

September 2000

**Introduction of the market abuse
condition into the licence of AES
Fifoots Point Limited**

**Ofgem's submission to the
Competition Commission**

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Note:

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

1. Introduction

- 1.1 This submission supplements the submissions and hearings that Ofgem has already given to, and had with, the Competition Commission in respect of AES Barry, AES Drax and AES Indian Queens. It sets out the reasons why Ofgem considers that AES Fifoots Point Limited (AESFPL) is also part of the problem.
- 1.2 In previous submissions and presentations we have explained the analytical framework which led Ofgem to consider that the unmodified generating licences of AES and British Energy groups may be expected to operate against the public interest. In this submission we explain why we consider that the unmodified generating licence of AESFPL may be expected to operate against the public interest.

Background

- 1.3 Earlier this year, a number of licensees in the AES and British Energy groups did not consent to the modification of their generation licences, under section 11 of the Electricity Act 1989, to include the market abuse licence condition (MALC). Consequently, on 2 May 2000 the Director General of Electricity Supply (the Director General) referred the matter to the Competition Commission under section 12 of the Electricity Act. Seven other companies, National Power (now Innogy), PowerGen, TXU, Edison Mission Energy, BNFL Magnox and EdF (London Electricity) consented to the licence modification.
- 1.4 At that time Ofgem was aware that AES would shortly be commissioning a further plant, at Fifoots Point in south Wales (the licence for which was held by AESFPL). Ofgem did not then seek to modify the licence of AESFPL as the plant was not bidding into the Pool. However, AESFPL began to bid into the Pool in July and Ofgem accordingly requested AESFPL's consent to modify the licence. AESFPL did not consent to their licences being modified to include MALC and therefore, under Section 12 of the Electricity Act, we referred the matter to the Competition Commission on 21 August 2000.
- 1.5 All the references made this year invite the Competition Commission to consider whether the matters set out in paragraph 1(a) of each reference operate or may be expected to operate against the public interest. In other words, the

Competition Commission has a duty to consider both the existing circumstances and circumstances that may be expected to prevail in the future. Ofgem has recently submitted to the Commission a joint legal Opinion, prepared by Jeremy Lever QC and Daniel Beard, concerning the interpretation of this duty¹.

- 1.6 The Director General has said that, if the Competition Commission concludes that the market abuse condition should not be included in the licences of either British Energy, AES, or both he will then consider whether it is appropriate for the condition to be removed from the licences of the other generators. This applies equally to the licence of AESFPL. Depending on the basis of the Competition Commission's conclusions, it seems unlikely that the condition would remain in the licences of the six generators who have accepted the MALC if it were not to be introduced into the licences of AES and British Energy. The Competition Commission's findings are therefore likely to have consequences not only in relation to AES and British Energy but also for the generation sector and wholesale electricity trading more generally.
- 1.7 In considering the future, the Competition Commission is looking at changes that will result both from the implementation of the Utilities Act and from the introduction of the new electricity trading arrangements (NETA). A summary of NETA was provided as an appendix to Ofgem's first submission². In order to assist the Competition Commission, a brief summary of the main changes to generation licences that are likely to flow from the Utilities Act was included in Appendix 1 of Ofgem's second submission³.

Outline of this document

- 1.8 This document outlines the problem: the history of manipulation and the continuing scope for abuse of substantial market power in the wholesale electricity market. We go on to describe why AESFPL, as part of the AES group,

¹ A copy of this Opinion is available on our Competition Commission website at www.ofgem.gov.uk. See the appendix to "A commentary on British Energy's submissions to the Competition Commission: Ofgem's third submission to the Competition Commission", Ofgem, September 2000.

² "Introduction of the market abuse condition into the licences of certain generators: Ofgem's initial submission to the Competition Commission", Ofgem, May 2000. This is also available on the Ofgem website.

³ "Introduction of the market abuse condition into the licences of certain generators: Ofgem's second submission to the Competition Commission", Ofgem, June 2000. Again, this is available on the Ofgem website.

is part of the problem (i.e. why we believe that AESFPL could have substantial market power) and comment as to the likely effects of any abuse of that substantial market power.

- 1.9 This submission also deals with Ofgem's proposed solution to the problem of market abuse and why we do not believe that the other remedies are sufficient to deal with the problem.

2. Introducing the MALC to the licence of AESFPL

The Problem

- 2.1 Ofgem's starting point in considering the need for the MALC is the legal duties of 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.
- 2.2 In considering these duties, we are conscious of the fact of market power, which has repeatedly been used - and has the scope to continue to be used - in a way that is deeply harmful to consumers. Examples of such manipulation, which are not in dispute, involve in particular: withdrawal of capacity; gaming of the detailed trading rules; and the use of physical positions to benefit contract positions. 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.
- 2.3 The reasons for this are various. The electricity market has special characteristics that are acknowledged by the existence of a specific regulatory regime. It requires moment-to-moment balancing of a system for a product that is impossible to store. This makes it possible for a participant, which is not obviously dominant, to exercise substantial market power, and there are many examples of this exercise of substantial market power by a small generator. The potential for manipulation may be expected to persist during the last months of the Pool, when NETA is introduced and even after NETA has become established.

2.4 In previous submissions we have set out the scale of the problem and why we believe that there is continuing scope for market abuse despite recent changes in the structure of ownership in the wholesale market that have led to further deconcentration. Since the condition was introduced Ofgem has initiated one investigation under the MALC, in relation to Edison's withholding of capacity. Our analysis showed that Edison's action had raised the Pool Purchase Price by more than 10%. In our initial findings we made clear that if Edison had not announced the return of the unit we would have taken enforcement action. Without the market abuse licence condition we would not have been able to take any action to tackle this form of market abuse, and the harm it was causing to customers and competition. In our view, this illustrates that market abuse is a continuing problem of a scale and importance which, given the statutory duties of the Director General, he cannot ignore.

2.5 Furthermore, we believe that the presence of the MALC in other generators' licences may have influenced their decision-making in the wholesale market since its introduction. Ofgem notes that other generators have returned temporarily withdrawn capacity to the market when, in the absence of the market abuse licence condition, they might not have done. It has clearly provided Ofgem with a much-needed additional regulatory tool during a period in which there have been significant temporary withdrawals of capacity from the system.

Why AESFPL, as part of the AES group, is part of the problem

Criteria for inclusion of the MALC

2.6 Under the current trading arrangements, Ofgem believes that companies or groups which account for at least 5 per cent of output or of system marginal price (SMP) setting may possess substantial market power and have the potential to abuse that substantial market power. This reflects our judgement that:

- ◆ at least in certain periods, modest changes in the level of output offered to the market can lead to substantial changes in market prices; and
- ◆ in the Pool, control of price setting enhances the degree of control that can be exerted over market prices as a whole.

2.7 Ofgem does not assume that a generator that accounts for more than 5 per cent of output or SMP setting will, in fact, possess substantial market power. Rather, the 5 per cent threshold is a mechanism for screening out generators who, under the existing trading arrangements, are unlikely to possess such power. The application of the market abuse condition to a class of generators is not discriminatory against that class. It is entirely consistent with Ofgem's general duties under EU Law and, in particular, with its obligations under those directives that apply to the electricity sector.⁴

2.8 In determining whether a generator met the criteria for the market abuse licence condition, Ofgem took into account all generation assets in which a company or group holds a controlling interest. This is because, even were the present management structure to be such that each plant under common ownership is separately managed (as AES sometimes but not always claims), management structures within corporate groups are capable of change at short notice. Moreover, whether a company is operating its generation assets as a portfolio is not transparent. Whilst many of the companies operating on a portfolio basis have highly visible energy management centres, a company could do so simply through a series of telephone calls between station managers, or through a series of contracts between the stations that aligned incentives and encouraged co-ordinated behaviour. Thus, we do not believe that it is credible to argue that generators, who at a particular point in time claim or even appear to operate units independently, should be judged to be independent when determining whether or not they could have a position of substantial market power.

The AES group

2.9 In our previous submissions we demonstrated that, following their recent acquisitions of plant, the AES group satisfied both the output and SMP setting criteria. In demonstrating this, Ofgem did not take into account the Fifoots Point power station. However, taking this power station into account only strengthens our case.

⁴ See Council Directive 90/547/EEC of 29 October 1990 on the transit of electricity through transmission grids and Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity.

- 2.10 With the Fifoots Point station added to the equation, the combined capacity of the four AES stations is 4678 MW (of which AESFPL contributes 363MW). Fifoots Point is a coal-fired plant that has been retro-fitted with flue gas desulphurisation equipment. The addition of this plant to the AES portfolio will increase its position in the market and the potential for SMP-setting under the present electricity trading arrangements.
- 2.11 Given the mix of plant in AES' portfolio, the potential exists for AES to exercise substantial market power in relation to bidding strategies, exploitation of complex rules and capacity withholding. These were explained fully in Ofgem's second submission to the Competition Commission. The addition of Fifoots Point only increases the potential for the AES group to exercise substantial market power in relation to the above activities.

Reasons for referring AESFPL to the Competition Commission

- 2.12 Ofgem has not taken the decision to refer the matter to the Competition Commission lightly, particularly given the extra pressures that this will place on the Competition Commission's timetable. We also appreciate that there will inevitably be additional costs for the company, the Commission and others. However, these considerations are outweighed by other factors that, in our view, required the Director General to make a reference.
- 2.13 Ofgem's priority is to ensure that the wholesale electricity trading arrangements are open, fair and competitive, and that prices reflect market conditions. This is both vital to confidence in the market and not always straightforward to achieve. The MALC provides us with the tools we need to tackle market abuse that raises prices, distorts competition, and has the potential to undermine confidence in NETA.
- 2.14 In October 1999 Ofgem set out its criteria for the inclusion of MALC. These are based on share of total output and the frequency with which generators have set system marginal price in the Pool. These criteria were judged to be reasonable and proportionate until such a time as a standard licence condition could be proposed. Crucially, they provide an objective basis for determining whether or not the MALC should be included in any particular licence, hence ensuring that the application of the licensing regime is fully compliant with EU law.

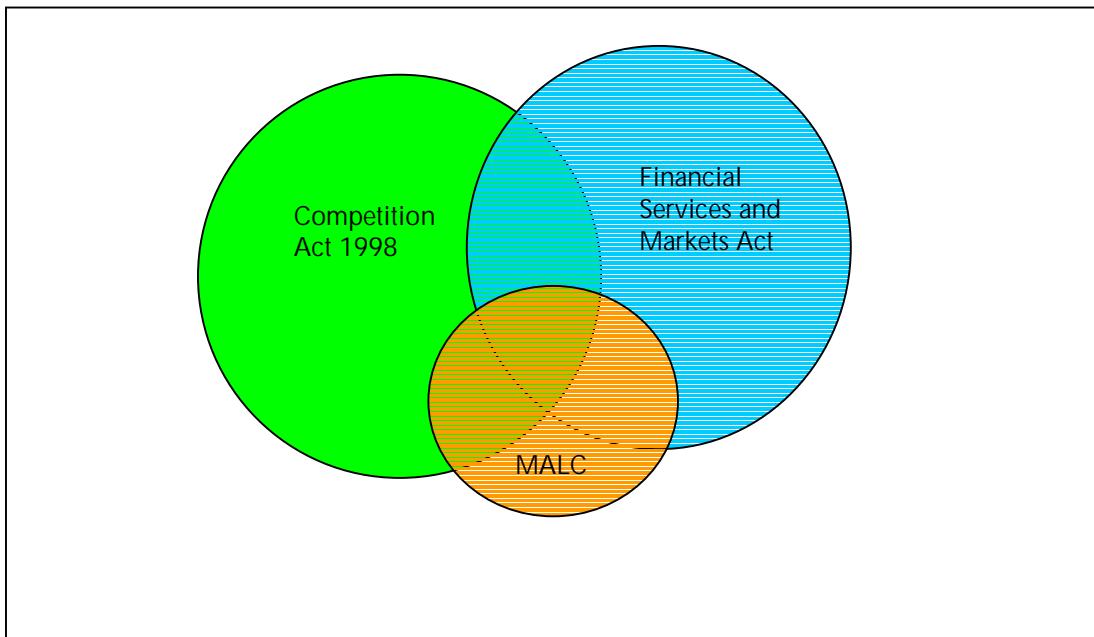
- 2.15 These objective criteria have subsequently been applied in a straightforward and consistent manner. When Elèctricitè de France (EdF) acquired Sutton Bridge power station, and thereby satisfied the relevant criteria, Ofgem modified the relevant generation licence so as to include the MALC. Recently, when PowerGen acquired a 50% interest in Corby power station, Ofgem sought firm undertakings from the company to accept the inclusion of the MALC in the licence of Corby.
- 2.16 Before the Competition Commission reports, we expect that there may be a number of further, significant transactions involving generating plant. In particular, PowerGen and TXU are attempting to dispose of plant and that there are a number of potential purchasers who, if they acquired that plant, would reach our threshold for the application of MALC. Consistent application of the objective criteria may, therefore, require that Ofgem propose that the MALC be included in other generators' licences in the near future.
- 2.17 In response to our seeking consent to introduce the MALC into its licence, AESFPL offered to undertake to be bound by the Competition Commission's determination on the licence references concerning AES Barry, AES Drax and AES Indian Queens. However, we were unable to make an exception for AESFPL by accepting undertakings that were contingent on future events (ie. a particular outcome of the Competition Commission Inquiry). This would mean discriminatory and favourable treatment for AES compared with EdF and PowerGen, and, potentially, with other generators in the near future. Such an approach would also reward a company that has challenged a measure that, in Ofgem's very definite view (which is supported by many interested parties, including suppliers and consumer groups), would promote consumers' interests and competition, relative to companies that have accepted, or might in the future be willing to accept, the MALC. In the longer term, this could have the damaging effect of encouraging obstructive appeals to the Competition Commission, on tactical grounds, thereby contributing, unnecessarily and unconstructively, to the Commission's workload.
- 2.18 It is also relevant that, in the short term, the fact that the operation of Fifoots Point would be neither subject to the MALC nor under investigation by the Competition Commission would mean running the risk that the plant might be

used, in the context of the wider AES portfolio, to manipulate prices. This risk would be greatly compounded in the event that, in the interests of equitable treatment of generators, similar, contingent undertakings were accepted in all future cases where the MALC criteria were met as a result of changing plant portfolios (and such forward looking, non-discriminatory treatment would not eliminate discrimination in relation to past EdF and PowerGen acquisitions).

- 2.19 Given the critical importance of confidence in the market during the period surrounding the NETA 'Go-live' date, Ofgem considers that such risks, whether in relation to Fifoots Point alone or to Fifoots Point and all subsequent cases taken together, are, quite simply, unacceptable.

Remedies

- 2.20 A variety of possible remedies relating to market structure and trading arrangements can contribute to the solution of the problem of abuse of substantial market power. Further new entry into the generation market may help to develop effective competition in generation. Changes to the trading rules may help to mitigate the exercise of market power once a particular abuse has been identified. NETA will help to overcome many of the problems specifically associated with the Pool.
- 2.21 However, no feasible market structure or set of trading arrangements can change the fundamental physical and economic conditions of electrical systems close to real time. It is for this reason that we are convinced that these possible remedies will not be sufficient.
- 2.22 Ofgem has sought to demonstrate why we believe that the other powers that we have under other legislation are not sufficient at the present time to deal with market abuse in the wholesale electricity market.



2.17 This diagram shows the overlapping jurisdictions applicable to electricity trading. Not all instances of abuses of substantial market power will fall under the Competition Act, the financial services regulatory regime or in the area of overlap between them. Rather, a similar action by the same person may in different circumstances appear anywhere on the diagram. The boundaries between the different jurisdictions will not be as clear as this diagram suggests. But a legal Opinion prepared for Ofgem by Jeremy Lever QC and Daniel Beard and submitted to the Competition Commission highlights the length of time it might take to obtain a definitive ruling on the boundaries of the Competition Act⁵.

2.18 It is our submission that it is possible for there to be actions which fall in the market abuse circle, but outside the other two circles and which are to the public detriment. Such actions cannot be regulated under either the Competition Act or financial services regulation. It is our submission that the public interest requires that they be subject to effective regulation. This diagram shows the overlapping jurisdictions applicable to electricity trading. Not all instances of abuses of substantial market power will fall under the Competition Act, the Financial Services regulatory regime or in the area of overlap between

⁵ See page 82 of Ofgem's second submission to the Competition Commission, June 2000.

them. Rather that the same action by the same person may in different circumstances appear anywhere on the diagram.

Conclusion

- 2.19 Ofgem believes that a market abuse licence condition is both an appropriate and a necessary solution to the problems that have been discussed in this submission. No other effective solution has been identified, either by Ofgem or by respondents to the consultations that have taken place on the introduction of the licence condition.
- 2.20 In the absence of the condition, Ofgem seeks to apply a mix of other measures, which could be expected to be less well targeted on the relevant market power problems and possibly more intrusive. With the condition in place in licences, not only will such incremental measures be unnecessary but also it will be possible to simplify, and possibly remove, some existing licence conditions, such as the licence condition concerned with information gathering for capacity withholding and those concerned with discrimination, thus reducing regulation.