

November 2000

**A commentary on AES' submissions
to the Competition Commission**

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

Public version

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1. Introduction

1.1 This analysis of the arguments made by AES in its various submissions to the Competition Commission follows a similar format to the critique of the arguments put forward by British Energy (BE) that we have already published.¹ However, since that document also contained a general consideration of the legal points that have been raised in relation to the market abuse licence condition (MALC) and the Competition Commission, these issues are not discussed in this submission. On 26 September, AES provided to the Commission a commentary on this legal discussion; that commentary is not addressed in this submission.

1.2 Our comments follow the structure of our second submission in that each chapter in this submission corresponds to a chapter in that submission. Our main comments can be summarised as follows:

- ◆ other markets may have one or more of the special features of electricity markets that set electricity markets apart, but it is the combination of these features that makes electricity markets special with regard to close to real time trading, particularly the potential consequences of a failure to balance the system;
- ◆ in introducing the MALC, Ofgem has acted on the principle that the prohibition on abusing substantial market power should apply to all generators that might be in a position to do so. Ofgem continues to believe that the fact that a licensee has not manipulated the market in the past does not imply that the licensee will not choose to do so, if it can and has incentives to do so, 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 and subject to incentives to abuse the market, including AES (and BE) should be subject to the MALC;

¹ "A commentary on British Energy's submissions to the Competition Commission, Ofgem's third submission to the Competition Commission", Ofgem, September 2000.

- ◆ AES' objections to the MALC appear to be based partly on a lack of understanding of the Condition. In applying the Condition, Ofgem will examine separately the question of the existence of substantial market power and of the abuse of that power. The existence of abuse will depend both on finding the exploitation of market power and appreciable harm to consumers and/or competition;
- ◆ as we have repeatedly made clear, we do not agree with the contention put forward by AES and others that all abuses of the market will necessarily be covered by the Competition Act 1998. In Ofgem's view, the Edison case clearly demonstrates that it is possible for companies to commit abuse whose small size makes it very unlikely that, given current case law and precedent, they could be considered to be dominant and hence susceptible to action under the Competition Act; and
- ◆ 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.

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

2.1 In this and subsequent chapters, AES's comments are shown in bold

The special nature of electricity

the limited storability of electricity has implications for market volatility and market structure. However, it does not in itself have any direct implications for market power

2.2 Ofgem considers that it is the combination of the limited storability of electricity, its inelasticity of supply and demand close to real time and the potentially serious consequences of a failure to balance that gives electricity its special nature. Taken together, these features can result in participants with relatively small market shares having significant market power. In other words, limited storability is a necessary but not sufficient condition for a market to be vulnerable to abuse close to real time. The issue has been discussed in more detail in the response that Professor Yarrow made to AES's interpretation of his comments in the 1999 Series IX IEA lecture on regulation "Competition Act: Analyses and Economic Efficiency" – Professor George Yarrow.

If the concerns are not sufficiently grave to warrant additional regulation in the case of conduct by newspapers (which are by their very nature directly capable of impacting on consumers), then arguments against excessive regulation in the electricity generation market are at least as compelling, if not more so.

2.3 The potential consequences of a shortage of 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 or news from the television, radio or internet). Entry and exit can also take place very rapidly. The consequences of a failure by a consumer to obtain a newspaper are benign compared with the potential consequences of a power supply failure. 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 country. 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. Moreover, entry to the market is not a credible threat over the short term since it typically takes around two years for a new plant to be commissioned. Consequently, Ofgem rejects the suggestion that arguments concerning the regulation of newspapers are relevant in an electricity context.

Costs of generation

between 1993/94 and 1999/2000 real prices have fallen by almost 20 per cent.

- 2.4 Whilst Ofgem accepts that Pool prices in 1990/91 were distorted by the very high level of contract cover and that there has been a small decline in prices over recent years, it remains the case that prices have remained around £25/MWh (on a rolling 12 month basis) since 1991. A comparison between 1993/94 and 1999/2000 is misleading in that it measures change from the year of highest prices in order to maximise the decline that it presents.

some commentators do project new entry price levels of £17/MWh in the longer term (in 5-10 years time)

- 2.5 As the Competition Commission will be aware, our new entry price levels were not based on projections for the longer term but on the views taken by city analysts (Merrill Lynch and Credit Suisse First Boston) over recent months.

Although the average reduction in cost over the period is 30%, the reduction towards 1999 is largely based on reductions in coal costs following the ending of the government brokered coal contracts

- 2.6 It is precisely our point that prices have not fallen in line with input costs. The fall in coal costs is very relevant to this calculation, so we do not understand the implication that this fall is irrelevant. Ofgem continues to believe that the fact that these substantial falls in costs have not been reflected in prices, despite the

continuing reduction in market concentration, is indicative of a lack of effective competition in the market.

Examples of the scope for manipulation

- 2.7 Many of AES' assertions with regard to the examples of the scope for manipulation provided in Ofgem's second submission, appear to misunderstand Ofgem's position.

We are not aware of any formal definition of the term 'manipulation' in the context of competition law and policy, but understand Ofgem to mean by it behaviour that is intended to take advantage of specific market rules, to the advantage of the party in question.

- 2.8 Ofgem has 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 MALC and we have not gone back and applied the licence condition tests to earlier events. Ofgem has been careful only to refer to conduct as abuse where the relevant tests inherent in the MALC have been applied. The term manipulation thus covers all types of behaviour directed at influencing market prices to a significant degree, and that might therefore be considered potentially abusive. The term is not restricted to behaviour intended to take advantage of specific market rules.

- 2.9 AES has either ignored or not understood the nature of the market abuse tests (existence of market power, exploitation of market power resulting in appreciable harm to consumers and/or competition). For example, it states that:

Ofgem has concluded that any action that affects either capacity payments or SMP necessarily indicates the existence of substantial market power and that such actions necessarily constitute abuse.

- 2.10 This statement misrepresents Ofgem's position. The ability of a participant to move prices may be evidence of market power but does not necessarily indicate that a company possesses substantial market power as defined by the thresholds specified in the MALC guidelines. Where a company is shown to have

substantial market power, an action by the company that moves prices is not necessarily abusive. For abuse to have occurred the action must lack justification in terms of normal competitive behaviour (for example, the withdrawal of capacity that cannot be justified against an avoidable cost test) and the *effect* of the movement must have been to cause material harm to consumers and/or competition.

Ofgem's analysis of anti-competitive bidding strategies appears to assume that it is an abuse for a generator to make different bids at different periods

2.11 Ofgem's position has always been that different bids may be justified either by changing market conditions or by changing costs. However, this is not to say that changes that are specifically designed to exploit bidding structures will be justified.

2.12 On a related point, AES states:

In its Second Submission, Ofgem provides an example of two different bidding strategies. There is no sense in which one of these bids can be said to be anti-competitive.

Ofgem criticises this bid [zero no load price and first incremental price, high second incremental price] for having a high marginal bid, despite the fact that at every level of output below full capacity (where the two bids have the same cost), this bid actually results in a lower electricity price!

2.13 As we explained in our Commentary on BE's Submissions, Ofgem made no claim that either of the bids was anti-competitive, we were simply trying to illustrate the impact that different bidding strategies can have on the prices that are set under the existing Pool rules. It is also incorrect to say that the bid with the high second incremental price will, at any level of output, result in a lower electricity price. This would not be the case during a Table B period when prices are set purely on the basis of incremental prices.

even independent of changes in market conditions, a generator may legitimately wish to alter the structure of its bids into the Pool. For example, it may wish to change the structure of its bids as between start-up and incremental prices

- 2.14 Ofgem accepts that there may be legitimate reasons for participants to alter the structure of bids. However, in the case of participants who, at the time of the change, possess substantial market power, Ofgem may wish to consider whether the change in bids is designed to increase prices or to reflect changing technical, contractual or cost conditions. It is because of this view that we consider AES' statement with regard to price spikes in winter 1998/99 to be irrelevant:

the main cause of the price spikes in Winter 1998/99 was the operation of the newly commissioned SuperGoal price-setting algorithm

- 2.15 Ofgem agrees that the new price-setting algorithm (SuperGoal 2) exaggerated the incidence of price spikes over the period following its introduction. However, a number of participants deliberately exploited the weakness in the algorithm by changing their bids in a way that made spikes much more likely.

normal actions, such as withdrawing capacity that is no longer economic to operate can raise the capacity payment. This is normal commercial behaviour

- 2.16 Ofgem fully accepts that generators should be allowed to withdraw plant that is uneconomic. But Ofgem does not accept that capacity withdrawal that is not justified on economic grounds is normal commercial behaviour and maintains that such actions may constitute abuse if they cause appreciable harm to consumers and/or competition. In a competitive market, a company would not be able to drive up the price significantly by withdrawing capacity.

There is no evidence of plants restricting their output to keep prices high.

- 2.17 We disagree strongly with this statement. In our view, the Edison case for example clearly illustrates that the output of plant has been restricted to keep prices high. Furthermore, in relation to Edison, we do not accept AES' assertion that "*withdrawal from existing assets may be difficult as the Edison case shows*".² As we have discussed above, the withdrawal of plant on economic grounds is clearly a commercial decision for the company involved and the

² Answer to question 19(c), page 69, Issues Letter.

issue with the Edison withdrawal was whether it was economically justified or not.

Return on capital employed (ROCE)

- 2.18 In its various submissions, AES has made a number of comments with regard to the relevance of ROCE calculations in assessing whether market abuse has occurred. The general thrust of its arguments is that:

The absence of abnormal levels of profits would therefore appear to be indicative of a competitive market

- 2.19 This is not an argument that Ofgem accepts for the reasons that we laid out in paragraphs 2.32 to 2.48 of our second submission and in our answer to question 7 of the Competition Commission's Issues Letter.

Ofgem's argument that abuse has resulted in excess capacity rather than excess profit is also inconsistent with its own June submission to the Commission

- 2.20 The inconsistency that AES claims is that Ofgem included two examples of market manipulation that increased the profits of National Power and PowerGen. However, this assertion indicates a misunderstanding of Ofgem's position. The point that we were seeking to make is that market manipulation does not necessarily result in supra-normal profits but is likely to result in supra-competitive profits. Supra-competitive profits can still occur with excess capacity and it is in this context that the profit increases by National Power and PowerGen should be viewed. Supra-competitive profits are an indication that companies are acting to raise prices above competitive levels although the level of profitability that is achieved may still be low (albeit higher than it would have otherwise have been). Despite an absence of excessive (supra-normal) profits this can still constitute abusive conduct since consumers face higher prices than they would have done if the market had been competitive.

If a firm's profits are low then, in the absence of inefficiency, it is difficult to see how it can be accused of having abused market power.

2.21 AES makes this comment in relation to the OFT guidelines for the Competition Act but the quote that is used to justify this assertion specifically refers to *“profits higher than it could expect to earn in a competitive market”* (our emphasis). Thus low profits, per se, do not necessarily indicate an absence of market abuse because, in any given time period in a constantly changing market, they could still be higher than would have been expected if the market had been competitive (i.e. supra-competitive profits).

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

By including AES in the category of MALC generators on the assumption that under its new AES ownership Drax would continue to be operated as before by a former monopolist, the Director has erred.

3.1 It is not correct as this statement implies, that Ofgem had chosen to include AES in the category of MALC generators on the basis of past manipulation of the market by Drax. As the Competition Commission will be aware, in determining which generators should have MALC in their licences, Ofgem set a screening threshold below which we considered that it was unlikely that generators would have substantial market power. Neither of the two criteria (output and price setting) used for screening purposes relates directly to past behaviour. Since its acquisition of Drax, AES has continued to meet both screening criteria and hence Ofgem would be acting in a discriminatory fashion if it did not seek to include AES in the category of MALC generators. The references to past bidding strategies used by Drax's former owners were included by Ofgem to demonstrate that Drax, because of its size and physical characteristics, can be used to set prices and could be used as part of a strategy to drive up prices artificially.

3.2 In their response to the Issues Letter, AES present some modelling that they have commissioned to examine the scope for profitable manipulation of prices by AES on a number of characteristic days. Whilst insufficient information on the model and its assumptions is provided for us to be able to comment in detail on the results presented, we would like to draw attention to the following three statements:

Within the model, we use an exponential function for the capacity component of market price, using the level of demand as the main driver.

there is no real difference between in-merit capacity being withdrawn and being offered at a price above that which the market will bear.

For illustration, the values of capacity (part of the all-in market prices) for the December business day rise to £23/MWh at the peak and £30/MWh if Drax unit 6 is withdrawn.

- 3.3 In relation to the first statement, it seems curious for the capacity component of market price to be driven by demand rather than by the demand-supply margin since it is the inelasticity of supply close to real time that leads to rapidly rising prices as the margin tightens. The second statement is incorrect in terms of the Pool (since all available plant, including those out of merit, affects the LOLP calculation). Under NETA, perceptions of whether or not there is a supply shortage are likely to colour participants' (and NGC's) contracting decisions and influence bidding strategies in the balancing mechanism. Finally, the peak capacity element calculated for a December day is clearly inconsistent with typical capacity payments seen under the Pool on such days. It is impossible to say whether it might be a reasonable expectation under NETA without knowing to what all-in prices it corresponds.

It is simply not relevant to present 'evidence' from the period before ownership of the plant changed hands. Nor does the behaviour described appear to represent an abuse of substantial market power as defined by Ofgem

- 3.4 In presenting evidence on price setting by Drax when the station was owned by National Power, Ofgem was simply demonstrating that the station is of a size and position in the currently prevailing merit order to possess substantial market power given appropriate market conditions. We did not suggest that the behaviour illustrated represented an abuse of the market.

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

The HHI for the coal and oil plant capacity, commonly described as price-setting, is now 1850

- 4.1 Although we have not checked AES' HHI calculation for coal and oil plant capacity, we note that the value quoted is above the level, albeit only just, that the US Department of Justice considers indicates that a market is concentrated. However, Ofgem's view is that the special features of the electricity market mean that such global indicators are not a good reflection of whether or not the market may be open to abuse. As the Edison case shows, abuse was possible even though the HHI calculated on capacity market shares was only 1100.
- 4.2 More generally, Ofgem agrees with AES that the generation market concentration has declined significantly since the Pool began, but we believe that the market share information presented by AES at the Public Hearing and in its various submissions is misleading because of the groupings that AES has chosen to use. Appendix 1 compares the capacity and output market shares for 1999/00 provided by AES with those calculated by Ofgem.

The exploitation of market rules is not a matter for competition policy

- 4.3 This is not a position that Ofgem accepts since such exploitation can cause appreciable harm to consumers and/or to competition in the wholesale or related markets. Thus, in such circumstances we would expect to proceed via the MALC or the Competition Act (as appropriate) and approve an appropriate modification to the Pool rules or, post NETA, to the Balancing and Settlement Code if this is forthcoming. The former action would prevent the abuser benefiting from the abuse (if it is proven that abuse has occurred) and the latter would remove the loophole.
- 4.4 In Ofgem's second submission, we also considered whether it would be prudent to consider that the ability to change the market rules would deal adequately with all the potential forms of market abuse. We concluded that, whilst market

rules had a role to play, they were unlikely to provide a sufficient safeguard - not least because changes in market rules would allow participants "one free hit" with regard to each loophole that they identified. Ofgem considers it to be a strange proposition that certain types of behaviour, such as exploitation of market rules, should be beyond the reach of competition policy.

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

5.1 AES has made clear that it is of the view that there is no need for MALC because:

Any potential anti-competitive conduct can be more than adequately controlled by application of the Competition Act 1998

it is not accepted that Ofgem's proposition that relevant markets in the overall electricity industry cannot be sufficiently narrowly defined, in product, geographic and/or temporal terms, to allow the application of the Chapter II prohibition.

Ofgem's arguments with respect to the Competition Act have been extensively rehearsed in our various submissions and hence we have not repeated them in this submission. It is worth noting, however, that AES has provided no evidence to show that a relevant market could be defined that would allow the Competition Act to be applied to those companies whom Ofgem considers may, under appropriate market conditions, possess substantial market power. The evidence that we have provided to the Commission shows that, with the possible exception of a geographic definition in the case of transmission constraints, no reasonable product or temporal market definitions suggest that the chapter II prohibitions could safely be relied on by the regulator, given the current position of case law and decision making.

It is ... noteworthy that the Ofgem analysis of the concept of substantial market power appears to confuse the two separate concepts of market power and abuse

5.2 Ofgem has been at pains to make clear, for example in its consultation document on the Edison case, that the concept of substantial market power is separate from that of abuse. The fact that a participant may possess substantial market power, that is it has the ability to *move* prices independently of changes in market or cost conditions, does not imply that the participant has used its market power. Furthermore, market abuse is defined by effects – for abuse to have occurred, the exercise of substantial market power must have resulted in

appreciable harm to consumers or to competition. Thus, the tests that are involved in proving that abuse has occurred under MALC are:

- ◆ to determine whether a market participant, at the relevant time, possesses substantial market power in that it is able to move prices independently of any changes in market demand or cost conditions; and
- ◆ to assess whether any such market power has, in fact, been exploited, and to establish what the effects on customers and/or competition of any exercise of market power have been. For Ofgem to conclude that abuse has occurred, it is necessary for appreciable harm to have been caused to consumers and/or to competition.

5.3 In this context, it is worth emphasising that it is possible to construct examples where the exercise of substantial market power would not cause appreciable harm to consumers or competition and hence would not constitute abuse. For example, if all participants were fully contracted then the unjustified withdrawal of capacity (unjustified in relation to avoidable costs) which doubled the spot price would not constitute abuse unless it also moved the forward curve. If the forward curve were unaffected then neither consumers nor competition would be harmed because full contract cover would provide a perfect hedge against spot price movements.

It is not clear how Ofgem proposes to decide whether prices have been raised by 5 per cent above the level they should be. There is no benchmark against which to arrive at a “competitive price”.

5.4 The focus of the substantial market power test of the MALC is on the ability of generators to *move* the market price so there is no reliance on the notion of a 'correct' price. The relevant price triggers are defined in terms of the quantum of effect on revenues - £30 million - which is a significant figure. It is recognised that, in practice, it may be harder to detect small price movements sustained over a long period than large price movements maintained for a shorter period.

Ofgem judges an abuse as a price that is, for example, 5 per cent or more above an unspecified benchmark over 30 days

- 5.5 As outlined above, abuse under MALC is determined by reference to harm to consumers and/or competition and not to a specific price increase. The 5 per cent test to which AES refers is in fact an illustration of the type of price movement which, if it could be achieved by a participant acting independently of market or cost conditions, would indicate that the participant possesses substantial market power. However, it would not indicate that an abuse has taken place.

there is a danger that Ofgem's approach in which market definition is made redundant is that the assessment of competition becomes entirely subjective whereby the Director is able to adopt a "I know abuse when I see it" approach

- 5.6 We do not consider that the three-stage test required for proving a breach of MALC is subjective. Indeed, it follows the steps that would be required to prove abuse under the Competition Act. The only difference would be that to proceed using the MALC, it would be necessary for Ofgem to be satisfied that the participant possessed substantial market power whereas, under the Competition Act, the equivalent test would be whether the participant might reasonably be taken to be dominant.

he ... admits that it is his intention to dispense entirely with the assessment of market power in applying the MALC.

- 5.7 Ofgem does not understand where AES has gained this impression. As we have repeatedly made clear, the assessment of whether or not a participant possesses substantial market power is the essential first step in any investigation under the MALC. This assessment requires Ofgem to analyse whether the participant can move prices independently of market or cost conditions.

if the proposed licence condition is introduced, Licence Holders will be subject to the dual jeopardy of regulation by two separate competition regimes

5.8 Ofgem does not accept that the existence of the MALC together with the Competition Act places participants in a position of double jeopardy. To suggest that that is the case demonstrates a misunderstanding of the legal framework of regulation. Conduct that might be considered an abuse under the MALC is a subset of conduct that would be covered by the Competition Act in relation to companies that are individually or collectively dominant. Consequently, we would not take action against participants under both the MALC and Competition Act but only via whichever route was more appropriate. Ofgem is prohibited from taking enforcement action or imposing a financial penalty under the Electricity Act where the Director General is satisfied that the most appropriate way of proceeding is under the Competition Act (s. 25(5) Electricity Act 1989). This provision is intended to remove the dual jeopardy of which AES complains.

5.9 AES complains that informal guidance given to participants as to whether a particular course of action might be problematic is not binding and argues that this implies that:

even the regulator who has drafted the MALC cannot guarantee that it understands what constitutes abuse

5.10 This assertion appears to ignore the fact that informal guidance can only be given in the light of prevailing market conditions. It is clearly the case that a change in market conditions or the costs of a participant can result in a specific type of behaviour that was non-abusive under one set of conditions becoming abusive (because, in the changed circumstances, it becomes damaging to consumers and/or competition).

We believe that generators should be free to adopt commercial strategies that give them reasonable expectation of recovering sunk and fixed costs, over the long term

5.11 As discussed in our commentary on BE's submissions, Ofgem does not agree that prices must necessarily be at a level that enables sunk costs (for example, those incurred when an investment is made) to be recovered. Competitive markets provide participants with no such guarantees. Whether or not sunk

costs are just recovered, under-recovered or over-recovered in such markets depends upon relative efficiencies, including the quality of investment decisions and planning. For example, if plant had been built or purchased at an excessive cost, Ofgem would not accept that this provides justification for the exploitation of market power to ensure that the plant recovers its fixed costs. Similarly, if there is excess capacity, it is not legitimate for companies to withdraw capacity to ensure that they recover fixed costs over the portfolio. 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.

- 5.12 One of AES' main concerns with the MALC is that it believes that it increases regulatory uncertainty compared to reliance on the Competition Act. For example, it is asserted that:

it will not usually be possible for generators to know whether their conduct falls foul of the condition

upon Ofgem's proposed criteria it is very difficult, if not impossible, for a generator to actually assess what would be a permitted price and what would be an "excessive price", as hypothesised by the Director

- 5.13 On the other hand, AES also appears to believe that the concept of abuse is also unclear under the Competition Act:

Even for dominant firms, whether an action they take is normal competitive behaviour or whether it is an abuse of market power is not obvious

- 5.14 Most generators, like participants in financial services markets, already have in place compliance provisions and procedures designed to ensure that actions they take do not contravene the various regulatory and legislative prohibitions to which they are subject.

- 5.15 In relation to regulatory uncertainty, AES also claims that the imposition of the MALC:

can also be expected to hamper the AES Licence Holders' otherwise rational and competitive independent decisions and, as a consequence, inhibit the most efficient operation of the system.

- 5.16 Ofgem disagrees with this analysis because the MALC is only designed to discourage abusive behaviour. If AES does not attempt to abuse the market, then the MALC will not affect AES. We assume that AES' concern is in distinguishing normal commercial behaviour from abuse. However, this is a judgement that AES will have to make regardless of whether or not the MALC is in place – it will be relevant, for example, with regard to compliance with both financial services regulation and the Competition Act.

Yet under MALC, he has sought to command non-dominant generators to generate at above avoidable costs ... it is difficult to see why the MALC could not be characterised as amounting to, if not having the effect of, price control.

- 5.17 The assertion that AES makes in the first part of the quotation above is without foundation and we do not understand how AES could have reached this view. If AES is referring to the Edison case, the issue involved was whether it was reasonable to suppose that the revenues that would have been earned by the plant that was withdrawn would have exceeded the avoidable costs of continuing to make the plant available. This analysis was undertaken in relation to a decision by Edison to mothball a unit over a twelve-month period and so the appropriate test was to compare those costs that Edison could avoid if the plant was withdrawn with the revenues foregone.

- 5.18 The MALC is not intended to be a price control and Ofgem does not accept that it can be characterised as such. Each instance of suspected market abuse will require a detailed investigation of the circumstances surrounding the actions of the participant. This will, of course, involve a consideration of the costs of generation of the participant but market conditions and the predictability of the effect will also be important considerations. As discussed in our commentary on BE's submissions, the appropriate costs to include for consideration will vary depending on the type of abuse being investigated. This "case by case" approach to market abuse is very different from a price control.

Looking at outcomes ex-post is very different from predicting events ex-ante

- 5.19 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. As discussed in our commentary on BE's submissions, 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 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. Ofgem's analysis has always been forward looking. We have never attempted to judge generators' actions with the benefit of hindsight.

It should be noted that Ofgem is concerned with short-term market power, which is not the same as short-term abuse of market power

- 5.20 Ofgem does not dispute that short-term abuse of market power is different from short-term market power and we agree that our primary concern in introducing the MALC is that there is, and will continue to be, the potential for abuse close to real time. However, it is worth emphasising that, in a more general context, Ofgem is concerned about all forms of market abuse and would seek to take action if the market was abused further in advance, for example via the taking of particular contract positions. The length of time for which exploitation of market power occurs is relevant to the extent that it influences the effects on competition and consumers that result from the exploitation. Exploitation that results in substantial changes in prices for a short period may be just as much of an abuse as more modest price changes that are sustained for a longer period.

we consider that the intrusive regulation and prospective micro management of an already competitive market will impede the competitive dynamics of the industry, contrary to the public interest and possibly, if taken to the extreme, prejudice the security of supply of electricity

Increasing regulation in a competitive market (electricity generation) goes entirely against the grain of privatisation

- 5.21 Ofgem has a statutory duty to protect the interests of consumers and competition and we do not believe that the scope for market power to be abused will disappear. 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 the MALC. They all arise from the need to address the scope for harm to consumers and/or competition from the exercise of market power in the wholesale electricity market. They will neither disappear nor diminish if the MALC is no longer available.
- 5.22 If the MALC becomes a standard condition, Ofgem would revisit existing licence conditions concerning non-discrimination, with a view, subject to the results of consultation, to simplification or removal. A similar process is occurring in relation to non-discrimination conditions in electricity and gas supply licences and Ofgem is keen to lift regulatory constraints where they are no longer necessary. In this context, earlier Ofgem decisions, for example on gas storage and on electricity and gas price controls, are also indicative of Ofgem's general policy on de-regulating where appropriate.
- 5.23 Ofgem would also be in a better position to avoid other, intrusive forms of regulation in the event that major problems of market power materialise. In California, for example, considerable reliance is placed on the ability to cap bid prices and to constrain generators' contractual positions. Ofgem finds such micro-regulation of the market unattractive.
- 5.24 Finally, as the Competition Commission will be aware, a significant number of suppliers and traders are in favour of the MALC on the grounds that it:
- ◆ it will foster competition by mitigating the risk of market abuse;
 - ◆ may encourage greater liquidity in traded markets, and

- ◆ should stimulate new entry in generation and supply (since entrants will have fewer concerns about the potential detrimental effects of abuse by portfolio players).

Appendix 1 Market shares

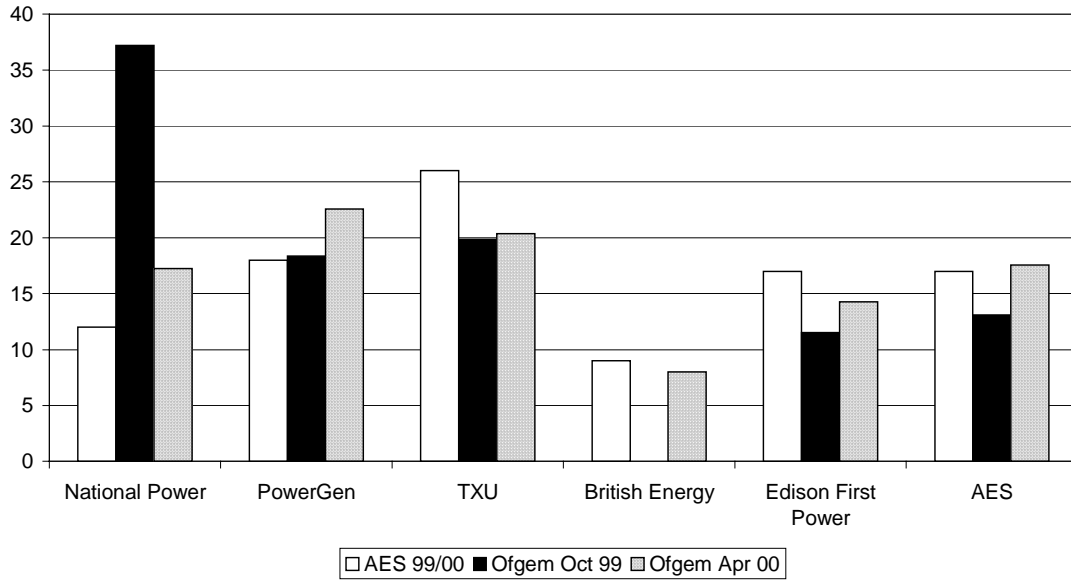
Table A1: Market shares by output 1999/00

Company	AES	Ofgem
National Power	16.3	17.5
PowerGen	15.1	15.3
TXU	6.1	7.3
Nuclear generators	22.1	22.5
<i>British Energy</i>		15.8
<i>Magnox Electric</i>		6.7
Interconnectors	9.1	15.4
<i>Scottish Power (inc. E&W interests)</i>		2.1
<i>Scottish & Southern (inc. E&W interests)</i>		8.2
<i>EdF</i>		5.2
Edison Mission	4.0	5.0
<i>Edison First Hydro</i>		0.8
<i>Edison First Power</i>	4.0	4.2
IPPs	24.1	13.3
AES	3.2	3.5

Table A2: Market shares by capacity

Company	AES		Ofgem	
	1999/00	Current	1/9/99	1/4/00
National Power	16.0	13.9	18.9	13.0
PowerGen	16.4	16.3	16.5	16.5
TXU	9.8	9.9	10.8	9.2
Nuclear generators	19.7	19.7	17.5	20.3
<i>British Energy</i>			12.0	14.9
<i>Magnox Electric</i>			5.5	5.4
Interconnectors	4.7	4.9	10.5	11.2
<i>Scottish Power (inc. E&W interests)</i>			1.6	1.5
<i>Scottish & Southern (inc. E&W interests)</i>			5.7	6.4
<i>EdF</i>			3.3	3.3
Edison Mission	8.7	9.3	9.0	8.9
<i>Edison First Hydro</i>	3.3	3.2	3.3	3.2
<i>Edison First Power</i>	5.4	6.1	5.7	5.7
IPPs	17.9	19.3	9.8	13.5
AES	6.8	6.7	7.1	7.5

Market shares of coal capacity



Market shares of coal output 1999/00

