apply the approach described above and set out in the Competition Act guideline *Transitional Arrangements* and the issues discussed in paragraphs 3.27 – 3.29 above.
- 5.8 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 General of Fair Trading's Procedural 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.

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

Appendix 1 Gas and Electricity 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 licence 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 consumers 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 the need 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)²⁵. 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

²⁵ 1st Tier Public Electricity Suppliers Electricity licences cover both distribution and supply functions, while 2nd Tier Electricity licences only cover supply functions.

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.

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 utility legislation, the duties of the DGGS and DGES will be combined and the Gas and Electricity Markets Authority will be formally created. The Utility Bill is expected to place a primary duty on the authority to protect the interests of consumers, where possible, through the promotion of competition. In performing this duty, the authority 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 authority 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 licences for distribution and supply activities, and to prevent the holding of both types of licence by the same company.

The Department of Trade and Industry expects that the Utility Bill will receive royal assent in the summer of 2000.

Annex – ‘Advance’ Consultation on the Energy Guideline

Respondents

Ofgem received 10 responses to the consultation, none of which were marked as confidential. The respondents were BG Group, BG Transco, BNFL, Centrica, East Midlands Electricity Consumers’ Committee, Gas Consumers’ Council, Independent Energy, National Power, North of Scotland Electricity Consumers’ Committee and Scottish Power.

The responses have been summarised below under the chapters in the attached consultation to which they relate. As a result of the consultation process, the structure of the current guideline may have changed from the advanced consultation document, consequently the sections to which these responses refer may differ. Overall comments on the guideline are summarised in the final section of this attachment.

The redrafted guideline also takes account of comments from, and discussions with, the Office of Fair Trading and other sector regulators.

Introduction

Respondents’ Views

A respondent believed that all sector guidelines should have been published at the same time to ensure consistency.

Four respondents were concerned that Ofgem had too much discretion to deviate from the guideline when enforcing its powers. One respondent believed that either the potential circumstances of any possible deviation should be listed in advance or a new guideline consulted on each time a deviation was proposed.

Two respondents believed that the guideline should better reflect the differences between the gas and electricity sectors, and one respondent suggested that a separate guideline for each sector would be appropriate.

Ofgem's Response

Ofgem accepts that respondents may have found it helpful to be able to compare all sector guidelines. However, due to the number of guidelines that had to be published by OFT and the sector regulators it was necessary to spread the development of the guidelines over a number of months.

Section 52 of the Competition Act 1998 ('the Act') obliges the OFT and the sector regulators to produce advice and information as to how the Act will be interpreted. This advice and information is not legally binding on Ofgem under the Act. If a decision is made by Ofgem which deviates from the guidelines, or an issue arises which is not discussed in the guidelines, Ofgem can publish revised guidelines or produce new advice and information. The guideline is not a substitute for the Competition Act 1998. It is intended to explain the provisions of the legislation to those who are likely to be affected by them and to indicate how the Ofgem expects the provisions to operate. Any party to a decision may appeal to the Competition Commission against or with respect to a decision.

Ofgem does not consider that a separate guideline is required for the gas and electricity industries. Each industry shares a number of common characteristics and there are a number of interactions between the sectors that may affect the interpretation of the Act. To the extent that the characteristics differ, the guideline takes account of these differences.

Legal Context

Respondents' Views

One respondent asked for an explanation of how the duties of the Director General of Electricity Supply, as amended by the Utilities Bill, would apply in the context of the Act.

Two respondents wanted more explanation of how the EC directives will affect the application of the Act. Two respondents suggested that other EC directives might be relevant to Ofgem's interpretation of the Act. Transco argued that Ofgem did not only have to have regard to the directives when enforcing the Act, but was bound by them. One respondent argued that Ofgem should not use the Act to enforce EC directives, as this was the DTI's responsibility.

Ofgem's Response

Ofgem can only have regard to its duties under sector specific legislation when applying the Act, if they are duties to which the Director General of Fair Trading could have regard when applying the Act. Otherwise, the duties of the Director General's of Electricity and Gas Supply under the Electricity Act 1989 and the Gas Act 1986 are restricted to issues and procedures under those Acts.

It will be necessary for Ofgem to consider how EC directives, including those not directly related to the gas and electricity industries, affect the application of the Act on a case by case basis. Section 60 of the Act sets out principles which provide for the Director General of Fair Trading and the regulators, including Ofgem, to handle cases in such a way as to ensure, so far as is possible, consistency with community law. The scope of these principles is described in the Competition Act Guideline *The Major Provisions*. EC directives do not fall directly within the scope of section 60¹ of the Act, but are matters that Ofgem can consider when applying the Act.

Economic Analysis

Respondents' Views

The Importance of Regulating Dominant Incumbents

One respondent was concerned that the guideline suggested that Ofgem was seeking to protect competitors in a market rather than deal with abuses of a dominant position. Two respondents supported Ofgem's emphasis of the importance of innovation in the gas and electricity industries.

Characteristics Specific to the Gas and Electricity Sector

Two respondents wanted the guideline to make reference to potentially relevant law from other sectors with similar characteristics, e.g. industries with monopoly networks. Both of these respondents also wanted Ofgem to explain more clearly how the application of the Act would be affected by the specific characteristics of the sectors identified by Ofgem.

¹ "The purpose of this section is to ensure that so far as is possible (having regard to any relevant differences between the provisions concerned), questions arising under this Part [Part I of the Act] in relation to competition within the United Kingdom are dealt with in a manner which is consistent with the treatment of corresponding questions arising in Community law in relation to competition within the EC."

Market Definition

One respondent wanted Ofgem to list its view of all the current geographical and product markets in the electricity sector.

One respondent was concerned that the guideline focused too much on wholesale pricing issues. Another respondent argued that the ability to raise prices in the short term is not always caused by dominance. One respondent argued that Ofgem should make more use of the indicators used by the American Federal Trade Commission when defining markets.

Four respondents believed that Ofgem must define a market as a first step in an investigation, otherwise it will not be possible to assess market power. It was argued that it had not been explained why Ofgem should depart from the other guidelines and that the approach to market definition may be inconsistent with EC jurisprudence. One respondent argued that Ofgem could not exercise its powers of investigation under the Act without first defining a market.

One respondent wanted a fuller explanation of how Ofgem would define a related market and analyse the effects of behaviour on a related market.

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

One respondent accepted that companies may be found dominant even when they have a lower market share than the level usually presumed dominant under EC law. One respondent wanted Ofgem to monitor all pricing activities by dominant companies, even when they are not specifically covered by a price control. One respondent believed that Ofgem should use more indicators of dominance, e.g. the Herfindhal Index.

The Assessment of Whether a Dominant Incumbent is Engaging in Pre-emptive Behaviour

One respondent wanted Ofgem to justify a different approach to assessing predatory pricing than the approach set out in the other guidelines. It also wanted Ofgem to explain how it would ensure compatibility between the application of the Act and Standard Condition 13 of the Gas Suppliers' Licence. One respondent believed that the guidance on this issue was not clear. One respondent said it assumed that the lack of specific examples of excessive pricing in the guideline meant that there were no current energy examples.

The Assessment of Agreements between Undertakings, Decisions by Associations of Undertakings and Concerted Practices Under the Chapter I Prohibition

One respondent was concerned that there would be significant uncertainty if agreements that met the 'indispensability test' at one point in time could not be assumed to meet the test in the future. It also wanted an explanation as to why Ofgem was applying a different test than would be applied to other sectors.

The Exclusion from the Act's Prohibitions for Services of General Economic Interest, Under Paragraph 4 of Schedule 3 to the Act

One respondent believed that it would be useful to consider this section alongside the specific guideline on this issue.

Ofgem's Response

The Importance of Regulating Dominant Incumbents

Ofgem believes that, as a number of parts of the gas and electricity industries have only recently been opened to competition, it will be particularly important to ensure that dominant incumbents do not seek to pre-empt the development of competition by abusing a dominant position.

Characteristics Specific to the Gas and Electricity Sector

The revised draft clarifies that, in accordance with section 60 of the Act, it may be appropriate to have regard to EC jurisprudence on corresponding questions from other sectors and not just EC jurisprudence from the energy sector.

Ofgem recognises that there could be benefit, for example, in terms of improved understanding, in providing greater detail as to how specific characteristics of the gas and electricity sectors give rise to the approach to applying the Act described in the guideline. On the other hand, there is a danger that greater detail could add complexity and length to the guideline, and that this may detract from the present degree of legal certainty provided. In this context, it is worth noting that Ofgem intends to provide full reasons behind its decisions under the Act. Against this background, Ofgem considers that the present drafting provides the appropriate level of guidance as to why the specific characteristics of the gas and electricity sectors lead to the application of the Act set out in the guideline.

Market Definition

The guideline is intended to explain the framework Ofgem will adopt when applying the Act, rather than addressing specific cases. The rapidly changing circumstances of the gas and electricity industries means that any market definition set out by Ofgem at this time may not be relevant when any particular case arises. The market definition will need to be considered in the light of the facts in each case at any particular point in time. Also, the extent of the work required to comprehensively assess the whole gas and electricity sector means that any such exercise would be excessively resource intensive.

Ofgem has taken out of the guideline the specific references to the 'market abuse' licence condition on electricity generators and we believe that the current draft, while covering wholesaling pricing issues, recognises that this is only one of the areas in which Ofgem may use its powers under the Act.

Ofgem will need to consider the reasons for short term increases in prices when carrying out investigations of such behaviour. Not all short term increases in prices by dominant firms will necessarily breach the Chapter II prohibition of the Act.

As set out in the Competition Act guideline ***Market Definition***, Ofgem will consider which indicators to use when carrying out a market definition exercise on a case by case basis. Such indicators may include those used by the American Federal Trade Commission.

At an early stage of any investigation under the Act, and on the basis of the information then available, Ofgem will arrive at a preliminary view of the scope of the economic issues involved and of the analysis that will need to be done. It will then proceed to more detailed consideration of the various conditions of demand and supply that are relevant both to assessing competitive pressures on the undertaking(s) concerned and to evaluating the effects of the relevant conduct, including the appreciability of those effects. In the course of the investigation, as the detailed analysis proceeds, it may be appropriate to revisit the question of the scope of the economic issues involved. In Chapter II cases, however, only after the market definition and assessment of dominance exercises have been completed, and only if the undertaking or undertakings has or have been found to be dominant, will conclusions be reached on whether or not the prohibition has been breached, that is, whether a dominant position has been abused.

Ofgem has clarified the section on related markets to ensure consistency with the contents of the other guidelines.

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

Ofgem has powers under the sector specific legislation to regulate the prices of dominant companies even if currently those prices are not covered by a price control.² Also, Ofgem can initiate an own initiative investigation under the Act if it has reasonable grounds for suspecting that one of the prohibitions of the Act has been breached. Ofgem believes that indicators such as the Herfindhal Index may be useful when carrying out an investigation under the Act and may use such indicators, consistent with the Competition Act guideline **Assessment of Market Power**, on a case by case basis.

The Assessment of Whether a Dominant Incumbent is Engaging in Pre-emptive Behaviour

Ofgem has clarified the section on potential abuses of the Act and explained that it intends to adopt the approach set out in the other guidelines to consider predatory pricing, although the specific circumstances of the energy sector, and in particular the recent opening of activities to competition, will require a relatively strict, avoidable cost test for predatory pricing, to be applied. Ofgem is currently assessing the relationship between the provisions of Standard Condition 13 of the Gas Suppliers' Licence and the relevant provisions of the Act, including the question of whether the Standard Condition is now partly or wholly redundant. This assessment will also consider other 'non-discrimination' provisions in the gas and electricity licences and we will be consulting on proposals during the summer.

The guideline does not discuss specific examples of current behaviour in the energy sector, which may breach the prohibitions of the Act. Ofgem will consider specific behaviour within the framework set out in the guideline.

The Assessment of Agreements between Undertakings, Decisions by Associations of Undertakings and Concerted Practices Under the Chapter I Prohibition

As the circumstances of a market change, the effect of any agreement on competition may change and it may be necessary to consider whether the Chapter I prohibition of the Act would be breached in the changed circumstances.

The Exclusion from the Act's Prohibitions for Services of General Economic Interest, Under Paragraph 4 of Schedule 3 to the Act

Ofgem, OFT and the other sector regulators will be consulting on the specific guideline on services of general economic interest in due course.

Process for Investigation

Respondents' Views

Two respondents believed that the guideline should address the potential incompatibility of compliance with utility legislation and the Act.

One respondent was concerned that there was an implication that undertakings would be subject to double jeopardy through the use of sector specific powers and powers under the Act, and that this was inconsistent with other guidelines.

One respondent wanted a non-exhaustive list of factors Ofgem would consider when categorising a complaint as trivial. Another respondent stated that Ofgem should only investigate when it had reasonable grounds and not just subjective suspicion.

One respondent fully supported Ofgem's intention to maintain propriety when publishing sensitive information.

One respondent wanted to understand when Ofgem would consult, what information would be sought and the weight that would be attached to respondents' views. Another respondent wanted a clear timetable for consultations.

Two respondents wanted guidance on the factors Ofgem would consider when deciding whether to use sector specific or Competition Act 1998 powers and sought confirmation about whether Ofgem would revisit issues that had already been considered under sector specific legislation.

² Standard Condition 13 of the Gas Suppliers' Licence and Condition 4a of the Public Electricity Suppliers' electricity licences.

Ofgem's Response

Paragraph 5 to Schedule 3 of the Act excludes conduct, to the extent to which it is engaged in in order to comply with a legal requirement, from the prohibitions of the Act.

While an undertaking will not be fined twice for the same infringement, it is possible that remedies could include action under both Ofgem's sector specific and competition law powers. However, Ofgem is required not to use its Gas Act 1986 and Electricity Act 1989 licence enforcement powers if its powers under the Act would be more appropriate to address the issue.

Ofgem can only investigate under the Act if it has reasonable grounds for suspecting that a prohibition of the Act has been breached (section 25 of the Act).

Ofgem has noted the comment about publishing sensitive information and these parts of the guideline remain in the revised draft.

The Director General of Fair Trading's Procedural Rules set out the procedures to be followed when deciding whether or not to consult on decisions made under the Act. In addition, section 31 of the Act requires Ofgem to consult affected parties when it intends to make a decision that one of the prohibitions has been infringed. In any event, Ofgem would normally expect to consult interested parties on decisions following non-trivial complaints, own initiative investigations or notifications of agreements.³

It may not be possible for Ofgem to decide which specific power(s) (either sector specific or competition law) are likely to be most appropriate to address a suspected infringement at the commencement of an investigation. However, Ofgem is required not to use its Gas Act 1986 and Electricity Act 1989 licence enforcement powers if it considers its powers under the Act would be more appropriate to address the issue.

Overall

Respondents' Views

Two respondents believed that Ofgem should take account of the late publication of the guideline when implementing the Act.

³ Ofgem will use its usual mailing list to identify interested parties, publish consultations on its website and list the consultations in the OFT's weekly gazette on the Act.

A respondent was concerned that customer issues should be given significant emphasis in competition decisions. It noted that customers value service and safety as well as price. It was concerned that the costs of competition investigations should be minimised as customers ultimately pick up the bill.

One respondent was concerned that any action taken against dominant players should not have a deleterious effect on new entrants. It also believed that often a better result would be achieved by regulatory action than simply through competition in the market.

A respondent asked for a summary of the guidelines.

Ofgem's Response

Ofgem does not intend to delay the use of its powers under the Act due to the timetable for publication of the energy guideline. Undertakings in the energy sector have been able to consider Ofgem's advance consultation and the other guidelines produced by OFT and the sector regulators prior to the substantive provisions of the Act coming into force on 1 March 2000.

Within the context of its powers under the Act, Ofgem will consult all interested parties on its proposed decisions, including customer representatives. Ofgem will endeavour to ensure that it carries out its powers under the Act as efficiently and effectively as possible.

Ofgem will consider the effect of any proposed directions against dominant undertakings under the Act, on other players in the market. In general, Ofgem believes that competition will deliver better value and choice for customers than regulation.

Ofgem is currently considering whether to publish a summary of the guideline. A summary would not, however, be a substitute for reading the whole guideline, bearing in mind the specific nature of a lot of the issues discussed in the guideline.