November 2000

The importance of the Market Abuse Licence Condition for the protection of consumers and competition

Final Submission to the Competition Commission

Public version

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1. Introduction

1.1 This final submission does not seek to summarise Ofgem's main arguments as to why we believe that the continuing absence of the market abuse licence condition (MALC) in the generation licences of AES and British Energy (BE) companies "operates or may be expected to operate against the public interest". Our previous papers have done so exhaustively.

1.2 In this, our last submission to the Commission, we wish instead to reply to a number of points made in recent arguments by the generators, and to comment on some recent submissions to the Commission, particularly the work of Professor Bunn and his colleagues. In doing so, we highlight those areas which Ofgem believes are key:

- the on-going potential for abuse both during the final months of the Pool and as under NETA, especially as the new electricity trading arrangements bed down;
- the desirability for any remedy involving a licence condition to be based on effects rather than a list of prohibited behaviours; and
- why it would be against the public interest for the licences of BE and AES to remain in an unmodified form without the MALC.

1.3 In a separate volume of appendices we provide Ofgem's comments on: BE's response to the transcript of Ofgem's hearing at the Commission on 28 July 2000 and to Ofgem's third submission to the Commission; AES' comments on Ofgem's note on avoidable costs versus marginal costs; COALPRO's submission to the Commission; AES' eighth submission and the transcript of its 'remedies' hearing at the Commission[1]; the principles of applying the MALC; price discrimination issues under the MALC; and the recent work of Professor Bunn and his colleagues.

1.4 The process of arguing Ofgem's case before the Commission has made us reflect carefully on the need for, and justification of, the MALC. Our firm belief in the

[1] All hearings at the CC are confidential between the parties and we are therefore unable to put this section into the public domain.

need for a MALC for the major generators, including AES and BE, under the Pool arrangements (and for all licensed generators and suppliers under NETA) has not changed over the course of the Competition Commission inquiry. If anything, recent events in the Pool (and in other liberalised power markets such as California) have reinforced our view. This view appears to be gaining additional international support. During the course of the inquiry anti-trust authorities and/or regulatory agencies concerned about the potential for market abuse in other liberalised wholesale electricity markets have contacted Ofgem to discuss the operation of the MALC. The UK remains a pioneer in the promotion of more competitive wholesale electricity markets, including protecting consumers and competition and helping to promote orderly traded markets by ensuring appropriate regulation of market abuse. We know of no comparable system that has achieved a satisfactory resolution of the particular market power issues that arise in wholesale electricity close to real time on an alternative basis (eg. via market rules including price capping rules).

1.5 We therefore continue to believe that there are now, and will remain under NETA, opportunities for generators to abuse market power to the detriment of consumers and of competition; that Ofgem has statutory duties which require us to seek to act to prevent this happening; and that the MALC represents the best means of so acting. We remain acutely concerned that at a time of great transition in trading arrangements the MALC might no longer be available as a regulatory instrument. Our judgement remains that the risks that such a loss would produce for consumers outweigh any contrary risks (the scale and nature of which have been exaggerated through misunderstanding or misinterpretation of the operation of the MALC) associated with the retention of the MALC, which has already proved its value this year in enabling Ofgem to act effectively against Edison, in a way which would have been impossible had the MALC not existed. Any alternative approach would, we believe, lead to less effective protection of the consumer and/or more intrusive regulation.

2. The on-going potential for abuse

2.1 Although acknowledging that manipulation has been a problem in the past, opponents of the market abuse licence condition, including BE and AES, have consistently argued that deconcentration of ownership in generation has left the market competitive and removed the scope for market abuse. They suggest the introduction of NETA, combined with the current diversity of ownership, will further reduce the opportunities for participants to abuse the wholesale electricity market.

2.2 Ofgem recognises that through divestment and new entry, the generation market has become more competitive. Ofgem also believes that the introduction of NETA will reduce opportunities for market abuse because of the removal of some of the worst features of the Pool, such as the capacity payment mechanism. However, we believe that the special features of the wholesale electricity market continue to make it vulnerable to abuse, particularly close to real time, by companies who are not obviously dominant and who have relatively small market shares. We believe that our view is supported by recent developments:

- the Edison case earlier this year shows that, even with the current low levels of market concentration, participants are able to abuse the market causing substantial harm to customers and competitors;
- the NETA simulations by Professors Bunn and Oliveira confirm our view that there will be both the scope and incentives for participants, including AES and BE, to abuse the market under NETA, particularly close to real time during periods of peak demand.
- in addition, customer representatives, suppliers and traders in responding to the Competition Commission have all made clear their belief that the problems of the last decade are also real dangers following the introduction of NETA and that it is essential that Ofgem has powers to tackle abuse.[2] In this respect we note that Enron, who were initially

[2] We therefore consider that AES' assertion that *"nobody actually thinks there are serious problems"* is simply untrue.

opposed to the MALC, appears to have accepted the need for a general effects based prohibition in its most recent submission to the Competition Commission.[3]

2.3 In our various responses we have shown that all the exemplary forms of abuse that have been discussed in relation to the Pool will continue to be possible and potentially profitable (given the right market conditions) under NETA, albeit sometimes in different forms. It has been argued that some forms of market manipulation would be breaches of the Grid Code and hence susceptible to control via enforcement orders and, in future, fines under existing licence conditions. Ofgem does not consider that such a course would be either practicable or appropriate. The Grid Code is concerned with technical rather than commercial issues. Although a very limited number of abusive forms of conduct may require companies to breach obligations in the Grid Code, Ofgem does not believe that it would be appropriate or practical to rely on this as a means to tackle market abuse. A very large number of specific forms of abuse would not be covered by the Grid Code and there would still be a need for a MALC to prohibit these activities.

2.4 A simple example of a possible form of abuse under NETA that would not be covered by the Grid Code is as follows. A participant provides a final physical notification (FPN) to the System Operator (NGC) that is designed to create a "virtual" constraint which can only be relieved by accepting a highly priced offer submitted by the participant (and in this sense is misleading). If the metered volume of the participant corresponds to the FPN submitted as adjusted by its accepted offer, then technically the information submitted has not been misleading. However, from a market exploitation perspective the combination of an abnormally low FPN with an abnormally high offer price may constitute abuse and could not be addressed through the Grid Code but would be covered by the MALC.

2.5 The Competition Commission has asked us whether we believe that the wholesale electricity market could ever be truly competitive.

[3] The Competition Commission's Electricity Generators Inquiry: Statement of Possible Remedies, A response by Enron Europe, 9 October.

2.6 The question of whether electricity markets can be truly competitive is open (in the sense that there is no international consensus on the answer). The Commission is aware of the re-evaluations of regulatory approaches taking place in the US, and we repeat again the view of Professors Borenstein and Bushnell:[4]

> *"electricity is especially vulnerable to the exercise of market power, even by firms with relatively small market shares, so there will be continued need for regulatory oversight in these markets, at least until there is much more real-time demand responsiveness."*

That there is *'continuing need for regulatory oversight'* is a view that is widely shared, including by Ofgem, although there is considerable disagreement as to what form such oversight should take.

2.7 However, we agree with the Borenstein and Bushnell argument that the market can be competitive when there is much greater participation by the demand side, particularly close to real time. Many of the examples of the scope for market abuse that we have highlighted would be mitigated to a greater or lesser extent if there were more active demand-side participation in the balancing mechanism and in the power exchanges trading energy close to gate closure.

2.8 NETA will create a new trading environment, free of the restrictions, complications and administered arrangements that characterise the Pool, and in particular, it will promote more forward contracting and will facilitate and encourage more active participation by the demand side either directly or through agents, aggregators and suppliers. Once these effects have fully worked through the market, which may take a period of years, then effective competition should emerge throughout the market and the scope for market abuse in the physical market close to real time will be very substantially reduced and/or removed. But until that time, Ofgem believes that problems associated with substantial market power and the scope for, and incentives to, abuse will continue to exist. An effective safeguard is required to protect competition and consumers until market conditions are such that it is no longer required. If

[4] See a working paper by Borenstein and Bushnell on deregulation or reregulation of electricity markets, UC Berkeley, 2000.

effective competition does develop Ofgem would not hesitate to seek to remove the MALC from electricity licences.

3. The need for an effects based remedy

3.1 As Ofgem made clear in our response to the Competition Commission's remedies letter, we believe that any remedy must be based on effects and not seek to prohibit specific conduct. We do not believe that it would be possible to write a definitive list of conduct that would be comprehensive and capture all of the possible forms of conduct that could constitute market abuse.

3.2 This view is supported by ten years of experience from the Pool. The rules associated with balancing and physical delivery of electricity are detailed and are complex to the extent that they require a number of technical parameters to be submitted. Traders and companies have proved very adept at developing new and innovative ways of using these parameters to leverage their market power in the close to real-time markets. As a result, we do not believe that it would be possible to develop a comprehensive list of prohibited conduct covering all potential forms of abuse, either under the Pool or under NETA.

3.3 In the absence of a comprehensive set of behavioural prohibitions, the anomalous situation will exist where the same harm is done to competition or consumers, but it can only be remedied when it has been achieved by a particular prohibited behaviour.

3.4 Opponents of the MALC have argued that where abuse is the result of exploitation of market rules, then rule changes rather than the MALC are the appropriate remedy. Ofgem has always accepted that rule changes have a role to play in combating market abuse. Nevertheless we believe that relying solely upon them would be inconsistent with our duties to promote competition and protect customers' interests.

3.5 Such an approach would allow participants 'one free hit' prior to the identification of the problem and potentially more than one, before a rule change could take effect. Even where it was clear what rule change is required, due process must be followed and this may limit the speed at which the rule change can be introduced. In addition some rule changes may be delayed by IT system constraints. During this period of delay, which may be either a matter of days or months, companies would be able to continue to exploit the existing

rule to the detriment of customers and/or competition. The history of the Pool suggests that manipulation even over a short number of days can have material adverse effects.

3.6 There are further drawbacks to relying on rule changes alone to tackle market abuse. Changes made to a rule can have unintended and possibly counterproductive consequences. There are therefore additional risks associated with making detailed rule change in haste in an attempt to close a loophole that is being exploited. Unnecessarily frequent rule changes can also undermine confidence in the market and stifle liquidity and innovation.

3.7 It has been argued, most notably by Professor Wolak, that an effects based approach is unworkable because *"assigning the blame to specific market participants for the exercise of market power is a virtually impossible task"*.[5] This is not a position that Ofgem accepts; although we acknowledge that it can be difficult to establish causation in some circumstances.

3.8 Ofgem recognises that, as stated by Professor Wolak, the California independent system operator (ISO) does not currently have procedures for determining if a market participant has abused its market power. We would point out, however, that the ISO in California is an industry body, not a regulatory or competition policy authority. This summer, the ISO has been criticised by the California Public Utilities Commission (PUC) and the Electricity Oversight Board (EOB) for not making available information that might have allowed the PUC and the EOB to assess potential market abuse. The ISO's assertion does not therefore appear to have been put to independent scrutiny. The PUC and the EOB commented that they were concerned that the ISO may be compromised and lack independence, as many of the members of its oversight board were also senior employees of the companies who may have benefited substantially from the very high prices under investigation. They said that:

> *"Because of the policies and procedures adopted over the last ten years, the data we need to assess wholesale market pricing and supply scheduling behaviour is in the hands of two private, autonomous*

[5] Correspondence of 12 July 2000 between Frank Wolak and British Energy, as submitted to the Competition Commission.

entities: the Californian Independent System Operator and the Power Exchange. Despite the Electricity Oversight Board's legislative mandate to oversee those institutions, we have been unable to obtain this data."[6]

3.9 The State Governor has asked the State Attorney General to investigate whether or not market abuse has occurred and, to the best of our knowledge, the Attorney General has not declined the task on grounds that it is infeasible.

3.10 More fundamentally, if this premise were to be correct in general, it would also follow that Chapter II of the Competition Act 1998 and EU competition policy would also be unworkable. Such an implication sits uneasily with the consistent claims by BE, AES and other companies opposing the MALC that the Competition Act 1998 is adequate for dealing with problems of abuse of market power in the wholesale electricity market.

3.11 One of the advantages of the wholesale electricity market, in comparison to many other markets, is the volume, scope and high frequency of data that is available on a half-hourly basis concerning the physical operation of the market. This greatly simplifies the task of market surveillance and the detection and investigation of anomalous patterns of prices.

3.12 It may, indeed, not be possible to demonstrate causality in some circumstances (in which case there cannot be a finding of abuse), but in other circumstances it may, in fact, be relatively easy. In any case Ofgem strongly believes that a task that it is necessary to undertake to protect competition and customers should not simply be abandoned because it is too difficult or may, in certain circumstances, be infeasible. As Ofgem has argued throughout this inquiry, the MALC will at least be effective in preventing and deterring the more egregious forms of market abuse. Such an outcome will clearly be in the public interest and consistent with our statutory duties.

3.13 Professor Wolak has also commented that the MALC approach is flawed because it is a fundamental contradiction of what makes a competitive market work to ask market participants not to act in their own interest. We agree with this statement with regard to competitive markets: if the market is fully competitive

[6] Report to the Governor of California on the electricity conditions facing California, 2 August 2000.

then there is no need for a MALC. However, if the market is not competitive then there is every reason to put in place a prohibition, to prevent participants doing things in their own commercial interests that give rise to anti-competitive effects and/or harm customers. This is also the basis on which UK competition law, EU competition law and US anti-trust seeks to condition behaviour. Since abuse is bad for small new entrants and liquidity in traded markets, it is important for the development of competition to be able to take action against market abuse.

3.14 We note that BE has offered to provide undertakings of "good behaviour" as an alternative to the MALC or the licence condition proposed in the Competition Commission's Remedies Letter. However, we do not consider an undertaking or assurance that is not backed up by a sanction of non-compliance is an adequate alternative remedy.

3.15 Professor Wolak has also indicated that he believes development of demand side responsiveness will be suppressed, if there is an intrusive regulatory arrangement. Ofgem agrees with this general proposition, but would simply point out that this is one of the reasons why we oppose the principal alternative to MALC that has been adopted in other electricity markets, namely price caps. In Ofgem's view, the MALC is a highly appropriate measure in relation to the development of demand responsiveness in that unlike price caps, it does not seek to suppress price spikes but it does seek to constrain pricing patterns that have little relationship to demand and cost fundamentals, and which are difficult for customers to anticipate and respond to.

4. The public interest test

4.1 The narrow public interest test that the Competition Commission has to consider is whether the continuing absence of the MALC in the licences of AES and BE "operates or may be expected to operate against the public interest".

4.2 The Commission will be aware of the legal arguments that we and our Counsel, Jeremy Lever QC and Daniel Beard, have put forward with regard to the interpretation of this test in the circumstances of this particular reference and we do not repeat them here. Instead we consider points relating to the public interest test in a somewhat broader sense, that have been made against the MALC by BE and AES.

4.3 The first point is the argument that is made that since BE and AES have not abused the market so far, it is unreasonable to expect that they will do so in future. This argument is flawed in a number of respects. Electricity regulation, including generation licences and, more generally, civil and criminal law contain numerous examples of prohibited actions which apply universally and not just to those who have transgressed in the past. Indeed, the MALC has been accepted by other generators whose conduct has not given rise to concerns in the past.

4.4 Also, the position of both AES and BE has changed substantially over the past year as a result of the plant that they have acquired, increasing their ability to abuse the market.[7] Finally, any compliance programmes they have in place to prevent abuse could be subject to change and/or more lax enforcement, if senior management and/or ownership of the companies change. In these circumstances, Ofgem cannot rely on statements by the current management teams of both companies that they would not abuse a position of substantial market power.

4.5 The second point concerns the balance of harm to competition and consumers if there were to be no MALC. Ofgem believes that the risk of harm from market abuse would far exceed the risk to generators of having the MALC in their

[7] At the same time, it is unsurprising that there is no evidence of their abusing the market since they have acquired plant given that they have been facing a Competition Commission inquiry (or the threat of one) ever since they gained control of the plant.

licences. We do not accept the argument that the MALC significantly increases the regulatory uncertainty to which generators are exposed. In the light of our statutory duties and in the absence of the MALC, Ofgem would need to rely more heavily on other measures to mitigate market power and, in our view, the resulting uncertainties for generators would not be lower, and could quite easily be higher.

4.6 Any prudent participant who faces the MALC would in any case need to have in place compliance procedures to guard against behaviour that would be unacceptable under the Competition Act 1998. We know of no major objections, on grounds of uncertainty, regulatory burden etc., which have been made by generators in relation to compliance to the Competition Act 1998.

4.7 Some, notably AES, have argued that the uncertainty regarding what constitutes abuse is greater under the MALC than the Competition Act 1998. Again, this is a suggestion that we reject; indeed we believe, if anything, the opposite proposition. Because the MALC is restricted to a single market (that for wholesale electricity), it is possible to define the test for applicability (the possession of substantial market power) more precisely and to provide concrete examples of the types of behaviour that Ofgem considers would (and would not) constitute abuse, if it caused significant harm to competition and/or consumers.

4.8 Substantial market power is defined as the ability to increase prices, independently of changes in market conditions or underlying generating costs, so as to increase the overall cost of electricity (price multiplied by system demand) by £30 million. This is a more precise test than is used to assess market power under the Competition Act.

4.9 Similarly, Ofgem has provided examples of behaviour that, if harmful, we believe would constitute abuse under the Pool and, more recently, under NETA, and we have also provided examples of non-abusive behaviour. To aid generators' understanding we have held a workshop on the operation of MALC under NETA and have offered to hold further workshops. As the OFT does in relation to the Competition Act, we are prepared to offer confidential guidance regarding particular proposed courses of behaviour (and where it is possible to identify general principles to make that guidance public and amend the

Guidelines accordingly). As we pointed out at Ofgem's Remedies Hearing, even BE's counsel, Tom Sharpe QC, accepts that the law related to Article 82 is best described as a wilderness of single instances and that although principles have emerged (and he has described them) the situation of markets in which dominance abuse arises are, by their nature, exceptional.[8]

[8] Tom Sharpe QC, Second Opinion on behalf of British Energy, 15 September 2000, paragraph 6.