

**AES
and
British Energy**

A report on references made under section 12
of the Electricity Act 1989



COMPETITION COMMISSION

AES and British Energy

A report on references made under
section 12 of the Electricity Act 1989

**Presented to the Director General of Electricity Supply
December 2000**

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Note by the Gas and Electricity Markets Authority

On 20 December 2000 the functions of the Director General of Electricity Supply under the Electricity Act 1989 were transferred to the Gas and Electricity Markets Authority.

In accordance with section 13(6) of the Electricity Act 1989, the Secretary of State for Trade and Industry has directed the Gas and Electricity Markets Authority to exclude from copies of the published report certain matters, publication of which appears to the Secretary of State to be against the public interest or the commercial interests of any person.

The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.

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Part I

Summary and Conclusions

1 Summary

1.1. This inquiry concerns proposed modifications to the operating licences of generating companies in the AES and British Energy groups. The Director General of Electricity Supply (DGES) had concluded towards the end of 1999 that the licences of the larger generators in England and Wales needed to be modified to include a condition prohibiting conduct which amounts to an abuse of a position of substantial market power. Six generator groups agreed to the modification but AES and British Energy refused. The DGES therefore referred the matter to us under the Electricity Act 1989. The question we are asked to report on is whether the continuation unmodified of these companies' licences operates, or may be expected to operate, against the public interest.

1.2. We have considered whether adverse effects might come about as a result of the use of market power, or through the manipulation of market rules, by AES or British Energy. An increase in electricity prices is the potential adverse effect on which we have principally focused.

Market power

1.3. Our working definition of market power is the ability of a generator, acting independently, to raise prices consistently and profitably above competitive levels. There are particular characteristics of the wholesale electricity market which can create opportunities for the exercise of market power by generators, particularly close to real time and when the system is tight. Such opportunities may arise even for generators whose market shares are only moderately high. When the market is highly concentrated as has been the case until the last 18 months, the problem is magnified. The problem is also exacerbated by some aspects of the current trading arrangements based on the Electricity Pool of England and Wales (the Pool).

1.4. The recent changes in the structure of the generation sector should significantly reduce the scope for the exercise of market power, and there are reasons to expect the structure to become even less concentrated over the next year or so. As the market becomes increasingly competitive, we would expect action by other generators to curtail the ability of any one of them to raise prices. New entry is taking place: whilst this has been restricted by the Government's stricter-consents policy concerning gas-fired plant in the past two years, that policy has now been lifted. In any event the overall plant margin is already at a comfortable level. The particular problem of transmission constraints has been substantially reduced.

1.5. Price trends lend some support to the above analysis. Annual average Pool prices fell in real terms by 17 per cent over the five years to 1999/2000, though estimates of new entry costs suggest that Pool prices may still be above the level which would emerge from a fully competitive market.

1.6. The Pool is due to be replaced by the new electricity trading arrangements (NETA), which have been under development for some time, in the first half of 2001. There are several features of NETA which suggest that both the opportunities for and the effects of the exercise of market power by generators are likely to be substantially less than they have been under the Pool. It is clearly important that the new arrangements be introduced as soon as possible.

1.7. That said, we find that the uncertainties over how NETA will work in practice are such that we cannot form a clear expectation as to the incidence of market power problems in the new circumstances. Nor is there a basis for an expectation that the absence of a prohibition of abuse of market power in the licences of the referred generators would put at risk the successful implementation of NETA.

1.8. One of the main ways in which generators might in principle be able to exercise market power is the withdrawal of capacity in order to cause higher prices from which the rest of the generator's portfolio of plant can benefit. We considered whether we could expect AES and British Energy, given their particular positions in the market, to behave in this way.

1.9. We have found that, largely because of the long-term contract between AES Drax (by far the largest generator in the AES group) and TXU, it is unlikely that circumstances would arise in which AES could predictably profit from capacity withdrawal. This constraint could be negotiated away but we would not expect this to happen in the remaining life of the Pool. We have not identified other ways in which AES is likely to be able to abuse a position of market power.

1.10. Some 90 per cent of British Energy's potential output comes from inflexible nuclear plant. British Energy's acquisition of the Eggborough coal-fired station has, however, created conditions in which it would be possible in principle for the company to profit from a strategy of capacity withdrawal during the remaining life of the Pool. We deal with this possibility under the heading of manipulation of market rules (see paragraphs 1.13 to 1.18). We have not identified other ways in which British Energy is likely to be able to abuse a position of market power.

1.11. We also considered effects on the development of markets. The perception that generators can exploit positions of market power may have had a harmful effect on contract and traded markets under the Pool, although there have also been other factors at work. Liquidity is now growing. Under NETA, actual experience of the new arrangements is likely to be the main factor influencing the development of these markets. We do not expect that the continuation without modification of the licences of AES and British Energy would significantly inhibit the development of these markets.

1.12. We have not therefore identified adverse effects which need to be addressed by the inclusion in the licences of AES and British Energy of a condition prohibiting abuse of market power. Moreover, we think that such a prohibition would cause uncertainty, because of the difficulty of distinguishing between abusive and acceptable conduct, and would risk deterring normal competitive behaviour. Competition should be given the opportunity to work in the new circumstances of NETA, and with a less concentrated generation sector, without the introduction at this stage of new broadly-framed regulation.

Manipulation of market rules

1.13. We see manipulation of the market as conduct for which a sufficient remedy would in principle be the modification of market rules or mechanisms. The wholesale electricity market is intrinsically vulnerable to such conduct because of the need for rule-based arrangements to govern the balancing of the supply system. Certain of the Pool rules have exacerbated this inherent problem.

1.14. There have been various ways in which Pool rules have been manipulated over its ten-year life. Some problems have been successfully addressed by rule changes but others have not been fully dealt with. In particular there are continuing difficulties over capacity payments.

1.15. However, despite the vulnerability of the capacity payments mechanism, the circumstances of AES are such that we do not consider it likely that it will manipulate the mechanism.

1.16. We believe that circumstances in which British Energy could predictably profit from strategic capacity withdrawal may arise for a short period in summer 2001 if the Pool has not yet been replaced by NETA. Because the balance of risk and reward is likely to be unfavourable for the company, however, we do not expect that British Energy would seek to manipulate prices in this way if its licences continued unmodified.

1.17. Under NETA the position will be different. NETA has been designed in such a way as to minimize the opportunities for manipulation of the market. Given the complexity of the arrangements needed, it is possible that some problems of this kind will nevertheless arise, but the governance arrangements for NETA should enable necessary rule modifications to be made without undue delay.

1.18. Beyond that, the DGES may be right to predict that manipulation will be a continuing problem because no workable set of rules could eliminate the possibility. But in view of the uncertainties we cannot form an expectation that manipulation by AES or British Energy will occur, with adverse effects for the public interest. We are also mindful of the disadvantages of a broad, effects-based prohibition—as mentioned in paragraph 1.12 in the context of market power—and our view that such a prohibition would not be suitable for dealing with manipulation of market rules. If, in the light of experience, such manipulation proves to be a significant problem under NETA and cannot be satisfactorily dealt with by rule modification, it will be open to the Secretary of State to consider using his powers under the Utilities Act to introduce new licence conditions to address the problem.

Conclusions

1.19. We conclude in respect of both AES and British Energy that the continuation without modification of those provisions of their licences which apply in relation to the determination of wholesale electricity prices is not against the public interest.