

Statement by Charles Bankes, General Counsel, Ofgem on ways of addressing market power

Topic 3, Possible Remedies

Market Concentration

The Director General outlined in his Presentation this morning that price manipulation and other exploitation of market power have not been confined to a time when National Power and Powergen dominated the sector. He explained the reasons for this. The special characteristics of electricity – the need for moment by moment balancing and the magnitude of the consequences of failure to balance – present special problems and scope for continuing abuse of substantial market power even following the significant reduction in concentration which has occurred in the wholesale electricity market.

Offer and Ofgem have initiated and supported the introduction of a more competitive market structure and Ofgem welcomes the significant reduction in market concentration which is clearly demonstrable by the indices. But we have no confidence, on the basis of the history to date, the fundamentals of the market and overseas experience, that it will prevent continuing, recurrent abuse of market power unless there are effective deterrents in place.

Rules

We also believe that it is not appropriate to rely on rule modification as the only or main means of preventing future manipulation and exploitation of substantial market power. Rule modification has three fundamental problems:-

- since there will always be a need for complex rules for system balancing, dealing with one source of distortion can give rise to other distortions and market participants can find new aspects of the rules to exploit;
- constant change in the rules is costly and gives rise to regulatory uncertainty;
- rule modification has forward looking effects only. There may be significant incentives for an operator to exploit a loophole in order to manipulate the market since it will retain the benefit even if the loophole is closed for the future.

Rule modification will continue to play a useful role in addressing anomalies and undesirable outcomes but it should not be either the only or even the first resort.

Competition Act

A number of generators have commented that the Competition Act 1998 removes the need for the Market Abuse Condition. Their argument has, on analysis, two elements:-

- First, it is argued that the Chapter II Prohibition under the Competition Act is the only appropriate mechanism for dealing with abuse of market power in wholesale electricity, as in other sectors of the economy (in particular newspapers). The logical conclusion of this argument is that, if the Chapter II Prohibition does not cover the sorts of market abuse Ofgem is concerned about, then such abuses should not be regulated.

I do not propose to deal with this argument in detail. It will be for the Commission to consider whether it is contrary to the public interest for there to be no restrictions on abuse of market power in wholesale electricity which go beyond those imposed in other sectors of the economy. For his part the Director General has concluded that it is appropriate for there to be such restrictions in electricity given his statutory duties of promoting competition in generation and protecting consumers in relation to prices that such control should be imposed.

I would only comment that the Electricity Act 1989 and the Utilities Bill currently going through Parliament are evidence of a clear intention that

electricity generation, along with other elements of the electricity industry, should where necessary be subject to additional regulation in order to secure the public interest objectives set out in Section 3 of the Electricity Act. In Ofgem's view this disposes of the case that electricity, like newspapers, should as a matter of Government policy only be subject to the Competition Act.

- The second ground of objection is, at least in part, a legal objection: that the Competition Act 1998 gives power to tackle all the abuses which the Director General is concerned with and that it is therefore neither proportionate nor necessary to impose an additional licence condition.

Some generators, although not all, have argued strongly that the Chapter II prohibition in the Competition Act could be expected to cover abuse of close to real time market power and other abuses of market power arising in the electricity market, notwithstanding the current market structure of electricity generation.

It is striking that different generators have expressed different views about the basis on which the Competition Act would apply. Some seem willing to acknowledge the generators should be treated as jointly dominant. Others argue that, in certain circumstances, an "innovative" approach to market definition could be adopted so as to construct evidence of

dominance. Some consider that an individual company might be held to be individually dominant in a relevant market, even if it did not have the largest market share; other responses show that respondents consider that there is quite a high market share threshold below which companies are unlikely to be dominant.

Ofgem's position can be summarised as follows:-

- we will use our powers under the Competition Act where appropriate;
- we consider that the abuse of substantial market power in the wholesale electricity sector could not safely be dealt with through application of the Chapter II prohibition;
- it is in the public interest that generators should have a responsibility – and should know that they have a responsibility – not to abuse substantial market power;
- the market abuse licence condition is therefore a necessary and proportionate regulatory response to the perceived risk.

Financial Services

It has also been suggested that since financial services regulation, particularly the new market abuse regime under the Financial Services and Markets Act,

will apply to at least some aspects of electricity trading, economic regulation is not required.

Ofgem is working closely with the FSA and the Treasury to determine the appropriate boundaries of financial services regulation in this sector. These boundaries will be made clear to all participants once established. Financial services regulation and electricity regulation have different objectives and the FSA is not the appropriate primary regulator of the wholesale electricity market.

Market Abuse Condition

We have listened very carefully to objections and representations from generators about the Condition itself – in particular about possible uncertainty, procedural issues and the risk that it will deter innovative trading strategies.

We have taken care to put in place and make public procedural arrangements which provide safeguards to those subject to the Condition but at the same time balance the need for swift enforcement. We have gone as far as the legislation allows in establishing an independent Advisory Board who will provide an independent view on enforcement action.

We are sympathetic to concern that the regulatory burden should be minimised to avoid stifling dynamic competitive behaviour. But all those operating the wholesale electricity market must recognise that they will need to put in place compliance programmes not only to deal with the market abuse condition

where this is applicable but to deal with the Competition Act and the new financial services market abuse regime. Some generators we know have already started to take compliance seriously. Others will need to do so and we make no apology for that.