

Application in the energy sector

Understanding competition law

Competition
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This guideline *Application in the energy sector* is published with 

Articles 81 and 82 of the EC Treaty and the Competition Act 1998 are applied and enforced in the United Kingdom by the Office of Fair Trading (the OFT). In relation to the regulated sectors these provisions are applied and enforced, concurrently with the OFT, by the regulators for communications matters, gas, electricity, water and sewerage, railway and air traffic services (under section 54 and schedule 10 of the Competition Act 1998) (the Regulators). Throughout the guidelines, references to the OFT should be taken to include the Regulators in relation to their respective industries, unless otherwise specified.

The following are Regulators:

- the Office of Communications (OFCOM)
- the Gas and Electricity Markets Authority (Ofgem)
- the Northern Ireland Authority for Energy Regulation (OFREG NI)
- the Director General of Water Services (OFWAT)
- the Office of Rail Regulation (ORR), and
- the Civil Aviation Authority (CAA).

This guideline provides general advice and information about the application and enforcement by Ofgem and the OFT of Articles 81 and 82 of the EC Treaty and the Chapter I and Chapter II prohibitions contained in the Competition Act 1998. It is intended to explain these provisions to those who are likely to be affected by them and to indicate how Ofgem and the OFT expects them to operate. Further information on how the OFT has applied and enforced competition law in particular cases may be found in the OFT's decisions, as available on its website from time to time.

This guideline is not a substitute for the EC treaty nor for regulations made and notices provided under it. Neither is this guideline a substitute for the Competition Act 1998 and the regulations and orders made under it. It should be read in conjunction with these legal instruments, community case law and United Kingdom case law. Anyone in doubt about how they may be affected by the EC treaty and the Competition Act 1998 should seek legal advice.

Contents

Part		Page
1	Introduction	2
2	Legal context	4
3	Economic analysis	9
4	Process for investigation	22
5	Transitional arrangements	29

1 Introduction

¹ The Competition Act 1998 and other Enactments (Amendment) Regulations 2004 SI 2004 No 1261 entered into force on 1 May 2004 and provides for the implementation of the Council EC regulation 1/2003 which requires national competition authorities and the courts of Member States to apply and enforce Articles 81 and 82.

- 1.1** The Competition Act 1998 (CA98) as amended by SI 2004, No 1261¹ confers on the Office of Fair Trading (OFT) and concurrently on the sector regulators in relation to their respective industries, powers to apply and enforce Articles 81 and 82 of the EC Treaty (Article 81 and Article 82 respectively) as well as the Chapter I and II prohibitions of the CA98.
- 1.2** Article 81 and the Chapter I prohibition contained in section 2(1) of the CA98 prohibit agreements between undertakings, decisions by associations of undertakings and concerted practices (agreements) which have the object or effect of preventing, restricting or distorting competition. Article 81 applies to agreements which may affect trade between Member States in the EU. The Chapter I prohibition applies to agreements implemented or intended to be implemented in the United Kingdom (or a part thereof), which may affect trade within the United Kingdom.
- 1.3** Article 82 and the Chapter II prohibition contained in section 18(1) of the CA98 prohibit conduct by one or more undertakings which amounts to the abuse of a dominant position in a market (conduct). Article 82 applies to conduct within the common market in so far as it may affect trade between Member States. The Chapter II prohibition applies if the dominant position is held within the United Kingdom and the conduct in question may affect trade within the United Kingdom (or a part thereof).
- 1.4** The competition law guideline *Application in the energy sector* (the guideline) provides advice and information about the factors which the Gas and Electricity Markets Authority (the Authority) will take into account when considering whether, and if so how, to exercise its powers under the CA98.² The Office of Gas and Electricity Markets (Ofgem) exercises certain functions under the CA98 on behalf of the Authority in accordance with the Authority's Rules of Procedure. For the purpose of this document Ofgem and the Authority are used interchangeably unless specified otherwise. This guideline is not exhaustive. It will be necessary to consider the circumstances of each case on an individual basis, with reference to the guideline.

² This guideline should be read in conjunction with other guidelines in the series – see the OFT website www.oft.gov.uk

- 1.5** The guideline was originally published in March 2001 and this first revision is being made to reflect the modernisation of EC competition law and the development of recent case law. The guideline will be updated from time to time, in the future, to take account of relevant developments in the energy sector. It will also need to take account of any changes to competition law guidelines issued by the OFT, other regulators, the European Commission and the development of relevant case law applying the CA98 and the EC Treaty. Consultation with interested parties, including the OFT and other sector regulators, will take place before making any changes to the guideline.³
- 1.6** Part 2 of the guideline sets out the legal context within which Ofgem will be operating. It explains Ofgem's powers under the CA98 and the relationship of these powers with other relevant legal provisions. Part 3 provides an economic analysis of the application of the CA98, with reference to the specific economic characteristics of the energy sector. The process for carrying out investigations and, in particular, how Ofgem intends to use its powers under the CA98, the Gas Act 1986 (as amended) and the Electricity Act 1989 (as amended) is discussed in Part 4. Part 5 describes Ofgem's approach to considering agreements covered by the transitional arrangements in Schedule 13 to the CA98.

³ The latest version of the guideline will be kept in the Ofgem library and will be available on Ofgem's website www.ofgem.gov.uk and on the OFT's website www.of.gov.uk

2 Legal context

The Competition Act 1998 as amended

2.1 The CA98 confers on the Authority and other sectoral regulators concurrent powers to apply and enforce Articles 81 and 82 of the EC Treaty as well as the Chapter I and II prohibitions. The application of these powers will be discussed in this guideline. They include the ability:

- to investigate suspected infringements⁴
- to impose interim measures during the investigation⁵
- to give directions to bring an infringement to an end⁶
- to apply Article 81(3) to agreements which infringe Article 81(1) and section 9 to agreements which infringe the Chapter I prohibition
- to accept binding commitments to address competition concerns, where appropriate⁷
- to impose financial penalties on undertakings of up to 10 per cent of an undertaking's worldwide turnover in the business year preceding the date of the decision.⁸

2.2 The CA98 also provides the OFT with powers to assist, or act on behalf of, the European Commission in connection with European Commission investigations regarding Articles 81 and 82. The OFT can also carry out an inspection on behalf of a national competition authority (NCA) of another Member State, if requested. The Authority does not have direct powers under the CA98 to assist the European Commission or other Member States by carrying out an inspection of premises on their behalf. However, Ofgem may assist fully in such investigations, which relate to Ofgem's areas of jurisdiction and where Ofgem has expertise.

Ofgem's jurisdiction

2.3 The jurisdiction of the Authority with regards to the application of Article 81, Article 82, Chapter I or Chapter II prohibitions is set out in section 36A of the Gas Act 1986 and section 43 of the Electricity Act 1989 ('Gas Act' and 'Electricity Act' respectively). Ofgem will consider

⁴ Sections 26, 27, 28 and 28A.

⁵ Section 35.

⁶ Section 32.

⁷ Section 31A.

⁸ Section 36 and Competition Act 1998 (Determination of Turnover for Penalties) Order 2000 as amended by the Competition Act 1998 (Determination of Turnover for Penalties) (Amendment) Order 2004. For more information refer to the competition law guideline *OFT's guidance as to the appropriate amount of a penalty* (OFT423).

on a case-by-case basis whether the agreements or conduct in question relate to:

- commercial activities connected with the generation, transmission or supply of electricity,⁹ or
- licensable activities or other activities (such as off-shore activity) which are ancillary to those subject to licences for transportation, shipping or supply of gas.¹⁰

⁹ The provisions relating to the use of the electricity interconnector introduced by the Energy Act 2004 have not yet commenced.

¹⁰ For detail on the activities relating to gas licensed by the Authority see section 5(1) of the Gas Act 1986. The provisions relating to the gas interconnector introduced by the Energy Act 2004 have not yet commenced.

¹¹ In accordance with the *Competition Act 1998 Concurrency Regulations* (SI 2004 No 1077) and the competition law guideline for the *Concurrent application to regulated industries* (OFT405).

¹² In accordance with the *Commission Notice on cooperation within the Network of Competition Authorities* (2004/C101/03).

2.4 Where an agreement or conduct has an impact upon competition in the markets regulated by the Authority, the case will be allocated by agreement with the relevant competition authorities concerned to the UK competition authority 'best' placed to act.¹¹ Where an agreement or conduct has an effect upon competition in the markets regulated by the Authority and on competition in another EC Member State, the case will be allocated to the competition authority in the Member State 'well' placed to act.¹²

The application of national and EC Competition Law

2.5 The CA98 provides the procedures to which the Authority must adhere when exercising its powers. These procedures are the same for the application and enforcement of EC competition law in conformity with Articles 81 and 82 as for the Chapter I and II prohibitions in national competition law. Therefore, the process (see Part 4) and economic analysis (see Part 3) in this guideline apply equally to the investigation of potential infringements of EC competition law (Articles 81 or 82) as to the investigation of potential infringements of the UK prohibitions (Chapter I or Chapter II prohibitions).

Obligation to apply Articles 81 and 82

2.6 Article 3(1) of the Modernisation Regulation requires the national competition authorities of the Member States (including the Authority) to apply Articles 81 and 82 where they apply national competition law and when such legislation is applied to agreements or conduct which may affect trade between Member States. Therefore, where Chapter I and/or II prohibitions apply, and there is an actual or potential effect

¹³ In cases where an undertaking has committed an infringement of both an EC competition law (Articles 81 or 82) and a UK prohibition (Chapter I or Chapter II), the undertaking will not be penalised twice for the same anti-competitive effects.

¹⁴ Refer to European Commission *Guidance on the effect on trade concept contained in Articles 81 and 82 of the EC Treaty* (2004/ C 101/07).

¹⁵ Standard Conditions 25 and 29 of the Electricity Supply Licence and of the Gas Supply Licence.

on trade between Member States, the Authority shall apply Article 81 and/or 82 in accordance with Article 3 of the Modernisation Regulation (see paragraph 2.13 of this guideline). The Authority shall decide whether to apply the Chapter I or Chapter II prohibitions in parallel to the application of Articles 81 or 82.¹³

Interaction with sectoral powers

- 2.7** When carrying out duties under the Gas Act and the Electricity Act 1989 the Authority may, in certain circumstances, be exercising powers which pursue the same objective as Articles 81 and 82. As such the exercise of sectoral powers would be considered an application of national competition law for the purposes of Article 3 of the Modernisation Regulation. Where the exercise of sectoral powers is considered an application of national competition law and has an actual or potential effect on trade between Member States,¹⁴ the Authority will also apply Articles 81 and/or 82 in accordance with Article 3(2) of the Modernisation Regulation (see paragraph 2.13 of this guideline). Where the Authority is exercising powers which predominantly pursue a different objective to that being pursued by Articles 81 and 82, it would not apply these Articles.
- 2.8** The Authority will consider on a case-by-case basis whether the exercise of sectoral powers amounts to an application of national competition law. The Authority will consider whether the predominant objective of the sectoral power is consistent with that of Articles 81 and 82. In considering the objective of the sectoral power in question, the Authority shall have regard to whether the legal base stems from EC law or from national legislation.
- 2.9** Where the Authority exercises a power conferred by the Gas or Electricity Acts which predominantly pursues an objective different to that being pursued by Articles 81 and 82, the obligation to apply EC competition law does not arise. For example, the provisions for invoking the supplier of last resort or those that ensure the efficient use of gas and electricity have the objectives of security of supply and the promotion of environmental standards objectives respectively.¹⁵ In such cases, the exercise of sectoral powers does not fall within the scope of Articles 81 or 82 and the Authority would not apply these Articles.

Interaction with other national laws

2.10 The Enterprise Act 2002 empowers the OFT and certain regulators (including the Authority) to make references to the Competition Commission (CC) for the investigation of particular markets.¹⁶ Market references may be made to the CC where it appears that the structure of the market or the conduct of suppliers or customers is harming competition. The obligation to apply EC competition law (Articles 81 and 82) may arise to the extent that the objective of market references is predominantly similar to that of Articles 81 and/or 82 and the conduct in question affects trade between Member States. Further details of the Authority's powers under Part 4 of the Enterprise Act 2002 are set out in the OFT Enterprise Act guidance *Market investigation references* (OFT511).

¹⁶ Part 4 of the Enterprise Act 2002.

2.11 The Enterprise Act gives the OFT powers to investigate individuals suspected of having committed the criminal cartel offence. The regulators (including the Authority) with concurrent powers under the CA98 do not have any power to investigate the criminal cartel offence. The competition law guideline *Modernisation* (OFT 442) sets out the OFT's approach to the interaction of EC competition law Articles 81 and 82 with this power.¹⁷

¹⁷ Paragraphs 4.41 to 4.27.

Effect on inter-state trade

2.12 Where the exercise of a provision may be considered an application of national competition law within the meaning of Articles 81 or 82, the Authority will also consider whether the agreement or conduct has an actual or potential effect on inter-state trade. The increased interconnection of GB gas and electricity networks and the new infrastructures for gas imports (such as LNG terminals), mean that the Authority will have to analyse on a case-by-case basis whether a particular agreement or conduct has an effect on trade. The Authority will act consistently with the principles developed by the EC case law in interpreting this concept and will have regard to the notice issued by the European Commission *Guidance on the effect on trade concept contained in Articles 81 and 82 of the EC Treaty* (2004/C 101/07).

Applying Articles 81 and 82

2.13 Where the criteria for applying Articles 81 and 82 are met, the Authority must apply such national competition law in accordance with Article 3(2) of the Modernisation Regulation. Article 3(2) prevents national competition authorities (including the Authority) from prohibiting agreements, decisions or concerted practices by undertakings which would be permitted under Article 81. This could be because the agreement does not restrict competition under Article 81(1), the conditions of Article 81(3) are met or the agreement is covered by an EC block exemption or a continuing individual notification exemption.¹⁸

2.14 The Authority may apply national competition laws more strictly and prohibit unilateral conduct under national legislation even if that conduct would be permitted under Article 82.

Conforming with Community law

2.15 Article 16(2) of the Modernisation Regulation prevents national competition authorities (including the Authority) from taking decisions under Article 81 or Article 82 which would run counter to decisions by the European Commission on the same agreement or conduct. They must also avoid giving decisions which would conflict with a decision contemplated by the Commission.

2.16 Section 60 of the CA98 places an obligation on the UK authorities (including the Authority) to answer questions arising under Part I of the CA98 (which includes the Chapter I and Chapter II prohibitions) in such a way as to ensure consistency with Community law. First, they must ensure that there is no inconsistency with either the treatment of corresponding questions arising in Community law, insofar as this is possible, having regard to any relevant differences between the provisions concerned. The competition law guideline *Modernisation* (OFT442)¹⁹ contains further detail on how conformity with EC law will be ensured.

¹⁸ The Modernisation Regulation abolishes the notification system for individual exemptions under Article 81(3) but individual exemptions issued prior to May 2004 remain binding until their expiry. There are no continuing individual exemptions under section 9(1) of the CA98 to agreements relating to the gas and electricity sectors.

¹⁹ Paragraphs 4.7 to 4.12.

3 Economic analysis

3.1 This Part highlights some of the characteristics of the gas and electricity industries that would be likely to affect the economic analysis in applying competition law. This includes characteristics arising from the existence of statutory monopoly businesses as well as other characteristics such as the relatively inelastic nature of supply and demand in the wholesale gas and electricity markets.

The importance of regulating dominant incumbents²⁰

3.2 The scope of monopoly and of public ownership in the electricity and gas industries (and other utility sectors) prior to privatisation gave rise to patterns of activity that were not subject to normal market disciplines. Not only was there a lack of competitive pressures on cost and price levels, but products, services, marketing methods, etc, tended to be relatively standardised, and incentives to respond to the varied requirements of different electricity and gas customers were weak. The unbundling and separation of natural monopoly activities from the other parts of the industries facilitated the subsequent introduction of competition to parts of the supply chain. This has enabled incumbents and new entrants alike to take advantage of the opportunities to better serve the interests of customers through:

- prices that more closely reflect efficient costs
- new tariff structures
- new products and services
- new combinations of products and services
- the offering of alternative billing and payment methods, and
- new marketing methods.

3.3 Such measures have been important in the transition from statutory or *de facto* monopoly to effective competition in gas supply, electricity supply, electricity generation and a range of related services. In its application of the UK and EC competition law and in particular the Chapter II prohibition/Article 82, Ofgem will therefore continue to be particularly vigilant in seeking to ensure that the conduct of undertakings does not restrict the opportunities for others to compete in the energy markets. This could occur, for example, by

²⁰ Ofgem notes that incumbents may not necessarily be dominant as competition develops and new entrants erode their dominance. New entrants may develop a position of dominance over time.

preventing the introduction of new products or services or by artificially restricting the profits that could be made by new entrants from the introduction of new products and services.

Characteristics specific to the gas and electricity sector

3.4 The application of the CA98 to the gas and electricity industries will raise a number of challenges associated with the specific economic conditions to be found in the energy sector. Ofgem will ensure that it applies its powers under the CA98 in a manner that is consistent with relevant UK and EC jurisprudence on competition issues that arise in other sectors, as far as is possible having regard to any relevant differences between the sectors concerned.

3.5 Ofgem considers that there are factors unique to the energy sector or not common in most other markets which are relevant to the application of competition law. The relevant factors include:

- the existence of monopoly providers of gas transportation, and electricity transmission and distribution networks, which are unlikely to be replicated due to the cost conditions faced by any undertaking seeking to duplicate such networks (including the high sunk costs associated with construction and other costs arising from planning and environmental constraints)
- the importance in the transition from monopoly to competition across a range of activities of ensuring effective separation of the network services from the potentially competitive parts of the supply chain
- the extent of market power of incumbent undertakings in parts of the gas and electricity industries, including supply, metering, connections and storage markets
- the existence of price controls for gas transportation and electricity transmission and distribution, where market power is particularly strong
- the low elasticity of supply and demand for electricity and gas, particularly over short periods and in specific locations. In part this results from the limited storability of electricity, and to a lesser

extent gas, which limits the substitution opportunities between time periods on either the supply side or the demand side

- the relative complexity of and the mandatory adherence by market participants to the various rules, codes and agreements in the gas and electricity markets. These include codes that aim to keep the gas and electricity networks operating within safe and efficient operational limits, and which govern customer transfers as well as the connection to and the use of electricity and gas systems, and
- the economic linkages between different parts of gas and electricity supply chains including: horizontal and vertical linkages, between spot and forward markets, and between electricity and gas wholesale markets.

3.6 All of these factors may not be relevant for every case that Ofgem considers under the CA98. For example, the limited storability of electricity, the low elasticity of demand for electricity particularly over short periods and the relative inelasticity of supply for electricity at some periods are likely to be factors that are highly relevant to an investigation of electricity generation activities. For cases regarding the supply of gas and electricity to domestic customers relevant factors are more similar to those considered by the OFT in relation to other markets.²¹

3.7 Ofgem will adopt approaches to applying the CA98 that are, as far as possible, consistent with those set out in other competition law guidelines. The particular characteristics of the energy sector identified above will, however, affect the emphasis that is placed on, and the weight given to, particular aspects of the analysis set out in other guidelines when assessing:

- market definition
- market power and in particular the assessment of dominance
- whether an abuse of a dominant position has occurred
- agreements between undertakings, decisions by associations of undertakings and concerted practices, and

²¹ Refer to the competition law guideline *Assessment of market power* (OFT415).

- the exclusion from the CA98's prohibitions, for services of general economic interest, under paragraph 4 of Schedule 3 to the CA98.

3.8 The remainder of this Part of the guideline explains how Ofgem intends to approach these five issues when applying the CA98 to the specific combination of circumstances in the gas and electricity industries identified above.

Market definition

3.9 Defining the relevant market is not an end in itself but a key step in identifying the competitive constraints on an undertaking. Market definition establishes the framework for assessing market power and analysing the effects of agreements or conduct. The Authority will define the market for each individual case as conditions of competition may change over time and will depend upon the particular case.²² A market definition normally contains a product, a geographic area and a temporal dimension, where appropriate.

3.10 As explained in the competition law guideline *Market definition* (OFT403), this will include a consideration of the following:

- the extent to which customers would switch to other products following a hypothetical price increase; as a rough rule of thumb the OFT considers the relevant period of time in which to assess switching behaviour to be one year, but states that the relevant time period may be shorter, for example, in markets where transactions are made more frequently
- the ability of suppliers to enter the market at short notice and act as a competitive constraint on prices
- the effect of the timing of production and purchasing on a customer's ability to switch products; in particular the guideline mentions the non-substitution of peak and off-peak services with regards to electricity supply.²³

3.11 In defining markets, one of the standard procedures to identify the extent of substitutability between products is to ask whether customers would switch products should a hypothetical monopolist

²² Coca-Cola Company and Coca-Cola Enterprises Inc v Commission T-125 and 127/97 [2000], ECR II 1733, paragraph 82.

²³ See Part 5 of the competition law guideline *Market definition* (OFT403) referring to temporal markets.

increase prices by a small but significant non-transitory amount above competitive levels (such as five to ten per cent). In electricity and gas markets, it is common to experience wholesale price movements that are many times higher than these benchmark numbers and which, in some cases, may persist for a relatively short period of time. As such when considering the relevant market Ofgem may adapt the assessment of hypothetical price increases or adopt alternative analysis when defining the relevant market.

- 3.12** The consideration of hypothetical price increases where a dominant undertaking is present may be particularly difficult because of the problems of identifying clear and appropriate benchmarks. Hence, the process of defining a market cannot be carried out in isolation, but should be considered alongside other evidence on market power and the undertaking's conduct.

Temporal markets

- 3.13** Due to the limited storability of electricity and, to a lesser extent gas, one of the standard mitigating constraints on the abuse of very short-term market power – the ability of undertakings and their customers to substitute transactions in one time period with transactions in another time period - is largely absent. In addition the need to keep the gas and electricity networks within safe and efficient operational limits has resulted in the introduction of formal balancing arrangements in the wholesale markets for gas and electricity on a daily and half hourly basis respectively. For this reason trading and contract settlement occurs more frequently and in relation to shorter periods of time than in many other markets. As such, in certain circumstances, the appropriate definition of the market may be limited to a shorter duration than has generally been used for analysis in many other industries.

Related markets

- 3.14** It is recognised in competition law that in many situations there may not be a single relevant market. An important class of cases concerns behaviour in one relevant market or market segment that may have anti-competitive effects in other related markets or market segments.

Such cases are important in gas and electricity markets, bearing in mind the economic linkages between the different activities in the sectors. For example, a particular entry point on a transportation network may initially be defined as a relevant market because customers using that particular entry point are likely to have limited substitution possibilities. The effects of conduct at that entry point, however, are likely to have economic effects on other parts of the network and potentially impact on the traded gas and electricity markets. In such circumstances it is appropriate that any market definition exercise does not unduly restrict the scope of an investigation and that it takes fully into account all of the relevant economic effects.

3.15 As explained in the competition law guideline *Abuse of a dominant position* (OFT402), Article 82 and the Chapter II prohibition apply where undertakings dominant in one market commit an abuse in a different but closely associated market.²⁴ In such cases it is not necessary to show that the abuse was committed in the market in which the undertaking is dominant. Such cases may be important in gas and electricity markets as many gas and electricity suppliers are now active in the supply of both electricity and gas and of other products. Similarly conduct or agreements relating to electricity generation or gas production may have an impact on downstream supply markets.

3.16 Ofgem will therefore have regard to the actual or potential effects of a firm's conduct on different activities in deciding the scope of an investigation and in defining relevant markets. Often the behaviour of competitors will provide practical examples of the relevant activities to consider in an investigation.²⁵

The assessment of market power, and in particular, the assessment of dominance

3.17 The European Court has defined dominance as

'a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to

²⁴ Case T-83/91 Tetra Pak v European Commission [1994] ECR II-755.

²⁵ Ofgas' investigation into the market for storage and related services in 1998 (*Review of the supply of gas storage and related services, The Director General's final proposals*, Ofgas, September 1999) showed the importance of considering all relevant markets when assessing market power. The investigation concluded that the conduct of BG plc, including its pricing, was affected by and could affect the related markets for spot and peak gas (swing) and interruptible supply contracts.

behave to an appreciable extent independently of its competitors, customers and ultimately of consumers.’²⁶

²⁶ Case 27/76 United Brands v European Commission [1978] ECR 207, [1978] 1 CMLR 429.

3.18 Dominance may involve more than one undertaking (joint dominance). An important indicator of dominance on the supply side is to consider whether a firm or firms has or have the ability consistently to raise prices above competitive levels. In cases involving a potentially dominant buyer, the test is reversed by considering whether a firm or firms has or have the ability consistently to reduce prices below competitive levels.

3.19 When considering whether undertakings can act to an appreciable extent independently of their customers and competitors, Ofgem will look at a range of factors including:

- customers’ behaviour and options (for example, awareness of competition, the extent to which alternative providers are chosen, the extent to which substitutes are available)
- competitors’ behaviour and capacities (for example, their range of offers, their ability to increase output within the relevant time period)
- market operation (for example, the extent of barriers to entry and exit)
- an undertaking’s conduct in a market with regards to price setting as well as its financial performance (such as consistently earning a rate of profit significantly above competitive levels), and
- market share.

3.20 There are no market share thresholds for defining dominance.²⁷ However, in developing the case law on dominance, the European Court has stated that dominance can be presumed, in the absence of evidence to the contrary, where an undertaking has a market share persistently above 50 per cent.²⁸ The OFT considers it unlikely that an undertaking will be individually dominant if its market share of the relevant market is below 40 per cent but considers that dominance could be established below this figure if there are other relevant

²⁷ See the competition law guideline *Assessment of market power* (OFT415), paragraph 2.11.

²⁸ Case C62/86, AKZO Chemie BV v the European Commission [1993] 5 CMLR 215.

²⁹ See the competition law guideline *Assessment of market power* (OFT415), paragraph 2.12.

factors (such as weak position of competitors and high entry barriers), which provide strong evidence of dominance.²⁹

3.21 In Great Britain's gas and electricity sectors, due to the particular economic characteristics to be found there (including relatively inelastic supply and demand conditions), there are circumstances where undertakings may have the ability substantially and consistently to influence prices, and therefore to act independently of customers and competitors, even though their market shares fall below normal thresholds for considering dominance. This may particularly apply to markets for wholesale gas and electricity and to markets for capacity on gas and electricity networks.

3.22 Therefore, Ofgem will seek, wherever possible, to assess demand and supply substitution possibilities and actual behaviour in addition to considering proxies such as market share.

The assessment of whether an abuse of a dominant position has occurred

3.23 It is the abuse of, not the existence of, a dominant position that is prohibited by Article 82 and the Chapter II prohibition. Therefore, where an abuse of a dominant position is alleged or suspected and it is found that an undertaking or group of undertakings has the ability to act, to an appreciable extent, independently of its customers and competitors (as manifested, for example, by an ability to raise prices above competitive levels to an extent that can cause significant harm), Ofgem will investigate further, to determine whether or not any infringement has occurred.

3.24 Such an investigation will focus on the commercial conduct of the relevant undertaking(s) and on the effects on customers of the conduct or agreements entered into by undertakings. Conduct by dominant undertakings that seeks to exclude or exploit actual or potential competitors is likely to breach Article 82 or the Chapter II prohibition.

The assessment of an abuse of a dominant position in temporal markets

3.25 The effect of abusive conduct on customers and on competition can be similar whether they are caused either by large price increases that are sustained only for a short period or small price increases over a long period. This is of particular relevance given that the relatively inelastic supply and demand conditions provide significantly enhanced opportunities for the exploitation of market power, enabling parties with relatively low market shares to affect prices. In assessing potential abuses of dominance in temporal markets, Ofgem will consider the effects of any deviations from competitive price levels even for relatively short durations. This may particularly apply to markets for wholesale gas and electricity and to markets for capacity on gas and electricity networks.

The assessment of whether a dominant incumbent is engaging in exclusionary behaviour

3.26 Bearing in mind the particular concerns about exclusionary behaviour in the gas and electricity industries, Ofgem considers that it is appropriate when considering whether an undertaking is engaging in such behaviour to apply a relatively strict cost-based test. Where prices are found to be below average variable cost and are a means of eliminating a competitor, the Authority is likely to presume this conduct abusive.³⁰ However, there are legitimate commercial reasons for pricing below average variable cost,³¹ which may not constitute an abuse.

3.27 Ofgem may consider an **avoidable costs** test more appropriate in assessing conduct in some gas and electricity markets. This test includes elements of costs that are often described as fixed costs that would not be included in a variable cost test. In cases where the costs are unlikely to be similar (such as in the electricity generation market) the Authority may also consider pricing below avoidable cost an abuse if there is an intention to eliminate an actual or potential competitor from a market or markets.³²

³⁰ Case C62/86, AKZO Chemie BV v the European Commission [1993] paragraph 71.

³¹ Refer to Aberdeen journals No.2 Aberdeen Journals Limited v The Office of Fair Trading [2003] CAT 11, paragraph 357.

³² Case C62/86, AKZO Chemie BV v the European Commission [1993] paragraph 71.

The assessment of agreements between undertakings, decisions by associations of undertakings and concerted practices under Article 81 and the Chapter I prohibition

3.28 Article 81 and the Chapter I prohibition prohibit those agreements between undertakings, decisions by associations of undertakings, and concerted practices which prevent, restrict or distort competition, or are intended to do so and, in the case of Article 81, may affect trade between Member States. The CA98 includes a list of illustrative examples of agreements, decisions or practices, which:

- directly or indirectly fix purchase or selling prices or any other trading conditions
- limit or control production, markets, technical development or investment
- share markets or sources of supply
- apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage
- make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

3.29 There are a number of features and requirements in gas and electricity markets that seek to ensure safe, secure and efficient operation of gas and electricity networks. These arrangements may contain provisions that have the effect of restricting competition as an unavoidable consequence of achieving their objectives relating to safety, security and efficiency. Undertakings are responsible for self-assessing whether agreements satisfy the criteria under 81(3) or section 9(1) and, as such, shall not be prohibited.

3.30 If an agreement satisfies all the conditions of Article 81(3) and section 9 (1), it is automatically exempt from the application of Article 81(1) and the Chapter I prohibition- no prior decision to that effect being required. The conditions of Article 81(3) and section 9(1) are similar; these are that the agreement:

- produces an improvement in the production or distribution (of goods) or promotes technical or economic progress
- provides a fair share of the benefits to consumers
- does not impose restrictions which are not indispensable to obtaining the improvements, and
- would not result in a substantial elimination of competition.

3.31 The Modernisation Regulation abolishes the system of notifying the Commission of agreements for individual exemption under Article 81(3). Likewise the Competition Act 1998 and other Enactments (Amendment) Regulations 2004 repealed the provisions in the UK for notifying Ofgem and the other Competition Authorities of agreements for exemption. An individual exemption decision made by the European Commission prior to 1 May 2004 is binding on Ofgem until its expiry. Prior to the repeal of the notification provisions in the UK no individual exemptions were granted for agreements relating to the gas and electricity sectors in Great Britain.³³

3.32 The Modernisation Regulation does not remove the ability for the Council of Ministers or the Commission to issue a block exemption from competition law for particular agreements,³⁴ which satisfy the conditions of Article 81(3). Where an agreement is covered by an EC block exemption regulation the parties to the restrictive agreement are relieved of the burden of showing that their agreement satisfies the conditions of Article 81(3). They only have to prove that their agreement is block exempted.

3.33 The Authority may in accordance with Article 29(2) of the Modernisation Regulation withdraw the benefit of an EC block exemption in respect of the United Kingdom or a part of it in a particular case from any agreements if the following conditions are met:

- the territory of the United Kingdom, or a part of it, has all the characteristics of a distinct geographical market, and
- the agreements in question have effects that are incompatible with Article 81(3) in the territory of the United Kingdom or part of it.

³³ Details of notification made under the CA98 are available on the OFT's Public Register.

³⁴ For details of the block exemptions currently issued by the Commission refer to the www.europa.eu.int/comm/competition/antitrust/legislation

The exclusion from the CA98's prohibitions for services of general economic interest, under paragraph 4 of Schedule 3 to the CA98

3.34 Neither Article 81, the Chapter I prohibition, Article 82 nor the Chapter II prohibition apply to an undertaking entrusted with the operation of **services of general economic interest** or having the character of a revenue-producing monopoly in so far as the prohibition would obstruct the performance, in law or in fact, of the particular tasks assigned to that undertaking. Ofgem will therefore be required to assess whether or not, in a particular case, this exclusion is applicable.

3.35 It is Ofgem's view that there are no revenue producing monopolies in the gas and electricity sector of Great Britain. Therefore the remainder of this Part will focus on the exclusion for services of general economic interest (SGEI).

3.36 As explained in the competition law guideline *Services of general economic interest* (OFT421), the interpretation of the exclusion will be particularly narrow, with undertakings seeking to benefit from the exclusion having to prove that they meet all the requirements of the exclusion. Where an undertaking is able to satisfy all the requirements the SGEI exclusion will only apply to particular obligations entrusted to the undertaking and will not apply to the undertaking itself or its activities generally.

3.37 The Authority will only consider an SGEI exemption where undertakings are able to show that:

- they have been 'entrusted' with the operation of a service of general economic interest
- the application of the Article 81, the Chapter I prohibition, Article 82 nor the Chapter II prohibition would obstruct the performance, in law or in fact, of the particular task entrusted to it.

3.38 For example, the deregulation and introduction of competition into the gas network sector has resulted in independent gas transporters building and operating both extensions to the existing network and

constructing separate networks. This reduces the likelihood that gas network providers will be considered to be entrusted with a service of general economic interest.

4 Process for investigation

Sector specific regulation

4.1 Unlike most sectors covered by the CA98, undertakings' behaviour in the gas and electricity markets, including that of dominant companies, is regulated by sector specific Acts of Parliament that have created a licensing regime. Among other things, these Acts and the licences regulate and aim to protect the interests of gas and electricity customers. This includes restrictions on some undertakings' level and structure of charges and the prevention of unduly discriminatory behaviour by network operators. The Gas and Electricity Acts set out the factors the Authority should consider when deciding whether to use its powers under these Acts to address anti-competitive behaviour. In particular, the Authority may not take enforcement action under the sector-specific Acts if it is satisfied that it would be more appropriate to address the issue under the CA98. In applying the CA98,³⁵ the Authority shall only take account of its duties under the Gas and the Electricity Acts to the extent that they are relevant factors under UK and EC competition law.

³⁵ See section 28 of the Gas Act 1986 and section 25 of the Electricity Act 1989.

4.2 The following Part of this guideline is about how Ofgem will proceed with a complaint relating to Article 81, Article 82, Chapter I or Chapter II prohibitions. It also explains how the Authority intends to use its powers under the Gas and Electricity Acts, Part 4 of the Enterprise Act 2002 and the CA98 to ensure that any anti-competitive behaviour is most effectively addressed without undertakings facing 'double jeopardy'.³⁶

³⁶ 'Double jeopardy' would occur where an undertaking faced the possibility of being subject to a penalty more than once for the same infringement.

Decision on whether to commence a CA98 investigation

4.3 Once there is agreement that the Authority is responsible for a case,³⁷ Ofgem will attempt as quickly as possible to determine whether the complaint falls within its administrative priority. As part of this process Ofgem will consider whether the case meets the requirements of section 25 of the CA98. This entails considering whether there are reasonable grounds for suspecting that Article 81, Article 82, the Chapter I prohibition and/or the Chapter II prohibition of the CA98 have/has been infringed, and the potential economic effect of the agreement or conduct in the particular case. To the extent that

³⁷ See the competition law guidelines *Concurrent application to regulated industries* (OFT405) and *Modernisation* (OFT442), Part 8, and the *European Commission's Notice on Co-operation within the Network of the Competition Authorities*, OJ C101, 27 April 2004.

it is relevant, Ofgem will use its existing knowledge of the issues to determine the nature of the complaint. Where it cannot be determined quickly whether a complaint falls within its administrative priorities, Ofgem may seek information informally from undertakings to decide whether to commence an investigation.

- 4.4** Where there are insufficient grounds for suspecting an agreement or conduct infringes Article 81, Article 82, the Chapter I prohibition and/or the Chapter II prohibition, Ofgem shall not commence a formal CA98 investigation. In such circumstances, Ofgem shall inform the parties bringing the complaint and those to whom the complaint relates of this decision in writing.

Information gathering

- 4.5** When investigating potential infringements under the CA98, the Gas and Electricity Acts or issues under Part 4 of the Enterprise Act 2002, Ofgem may need to seek information from various undertakings and other relevant persons. When requesting information, Ofgem will specify the potential infringement it is investigating and the legal instrument under which the questions are posed. Where more than one of the Authority's powers (Article 81, Article 82, the Chapter I prohibition or the Chapter II prohibition or sector specific powers) is considered to be potentially appropriate, Ofgem may make separate information requests under each of these legal instruments. This will enable Ofgem to decide which specific power(s) are likely to be the most appropriate to address the conduct or agreement concerned.
- 4.6** If it becomes clear to Ofgem when conducting its investigation that a particular power is no longer appropriate to the particular case, it will cease to request information under the respective power and will inform the undertaking concerned. Also, Ofgem will inform an undertaking if a new infringement is suspected after the investigation has commenced, which may affect the powers Ofgem considers could be appropriate to address the suspected infringement(s).
- 4.7** Where information has been gathered using powers under the CA98, Ofgem may use information gathered to investigate other matters under the CA98, the Gas and Electricity Acts, or Part 4 of the

Enterprise Act 2002, subject to and in accordance with the provisions of these Acts, relevant EC legislation and case law. Where information has been received from the European Commission or an NCA in another Member State, Ofgem may only use this information for the following purposes:³⁸

- the application of Article 81 or 82 in relation to the subject matter for which it was collected, or
- the parallel application of national competition law to a case which is being considered under Article 81 or 82 and will lead to the same outcome.

³⁸ Article 12 Council Regulation EC1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty 16 December 2002 OJ L1, 4.1.2003, p 1.

Making representations

4.8 Section 31 of the CA98 requires the Authority, if it proposes to make a decision that Article 81, Article 82, the Chapter I or Chapter II prohibition has been infringed, to give written notice to the person or persons likely to be affected by the proposed decision and to give that person or persons an opportunity to make representations.

Enforcement action

4.9 As early as possible in the course of an investigation where infringements of more than one provision are under consideration, Ofgem will determine the most appropriate power(s) that apply to or remedy the competitive concerns identified.

4.10 Section 28 of the Gas Act 1986 and section 25 of the Electricity Act 1989 provide that the Authority shall not make a provisional or final order, or confirm a provisional order under either sector-specific Act, if it is satisfied that the CA98 is the most appropriate way of proceeding to address the issue. Section 30A(2) of the Gas Act 1986 and section 27A(2) of the Electricity Act 1989 prevent the Authority levying a financial penalty in a matter where it is satisfied that it is more appropriate to proceed under the CA98. The Authority will therefore not levy a financial penalty under the Gas or Electricity Act where a financial penalty under the CA98 has already been levied.

4.11 With regard to Articles 81 and 82, the Modernisation Regulation requires the Authority to apply these provisions as well as national competition law (as noted in Part 2 of this guideline). It is possible that certain provisions of the Gas and Electricity Acts could be deemed an application of national competition law and could relate to agreements or conduct, which have an actual or potential effect on trade between Member States. Where the Authority is satisfied that Articles 81 and/or 82 apply, Ofgem will not take enforcement action under the Gas and Electricity Acts. However, the Authority retains its discretion in deciding between taking enforcement action under the Gas and Electricity Acts or under competition law where only the Chapter I or Chapter II prohibitions would apply.

Accepting commitments

4.12 Under the CA98 as amended, the Authority may accept binding commitments from undertakings suspected of infringing Article 81, Article 82, Chapter I or Chapter II prohibitions. The Authority is required to have regard to the OFT's guidance when considering whether to accept commitments offered.³⁹ The Authority is only likely to accept commitments in cases where the competition concerns are readily identifiable, where the concerns are fully addressed by the commitments offered and the commitments are capable of being implemented. The Authority may accept commitments in respect of some of its competition concerns and continue its investigation in respect of other concerns arising from the same agreement or conduct.

³⁹ See the competition law guideline *Enforcement* (OFT407), Part 4, for further information.

4.13 In conformity with the guidance, the Authority will not, other than in exceptional circumstances, accept binding commitments in cases involving secret cartels between competitors which include:

- price-fixing
- bid-rigging
- establishing output restrictions or quotas
- sharing markets, and/or
- dividing markets

nor in cases of a serious abuse of a dominant position.

Imposition of penalties

- 4.14** The Authority is required to have regard to the OFT's guidance when determining the appropriate level of a penalty⁴⁰ it will impose for an infringement of Article 81, Article 82, the Chapter I prohibition and/or the Chapter II prohibition.
- 4.15** In cases where an undertaking has infringed both EC competition law (Articles 81 or 82) and UK prohibitions (Chapter I or Chapter II), the undertaking will not be penalised twice for the same anti-competitive effects.⁴¹ If a penalty or fine has been imposed by the European Commission, or by a Court or a body in another Member State in relation to the same anti-competitive agreement or conduct, the Authority will take this penalty or fine into account when determining the amount of penalty for that agreement or conduct.⁴²
- 4.16** In accordance with section 30A(2) of the Gas Act 1986 and section 27A(2) of the Electricity Act 1989, the Authority will not impose a penalty under these Acts if a penalty is being imposed under the CA98. When imposing a penalty under the CA98, the Authority does not have the ability to take into account its duty under the Gas Act 1986 and the Electricity Act 1989 to have regard to the ability of licensees to finance their activities.
- 4.17** When publishing any decisions following investigations, Ofgem will have regard to whether the information to be published is market sensitive. Ofgem will take this into account when deciding on the timing of announcements, as is current practice for announcements relating to price control proposals. This is in accordance with Ofgem's voluntary agreement with the London Stock Exchange.⁴³

Compliance

- 4.18** When setting penalties, in accordance with the OFT's guidance, Ofgem will consider the extent to which the undertaking has taken reasonable steps, taking into account the undertaking's resources, to put in place programmes designed to ensure compliance with the requirements of the CA98. The OFT has produced a range of material to assist companies in developing compliance programmes.⁴⁴

⁴⁰ Section 38 of the Competition Act 1998.

⁴¹ *OFT's guidance as to the appropriate amount of a penalty* (OFT423), paragraph 1.15.

⁴² See the above publication, paragraph 2.20.

⁴³ The voluntary agreement was published by the London Stock Exchange on 2 January 1996.

⁴⁴ These can be obtained directly from the OFT.

4.19 Ofgem expects companies within the gas and electricity sectors to have implemented corporate compliance programmes. Ofgem expects that such programmes will minimise the risk of infringing the prohibitions by systematically ensuring that all relevant employees are sufficiently knowledgeable of the provisions of competition law.

4.20 Compliance programmes are likely to vary between companies, particularly due to differing resources. A minimum programme might be expected to comprise at least four elements, with the depth with which each element is covered being dependent on a company's resources. The four elements are described below:

- support and personal commitment from senior management. This commitment needs to be both visible and continuous and will be essential to ensure that a culture of corporate compliance is instituted. Senior management commitment ensures that compliance is treated as important and encourages acceptance by other employees who will be more receptive to an initiative which is seen to be applied equally to senior managers.
- appropriate compliance policy and procedures will include a clear policy commitment to comply with competition law by not engaging in anti-competitive behaviour or condoning such behaviour in other parties. Measures to implement this policy could be put into personal development performance objectives, contracts and the establishment of disciplinary arrangements. Compliance procedures could include a framework within which employees can check whether or not a particular contract or deal is in breach of the law. This might involve a nominated expert or competition compliance officer. An effective mechanism to communicate the policy and procedures supported by a review process is important. For example, this could take the form of a manual or handbook provided to all relevant staff.
- training will form an essential aspect of any compliance programme. It should be designed to ensure that all relevant staff are given proper training on both the law and the company policy and procedures. It will not be sufficient to limit training to the implementation phase. It must be offered on a regular basis to

reinforce and update the message. Such training is likely to be an essential element of any induction programme for new staff, and

- evaluation of the effectiveness of the overall compliance programme is the final essential ingredient. This might include informal feedback at an individual level and perhaps as part of individual performance appraisal. At a broader level formal audits, both with and without warning, could be undertaken. A transparent approach to the correction of any revealed infringements would serve as a constant reminder to employees that their business dealings are subject to review and will thereby deter complacency.

Informal guidance and opinions

4.21 Following a request from an undertaking, Ofgem may give informal confidential advice on the application of Article 81, Article 82, the Chapter I or Chapter II prohibitions with regards to specific cases likely to be in the Authority's jurisdiction. Ofgem will only give advice to the extent it is able to do so based on the information provided and Ofgem expects most undertakings to carry out their own self-assessment of whether their conduct complies with competition law. Where information is insufficient to give advice on certain aspects of a request, Ofgem may decide not to give advice or to only give advice on the general principles of the CA98 as opposed to issues raised by the specific case. Any views expressed will be confidential and will not be legally binding.

4.22 Where a case raises novel or unresolved questions about the application of Article 81, Article 82, the Chapter I or Chapter II prohibitions, Ofgem may publish written guidance in the form of an opinion. Ofgem will only publish such an opinion where there is insufficient guidance, a lack of precedent in EC or UK case law or decisions, and where a wider audience would benefit from a published opinion. An opinion would not bind the Authority in any subsequent assessment of the issues raised. Ofgem will follow the approach to giving opinions set out in the competition law guideline *Modernisation* (OFT442).⁴⁵

⁴⁵ Part 7.

5 Transitional arrangements

5.1 Provisions for the transition from the competition law that preceded the CA98 to the CA98 are set out in Schedule 13 to the CA98.⁴⁶ These provisions provide a transitional period during which the Chapter I prohibition does not apply to certain agreements under the Gas Act 1986 or the Electricity Act 1989. There were no transitional periods available in respect of the application of the Chapter II prohibition.

⁴⁶ Further details are provided in the competition guideline *Modernisation* (OFT442).

Agreements benefiting from the transitional periods

5.2 The transitional period during which the Chapter I prohibition does not apply to certain agreements lasts for five years from the date on which the Chapter I prohibition entered into force (1 March 2000).

5.3 There are three categories of agreement that benefit from the transitional periods in the gas and electricity industries:

- agreements which on 1 March 2000 were exempt from the Restrictive Trade Practices Act 1976 by virtue of section 100 of the Electricity Act 1989 or section 62 of the Gas Act 1986 respectively. These agreements received a five year transitional period from 1 March 2000.
- agreements made during the five year period beginning on 1 March 2000 which are of a type that would have been exempt from the Restrictive Trade Practices Act 1976 had it not been repealed. These agreements receive a transitional period applying from the date that the agreement is made and for the remaining part of the five year period, and
- agreements specified in transitional orders by the Secretary of State. These will receive a transitional period applying from the date specified in the order and, again, apply for the remaining part of the five year period beginning on 1 March 2000.

5.4 The transitional exclusion from the Chapter I prohibition will not apply if the agreement is varied in such a way that it ceases to be an agreement, which would have been exempt from Restrictive Trade Practices Act 1976, or one, to which a transitional order applies.

Extending the transitional period

5.5 The Authority may extend for up to six months the transitional period. The Authority may do so either on application by one of the parties to the agreement or under the Authority's own initiative. The details of the procedures in relation to the extension of transitional periods are given in the OFT's Rules.⁴⁷

5.6 It is unlikely that an agreement, which the Authority considers would infringe the Chapter I prohibition, would be granted an extension unless there are good reasons for an extension. For example, if the agreement is being re-negotiated or is due to expire shortly after the end of the unextended transitional period.⁴⁸

Terminating the transitional period

5.7 The Authority may by direction terminate the transitional period in relation to any agreement if either:

- the Authority has required any party to that agreement to give it such information about that agreement as it may require and, at the end of the period specified in the OFT's Rules for providing such information, any party has failed, without reasonable excuse, to do so, or
- the Authority considers that the agreement would, but for the transitional period, infringe the Chapter I prohibition.

5.8 Any direction terminating a transitional period is subject to revocation, before it takes effect, either by the Authority or the Secretary of State.

⁴⁷ The Competition Act 1998 (Office of Fair Trading's Rules) Order 2004.

⁴⁸ See the competition law guideline, *Modernisation* (OFT442), paragraph 11.25.

Competition law guidelines

The OFT is issuing a series of competition law guidelines. New guidance may be published and the existing guidance revised from time to time. For an up-to-date list of guidance booklets check the OFT website at www.of.gov.uk

All guidance booklets can be ordered or downloaded from the OFT website at www.of.gov.uk Or you can request them by:

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