September 2000

A commentary on British Energy's submissions to the Competition Commission

Ofgem's third submission to the Competition Commission

Public version

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1. Introduction

1.1 Ofgem's starting point in considering the need for the market abuse licence condition (MALC) is the legal duties of the Director General of Electricity Supply (the Director General) under the Electricity Act 1989. These include promoting competition in the generation of electricity and protecting the interests of consumers of electricity in respect of price and other terms. The Commission is required to have regard to these duties in considering the public interest.

1.2 In considering these duties, we are conscious of the fact of market power, which has been and has the scope to continue to be used in a way that is deeply harmful to consumers. No one, including the generators, has argued about the existence of market power in the past. In our various submissions to and hearings with the Competition Commission, Ofgem has made clear why we believe that the scope for misuse of market power will be a continuing problem:

- in the last days of the Pool,
- in the particularly uncertain time of the transition to the new electricity trading arrangements (NETA), and
- even when NETA has bedded down.

1.3 We have also set out the scale of the problem. Ofgem has used the MALC once so far since it was introduced in April 2000, in relation to Edison's withholding capacity. Our analysis showed that Edison's action had raised the Pool Purchase Price by more than 10%. This illustrates that market abuse is a problem of a scale and importance which, given the statutory duties of the Director General, he cannot ignore.

1.4 The question that Ofgem has had to address is how the problem should best be remedied. If we could have relied on the Competition Act 1998 to deal with it then we should have done so, notwithstanding that the statutory framework itself is neutral as to whether we should use regulatory powers or powers under the Competition Act, where both are capable of applying. However, it would have represented a radical departure from established case law and decisional practice for the purpose of the Chapter II prohibition under the Competition Act

to assume that all companies capable of abusing the electricity market would be found dominant. For example, Edison is only the third or fourth largest company and has a market share of between 5% and 10%. We recognise - and welcome - the possibility that one day European law (or jurisprudence developed under the Competition Act) may have advanced to a point when it is possible to rely on the Competition Act (see paragraph 9.3 below). However, for this to happen it will be necessary for the concept of dominance to have been developed to the point at which it looks at market power only, and has cast aside its reliance on market share and comparative size. At present, the most salient benchmarks in the test of dominance are very far removed from that position.

1.5 Against these benchmarks, Ofgem cannot safely assume that it can act effectively under the Competition Act against all the instances of the real and present harm with which Ofgem has a statutory duty to deal. Under the Electricity Act, Ofgem has a means of dealing with the harm caused by the exercise of market power through licence conditions, which is not only available but – as the Edison experience shows – practicable. Ofgem believes that we would be acting imprudently and wrongly not to make use of this power and that it would not be proper for Ofgem to wait for a period of years, while consumers suffer harm, to develop a concept of dominance from a point of theoretical argument to a point where it is what Ofgem needs – a practical weapon against a real harm.

1.6 The combination of statutory duty and the scope for market power being used to harm consumers and competition will not go away. If Ofgem cannot in future use the MALC, we shall be forced to use other remedies that we judge to be worse – less likely to be effective and more likely to lead to intrusive regulation through rule changes. Many of the issues which concern us and others in relation to the MALC will continue to occur: the need for market surveillance, the need to investigate what appear to be deviations from what would be expected in a competitive market, the need to make judgements as to the effect on markets of the actions of players in those markets including some with small market shares. None of these issues, all of which have been identified in the context of the MALC, is specific to it. They all arise from the need to cope with the scope for harm to consumers from the exercise of market power in the

wholesale electricity market. They will not disappear, nor diminish, if the MALC is no longer available.

1.7 It is in the context of the foregoing remarks that the following critique of the arguments made to the Competition Commission by British Energy (BE) should be considered (Part A). Ofgem intends to complete a similar analysis of the arguments made by AES but has been unable to do so due to a delay in AES returning the transcript of their hearing to the Competition Commission. Our comments follow the structure of our second submission so that each chapter in this submission corresponds to a chapter in the submission.

1.8 Our main comments can be summarised as follows:

- other markets may have one or more of the features that set electricity apart but it is the combination of these features that makes electricity special with regard to close to real time trading, particularly the potential consequences of a failure to balance the system;

- BE appears to be under the mistaken impression that Ofgem considers that generators should always bid at their marginal cost. This is not, and has never been, our position;

- Ofgem continues to believe that the fact that a company has not manipulated the market in the past does not imply that the company will not choose to do so, if it can, in the future. Market conditions or company circumstances can change in ways that increase the incentives to abuse the market. It is for this reason that we believe that all companies who may be in a position to abuse the market should be subject to the MALC. It is for this reason that we sought to introduce the MALC into the licences of BE (and AES);

- Ofgem acknowledges that further divestment of plant; rule modifications and the introduction of NETA all have a role to play in limiting the scope for participants to abuse the market. However, we do not consider that we would be acting in accordance with the statutory duties of the Director General if we assumed that they would be sufficient to tackle the problem of market abuse close to real time;

- BE's objections to the MALC appear to be based partly on a misunderstanding of Ofgem's position with regard to the relevant costs to consider in assessing market power and abuse. We do not accept that MALC leads to greater regulatory uncertainty than would be the case if Ofgem were to rely upon the Competition Act 1998 because the processes involved in investigations under both routes are very similar; and finally;

- BE uses the argument that abuse cannot take place unless prices are increased for a period over which a competitive response could have occurred to assert that short-term price increases could not be abusive. This appears to ignore the fact a competitive response in the electricity market can take place very rapidly (as soon as participants can change the prices that they bid). If, as BE suggests, we were to wait to see if new entry occurs before taking action, the scale of harm to consumers that could occur would be wholly unacceptable.

1.9 The second part of this submission (Part B) is a more general consideration of the legal points that have been raised in relation to the MALC and the Competition Commission referral. Unlike the economic commentary in Part A, this part of the submission is not specific to comments raised by BE. Also included, as an appendix to this submission, is a legal Opinion prepared for Ofgem by Jeremy Lever QC and Daniel Beard. This Opinion provides an interpretation of the Commission's duty to conclude whether the matters specified in the references may be expected to operate against the public interest. Again, this part of the submission is not specific to comments raised by BE.

Part A

Commentary on British Energy's submissions

2. Part 1: The Problem – (i) Description

The special nature of electricity

'Differences between electricity and other manufactured commodities and services are matters of degree rather than substance'

Paragraph 3.2, Commentary on Ofgem's Second Submission

2.1 Ofgem agrees that other markets may have one or more of the features that set electricity apart but we consider that it is the combination of these features that makes electricity special with regard to close to real time trading. In particular, the consequences of a failure to balance the electricity system can potentially be much more serious than a failure to clear the market for most commodities (with the notable exception of gas).

'Electricity is by no means unique in being subject to storage constraints. There are limitations on the storage of fresh food products, for example.'

Paragraph 3.19, First Submission

2.2 Ofgem considers that there is a difference: although fresh fruit is a perishable commodity it can be stored for a period through the use of refrigeration whereas electricity cannot be stored in any significant quantities (except via pumped storage stations). BE further maintains that electricity is not unique in having to be supplied at a particular point in time (quoting newspapers as an example). However, the potential consequences of a shortage of either fruit or a newspaper on the one hand and of electricity on the other are very different. If there is an insufficient supply of a particular newspaper, some demand goes unsatisfied but customers can substitute a comparable product (e.g. an alternative newspaper). In electricity, failure to balance leads to frequency excursions, which can damage electrical equipment or, in more extreme circumstances, result in a loss of supply to part of or all of the market. There is very limited potential for customers to switch to alternative fuel sources at short notice and for some important end-uses (e.g. for lighting there is no comparable substitute). Failure to balance supply and demand does not merely lead to wasted product, but runs the risk of systemic failure.

'a low overall demand inelasticity obscures high elasticities for individual companies. Generators who raise prices above those of their competitors will face a loss of market share and profit'.

Paragraph 3.19, First Submission

2.3 Ofgem agrees that some consumers will have high demand elasticities but we question the extent to which these will be manifest over Balancing Mechanism timescales, particularly in the period immediately following the introduction of NETA. BE recognises this point since in the next bullet, it asserts that other markets (such as the transport sector) are characterised by supply that is inelastic in the short term, implying that electricity is also inelastic in the short term.

'A range of markets are subject to complex rules and arrangements. There is no evidence that the Pool rules have formed a barrier to entry into generation or supply.'

Paragraph 3.19, First Submission

2.4 Whilst suggesting that many markets have complex rules, BE provides no examples of such markets. With regard to generation entry, it is worth noting that so far, only a handful of new generating plant belonging to independent producers have been commissioned that have any significant exposure to Pool prices. By far the majority of new plant have been insulated by back-to-back fuel supply and offtake contracts.

"Ofgem has not provided any compelling evidence for introducing additional sectoral specific competition regulation in the electricity sector".

Paragraph 3.20, First Submission

2.5 As outlined in our second submission, Ofgem believes that the special nature of electricity compared to other commodities is implicit in the existence of an electricity specific regulatory regime, which is encompassed in the Electricity Act 1989 and the appointment of an industry regulator (the Director General of Electricity Supply). Typical commodities such as fruit or metals do not have specific primary legislation governing their trading arrangements; nor do they have industry-specific regulators; nor are individual participants in most other commodity markets required to be licensed.

"no general feature of electricity generation – features faced by every wholesale electricity market in the world – suggests the need for special competition powers, and overseas regulators facing similar inelastic supply/demand conditions have developed more pro-competitive approaches to regulation."

Paragraph 3.2, Commentary on Ofgem's Second Submission

2.6 We agree that the England and Wales electricity system is not essentially different to other electricity systems. With regard to regulatory approaches, we have pointed out in various submissions that concerns surrounding market abuse are a common theme. Whilst it is true that no other regulator has introduced a specific market abuse licence condition, Ofgem would contend that this is a more pro-competitive approach to regulation than the use of price caps which has been adopted in California and Australia.[1]

Costs of generation

'New entry costs of baseload plant would be highly relevant to overall market prices if all plant in the system ran at baseload – but it is common place that only a fraction of plant is required for baseload'

Paragraph 2.4.2, Commentary on Ofgem's Second Submission

2.7 Ofgem believes that baseload new entry costs are a relevant indicator for *time-weighted* prices although we accept they would not be a suitable comparison for, say, peak prices. New entry costs in relation to market prices are also an indicator of the extent to which entry to the market is likely to occur, which is an important consideration in relation to the competitive state of the market overall.

2.8 BE argues that the range for new entrant prices quoted by Ofgem (£17-20/MWh) is too low and suggests that, assuming electricity prices continue to decline in real terms at 2.1% per annum and *"using the latest gas prices"*, the new entry price at a 90% load factor would be around £21/MWh. It is not clear precisely what gas prices BE has used but it is worth noting that, at the time that BE submitted its Commentary (12 July), spot and forward gas prices were at a high

[1] In Australia, an administered price is used when there is insufficient generation to meet demand and this sets an implicit price cap.

level compared to prices over the past few years and that prices more recently have shown wide swings in value.

2.9 BE further argues that that prices of around £23.7/MWh would actually be required by a new entrant to compensate for a decline in the plant's load factor over time – BE suggests that after 15 years of operation, this might have fallen to 60%. Whilst we accept that the load factor of plant generally declines over time as newer plant are commissioned, we believe that BE has overestimated this effect in the case of CCGTs. This is because gas supplies for such plant are typically secured via long term contracts with high take or pay requirements which effectively reduce the short run marginal costs of the plant to close to zero. Moreover, so far as we can tell, BE does not appear to have taken any account of the fact that as the load factor of the plant declined, the average price it received would increase. For example, assuming that the high load factor end of the price duration curve will not change significantly from that seen in 1999/00, we estimate that, using BE's assumptions on load factors and price decline, the required time-weighted price in 2000 would be £20.7/MWh rather than £23.7/MWh. Moreover, there appears to be an inconsistency in BE's assertion that new entry prices are above the current level of Pool prices and its assumption that they will continue to fall at 2.1% p.a. over the next fifteen years.

'There are reasons to believe that Ofgem's figure of 40%-50% cost reduction is an overstatement.'

Paragraph 2.4.3, Commentary on Ofgem's Second Submission

2.10 BE calculates that a 40-50% reduction in costs implies that new entry costs in 1990 would have been in the range £34-40 /MWh (in January 2000 prices) and indicate that *"new entry costs were rarely estimated at more than £30/MWh in 1990"*. These statements are misleading in two respects. First, the range presented by BE assumes a 50% reduction – a 40% reduction leads to a range of new entry costs of £28/MWh – £33/MWh. Second, the 1990 new entry cost quoted by BE appears not to have been adjusted for inflation. We would agree that new entry prices in 1990 were around £30/MWh in nominal terms but in real (January 2000) terms this equates to a price of over £38/MWh.

2.11 More generally, Ofgem's views on the reduction in overall costs are based on the total costs of meeting demand i.e. it involves the generating costs of both

existing and new plant. We accept BE's point with regard to the sunk costs of existing plant but note that many of the existing plant were built in the 1960s or 1970s and hence that their sunk capital costs are likely to be small in relation to their overall costs. Given that the marginal costs of existing coal plant have fallen by over 50% and that we believe that new entry costs have fallen by a similar amount, we do not consider that our "*presentation of statistics on actual costs is incomplete or misleading"*.

2.12 BE also suggests that Figure 2.1 of Ofgem's second submission is misleading. In particular, they comment that *"it might be concluded that these events* [those identified in the graph] *are all instances of market abuse, which illustrate the need for stricter control. However, the truth is different"*. Any such conclusion would be an unwarranted inference from what Ofgem stated: that this was never Ofgem's intention is clear from the reference to the graph in our submission (quoted by BE) that *"it highlights significant events that have influenced prices over that period"*. On the other hand, we consider that Figure 6 of BE's Initial Submission is in fact misleading since the daily Pool prices in that graph are shown to a completely different scale to the forward prices.

Examples of the scope for manipulation

2.13 In its various submissions, BE has made a number of points regarding price bidding strategies, capacity withdrawal and manipulation of complex rules and we consider these in turn below.

Capacity withdrawal

2.14 BE, in paragraph 2.5.1 of its Commentary, suggests that the analysis undertaken by Ofgem in relation to the withdrawal of capacity by Edison '*is seriously flawed'* because it would

> **'institute a form of regulation that systematically prevented generators from achieving prices above avoidable costs even if such prices were (1) necessary to recover total costs and (2) consistent with an unhindered competitive entry process.'**
>
> Paragraph 2.5.1, Commentary on Ofgem's Second Submission

2.15 Moreover, in paragraphs 3.40 and 3.41 of its Initial Submission, and in subsequent hearings with the Commission, BE has suggested that Ofgem believe that generators should always bid in relation to their marginal costs. We know of no reason for BE to hold this view. It is not, and has never been, Ofgem's position – as was made abundantly clear to BE, at the time of the early discussions on the MALC. It is a source of regret that BE should have failed to recognise this, and has based its analysis on an incorrect assumption.

2.16 For example, as long ago as 1992,[2] OFFER introduced the concept of one-year avoidable costs as an appropriate benchmark for wholesale prices. Avoidable costs were defined as the additional cash outlays required to produce a planned level of output from an individual plant in a particular year plus an allowance for some of the administrative costs at the company level.

2.17 It is clearly the case that a key question in relation to the MALC concerns the categories of costs that are relevant in considering whether or not abuse has occurred. There is no straightforward answer to this question since it will depend on the specific abuse that is being considered. For example, if a generator decides to withdraw plant temporarily (as in the Edison case), then the one-year avoidable costs (fuel, labour, start-up, use of system, rates, maintenance, overhaul and major repairs) of the withdrawn plant are a relevant consideration. This, indeed, was the approach that Edison claimed to have adopted in considering whether or not to return the plant it had withdrawn. In such a case it is not appropriate to consider capital costs (including debt service), as these are not costs that can be avoided by a temporary closure. On the other hand, capital costs would clearly be a relevant consideration if the abuse being considered related to entry decisions. In neither case would marginal costs be an appropriate comparator – as should be clear to BE.

2.18 In its issues hearing with the Competition Commission, BE suggested that Ofgem should not be involved in exercising hindsight on generators' decisions. We fully appreciate that generators can only make decisions based on prevailing market conditions and prices and estimates of how these may change in future. It was for precisely this reason that, in analysing Edison's initial decision, Ofgem based its analysis on the level of prices (Pool and EFA) in March. In considering

[2] Review of Pool Prices, December 1992.

the continuing withdrawal of capacity, we concentrated on the prices that had been seen since April, the forward curve for the rest of the year and contract offers received by Edison.

2.19 One final point worth noting in relation to capacity withdrawals is BE's assertion that *"all major generators are subject to a licence condition which requires them to supply regular statements to Ofgem as to planned plant availability and reconciliation with forecasts together with explanations"* (paragraph 4.21 of BE's Initial Submission). First, this licence condition (9a) does not currently apply to all generators or necessarily to all the stations owned by a generator. For example, although BE's nuclear stations are covered by this licence condition, Eggborough is not. This situation will be rectified with the introduction of standard licence conditions under the auspices of the Utility Bill, which will include a simplified form of the condition in the licences of all generators. Second, and more importantly, this licence condition only relates to the provision of information. It does not give Ofgem any powers in relation to prohibiting capacity withdrawals and hence can not be used to address market abuse involving such actions.

Price bidding strategies

2.20 We have discussed in the previous paragraphs why we consider BE's understanding of Ofgem's approach to considering prices and costs in relation to abuse to be flawed. BE also questions Ofgem's concepts of discrimination between time periods and temporary market power (paragraphs 4.12 to 4.18 of its Initial Submission). Ofgem fully accepts that prices will vary between time periods. Our concern is related to differences in prices that are not justified by changes in demand and/or cost conditions. In relation to temporary market power, BE argues that persistently excessive prices are necessary for a finding of abuse, in part because the majority of electricity consumers are not affected by temporary movements in prices. Ofgem believes that short-term price movements can have implications for consumers over the medium term because they can reduce competition (for example, by deterring new entrants) and may influence the premium that suppliers are prepared to pay for price hedges.

'In paragraph 2.19 [of Ofgem's Second Submission] Ofgem effectively equates manipulation to price setting, which implies that manipulation is an integral and necessary aspect of a properly functioning market.'

Paragraph 2.5, Commentary on Ofgem's Second Submission

2.21 This is not Ofgem's position since it is obviously the case that some generator has to set prices in each half-hour under the Pool. Ofgem relates market power to the ability to influence prices in ways that are not reflective of supply and demand fundamentals and this may be, but is not necessarily, associated with price setting. If the market power is exercised (i.e. the market is manipulated, and the detriment to customers or competition is material), then we consider that the participant may be abusing the market.

Manipulation of complex rules

'a market abuse prohibition does not provide the means of remedying flaws and weaknesses in market rules.'

Paragraph 4.27, Initial Submission

2.22 Ofgem's underlying concerns in this area have been outlined in our Second Submission. Whilst we accept that ultimately market rule flaws will have to be addressed by changes to the rules, we do not accept that the MALC does not have a role to play in this regard. It enables abuse relating to the manipulation of complex rules to be punished whereas without the condition generators would be able to benefit from exploiting loopholes until they were closed (the "one free hit" effect). This feature of the MALC may also deter such types of abuse.

'In paragraph 2.24 [of Ofgem's Second Submission], Ofgem considers two contrasting bid structures and asserts that one will lead to unjustified increases in the Pool prices. Ofgem's assertion is incorrect, being based on a faulty understanding of the Pool rules.'

Paragraph 2.5.3, Commentary on Ofgem's Second Submission

2.23 Our example was only intended to illustrate a general point with regard to bidding strategies rather than becoming fully embroiled in the details of scheduling and price setting under the Pool. Nonetheless, we believe that our

description is factually correct although we accept that marginal prices i.e. incremental bids, are only of direct relevance to prices during Table B periods. Furthermore, we did not, as BE alleges, assert that one of the bidding strategies would lead to unjustified increases in Pool prices.

3. Part 1: The Problem – (ii) Why BE could be part of the problem

3.1 BE (in section 3 of its Commentary on Ofgem's Second Submission) raises a number of questions regarding the relationship between the criteria for including MALC in a generation licence and the criteria for substantial market power. Their general theme is that there is no reason for BE to subject to the MALC.

3.2 In setting the criteria for companies to have the MALC included in their generation licence, Ofgem has adopted a pragmatic approach designed to capture those generators who are most likely to possess substantial market power. However, we have made it clear that, for the longer term, we consider that it would be desirable for the MALC to be a standard condition in the licences of all generators and suppliers. In the interim, we have effectively simply adopted a screening mechanism. The fact that a generator has the MALC in its licence does not imply that the generator ***does*** possess substantial market power (as defined in the guidelines) at any particular time, merely that there is a reasonable expectation that it ***may*** at some time have substantial market power. It is also important to note that the fact that a generator possesses substantial market power does not mean that it is exercising that market power. Nor does it necessarily follow that the exercise of market power will amount to abuse (since abuse is an effects-based test relating to appreciable harm to consumers or competition). Thus, the impact on a generator from including the MALC in its licence will be minimal unless it chooses to exploit its market power in a way that results in abuse.

3.3 BE also takes issue with Ofgem's examples of the ways in which it might be possible for it to exercise substantial market power under the Pool and NETA. It is worth re-emphasising that we were not suggesting that BE would necessarily act in these ways, merely that it might have the ability and the incentive to do so. With regard to capacity withdrawal, we understand that BE now accepts that this could be a profitable strategy under certain circumstances, although it suggests that it does not intend ever to be in those circumstances[3]. Ofgem accepts that this is BE's current position but would point out that circumstances

[3] Ammended for reasons of confidentiality

and policies can change (particularly decisions on contract cover that can easily be adjusted) and hence that our contention that capacity withdrawal might be a profitable strategy remains valid. *

'Ofgem argues (without any apparent logic) that, as the owner of inflexible plant, BE may have added incentives at times to manipulate the imbalance price under NETA. Once again, Ofgem appears to confuse an incentive to see higher prices (common to most producers) with an ability to bring about such prices.'

Paragraph 3.1, Commentary on Ofgem's Second Submission

3.4 Although we accept that BE anticipates contracting fully to cover its nuclear capacity (paragraph 3.1 of its Commentary), there may be times when it is unable or unwilling to contract in this fashion; it would then have an incentive to increase the System Sell Price. This would involve offering to pay a high price for reducing the output of Eggborough. This is the opposite of endeavouring to increase prices for generation i.e. increasing the System Buy Price, which is what BE appears to think we are suggesting.

3.5 BE is right to suggest that the incentive to manipulate prices in a particular fashion is different to the ability to bring about such prices. In our second submission, we noted that during 1999/00 Eggborough had set prices for 8.9% of the time by way of illustrating that, from time to time, this plant might have substantial market power. In addition to reiterating that setting prices does not necessarily equate to market power, BE pointed out that our analysis focused on a period when Eggborough was owned by National Power. The frequency with which Eggborough has set prices since it has been owned by BE remains essentially unchanged compared to last year – over the period from 30 March 2000 to 30 June 2000, Eggborough set prices for 8.4% of the time. [4]

4. Part 1: The Problem - (iii) Its effects

4.1 BE criticises the fact that in the examples of excessively high prices given in paragraph 4.2 of our second submission, we made the statement that we were not contending that *"prices or profits were excessive per se but simply that they were higher than they would have been in a competitive market"*. This comment was made for two reasons. First, we had not gone back and formally gone through the steps necessary to prove abuse under the MALC. Second, as we discussed in our answers to the issues letter,[5] in a market with excess capacity there may not be supra-normal profits but there can be supra-competitive profits.

Price levels

"Ofgem presents evidence of the supposed scale of the problem but the evidence is not substantiated".

Section 4, Commentary on Ofgem's Second Submission

4.2 This criticism by BE appears to be directly related to the fact that it disagrees with our analysis of the relative movements in generation costs and wholesale prices. As we have explained in Chapter 2, we consider that BE's calculations of new entry costs are misleading and its criticisms with regard to total generating costs unfounded.

4.3 BE also asserts that our discussion of prices suggests that Ofgem believes that *"it can actually determine what the competitive price 'should be'"*. This is not the case. Ofgem does not deny that it can be difficult to distinguish between commercial and abusive behaviour or that price comparisons are, in themselves, insufficient to prove abuse. Rather Ofgem sees the review of prices charged as an essential first step in any regulatory surveillance of the market, irrespective of what route (i.e. MALC or Competition Act) we might choose to take if we believed that market abuse had taken place.

[5] "Introduction of the market abuse licence condition into the licence of certain generators: Ofgem's response to the Competition Commission's issues letter", Ofgem, July 2000.

Effect on contract prices

'In paragraphs 4.8 to 4.9 [of Ofgem's Second Submission], Ofgem cites "further evidence" of abuse conduct which leads to both:

- **contract prices *above* Pool prices; and**
- **contract prices *below* Pool prices.'**

Paragraph 4.1, Commentary on Ofgem's Second Submission

4.4 We did not claim that the contract premia shown in Figure 4.1 were evidence of abuse as BE suggests. Ofgem's only claim was that the fact that contract prices for the period March-October 1999, in contrast to the position in adjacent six-month periods and indeed more generally, was confirmation that the market had been manipulated in the summer of 1999.

4.5 Ofgem also takes issue with BE's statement that the data shown in Figure 4.2 of our Second Submission contradicts our argument that the scope for manipulation of prices has restricted the development of traded markets. It shows very clearly that, for the first nine years of the Pool, very little trading of futures took place. Moreover, it shows that the introduction of the MALC (in April 2000) has not affected the increase in liquidity in the EFA market. This is in contrast to BE's assertion that *"Ofgem's proposed interventions will not improve matters"*.

5. Part II: Solutions – (i) Generation market structure and trading arrangements

Generation market structure

5.1 Paragraphs 3.2 to 3.9 of BE's Initial Submission discuss the changes to the ownership of power plants in England and Wales since 1990 and concludes that the market has become significantly more competitive and will become more so as new plant come on stream over the next few years. These observations lead BE to assert that the MALC is unnecessary and inappropriate.

5.2 We do not dispute that the market shares of the major players have declined over time and will continue to do so but we do not believe that this means that the scope for, or incentive to, abuse the market has disappeared. Indeed, Ofgem has recently concluded that market abuse has taken place at a time when the HHI for the electricity market (measured in respect of capacity) was only 1100.

5.3 [Point withdrawn for reasons of confidentiality.]

5.4 BE implies that by divesting plant the potential for price manipulation is removed rather than transferred. Transference of ownership does not necessarily remove the potential for a given station to influence prices. For example, National Power divested two coal-fired plant to Eastern in 1996 and Ofgem investigated the behaviour of the self-same plant in February 1999.

Rule modification

'While constant rule changes may indeed stifle innovation, constant, unpredictable and retrospective regulatory interventions are sure to have an even greater adverse effect.'

Paragraph 5.2, Commentary on Ofgem's Second Submission

5.5 The logic of this statement seems flawed since rule changes, by their very nature, must be unpredictable. Moreover, the use of the MALC (or the Competition Act) is no more retrospective than a rule change. A rule change implies that behaviour that was previously not prohibited will now be prohibited

and this is exactly the same effect as finding that a particular form of conduct constitutes abuse.

NETA

5.6 Ofgem agrees with BE that the scope for market abuse, particularly in the forwards markets, should be reduced under NETA. However, we cannot be confident that the scope for and incentive to manipulate the market close to real time will disappear for two main reasons.

5.7 First, although the volumes traded through the Balancing Mechanism may only be a small percentage of the market, there could be a feedback from the energy imbalance prices, based on Balancing Mechanism trades, to the short-term forwards markets and power exchanges as participants seek to benefit from the arbitrage opportunities of any price differences between the markets. Such arbitrage was a feature of the wholesale gas market, particularly in its early days. If such a feedback does exist, and is significant, the incentive to manipulate the Balancing Mechanism will exist and the need for second by second balancing and the short-term inelasticity of supply and demand could provide the opportunity for abuse.

5.8 Second, it will take time for the full impact of the change in the trading arrangements to be felt. This is particularly likely to be the case with the potential for demand-side participation to act as a countervailing force to generator market power.

5.9 For these reasons, Ofgem considers that we would be failing in our statutory duty to protect consumers if we did not take steps to ensure that we had adequate powers to address problems of market abuse. As we have stressed in previous submissions, Ofgem believes that the market abuse licence condition is the most appropriate way of providing us with a means to tackle market power.

6. Part II: Solutions – (iii) Market abuse licence condition

6.1 BE has indicated that it objects to the MALC on principle for a number of reasons that we consider in turn below.

'It is wrong in principle to have a different competition prohibition for electricity.'

Executive Summary, Initial Submission

6.2 Ofgem has consistently argued, see for example Chapter 2 above, that the wholesale electricity market has a number of special characteristics which mean that participants with relatively small market shares may be able to abuse the market. BE, on the other hand, appears to believe that the ability to abuse a market is synonymous with dominance and hence is covered by the Competition Act 1998:

'We would argue non-dominant generators cannot abuse the market, and, therefore, if a generator is abusing the market, they must be dominant'.

Paragraph 2.3.1, Commentary on Ofgem's Second Submission

6.3 In our various submissions, we have shown several examples of manipulation or abuse[6] by companies whose market position was less than that generally considered to be the threshold of dominance. For example, their shares were considerably below the standard test for dominance (40%) irrespective of how the market is defined and they were not the largest market participant. (An obvious and recent example is the withdrawal of capacity by Edison First Power.) Under any reasonable interpretation these companies cannot be considered as dominant but there is ample evidence of their ability and willingness to manipulate prices.

[6] We have consistently used the term "manipulation" in relation to events that took place before the introduction of the MALC. This is because the term "abuse" now has a particular connotation associated with the licence condition and we have not gone back and applied the licence condition tests to earlier events.

6.4 The ability for a smaller player to exercise market power can be explained by recourse to basic models of oligopoly. These models provide a rough quantification of the significance of demand elasticities relative to the significance of market shares.

6.5 A standard result is that the price-cost margin, a measure of market power, is proportional to market share divided by the market demand elasticity. This means, for example, that the same price-cost margin can be associated with (a) a 50% market share and a demand elasticity of 1, and (b) a 5% market share and a demand elasticity of 0.1. Since demand elasticities for wholesale electricity are very low, it follows that relatively low levels of market concentration are no guarantee of competitive pricing. Further, small (absolute) changes in the demand elasticity can be equivalent in effect to large changes in concentration. For example, an increase in the market demand elasticity from 0.05 to 0.1 is equivalent to a halving of the level of market concentration.

6.6 Whilst demand elasticities are low throughout the year, supply elasticities tend to vary from period to period depending upon what plant is on the system, the relationship of demand to available capacity, and the bidding and capacity availability strategies of generators. This is perhaps the major reason why the degree of market power can be expected to vary to an appreciable extent from hour to hour, day to day, and month to month; this is why Ofgem, like other electricity regulators, pays close attention to systems conditions when interpreting data on prices and price movements.

'The market abuse condition is flawed in conception and has significant procedural defects.'

Paragraph 2.3.1, Commentary on Ofgem's Second Submission

6.7 In relation to this assertion, BE has raised concerns over the question of confidential guidance and the extent to which giving one company guidance which is not available to other market participants prejudices effective competition. (With respect to the alleged advantages of the Competition Act, it is worth noting that confidential guidance is specifically provided for on the face of the Act and hence that this is an area in which the MALC and the Competition Act operate in the same way.) On the other hand, BE appears to accept that, from the perspective of an individual company, it would be advantageous to be

able to seek the advice of the regulator. Ofgem accepts that asymmetry of information is a concern in a traded market but does not consider that this should preclude the provision of confidential guidance. Instead, it places an onus on Ofgem, where relevant, to publish as soon as is practicable general guidance on the issues for which confidential guidance has been sought. Ofgem has also suggested holding public seminars to discuss the application of the MALC and its guidelines.

6.8 On a related point, Ofgem would like to make clear that although it discussed the MALC with affected generators prior to its introduction no deals were concluded with those generators to induce them to accept the MALC[7].

'The market abuse condition would introduce significant regulatory uncertainty'

Paragraph 2.3.1, Commentary on Ofgem's Second Submission

6.9 BE claims that the MALC increases regulatory uncertainty because the concepts that it embodies are, and will always remain, ill defined. Ofgem rejects absolutely this assertion. The steps that Ofgem goes through in determining whether or not an abuse has occurred under the MALC are the same steps that it would have to go through in taking action under the Competition Act.

6.10 In both cases, the starting point for an investigation will be that market surveillance has thrown up evidence of unusual patterns in prices. At this stage, there is no presumption that these are unjustified, but merely that they warrant further investigation. A preliminary stage in such an investigation will involve comparing the prices that have caused concern with prices that have been seen when market conditions (demand, total generating capacity) and generating costs have been similar. If this initial investigation suggests that the pattern of prices is not explicable in terms of these macro variables, then a more detailed investigation will be undertaken to establish what caused the abnormal prices. Until this point, it should be stressed that that investigation would not differ according to whether the MALC or the Competition Act was eventually invoked. To the extent that one participant appears primarily responsible, then it will be

[7] Ameneded for reasons of confidentiality

necessary to consider whether action under the MALC or the Competition Act is appropriate.

6.11 To proceed using the MALC, it would be necessary for Ofgem to be satisfied that the participant possessed substantial market power (under the Competition Act, the equivalent test would be whether the participant might reasonably be taken to be dominant). In both instances, this will involve determining whether the participant can bring about, independently of any changes in demand or cost conditions, a substantial change in wholesale prices. If this test is passed, it is then necessary to consider whether the participant has exploited its market power (or dominance). It is at this stage that the question of costs discussed above becomes relevant since the issue of expected profitability would be an important consideration. The final step is to establish what effects any exploitation of market power has had in relation to competition and consumers. Only if appreciable harm has been caused by the actions of the participant will abuse be deemed to have taken place.

6.12 Another criticism that BE raises in relation to Ofgem's arguments for the MALC is that it is intended to capture market abuses that may be short-term or temporary in nature:

'The substantial emphasis of the Guidelines is on short-term price levels assessed in relation to market conditions and avoidable costs.'

Paragraphs 3.40 and 3.41, Initial Submission

6.13 BE argues that temporary price rises are an intrinsic part of the competitive process and hence that short-term effects cannot constitute abuse. This argument seems to ignore the fact that, in considering whether abuse has occurred, Ofgem has repeatedly made it clear that prevailing market conditions are an important consideration. We fully accept that prices will fluctuate in the short-term but this does not mean that prices should necessarily be substantially different between periods in which market conditions and generation costs are the same. BE also alleges that abuse cannot take place unless prices are increased for a period over which a competitive response could have occurred. In an electricity context, a competitive response from existing generation can happen very rapidly. For example, generators can change their bids on a day to day basis and hence it is entirely appropriate to look at short-term effects if the

harm they cause is appreciable. BE suggests that entry is an important competitive response but Ofgem would have to wait for several years to see whether new entry occurred and what effect it had. During all this period, abuse could be continuing to take place. This illustrates one of the reasons why Ofgem considers that the Competition Act, as explained in the OFT guidelines with their emphasis on the persistence of effects, is unlikely to capture all the forms of abuse that may occur in the wholesale electricity market.

'It [the MALC guidelines] ignores the key fact that generation plant has significant sunk costs'

'It would be wrong for Ofgem to use regulatory intervention (or the threat thereof) to preclude the recovery of such costs.'

6.14 The MALC in no way implies that efficient generators will be prevented from making a normal return on capital. We also fully accept that prices and generators' bids will vary across the course of a year as market conditions vary and thus that avoidable costs are not a relevant consideration in relation to prices for individual half-hours.

6.15 Ofgem would also take issue with BE's assumption that prices must necessarily be at a level that enables sunk costs (for example, those incurred when an investment is made) to be recovered. Whether or not this is appropriate must depend on whether the sunk costs have been efficiently incurred. For example, if plant had been built or purchased for an excessive cost, Ofgem would not accept that this implied that in considering the costs of the generator who had built or bought the plant, the full costs of the plant should be taken into account. Similar points were made in Ofgem's second submission (paragraph 2.40) and in our answer to question 7 of the Competition Commission's issues letter.

Part B

Commentary on legal arguments

7. Introduction to legal commentary

7.1 During the course of the Competition Commission inquiry AES and British Energy have made a number of legal points upon which Ofgem wishes to comment. Rather than identifying each point raised by the generators with which Ofgem concurs and rebutting each one with which it disagrees, we consider that these matters can be dealt with more broadly under the following heads:

(A) the nature of the test to be applied by the Competition Commission;

(B) the definition of substantial market power under the proposed Market Abuse Licence Condition ("MALC") and its relationship with the notion of "dominance" in Chapter II of the Competition Act 1998;

(C) the relevance of the notion of joint dominance as applicable under the Chapter II prohibition;

(D) the concept of abuse of a position of substantial market power and its relationship with the notion of abuse under the Chapter II prohibition; and

(E) procedural matters.

7.2 The following comments are made as additions to the submissions and responses to questions which Ofgem has made during the course of this inquiry and which, it hopes, have already made its views on the legal issues clear.

8. The nature of the test to be applied by the Competition Commission

8.1 Ofgem adopts the analysis of and approach to the test to be applied by the Competition Commission in this inquiry set out in the Opinion of Jeremy Lever QC and Daniel Beard dated 23 August 2000, a copy of which is attached to this submission. In summary, in order to assess whether the continuation of the provisions of the licences of the referred generators in relation to the determination of wholesale electricity operates, or may be expected to operate, contrary to the public interest, the Competition Commission must undertake the following four stage test:

(i) what is the probability of public interest detriment in the absence of any proposed regulation?;

(ii) what is the potential magnitude of any such detriment?;

(iii) what, if any, disadvantages would be associated with introduction of the regulation?; and finally,

(iv) would less extensive regulation serve equally well or, even if not equally well, would it better satisfy the balance principle, as or than the proposed regulation?

8.2 Ofgem considers that there is a real risk that generators in the position of the referred generators may be able to operate so as to cause detriment to the public interest in relation to wholesale electricity prices. By making that statement, we are not saying that either of the referred generators *will* act to cause a public interest detriment or even that they are *more likely than not* to cause such a detriment. Instead, Ofgem is simply stating that it considers that on occasions generators in the position of the referred generators are likely to have both the ability and the incentive to cause such detriments.

8.3 Furthermore, specifically in relation to the MALC, Ofgem believes that persons in the position of the referred generators (along with the six other generators) are likely to hold positions of substantial market power and are likely to have incentives to abuse that market power. Again that is not to say that the referred

generators will or are more likely than not to do so. It is impossible for Ofgem to provide conclusive factual evidence that this is the case since the assessment relates to future activity and the future in relation to such questions can never be predicted with complete certainty. Criticism of a lack of specific evidence that either of the referred generators has held substantial market power and abused it is, therefore, misplaced.

8.4 A further matter which the referred generators have raised in their submissions which is pertinent to the test set out above is the extent to which disadvantages stem from including in their licences further conditions (and, in particular, the MALC) which relate to wholesale electricity prices. The generators' consideration of this matter has focussed exclusively upon the MALC. There have been forthright pronouncements as to the significantly increased regulatory burden the MALC will impose on generators and the inconsistency of the MALC with the Chapter II prohibition in the Competition Act. To some extent Ofgem's comments upon this issue pre-empt the points made below in Chapters 9, 10 and 11: it suffices to say at this point that the notion of substantial market power is no more uncertain than that of "dominance" and is modelled upon it. Furthermore, the notion of abuse of substantial market power refers to a subset of behaviour which would constitute abuse of a dominant position contrary to the Chapter II prohibition were the generator in question found to be dominant. Compliance with the MALC will, therefore, be no more burdensome or costly than compliance with the Chapter II prohibition and is not inconsistent with it.

8.5 Finally in this context, Ofgem believes that the submissions of the referred generators have failed sufficiently to analyse the nature of the test with which the Competition Commission is faced. In particular, the referred generators have made no suggestions as to how alternative licence conditions other than the MALC could address the problems addressed by the MALC in a more satisfactory manner (a question squarely within the terms of reference of the Competition Commission in this inquiry).

9. Substantial market power and dominance

9.1 The notion of substantial market power in the MALC has been subject to two main criticisms from the referred generators: first, it is inconsistent with the Chapter II prohibition; and, secondly, it is uncertain in ambit. In order properly to articulate Ofgem's responses to these criticisms, it is necessary to reiterate Ofgem's approach to the definition of substantial market power.

9.2 Substantial market power is defined in the MALC as the ability to bring about, independently of any changes in demand or cost conditions, a substantial change in wholesale electricity prices. Ofgem accepts that there are intellectually respectable arguments why it may be argued that such an ability marks a generator out as dominant in a relevant market. Ofgem therefore accepts the points made by the referred generators that it is *arguable* that generators in a position of substantial market power could be held to be dominant for the purposes of the Chapter II prohibition.

9.3 However, Ofgem is not confident that the definition of "dominance" in the Chapter II prohibition will cover circumstances within the electricity industry where generators are able to act in an abusive manner in which only dominant undertakings could act in other markets. The case law and decisional practice in relation to Article 82 of the Treaty Establishing the European Community, which, by virtue of section 60 of the CA98, directs the interpretation of the Chapter II prohibition, does not clearly indicate that the Chapter II prohibition will so apply. As the DGES said at the hearing on 28 July 2000 (transcript p.4 ll.31 – p.5 ll.4):

> *"If I could with reasonable confidence have relied upon the Competition Act 1998 to deal with* [the problems in rises in pool prices]*, I should have used those powers. It is possible that one day European law will have advanced to a point where I, or I suspect some distant successor, can rely on the Competition Act, but for this to happen it will be necessary for the concept of dominance to have developed to the point that it looks at market power only and has cast aside its reliance also on tests of market share and comparative size. The concept of dominance may well move in that direction, I hope it does …"*

9.4 The difficulty for Ofgem is that, amongst other matters, it is charged with duties not only (i) to ensure that all reasonable demands for electricity are satisfied but also (ii) to exercise its functions in a manner best calculated to protect the interests of consumers in relation to the prices charged for electricity and (iii) to promote competition in the generation of electricity. Ofgem considers that there is a high risk that a generator which is able to bring about, independently of any changes in demand or cost conditions, a substantial change in wholesale electricity prices would not be found to be dominant if it either:

a) had a small absolute market share;
b) had a smaller market share than another generator on the relevant market; or
c) because of the transience and irregularity of its enjoyment of market power.

9.5 Given the state of the law on the definition of dominance and, in addition, the possible delays entailed in trying to clarify the definition, Ofgem considers that it would not be exercising its functions in a manner best calculated to protect the interests of consumers were it simply to rely upon the Chapter II prohibition to police the activities in question.

9.6 In saying this and proposing the MALC, Ofgem is not resiling from any statements that it has made previously in relation to the nature of market definition. As has been (partially) quoted by Mr Tom Sharpe QC in his Opinion for British Energy, paragraph 3.24 of the Formal Consultation Draft on the Competition Act 1998: Application to the Energy Sectors stated that:

> *"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 sector. 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."

9.7 That paragraph recognised that the special circumstances of the electricity market in Great Britain may mean that firms that are not the largest firm in the market may be able to act independently of customers and competitors. It also recognised that this is not the analysis of dominance that has in practice to date been applied by the European Commission or Court of Justice.

9.8 The Formal Consultation Draft also considered the nature of the market definition in the context of the British electricity market. In particular, it considered in what ways the temporal dimension of the relevant market might be affected by the special nature of the electricity market and stated:

"*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."

9.9 As expounded in the paragraphs quoted above, Ofgem's view is that there are special features in the electricity market which have an impact upon the manner in which the market is regulated and may, in particular, have an impact upon market definition for the purposes of the Chapter II prohibition. However, nothing in the Formal Consultation Draft or any other material promulgated by Ofgem runs contrary to the conclusion of the Lever/Beard Opinion at Appendix 5 to Ofgem's Second Submission (at paragraph 5.7) that:

"it would represent a radical departure from the established case law and decisional practice – in a manner not foreshadowed in the academic literature – to hold that:

(i) the relevant market was to be defined in temporally highly restricted terms (e.g. as each of a series of "half hour markets") – and this despite the indisputable existence of a market for electricity not so restricted temporally; and

(ii) that an undertaking was individually dominant in a narrowly defined market of that kind notwithstanding that its market share even in that narrow market was –

(a) substantially less than 20 per cent even in the narrowly defined market;

(b) even less in a normally defined British market for electricity; and

(c) often substantially less than one or more other undertakings' shares of the narrowly defined market or the normally defined market."

9.10 As Jeremy Lever QC put it at the hearing on 28 July 2000, according to the case law as it stands, it appears that, leaving aside the temporal dimension, in order to make a finding of dominance three boxes need to be ticked: (1) ability to behave independently; (2) large market share (generally over 40%); and (3) largest market share. Substantial market power, on the other hand, requires only the first of these three boxes to be ticked.[8] In other words, the nature of substantial market power is entirely consistent with the notion of dominance, being defined, as it is, by one part of the existing definition of dominance. Furthermore, the manner of definition of substantial market power, and its relationship with the definition of dominance, means that it is no more uncertain than the notion of dominance. Indeed, the level of uncertainty is reduced to the extent that any potential conflict between the three limbs of the dominance test is removed.

[8] Ironically, this is the very element of the definition of dominance upon which the referred generators contend that Ofgem should be relying in policing anti-competitive conduct in the electricity market.

10. Joint dominance

10.1 In order for more than one independent undertaking to occupy a jointly or collectively held dominant position the undertakings must be united by economic links in such a way that they adopt the same conduct on the market. In the most recent case to come before the ECJ in relation to the nature of joint dominance, *Compagnie Maritime Belge,*[9] the Court stated at paragraphs 35 and 36 of its judgment:

> *"In terms of Article [82] of the Treaty, a dominant position may be held by several undertakings. The Court of Justice has held, on many occasions, that the concept of undertaking in the chapter of the Treaty devoted to the rules on competition presupposes the economic independence of the entity concerned (see, in particular Case 22/71* Beguelin Import v GL import Export *[1971] ECR 949).*
>
> *It follows that the expression "one or more undertakings" in Article [82] of the Treaty implies that a dominant position may be held by two or more economic entities legally independent of each other, provided that from an economic point of view they present themselves **or** act together on a particular market as a collective entity. That is how the expression "collective dominant position", as used in the remainder of this judgment, should be understood."* (Our emphasis.)

10.2 Whilst there are a range of links which may suffice to give rise to a presumption of joint dominance, there is no indication that participation in a market mechanism such as the Pool or NETA amounts to a sufficient link between participants to give rise to any inference of joint dominance. Indeed, it appears illogical to suggest that participation in a market mechanism could, alone, give rise to an inference that undertakings were adopting the same position in relation to their customers and competitors as a single dominant entity would adopt and were, thereby, removing effective competition between themselves.

[9] Joined Cases 395/96/P and 396/96/P, judgment 16 March 2000.

10.3 In the absence of a reliance upon the market mechanism, Ofgem fails to understand upon what basis it is suggested that the various generators can be assumed to hold a jointly dominant position. Were generators to indicate to Ofgem that they considered themselves to hold a jointly dominant position such that it would be unnecessary for Ofgem to need to modify the licence conditions of the generators in order to prevent the risk of abuse of substantial market power, Ofgem would give further consideration to the need for modification. No generator has indicated that it considers itself to be in such a position.

10.4 In these circumstances, Ofgem can have no confidence that any court would support a finding of joint dominance amongst generators so as enable it to use the Chapter II prohibition to prevent the types of activity at which the MALC is targeted.

10.5 Although, in their submissions, the referred generators have placed emphasis upon Commission and Court of First Instance decisions relating to the Merger Regulation[10] none of those decisions purports to depart from the test of joint dominance laid down by the ECJ. The decisions may be useful in illustrating how various considerations might be taken into account in assessing whether or not a jointly dominant position is held in a particular market by a series of undertakings. However, they do not suggest that generators in the position of the referred generators would be held to be in a joint dominant position with other generators so as to enable Ofgem to use the Chapter II prohibition to prevent the conduct which would be prevented by the MALC.

10.6 It has been argued that if AES, due to its participation in the electricity market in the UK, were in a position to engage in the types of conduct which Ofgem is concerned to prevent by use of the MALC, other larger generators would also be in such a position. This reasoning is used to claim that it would, therefore, form part of a group which would be considered dominant in any relevant market. Consequently, it is suggested that any behaviour engaged in by AES could, therefore, be subject to challenge using the concept of joint dominance under the Chapter II prohibition.

[10] In particular, Case IV/M.619 *Gencor/Lonrho* [1997] OJ L 11/30 and T-102/96 *Gencor v Commission* [1999] 4 CMLR 971; and Case IV/M.1524 *Airtours/First Choice* [1999] OJ L 093/1 (on appeal to the CFI).

10.7 It is unclear why the test for joint dominance outlined above would invariably be fulfilled in these circumstances. The points made concerning AES in relation to other generators, if correct, would only indicate that there is potentially more than one generator which could have substantial market power. The circumstances referred to do not give rise to any indication that the generators in questions would be hold a *joint* dominant position. Furthermore, no reason is given why the larger generators must necessarily be in a position to act in the same way as AES is able to act, Ofgem can envisage a range of circumstances where much larger generators are not able to operate to abuse substantial market power in the way that a smaller generator might be able to do over a limited period of time.

11. Abuse

11.1 Ofgem has been criticised by the referred generators for apparently failing to define the notion of "abuse" in the context of the MALC. The point has been made that a particular practice, when engaged in by a dominant undertaking, could amount to abuse but, when engaged in by a non-dominant undertaking, would be perfectly legal (which is true and is indeed the reason why a licence condition to deal with the problem is required). On this basis, it is argued, no useful guidance can be gained from a reference to the case law or decisional practice relating to Article 82 when trying to understand the notion of abuse within MALC since the undertakings subjected to the MALC may not be dominant. For the reasons set out in section (B) above, that criticism is misplaced.

11.2 From an economic standpoint, "abuse", whether in the context of Article 82 of Chapter II or in the context of the MALC, is abuse of the ability to act independently ie. in a manner not constrained in the normal way by effective competition. The types of behaviour which will constitute an abuse under the MALC will be those which constitute abuses contrary to the Chapter II prohibition. It is simply by virtue of the nature of the electricity market that Ofgem doubts whether, in practice, the activities in question would be caught by the Chapter II prohibition due to the present state of the definition of dominance.

11.3 In fact, the types of behaviour which would be found to constitute an abuse of the MALC are a subset of those which constitute abuses under the Chapter II prohibition. The role of the MALC is to prevent generators using their market power to raise the wholesale prices of electricity when nothing in the relevant cost or demand conditions justifies such rises. It is intended to prevent inter-temporal discrimination in relation to electricity prices.

11.4 In other words, the MALC is not intended to be used to identify when generators are engaged in excessive pricing by reference to their underlying costs. Instead, it endeavours to identify (and prevent) instances where generators create high prices, for example, by using their bidding strategies when they have substantial market power, to set higher prices than would otherwise have obtained, as

generally evidenced by the prices that in fact obtained in similar demand and cost conditions on other occasions. The MALC is not intended to be, and would not be operated as, a "back door" price-capping mechanism. The role of the MALC is not to try to force generators to set prices in line with their short run marginal costs or indeed on any other specific cost-related basis.

11.5 As described by Ofgem in its responses to the Competition Commission's Economic Questionnaire, Ofgem is constantly monitoring the market for abnormalities in pricing. It is only if an abnormality were detected and it were considered that such an abnormality caused appreciable harm to consumers or competition that conduct causing the abnormality might be considered abusive. Were that to be the case, the generator whose behaviour had resulted in a detrimental impact would be able to put to Ofgem material that indicated why its behaviour was justified. In the case of a capacity withdrawal from the system, such justification might well take the form of an analysis of the generator's avoidable costs in respect of the withdrawn plant. For a generator to be able to justify actions which otherwise appear to amount to abusive behaviour is wholly different from Ofgem requiring generators to price (or withdraw plant) only by specific reference to their costs.

11.6 Finally, it has been suggested that, as with the notion of substantial market power, the notion of abuse is legally uncertain. Legal rules can be of two kinds, those that prescribe or prohibit certain, precisely defined, types of behaviour and those which lay down general principles which govern behaviour. In the case of rules of the former type, there may be arguments about whether, in fact, a particular set of circumstances falls within the scope of the rule or note. So, for example, a statutory provision might require the blades of all circular saws to be protected by guards covering the uppermost half of the blade. Whether or not a particular saw design complied with the rule might be a matter of argument, but the rule itself is tolerably clear and precise.

11.7 On the other hand, rules of the latter kind admit of argument as to the ambit of the rule. So, for example, a statutory provision which required power tools to be designed so as to protect personal safety could be the subject of extensive argument about what methods and levels of protection were required. The notion of "abuse" in Article 82, the Chapter II prohibition and the MALC is

concept which, like many other well-known legal concepts, creates a rule of the latter kind. There can be no suggestion, however, that simply by creating a legal rule that encapsulates a principle is, therefore, a breach of the concept of legal certainty. Furthermore, the case law and decisional practice related to the application of Article 82 assists in interpreting the notion of abuse in the MALC. In addition, Ofgem has endeavoured, through its guidelines, to provide as much certainty as possible to generators in this regard.

12. Procedural matters

12.1 The referred generators have suggested that the procedural safeguards applicable in relation to the MALC are inadequate to offer them proper protection and therefore, constitute a further reason why the MALC should not be introduced. First, it must be emphasised that such criticisms apply not only to the MALC but to any modification of the referred generators' licences. Secondly, the protection of the referred generators in relation to the manner of application of any licence condition by Ofgem is a matter of legislative provision. The statutes setting out the duties and obligations of Ofgem have been enacted by Parliament. It is not appropriate, in the context of this inquiry, for Ofgem to comment upon the machinery specified by Parliament for the determination of breaches of licence conditions.

12.2 In general terms, where Ofgem is satisfied that a licensee is, or is likely to be, in breach of a licence condition, including the MALC, it is bound to initiate enforcement action under the Electricity Act 1989 ("the Electricity Act").[11] However, where Ofgem considers that it would be more appropriate to proceed against a generator under the Competition Act 1998, Ofgem cannot conclude enforcement action under the Electricity Act.[12] This has the effect of protecting generators from the possibility of "double jeopardy" of investigation and enforcement under both the Electricity Act and the Competition Act in relation to the same conduct.

12.3 Should Ofgem initiate enforcement action under the Electricity Act, the Act itself prescribes the procedures that Ofgem must follow before making a final order or confirming a provisional one.[13] Should a generator wish to challenge an enforcement decision, it can do so by way of a procedure akin to judicial review under section 27 of the Electricity Act.

12.4 In addition, in relation to the MALC, Ofgem has established an Advisory Body, which may be called upon to give a formal opinion on the merits of a particular

[11] Section 25.
[12] Section 25 of the Electricity Act as amended by paragraph 12(5) of schedule 10 to the CA98.
[13] Section 26.

case should the licensee in question (or the DGES) request it. The Advisory Body will, therefore, be able to provide a full review of any enforcement decision proposed to be taken by Ofgem. The opinions of the Advisory Body will be made available to the will be made public and will, no doubt, form the basis of any judicial review proceedings a party may wish to take against Ofgem. Contrary to certain suggestions made in the course of this inquiry, the Advisory Body will be made up of independent appointees in order to create what is intended to be the most effective method of scrutinising Ofgem's activities in relation to the operation of the MALC outside a specific statutory arrangement.[14] Guidance notes on the procedure of the Advisory Body have already been published by Ofgem.

12.5 Ofgem fully expects that were it to diverge from the findings of the Advisory Body without good reason to do so, any enforcement decision it took would be successfully reviewed.

12.6 At present, Ofgem cannot impose financial penalties under the Electricity Act for breaches of licence conditions. However, with the coming into force of the Utilities Act 2000, amendments will be made to the Electricity Act enabling Ofgem to do so. The penalties are capped at 10% of the turnover of the licence-holder (a level lower than that prescribed in the Competition Act 1998 in almost all circumstances since, under the Competition Act, fines are capped at 10% of *group* turnover). The procedures which Ofgem must follow in relation to the imposition of financial penalties for the breach of licence conditions (including the provision of a statement of policy on such penalties) are set out in the new sections 27A to 27C of the Electricity Act. Furthermore, by inserting into the Electricity Act section 27E, the Utilities Act provides a system by which a generator upon which a penalty has been imposed, can apply to have the penalty quashed or reduced when the court considers that in *all the circumstances* of the case one or more of the grounds set out in section 27E(4) is or are fulfilled. Section 27E(4) provides as follows:

[14] The Advisory Body consists of Professor Richard Whish, who will chair the Body, Sir Bryan Carsberg, John Flemming, Richard Smethurst and Professor Michael Waterson.

The grounds falling within this subsection are –

a) *that the imposition of the penalty was not within the power of the Authority under section 27A;*

b) *that any of the requirements of subsections (3) to (5) or (7) of section 27A have not been complied with in relation to the imposition of the penalty and the interests of the licence holder have been substantially prejudiced by the non-compliance; or*

c) *that it was unreasonable of the Authority to require the penalty imposed or any potion of it, to be paid by the date or dates by which it was required to be paid.*

12.7 In relation to the review of enforcement proceedings under either section 27 or 27E, the scope and intensity of scrutiny of the review to be carried out in any particular case would be a matter for the courts. However, section 27E specifically provides the reviewing court with a broad scope to review the imposition of a financial penalty. Furthermore, it may be expected that, with the coming into force of the Human Rights Act 1998 on 2 October this year, the scope and intensity of any scrutiny may be extended where necessary in order to ensure compliance with that Act. It should be noted in this context that the Utilities Act has been certified as compliant with the Human Rights Act.

Appendix 1 Legal Opinion by Jeremy Lever QC and Daniel Beard

ELECTRICITY ACT LICENCE MODIFICATION REFERENCES

TO THE COMPETITION COMMISSION: THE PUBLIC INTEREST TEST

JOINT OPINION

1. The present references to the Competition Commission ("the CC") are made under section 12 of the Electricity Act 1989, as amended by the Competition Act 1998 ("section 12"). So far as is material to this Opinion, section 12 is in the following terms:-

> "**12 Modification references to Competition Commission**
>
> "(1) The Director may make to the Competition Commission a reference which is so framed as to require the Competition Commission to investigate and report on the questions –
>
> (a) whether any matters which –
>
> (i) relate to the generation, transmission or supply of electricity in pursuance of a licence; and
>
> (ii) are specified in the reference,
>
> operate, or may be expected to operate, against the public interest; and
>
> (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.
>
> ...
>
> "(3) The Director may specify in a reference under this section, or a variation of such a reference, for the purpose of assisting the Competition Commission in carrying out the investigation on the reference –
>
> (a) any effects adverse to the public interest which, in his opinion, the matters specified in the reference or variation have or may be expected to have; and

(b) any modifications of the conditions of the licence by which, in his opinion, those effects could be remedied or prevented.

...

"(7) In determining for the purposes of this section whether any particular matter operates, or may be expected to operate, against the public interest, the Competition Commission shall have regard to the matters as respects which duties are imposed on the Secretary of State and the Director by section 3 above.

..."

2. So far as is directly relevant for the purposes of this Opinion, section 3 of the electricity Act 1989, to which section 12(7) refers, is in the following terms:

"(i) The Secretary of State and the Director shall each have a duty to exercise the functions assigned or transferred to him by this Part in the manner which he considers is best calculated –

(a) to secure that all reasonable demands for electricity are satisfied;

(b) to secure that licence holders are able to finance the carrying on of the activities which they are authorised by their licences to carry on; and

(c) subject to subsections (2) and (2A) below, to promote competition in the generation and supply of electricity.

.....

(3) Subject to subsections (1), (2) and (2A) above, the Secretary of State and the Director shall each have a duty to exercise the functions assigned or transferred to him by this Part in the manner which he considers is best calculated –

(a) to protect the interests of consumers of electricity supplied by persons authorised by licences to supply electricity in respect of –

(i) the prices charged and the other terms of supply;

(ii) the continuity of supply; and

(iii) the quality of the electricity supply services provided;

(b) to promote efficiency and economy on the part of persons authorised by licences to supply or transmit electricity and the efficient use of electricity supplied to consumers;

(c) to promote research into, and the development and use of, new techniques by or on behalf of persons authorised by a licence to generate, transmit or supply electricity;

(d) to protect the public from dangers arising from the generation, transmission or supply of electricity; and

(e) to secure the establishment and maintenance of machinery for promoting the health and safety of persons employed in the generation, transmission or supply of electricity;

and a duty to take into account, in exercising those functions, the effect on the physical environment of activities connected with the generation, transmission or supply of electricity."

(For the purpose of the present references to the CC, section 3 of the Electricity Act, as it stood prior to the enactment of the Utilities Act 2000, i.e. printed as it is above, continues to be the provision to which section 12(7) of the Electricity Act refers).

3. On 2 May 2000 the Director General of Electricity Supply, in exercise of his powers under section 12, made five references to the CC, three relating to AES licensees and two relating to British Energy licensees. Apart from the identity of the generator to whose licence the reference relates, the references are in the same terms.

4. In each case the "matter" referred to the CC is –

(i) whether the continuation, without modification, of the provisions of the relevant licence, which apply in relation to the determination of wholesale electricity prices, operates or may be expected to operate against the public interest and, in particular (omitting certain expansive qualifications),

(ii) whether the absence from the licence of any provision that prohibits conduct which amounts to abuse of a position of substantial market power operates or may be expected so to operate.

If so, the reference then asks whether the effects adverse to the public interest which that matter has or may be expected to have could be remedied or prevented by modification of conditions of the licence.

5. Thus, the references raise the question whether the absence of a condition of one or another kind in the licensee's licence operates or may be expected to operate against the public interest. More simply but with, we think, equal accuracy in substance, the references ask whether, looking ahead, it would be against the public interest if, in each case, the licence continued not to contain a prohibition of conduct of the kind in question. If the answer to that question is "Yes, that would be against the public interest" and if the public interest detriment could practicably be remedied or prevented by inclusion of an appropriate licence condition, Ofgem will be able to introduce such a condition into the licences in question.

6. In relation to such a reference, semantic arguments about precisely what is meant by the expression "may be expected to operate" are substantially beside the point. The essential question is simply whether the public interest requires the inclusion of a licence condition of the kind in question.

7. Looking at the matter in quite general terms, the task of regulators of a host of activities that are capable of causing effects which it is in the public interest to prevent, reduce or remedy, appears to us to involve consideration of the following questions:-

(i) What is the probability of public interests detriment in the absence of the proposed regulation?

(ii) What is the potential magnitude of any such detriment?

(iii) What, if any, disadvantages would be associated with introduction of the regulation?

(If the public interest detriment is very large, then even a small risk of its eventuation may well suffice to justify the regulation; and if the probability of the risk eventuating is high in the absence of regulation, even a relatively small public interest detriment may equally do so; on the other hand, the greater the disadvantages associated with the regulation (magnitude of disadvantage times probability of its eventuation), the greater the chance that they will outweigh the case for implementing the regulation (the "balance principle")).

(iv) Finally, would less extensive regulation serve equally well or, even if not equally well, would it better satisfy the balance principle, as or than the proposed regulation (the "principle of proportionality")?

8. We see nothing in the Electricity Act 1989 that should lead the CC to depart from the procedure outlined above which we believe to be the standard appropriate procedure for ascertaining whether, in the context of a regulated activity, particular regulation is required in the public interest. Since the required exercise looks forward to the future with and without the proposed regulation, one is concerned with what may be expected (*cf*. the Shorter Oxford English Dictionary meaning of "to expect" as "to look forward to"). But that does not mean that one is automatically to disregard possibilities unless the probability of their occurrence exceeds 50 per cent (for example, assume that the London Eye Ferris Wheel has an expected life of 10 years and that it is calculated that, as things stand, there is a 1 in 4 chance of a catastrophic failure occurring, with substantial loss of life, in the course of the next 10 years; the fact that the chances of such a failure are substantially less than 50:50 would not be a good reason for an authority responsible for regulating the operation of the Wheel not to require the operator to make a modification to eliminate the risk).

9. Considering the application of the methodology described above specifically in the present case, the question set out at **paragraph 7(i)** above seems to us to involve the following exercise. It is necessary to consider whether a risk is to be expected, and, if so, how great a risk, that, in the absence of:-

(i) a further condition in the licence relating to the determination of wholesale electricity prices (paragraph 3(i) above) and, specifically,

(ii) a further condition in the licence to prohibit conduct which amounts to abuse of a position of substantial market power (paragraph 3(ii) above),

a person in the position of the licensee may do something which will be against the public interest. This, in turn, depends on -

- the *ability* of the person to do it,

- the potential *advantage to the person* of doing it and

- whether, if the *person* does it, it will be *against the public interest.*

10. If one were to conclude -

a) that, contrary to Ofgem's view, a person in the position of the licensee could not engage in the conduct in question; or

b) that, again contrary to Ofgem's view, such a person could not profitably do so (and therefore would not do so); or

c) that, contrary to our Opinion of June 2000, at Appendix 5 to Ofgem's Second Submission to the Competition Commission, because of the existence of the Chapter II prohibition, such a person would be no more likely to engage in such conduct if the licence conditions were to remain as they are at present rather than expanded; or

d) that, contrary to our Further Joint Opinion of 10 July 2000, even if the person were to engage in such conduct, it would not be against the public interest (i.e. one took the view that conduct of *any* kind that might be prohibited by a further licence condition of any of the kinds under consideration would simply stop persons in the position of the licensee from "earning an honest penny"),

then the answer to the question set out at **paragraph 7(i)** above would be that there is no risk to the public interest to be expected in the absence of the condition. But if the answer to the question set out in **paragraph 7(i)** above is positive, i.e. a risk to the public interest may be expected to exist, one had to form at least a qualitative view about the likelihood of eventuation of the risk (substantial, appreciable, moderate, slight).

11. The question set out at **paragraph 7(ii)** above then requires one to form at least a qualitative view about the potential magnitude of the detriment to the public interest if the risk eventuates.

12. In this case the questions at **paragraph 7(iii)** (the balance principle) and **paragraph 7(iv)** (the principle of proportionality) are closely interrelated. So far as we are aware the only actual disadvantage that may be said to be associated with further regulation in relation to the determination of wholesale electricity prices generally and the prohibition of conduct which amounts to abuse of a position of substantial market power, in particular, is that, to a greater or lesser extent depending on the terms of the further licence condition(s), it or they would give rise to legal uncertainty and/or increased compliance costs.[15] Unless one concludes that *any* further regulation in relation to the determination of wholesale electricity prices would have disadvantages that would outweigh the public interest detriment that it would prevent or remedy, one needs to weigh up the relative merits (simplicity, efficacy and ease of administration) and demerits (in particular, any increase in compliance costs) of two kinds of condition: -

(i) a prohibition embodying a general principle;

(ii) prohibitions of specified acts in specified circumstances.

[15] We here leave aside the point that a prohibition of conduct which amounts to abuse of a position of substantial market power would import no more legal uncertainty and necessitate no higher compliance costs than the Chapter II prohibition - which appears to be relied on by opponents of further regulation as rendering it unnecessary.

13. A type (i) condition would have particular advantages if, as is the case with the MAC proposed by Ofgem, it were modelled on the Chapter II prohibition, modified to allow for the particular circumstances of the electricity industry, since, in relation to such a condition, considerable guidance is available in the form of EC case law, decisional practice and legal literature. In any event, a prohibition embodying a general principle could deal broadly with the problem of abusive conduct in regard to the determination of wholesale electricity prices in circumstances in which there is a reasonable apprehension that the Chapter II prohibition will not be applicable. Insofar as it is possible to identify precisely each type of prohibited conduct, type (ii) conditions would have the advantage of greater specificity, but there would remain areas of judgment and potential disputed interpretation associated with the conditions, and the conditions would probably need to be numerous. Furthermore, additions to them would probably need to be made quite frequently for the foreseeable future as licensees found new ways to abuse positions of substantial market power as changes in external circumstances opened up new opportunities for them to do so.

14. Once the first part of the entire public interest exercise described above has been completed, if the public interest is found to require inclusion of a further Licence condition(s) in the referred generators' licences, it is then necessary to examine the precise wording of the condition(s) that will best prevent or remedy the deficiency in the Licences as they currently stand. Having regard to the "matters" referred to the Competition Commission by the present references (paragraphs 3(i) and 3(ii) above), that tasks will already have been largely, if not completely, covered by the analysis required in order to reach conclusions on the "matters", since the matters themselves relate to what the public interest requires to be included in the Licences.

15. We are then asked whether the CC should or should not take into consideration the effect of its conclusions with regard to the licences of "the non-referred generators". That question needs to be viewed against the background that the CC will, as we see it, be considering whether the public interest requires the inclusion of the market abuse condition ("the MAC") or some alternative condition(s) in Electricity Act licences of generators *in the position of* each of the referred generators. If the CC reaches a negative conclusion on that question in respect of any of the referred generators and that conclusion prevails, then we think that it would be contrary to principles of good administration and, in particular, the principle of equal treatment of

equal situations (as embodied in the Internal Market in Electricity Directive[16]), if Ofgem maintained the MAC in place in the licence of any other generator that was in *the same position in the relevant respects* as the generator in relation to whom the CC had given the negative answer. On the other hand, the CC's conclusion would have no bearing at all on other generators who were *not* in the same position in the relevant respects as the generator in relation to which the CC had reached the negative conclusion.

16. We appreciate that to date Ofgem has proceeded on the basis that there is no material difference between either of the referred generators and the six non-referred generators in whose licences the MAC has been included and that the CC's conclusions in the present references would not be peculiar to the referred generators or either of them but would be equally applicable to the non-referred generators. On that assumption, the correctness of which we have no reason to doubt, we agree with the position as explained by Ofgem's General Counsel in his letter to the CC dated 5 July 2000 to the effect that Ofgem would be legally constrained to apply to the non-referred generators any negative conclusion reached by the CC in relation to BE and AES (assuming that that conclusion prevailed). Ofgem would, in particular, be subject to the duty, set out in the Internal Market in Electricity Directive, not to discriminate as between undertakings. However, for analytical purposes, it is necessary to consider also, as we have done above, the legal position if the CC were to make a finding peculiar to one of both of the referred generators, albeit on a basis that we cannot foresee.

17. We now briefly address three further questions:-

(i) *In deciding whether to include* the MAC (or some other such condition) in *an* Electricity Act licence, is *Ofgem required to disregard* the fact that, if it does not include the condition in *that* licence, it will not be able to do so in any *other* licence, the holder of which is in all relevant respects in the same position as that of the holder of the licence under consideration? (In our opinion the answer to this question is No.)

[16] Directive 96/92/EC [1997] OJ L27/20.

(ii) Alternatively, does good regulatory practice *positively require Ofgem*, when it undertakes the exercise in question, *to take into account* the *overall position*, if it includes the condition in, or omits the condition from, the licences of all holders who are, in the relevant respects, in the same position? (In our opinion the answer to this question is Yes.)

(iii) Does the Electricity Act 1989 require the *CC* to approach the matter *differently from Ofgem* on a licence modification reference under section 12 of that Act? (In our opinion, the answer to this question is No.)

We now discuss each of those questions in turn.

(i) *Ofgem: Is there a duty to disregard inevitable consequences?*

18. We can find nothing in the Electricity Act 1989 and we know of no principle of general law that requires Ofgem, when it is considering whether to include a condition in, or omit a condition from, *a* licence to close its eyes to the fact that, if it does not include the condition in that licence, it will not be able to include, or maintain the inclusion of, the same condition in other licences, the holders of which are in the same position in relevant respects as the holder of the licence under consideration. If and so far as the inclusion of the condition in other licences is *relevant* to its inclusion in the licence under consideration (as to which, see the answer to question (ii) below), Ofgem is in our opinion not only free but also, as a matter of general administrative law, bound to take it into account – as one of the relevant considerations.

(ii) *Ofgem: Relevance of the overall situation.*

19. We do not see how, in formulating conditions for inclusion in Electricity Act licences, Ofgem could discharge its duties under section 3 of the Act (see paragraph 2 above), if it could not take into account the overall position and the effects of including, or not including a particular condition not only in the licence of, e.g., a particular generator but also more generally in the licences of other generators in the same position as that generator. That this is so is not only because of the consideration set out at paragraph 18 above but also because, in our opinion, the

proper exercise of the regulatory function often requires the regulator to take into account the overall position and the effects of including a condition in, or omitting a condition from, the licences of a class of licensees who share relevant characteristics. Only by so doing can a regulator assess the potential magnitude of the public interest detriment that the regulator apprehends and the overall probability of its eventuation both of which will be relevant to the regulator's decision.

(iii) *The CC: The same or a different approach?*

21. It would be perverse if, on an Electricity Act licence modification reference to the CC, the CC were obliged to reach a result different from that, in effect, reached by Ofgem even though Ofgem had reached a result which, having regard to its legal powers and duties, was a result that Ofgem was entitled, and perhaps obliged, to reach.

22. It may, however, be suggested that the CC is nevertheless obliged to reach such a different result because each licence modification reference relates to "*a licence*" and that therefore only matters which relate to e.g., the generation of electricity in pursuance of *that* licence are relevant to CC's deliberations. In our opinion, such a conclusion would be not only perverse but also wrong in law.

23. In the first instance, so far as we can see, there is nothing in the Electricity Act and there is no other rule of law that requires the CC any more than Ofgem to disregard the consideration set out at paragraph 18 above when the CC considers the public interest implication of including a further condition in, or omitting the further condition from, the licence of each of the referred generators. To disregard the fact that if a particular condition cannot be included in the licence of a referred generator, it equally cannot be included in the licence of any other generator who is in the same position as the referred generator in all relevant respects is simply to ensure that one's conclusion is based on a false or factually incomplete basis. In our opinion there is nothing that constrains the CC to proceed in that way.

24. Secondly, section 12(7) of the Electricity Act (see paragraph 1 above) requires the CC in its deliberation about the public interest to "have regard to the matters as respects which duties are imposed on [Ofgem] by section 3 ...". In our opinion that does not

mean merely that, subject to the considerations referred to at subsections (1), ... (2) and (2A) of section 3 of the Electricity Act, the CC is to have regard to "[protection of] the interests of consumers of electricity supplied by persons authorised to supply electricity in respect of ... the price charged ..." (see section 3(3)(a)(i) of the Act). In the context of the scheme of the Electricity Act and the rôle assigned by it to the CC as the authority with responsibility for surveillance of the exercise by Ofgem of its powers and duties in relation to the inclusion of conditions in Electricity Act licences, we think that section 12(7) also requires the CC to approach the need to protect the public interest in question in the same way as Ofgem is to approach it – and, indeed, in the way dictated by good regulatory practice (as to which, see paragraph 20 above).

(iv) *Conclusion on (i) – (iii) above*

25. Our conclusion on (i) – (iii) above is that, in the result, the correct approach of both Ofgem and the CC is to consider the effects of including a further condition in, or omitting such further condition from, the licences of generators in the position of each of the referred generators. Any argument to the contrary appears to us to be not only legalistic and calculated to lead to perverse conclusions but also misconceived as a matter of law.

26. In applying the tests set out at paragraphs 7 to 11 above the CC should, in our opinion, ask itself the question whether the public interest requires the inclusion of a further condition in the licences of persons *in the position of* each of the referred generators and *not* simply whether the public interest requires the inclusion of the condition in the licence of each of the referred generators *viewed in isolation* and without reference to the existence of other licensees in the same position as that generator.

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