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ENERGY REGULATION BRIEF

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UK Competition Commission Rejects Tighter Regulation of Generators

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Following an extensive inquiry, the UK Competition Commission (CC) has rejected the attempt by energy regulator OFGEM to acquire new powers over the behaviour of two electricity generator companies, AES and British Energy. The CC's decision, published by OFGEM on 11 December 2000, ends a long period of uncertainty over the appropriate role of regulation in UK electricity markets. The CC's grounds for rejecting the new powers are significant, as they limit the ability of regulators to rule on a subjective and discretionary basis. The CC rejects OFGEM's case because of a lack of evidence, but also because the proposed powers would create uncertainty and deter normal competitive behaviour. OFGEM had previously included the proposed powers through a condition in the licences of six other generators. In the light of the CC's criticisms, the condition is effectively inoperable. OFGEM has said that including the condition in some licences would be discriminatory and proposed its removal from all licences.

During much of 1999 and 2000, British energy regulator OFGEM had been agitating for increased powers over the market behaviour of generators. These powers were incorporated in a new licence condition known as the "Market Abuse Licence Condition", or MALC. Six generators[1] eventually accepted the condition but AES and British Energy rejected OFGEM's proposal. Following its failure to introduce the licence modification by agreement with these two generators, OFGEM then referred them to the Competition Commission, under the Electricity Act 1989. The CC reviewed the proposal between May and December 2000 and OFGEM published its decision on 11 December 2000. The CC rejected the proposed licence amendment.[2]

So far, OFGEM has only published the Summary of the CC's report, although OFGEM and the companies concerned have seen the full version. (NERA advised both companies involved, but this Brief discusses only the published Summary.)

What Was MALC?

The MALC was nothing less than an attempt to re-invent competition policy on a new and untried basis. In the UK, the Competition Act 1998 follows European practice in prohibiting cartels and abuse of a *dominant* position. The Financial Services and Markets Act 2000 provides a general basis for scrutiny of traders' behaviour in all financial markets, including markets for electricity contracts. OFGEM believed these powers to be inadequate, due to the "special characteristics" of electricity. Instead, OFGEM wanted to be able to penalise abuse of *substantial market power*, as defined by OFGEM.[3]

OFGEM carried out a consultation, including a public seminar, designed to produce guidelines on the forms of behaviour that might be considered an abuse. OFGEM grouped abusive behaviour under four headings:[4]

1. Withholding or withdrawal of generator capacity;
2. Bidding strategies in electricity markets;

[1] BNFL Magnox Electric, Edison Mission Energy, PowerGen, National Power (now Innogy), TXU Europe and London Electricity (EDF). In some cases, where OFGEM was being asked to issue new licences (eg for National Power's restructured businesses), the generator had no opportunity to reject the licence condition.

[2] OFGEM had asked the CC to consider whether continuation without modification of the current licences of AES and British Energy would be against the public interest. The CC concluded that it would not be against the public interest, ie that no modification was required.

[3] OFGEM defined substantial market power as the ability to increase prices by an average of 0.4% over a one year period. (This could be either a very large increase of short duration, or a smaller but more prolonged increase.). At current prices, the test amounted to whether the generator could increase system costs over a year by some £30 million.

[4] See, for example, OFGEM's initial submission to the Competition Commission (May 2000).

3. Manipulation of the market rules; and
4. Influence of contract market positions.

In practice, these headings cover behaviour that can be both pro- and anti-competitive, so OFGEM also tried to describe a procedure for identifying abuses. OFGEM described the steps in this procedure as: (1) check whether the generator possesses substantial market power; (2) check whether the generator has exercised substantial market power; (3) check whether the generator's behaviour has harmed consumers. In practice, however, each step in this process reduced to one narrow question: to what extent has the generator raised prices above the competitive level? As such, OFGEM departed from the broad framework of market analysis adopted by competition authorities, and the concept of dominance in particular.

OFGEM's Flawed Test

The problem with OFGEM's approach lies in the inability of regulators to know with any certainty where the competitive price lies, especially since OFGEM wished to make such judgements over short timescales such as two weeks or even a few hours. The CC accepts that market power, defined as the ability of generators to raise prices "consistently and profitably above competitive levels", is relevant, but rejects OFGEM's tests as a foundation for competition policy. In particular, OFGEM's approach does not provide a basis for distinguishing between acceptable and abusive conduct. After all, if government officials knew exactly what competitive outcomes should look like, period by period, it would be unnecessary to institute competition itself; the officials could merely mandate a competitive outcome. It is precisely the lack of such omniscience that led the government to open generation to competition in the first place.

OFGEM is no better placed than any other agency to decide what the competitive price level should be. Since OFGEM could never define objectively what level of prices was "competitive", it was impossible to say when, by how much, and why prices in specific periods were above competitive levels without making arbitrary or subjective judgements. Hence, the MALC had a weak intellectual basis and was liable to create procedural injustices from the very beginning.

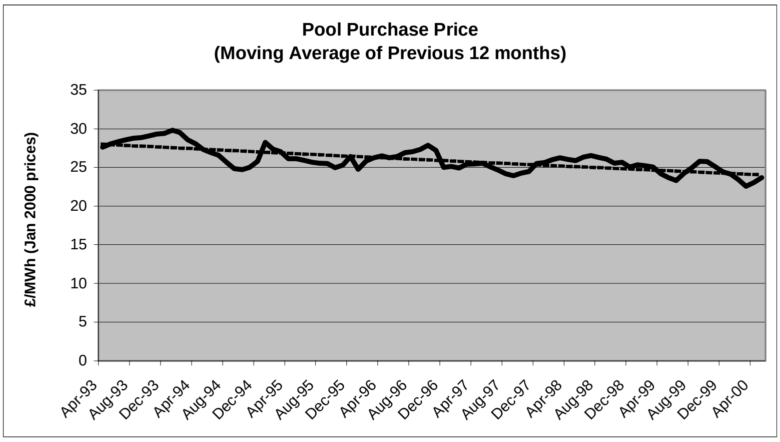
The Competition Commission's Assessment of Electricity Prices

The context of the referral did not require the CC to determine whether or not AES, British Energy or any other generator had actually abused the electricity market. However, the CC did review comments on electricity prices. OFGEM had claimed that electricity prices had remained "around £25 per MWh",[5] despite a decline in costs and an increase in competition. The CC noted instead that annual average prices had declined 17 per cent in real terms (ie, deflated by the Retail Price Index) in the five years to 1999 / 2000. The CC took this development, along with falling concentration, entry by new investors and high plant margins, as support for the notion that the market was becoming more competitive over this period.

In fact, as the diagram below shows, electricity prices have been declining steadily (by about 2 per cent per annum) since 1993. That was the last year in which generator revenues were supported by high-priced contracts issued when the industry was restructured. Since then, all generator revenues from power sales have depended – directly or indirectly - on prices in electricity markets.

The CC does not give the generation sector an entirely clean bill of health. The CC's analysis of new entrant costs suggests that prices may still be above the level that would emerge from a fully competitive market. However, the CC does not conclude that the appropriate response is tighter regulation of generators' behaviour. Instead, says the CC, some problems may be addressed by the introduction of the New Electricity Trading Arrangements (NETA). In contrast to OFGEM, the CC prefers to wait and see the effects of actual behaviour, before taking action.

[5] See paragraph 2.8 of OFGEM's second submission to the Competition Commission (June 2000).



The Competition Commission's Comments on the Evidence

The CC appears to accept many of the statements made by OFGEM about the electricity market – for example the characteristics of supply and demand that create market power near to real time - but rejects them as insufficient justification for special regulatory powers. The CC adopts the commonly held view that the electricity market was highly concentrated, but notes that the structure has become a lot more competitive in the last 18 months, and will experience further entry by new generators in future.

The CC also notes that the Pool Rules contain features that may exacerbate market power. However, the existing Pool is due to be replaced by NETA in the first half of 2001. The CC notes that NETA possesses several features likely to reduce the opportunities for and effects of exercising market power, including new governance arrangements which "should enable necessary rule modifications to be made without undue delay."

The CC concentrated on the potential for abusing the market by withdrawing capacity, but the CC concludes that neither AES nor British Energy are likely to profit from such strategies, given the constraints posed by contracts on the one hand, and the risk of operating without contracts on the other.

The CC bases its findings on the available evidence. Notably, it highlights evidence that market forces are working in the wholesale electricity market, and that the structure of the industry is changing for the better. The CC concludes that there is no evidence that the MALC is needed. This demand for evidence contrasts strongly with the claim by OFGEM that "broad powers" are needed as a precautionary measure, *just in case* an abuse occurs, because abuses can't be exhaustively defined in advance.

The Competition Commission's Condemnation of the MALC

The CC goes further, in rejecting the MALC on the grounds that its adoption would act *against* the public interest by creating uncertainty. This finding is significant, and separate from the general finding that the MALC is unnecessary. It militates against the imposition of the MALC as a precautionary measure and explains why OFGEM really has no choice but to withdraw the MALC from those licences where it has already been included.

The CC apparently thought the problem so important that the Summary discusses it twice – once in the context of market power, and once over the "manipulation of market rules". As explained above, OFGEM's guidelines for the MALC did not (and indeed could not) succeed in objectively defining what constituted an abuse. The CC therefore found that the MALC could cause uncertainty "because of the difficulty of distinguishing between abusive and acceptable conduct". This finding was serious, because it meant that the MALC "would risk deterring normal competitive behaviour".

In other words, the CC effectively found the MALC to be anti-competitive, because it relied on a subjective interpretation of the boundary between abusive and acceptable conduct. The significance of this finding should not be underestimated. Until now, UK regulators have emphasised the desirability of being able to exercise "discretion" when carrying out their duties. The CC's findings should warn UK regulators that unfettered discretion is not necessarily beneficial to competition or to the public interest.

Conclusion

Electricity markets in England and Wales are already covered by the Competition Act 1998 and the Financial Services and Markets Act 2000. OFGEM's attempt to create additional powers through the MALC was predicated on two notions: (1) that adverse effects in the electricity sector were inadequately addressed by market forces or by existing laws and (2) that an electricity sector regulator could use the MALC to promote competition through more specific interventions into generators' behaviour in the market.

The Competition Commission has conclusively rejected both these notions, in practice rendering the existing versions of MALC unusable. The CC finds no evidence of a need for additional powers. What is more, the CC also finds that arbitrary or subjective use of powers (to penalise ill-defined abuses) is not good for competition.

OFGEM now has to decide when to publish the CC's full report. Only when it becomes available to a wider audience can the full ramifications of the CC's decision be fully assessed. However, the arguments set out in the Summary already demonstrate that regulatory interventions (in the competitive sphere at least) should only be used as a last resort, when market forces persistently fail to respond. Even then, they should be rejected if they are not soundly based on evidence, or if they rely excessively on subjective use of the regulator's discretion. In reaching this conclusion, the CC provides a useful lesson for all sector-specific regulators.

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