

MLex Ab Extra:

Tackling energy pricing abuses

Peter Willis examines when electricity generators in the UK are incentivised to switch off their machinery



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Introduction

In September 2011, a number of UK newspapers revisited a favourite and contentious theme – payments to wind farms *not* to generate electricity. For example, on 17 September, *The Daily Telegraph* reported the payment of 1.2 million pounds to one wind farm not to generate for a period of eight and a half hours – an amount “10 times greater” than the generator would have received if it had generated.¹ The need to constrain off generation arose from the high winds across Scotland at the tail end of Hurricane Katia over the weekend of 10-12 September, combined with restrictions on the amount of electricity that could be moved over the transmission system. A similar situation in April resulted in payments to one generator that were 20 times greater than the prices it would have received for selling its electricity.

The Telegraph reported a spokesman for industry regulator Ofgem as having commented that it was “looking carefully at the bidding behaviour of generators behind constraints, including wind generators.” What tools might Ofgem and other authorities use to tackle prices that may be 10 or 20 times higher than “normal” market prices? Could high prices such as these infringe the competition rules?

The GB Balancing Mechanism

Before looking at the application of competition and other tools to this kind of scenario, a brief explanation of the background may be useful.

Under the GB electricity market rules, all large and some smaller generators are required to submit a Physical Notification (PN) for each half-hour settlement period, setting out their anticipated output level. The PN may be progressively revised in the run-up to the settlement period, until it is crystallised in a Final Physical Notification (FPN) at Gate Closure, one hour before the start of the settlement period. With its FPN, a generator may submit Offers and Bids within the Balancing

Mechanism, indicating the terms on which it is prepared to depart upwards or downwards from its FPN. A Bid therefore indicates the price in pounds per megawatt hour (MWh) that the generator is willing to pay in order to reduce generation from its FPN. A negatively-priced Bid (e.g. –150 pounds per MWh) indicates that the generator expects to be paid for reducing generation.

Because electricity cannot currently be stored at scale, and the system must remain in constant balance, National Grid needs to be able to call on generators and consumption units to increase and decrease generation and consumption in real time. In the period between Gate Closure and the start of the settlement period, it therefore accepts Bids and Offers in the Balancing Mechanism, as required in order to balance the system during the settlement period. While it is usually able to balance the system across GB as a whole, in some circumstances the transmission network is unable to carry sufficient electricity into or out of a particular area, so National Grid is therefore required to carry out balancing actions either side of the resulting bottleneck (constraint).²

This is what happened over the weekend of 10-12 September.³ National Grid was faced with a number of transmission outages, both within Scotland and between Scotland and England. The Moyle interconnector from Scotland to Northern Ireland was also unavailable. Roughly three gigawatts of wind generation was connected behind these constraints. Having done what it could to reduce generation by means of contracts entered into pre-Gate Closure, National Grid had a limited number of options. They included constraining off wind farms and a number of small hydro generation units, and using pumped storage to increase demand. National Grid had received bids as high as –9,999 pounds per MWh, and it accepted bids ranging from –150 to –999 pounds per MWh. One of the bids at the top end of this scale was the –999 pounds per MWh bid submitted for Crystal Rig II, a 138 MW wind farm in the Scottish Borders. This resulted in the 1.2 million-pound payment that attracted the attention of the press.

National Grid is consulting on a number of possible solutions, including the possibility of accepting Bids from generators that do not participate in the Balancing Mechanism, and issuing “emergency instructions” before accepting prohibitively priced bids. These measures are likely to go some way towards addressing the issue. However, one of the questions raised in its consultation is the question of why generators submit high-priced negative bids. In some cases, these “sleepers” bids are merely intended as a signal that the generator does not want to be constrained off, for example because it wishes to ensure that it obtains sufficient Renewables Obligation Certificates, or because its plant is highly inflexible. For example, National Grid received bids of –10,000 pounds per MWh in respect of nuclear plant during the April high wind/constraint period.

However, there are concerns that in some cases generators will submit high-priced bids in the expectation that they will need to be constrained off, with the intention of exploiting their ability to carry out the necessary balancing action. It should be emphasised that there is no indication in the press or in National Grid’s reports that the operator of Crystal Rig II or any other generator had any such intent. Nevertheless Ofgem is apparently investigating some of these bids.

Scottish generators

Concerns about activities in the Balancing Mechanism are nothing new, and are not restricted to renewable generators. In 2008, Ofgem opened an investigation into Scottish generators SSE and Scottish Power, under Chapter II of the Competition Act 1998. It explained that it suspected they had a dominant position in a relevant market during a four-week period from September 2007, and that they had withheld generation plant from the wholesale forward market (in other words, submitted FPNs indicating that they would not generate with particular units). They had then used the same plant to supply balancing power to National Grid at excessive prices, by submitting Offers in the Balancing Mechanism to increase generation at higher prices, and by charging high prices for other balancing actions.

Ofgem closed the case after a nine-month investigation. Ofgem’s case-closure letter noted that it had concerns about the conduct of the generators, in particular that their output during periods of constraint was more expensive than that of comparable generators in England and Wales, and that there was evidence the generators might have exacerbated or created the constraint situations. Nevertheless, Ofgem considered that the likelihood of making an infringement decision was low.⁴

Ofgem did not publish detailed reasons for the decision to close

the investigation, but it indicated subsequently that it would be difficult to establish that generators enjoying market power only intermittently and in conjunction with other generators would be dominant within the accepted sense of the term.⁵

Ofgem never made clear what it considered to be the relevant product or geographic market in this investigation. It has historically taken the wholesale electricity market (including the provision of balancing services) to be a GB-wide market.⁶ Establishing that an individual large flexible conventional generation plant is dominant in the GB wholesale electricity market is difficult enough; establishing that a smaller intermittent and inflexible renewable generator is dominant will be even more difficult if traditional competition law measures of dominance are used.

However, there are signs that competition authorities across Europe are becoming increasingly sophisticated in their approach to these complex markets. That is not surprising, as greater intermittency requires more frequent and larger balancing actions at ever-greater cost to transmission system operators and the users of their systems.

Spanish “technical restrictions” cases

Over the last few years, the Spanish competition authority, the Comisión Nacional de la Competencia (CNC), has imposed significant fines on a number of the major Spanish generators for withholding generation capacity from the intraday market

during certain periods, in the knowledge that they would be called upon to supply electricity in the technical restrictions market (for these purposes, broadly equivalent to the GB Balancing Mechanism) in order to resolve the resulting constraints. In the *Iberdrola Generación* case, for example, the CNC found that the relevant market was the market for the generation of electricity to resolve technical restrictions in the Levante-Sur region.⁷ In January 2010,

the Spanish Tribunal Supremo overturned one of the earliest of these decisions on the grounds that the CNC had not established that the generators were sufficiently certain they would be called upon to resolve the constraints, and that the CNC had therefore not established an abuse.⁸ The Audiencia Nacional subsequently applied the same principle in relation to the *Iberdrola Generación* decision.⁹ Nevertheless, the decision provides a useful illustration of the way in which competition authorities may approach market definition and dominance in this area.

EDF’s reserve services bids

A similarly narrow approach to market definition in this area is also seen in a recent decision of the French competition

The adoption of narrower market definitions could see individual generators being found to be dominant

authority, the Autorité de la Concurrence, rejecting a complaint against the conduct of EDF and the French transmission system operator RTE.¹⁰ The complaint concerned a tender to provide fast and complementary tertiary reserve services – reserves of up to 1,500 MW that can be manually activated within a short period (15 and 30 minutes respectively) to restore the automatically activated primary and secondary reserves.¹¹

The complainant argued that the relevant market was the market for the offer and demand of fast tertiary reserve and complementary tertiary reserve in the context of offers organised by RTE in 2007. In contrast, EDF argued that the relevant product market was the French electricity wholesale market, of which the balancing mechanism and contracts for the supply of tertiary reserve services formed only a small part.

The Autorité concluded that the relevant product market was the narrower market for tenders for offers to provide the fast tertiary reserve and complementary tertiary reserve. The characteristics of this market differed greatly from those of the wider wholesale market. There were a number of purchasers on the wider wholesale electricity market, but only one, RTE, on the narrower market for tenders for providing reserves. On the supply side, traders also participated in the wholesale market, but not in the reserve market, which was limited to generators. For similar reasons, the market for tendering to provide reserves was different from the general balancing mechanism. Furthermore, within the market for tendering for providing reserves, there were differences between the fast tertiary reserve and complementary tertiary reserve, mainly relating to the time within which reserve power was to be provided, and for how long each day, suggesting that they might constitute separate markets. However, it was unnecessary for the Autorité to come to a definitive conclusion on this point.

A similar approach to the GB market could see Ofgem argue that there was a separate balancing market, and even that there was a separate market for the services required to balance each localised constraint situation.

Measuring market power in Germany

The adoption of narrower market definitions could, where only one plant is capable of resolving a particular constraint, see individual generators being found to be dominant on the basis of traditional market share-based indicators of dominance. However, the energy sector enquiry recently conducted by the German competition authority, the Bundeskartellamt, saw the use of an alternative tool that can indicate market power in the absence of traditionally-measured dominance.¹² This is the Residual Supply Index (RSI), which measures the extent to which the output of an individual generator is necessary to meet demand. The RSI is measured according to the following formula:

$$RSI = \frac{\text{Total Capacity} - \text{Company I's Relevant Capacity}}{\text{Total Demand}}$$

An RSI of less than 1.0 means that the generator is indispensable, while an RSI of 1.1 or less in more than five percent of hours is often used as an indicator of market power. In the German case, while none of the generators was individually dominant on a traditional market share analysis (in 2009: RWE 31 percent, E.ON 21 percent, Vattenfall 16 percent and EnBW 14 percent), the Bundeskartellamt found that each of them had an RSI of 1.1 or less for at least 25.7 percent of the hours in 2007 and 2008 – RWE had an RSI of 1.1 or less for more than 73.8 percent of the hours in 2008 – and concluded that each of them was individually dominant during the period. A similar tool could be used to assess the extent to which a generator is indispensable for the purposes of reducing generation in a particular area.

The application of more sophisticated economic assessment tools such as this to actions in the GB Balancing Mechanism could similarly suggest incidences of market power or dominance.

How to measure prices

The final piece in the competition jigsaw is of course the assessment of abuse. Having established that an individual wind farm is dominant in a relevant market, it will be necessary to assess whether its prices are excessive. This is a notoriously difficult exercise, and Ofgem (in common with the CNC in the case of the Spanish decisions) is perhaps more likely to focus on those cases that involve additional indicators of abuse, such as a generator withholding capacity from the wholesale market when it would be economical to run, in the expectation of being paid a much higher price to reverse its position in the Balancing Mechanism after Gate Closure.

In pure “pricing” cases, some assistance may be derived from the EDF/RTE decision of the Autorité de la Concurrence mentioned above. Although it was a decision on predatory pricing, the Autorité’s analysis of costs provides a useful precedent for the analysis of costs in cases involving alternative generation markets. The Autorité considered whether EDF had forgone some of the profit that it would have obtained on the French wholesale electricity market and in particular the cost of deoptimising its generation fleet, by offering its plants to RTE in the reserve power market.

EDF indicated that it had determined the required capacity payment by reference to the figure that would cover the loss of opportunity corresponding to the loss of profits that it would have derived from selling on the wholesale market the resources proposed for fast tertiary reserve and complementary tertiary reserve. EDF was able to produce internal working

documents prepared just before the submission of its 2008 offers, valuing the loss of opportunity at or below the prices proposed to RTE. There was therefore insufficient evidence to establish that EDF had forgone part of its short-term profit in submitting its offers to RTE in 2007, and the Autorité was able to conclude that EDF had not abused its dominant position. The approach of assessing prices against the costs incurred not only directly in running plant (or not running it) during a particular period – but also indirectly in forgoing the potential profit from an alternative strategy – also has applications in the context of assessing pricing in the GB Balancing Mechanism.

Tools other than competition law?

However, competition law tools are not the only ones available to the regulators, and in fact other tools are now likely to be used in preference to competition law in the GB market. On 8 December 2011, just as *MLex Magazine* went to press, the UK government and Ofgem launched a consultation on a proposed “transmission constraint licence condition” that would be inserted into generators’ licences.¹³ This would essentially prohibit them from creating or exacerbating transmission constraints by submitting uneconomic FPNs and then seeking excessively high payments for reversing their positions through Bids or Offers in the Balancing Mechanism. The condition

would also prohibit generators from exploiting periods of export constraint (where there is excess generation within a region) by submitting Bids to reduce generation at excessively low prices – or at excessively high negative prices. Ofgem’s proposed guidance outlines how it proposes to assess whether it is uneconomic to run or withhold plant, and whether a Bid price is excessive.

A second tool, more likely to be employed in member states without a comparable licence condition, is the Regulation on Wholesale Energy Market Integrity and Transparency (Remit), due to enter into force on 28 December 2011. This provides a specific mechanism for tackling energy market abuse. It extends to wholesale energy markets the prohibitions on market manipulation and insider trading previously applied in financial markets as a result of the Market Abuse Directive (MAD).

Remit prohibits a person from securing a price for a wholesale energy transaction “at an artificial level.” At first sight, Ofgem seems very likely to consider a Balancing Mechanism Bid or Offer of 10 or 20 times the “normal” price as “artificial.” Reversing the usual burden of proof, it will then be for the generator to prove to the regulator that its reasons for pricing at a high level are legitimate and also that the transaction “conforms to accepted market practices on the wholesale

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energy market.” While high-priced Bids and Offers on the GB Balancing Mechanism are inherent in the regime and may therefore be argued to constitute accepted market practices, the question of legitimacy is likely to depend more on intent. It will therefore be very important for generators in such cases to be able to demonstrate that their pricing decisions reflect the costs of running or not running as the case may be.

The major advantage of Remit over Article 102 and other competition tools is the fact that there is no express requirement for the enforcement authority to establish dominance or market power. The recitals to Remit, and the guidance prepared for MAD, give as an example of market abuse the situation where a market participant with a “dominant position” or a “significant influence” over the supply of a wholesale energy product distorts the price. However, even if a “dominant position” is taken as a necessary condition for market abuse, and not just an example of the circumstances in which it may occur, regulators are likely to argue that the reference is not to be interpreted as requiring dominance in the competition law sense of the term. Interestingly, both the European Commission and Ofgem referred at an early stage to the possibility of using Remit to tackle this kind of abuse. The commission commented¹⁴ that:

“Tailor-made rules are also needed to take into account energy-specific market abuses, such as withholding of energy production from the market to increase prices. Electricity cannot be stored on an industrial scale. It must be produced in the moment it is consumed. This means

that market prices are highly sensitive to the availability of generation capacities.”

It is likely to be 18 months or so before regulators are given the necessary enforcement powers, although the possibility of private enforcement before then should not be overlooked.

Conclusion

This is an issue that will only grow in significance, as electricity transmission system operators address the intermittency caused by the integration of greater volumes of renewable energy over the next couple of decades. While energy market reforms are likely to change pricing mechanisms and may reduce the scope for abuse, they are unlikely to do so completely. Ofgem and its counterparts in other member states are likely to come under increasing pressure to tackle any remaining abuses. A more sophisticated approach to market definition, dominance and the assessment of costs may facilitate enforcement, and some interesting decisions in this area seem inevitable. However, it is also likely that some enforcement will move away from the competition and into the regulatory arena with the introduction of tools such as Remit and the transmission constraint licence condition. ■

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Footnotes

- 1 <http://www.telegraph.co.uk/earth/energy/windpower/8770937/Wind-farm-paid-1.2-million-to-produce-no-electricity.html>
- 2 Balancing actions are activated and priced differently across Europe, in some cases on a pay as bid basis as in GB and in some cases on the basis of some form of price limitation. The basic principles outlined here are capable of being applied to other mechanisms, however.
- 3 There is a useful National Grid presentation explaining the background and NG's actions at http://www.nationalgrid.com/NR/rdonlyres/F86FE0D1-0D3C-45B7-836B-3C24EDDD029/49603/02_Wind_Operation.pdf
- 4 <http://www.ofgem.gov.uk/Media/PressRel/Documents1/ofgem4-190109.pdf>;
<http://www.ofgem.gov.uk/About%20us/enforcement/Investigations/ClosedInvest/Documents1/Competition%20Act%20investigation%20into%20ScottishPower%20and%20Scottish%20and%20Southern%20Energy.pdf>
- 5 <http://www.ofgem.gov.uk/Markets/WhIMkts/CompanEff/Documents1/Market%20Power%20Concerns-%20Initial%20Policy%20Proposals.pdf>
- 6 See for example Ofgem's views reported in the Commission's decision in Case No COMP/M.4517 Iberdrola/Scottish Power, at paragraphs 17 and 33 to 37. See also the Commission's decision in Case No COMP/M.5224 EDF/British Energy, at paragraph 17.
- 7 See for example, the decision of the CNC in Case 624/07 Iberdrola Generación http://www.cncompetencia.es/Inicio/GestionDocumental/tabid/76/Default.aspx?EntryId=112347&Command=Core_Download&Method=attachment.
- 8 Judgment of the Tribunal Supremo: http://www.cncompetencia.es/Inicio/GestionDocumental/tabid/76/Default.aspx?EntryId=113839&Command=Core_Download&Method=attachment
- 9 Judgment of the Audiencia Nacional of 23 March 2010: http://www.cncompetencia.es/Inicio/GestionDocumental/tabid/76/Default.aspx?EntryId=112350&Command=Core_Download&Method=attachment
- 10 <http://www.autoritedelaconurrence.fr/pdf/avis/11d09.pdf>
- 11 The differing terminology and specifications of balancing and reserve services across Europe can be confusing. For a useful comparison, see here: http://www.eee.manchester.ac.uk/research/groups/ees/publications/reportstheses/aoe/rebours%20et%20al_tech%20rep_2005B.pdf
- 12 http://www.bundeskartellamt.de/wEnglisch/download/pdf/2011-05-05_SU_Strom_Executive_Summary_EN_final-2.pdf
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