

Eve Engledow
Financial Stability and Regulatory Policy
Team
Room 4/23
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Your Ref:
Our Ref:
Direct Dial: 020 7901 7021
Email: kyran.hanks@ofgem.gov.uk

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Dear Ms Engledow,

FSMA Two Year Review – Changes to Secondary Legislation Volume 1: Proposal for Change

Thank you for the opportunity to respond to the consultation regarding the Financial Services and Markets Act Two Year Review. This letter constitutes Ofgem's¹ response to this consultation and focuses specifically on the Exemption for Advice under the New Electricity Trading Arrangements ('NETA') detailed in section 9 of the consultation document.

Ofgem's principal objective in relation to electricity markets is to protect the interests of electricity consumers, wherever appropriate by promoting effective competition between those engaged in or associated with commercial activities connected with the generation, transmission, distribution or supply of electricity.

¹ Ofgem is the office of the Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

The new wholesale electricity trading arrangements were designated by the Secretary of State on the 27 March 2001 (referred to as 'NETA Go-Live'). Under NETA, generators sell electricity directly to suppliers, traders and other generators through bilateral contracts, in much the same way as any other commodity market, rather than at a uniform price determined through accepted offers into an electricity pool as was the case previously. The National Grid Company plc ('NGC') operates the transmission system, and is responsible, in its role as system operator, for maintaining its stability and security, which it achieves in part by accepting bids and offers in the Balancing Mechanism.

At the time NETA was implemented and the new Financial Services and Market Act 2000 ('FSMA') was introduced, the Financial Services Authority ('FSA'), Ofgem, HM Treasury and the Department of Trade and Industry ('DTI') agreed that the FSMA definition of the "general prohibition" may create a risk that the Balancing Mechanism as well as imbalance settlement² itself may be considered investments because of the width of the definitions of contracts for differences, futures and options. It was widely acknowledged that these arrangements do not naturally look or feel like investments.

In particular, there was a concern that imbalance settlement itself could be considered a contract for difference, because it involves the set-off of net contracted volumes and net metered volumes. There was a similar concern that bids and offers in the Balancing Mechanism – to take or generate more or less electricity – could be characterised as contracts for differences.

Therefore all NGC's actions taken to balance the system and parties participating in the Balancing Mechanism as well as imbalance settlement were subject to the FSMA Exemption. This was to ensure that the central NETA arrangements would not be found unenforceable on the basis that the parties are not FSA regulated. It was agreed that the exemptions would be further reviewed to establish whether the exemption requirement should remain.

At the same time it was also recognised that other aspects of electricity trading should be subject to Financial Services Regulation. Ofgem welcomed the application of the FSMA to these aspects of the wholesale electricity market. Ofgem considered

² The method by which market participants in effect pay or are paid for electricity that does not match their contract commitments.

that financial regulation within the agreed areas would protect users (to the ultimate benefit of electricity customers) through encouraging competitive markets, and in turn build market confidence.

Ofgem considers that it is appropriate for certain market participants in the electricity market, namely those who maintain significant trading positions in the forwards and futures markets and who offer trading and risk management services, to continue to be regulated by the FSA as it improves market confidence and liquidity. FSA regulation of those participants' internal controls and procedures is desirable to ensure that risks are being actively managed and understood, thus contributing to the operation of the competitive market.

However, Ofgem remains of the view that it is not appropriate for financial regulation to be extended to Balancing and Settlement Code ('BSC') parties in relation to Balancing and Settlement arrangements or BSC agents or to NGC as system operator or to any of the central BSC parties, Elexon and Elexon Clear³.

In this current review of the FSMA, Ofgem has been asked by the DTI and the Treasury to consider the extent to which it remains appropriate for participants in the Balancing and Settlement arrangements to be exempt from FSMA regulation. Ofgem provided a formal response to the DTI and the Treasury on the following points in January 2004. A copy of the January response is attached to this letter.

Ofgem was asked to consider the following points:

- Why the NETA exemption is required;
- The need, in particular for the advice exemption to remain;
- The extent to which 'consumer' detriment arises from the continued existence of the exemptions, particularly in the context of advice that is being given to such 'consumers'; and
- The extent to which arrangements between Ofgem and the FSA have been put in place to facilitate an appropriate exchange of information.

Why the NETA Exemption is necessary and should remain

³ ELEXON Clear Ltd and the BSC agents ECVA, SAA, BMRA, FAA, CDCA, and SVAA.

When the advice exemption was first considered, the type of advice Ofgem envisaged was that which could be given by consolidators to smaller parties when putting together bids and offers in the Balancing Mechanism on their behalf. The advice would be given in respect of taking or generating more or less electricity. The advice was not advice in relation to futures or forwards contracts.

The advice exemption was not designed to cover advice in respect of complex futures and forwards trades or financial engineering. Those arrangements concern bi-lateral contracts between the parties (rather than the central arrangements for balancing the system). Parties offering such advice will need to consider whether what they are doing involves investments and whether authorisation will be required. The exemption does not exempt that kind of advice, because it is confined to the Balancing and Settlement Arrangements as defined.

A number of electricity industry participants have taken the view that the trading that they engage in involves investments⁴. Those that are not regulated are relying on the Exemption to take outside of FSA Regulation any Balancing Mechanism offers and bids, and imbalance settlement itself. As to futures and forwards, they are either relying on the fact that bi-lateral trades are forwards because the parties to them have a commercial intention or alternatively they accept that the bilateral trades may be investments, but are not authorised because they are relying on one of the exclusions in the Regulated Activities Order ("RAO") relating to risk management, groups or "with or through"

The extent to which 'consumer' detriment arises from the continued existence of the exemptions

Ofgem has no evidence of investor detriment from unregulated advice being given to investors in the electricity forward markets, or in the course of either the Balancing and Settlement Arrangements or the provision of balancing services to NGC.

Ofgem considers that imposing FSA regulation on all BSC signatories would increase the barriers to entry to the physical wholesale electricity markets. Imposing FSA regulation on the central BSC parties and NGC would in Ofgem's view increase the

⁴ The Exemption is not wide enough to cover bilateral trading. As per the January 2004 Ofgem submission to the DTI and Treasury, Ofgem consider there to be approximately 17 companies that are currently BSC parties and that are also FSA authorised.

cost to wholesale electricity market participants and may thereby create a barrier to entering the market, which may reduce the level of competition in the wholesale market. The BSC is maintained by NGC under a condition in its transmission licence, and additional costs incurred would also be ultimately passed through to consumers via NGC charges to electricity market participants. This is likely to have a detrimental effect on the end-consumers of electricity.

Ofgem continues to regulate those aspects of the electricity market covered by the exemptions. Such regulation is undertaken through licenses in the case of both NGC and those BSC parties who hold generation and/or supply licenses. Furthermore, Ofgem has wide-ranging powers to take enforcement action in respect of breach of licenses, which could result in fines or ultimately the revocation of such licenses. Ofgem also has concurrent powers under the Competition Act 1998 with the Office of Fair Trading, including extensive information gathering powers. In monitoring the activities of parties in the Balancing Mechanism, Ofgem has a market analytics team dedicated to ensuring that the mechanisms are operating appropriately.

In the case of non-licensed companies who are parties to the BSC, the governance arrangements of the BSC allow for the arrangements to be modified with Ofgem approving or rejecting such modifications giving due consideration to the BSC objectives and Ofgem's statutory duties, the principal objective being to protect the interests of both existing and future consumers.

Arrangements between Ofgem and the FSA to facilitate an appropriate exchange of information

On 12 May 2003, Ofgem published a Concordat with the FSA, the Concordat serves as a point of reference for both agencies who work in parallel in the sharing of information, allowing the FSA and Ofgem to be able to discharge their statutory objectives by working closely together both in areas where there may be a degree of overlap in the agencies' respective functions, on any formal investigations or informal enquiries that may be being undertaken, specifically in relation, but not limited, to market abuse. Both agencies also share information in areas of mutual interest where no such overlap exists.

Ofgem and the FSA hold regular conference calls and meetings to update each other on areas of mutual interest, and ad hoc meetings in between these scheduled sessions to ensure the facilitation of an appropriate exchange of information. Ofgem considers that these arrangements are working in a satisfactory manner and

further enhance Ofgem's ability to better regulate the electricity market in an effective manner.

The effectiveness of Ofgem's close working relationship with the FSA has been demonstrated by the work carried out in connection with the rise in gas prices seen in October and November 2003. Following an initial meeting at which we identified which areas Ofgem and the FSA would take the lead, we have remained in regular contact with the FSA in relation to this issue (by telephone and face to face).

Investment Service Directive (ISD)

The new Investment Service Directive ('ISD') includes in the list of regulated financial instruments commodity derivatives and physically settled commodity contracts, provided they are traded on a regulated market or multilateral trading facility ('MTF'). Ofgem is aware that many bilateral notifiable electricity contracts are made via MTFs. Accordingly, it considers that the new ISD is likely to increase the number of wholesale electricity market participants that require authorisation.

The FSMA and all the statutory instruments will have to be amended in the near future to take account of the new ISD. Ofgem considers that it would be appropriate to re-examine the Exemptions in light of the new ISD when this is implemented in the United Kingdom, likely to be around June 2006.

Summary

In summary, Ofgem considers the following:

- That it clearly remains appropriate for the FSA to continue to regulate market participants in the electricity market who maintain significant trading positions in the forwards and futures market and who offer trading and risk management services, and that this enhances market confidence and liquidity;
- That it is Ofgem's view there is no evidence of investor detriment from unregulated advice being given to investors in the electricity forward markets, or in the course of either the Balancing and Settlement Arrangements, or the provision of balancing services to NGC.

- That there are suitable and effective working arrangements in place between the FSA and Ofgem to facilitate an appropriate exchange of information; and
- That it may be appropriate for the requirement for the NETA exemption to be reviewed in light of the new ISD when this is introduced in the United Kingdom, due to be in or near June 2006.

Ofgem has carefully considered the need for such exemptions to remain and is of the view that they remain important under the new GB arrangements, and therefore appropriate that they should continue. The Energy Bill, which is currently at second reading in the House of Commons, makes provision to introduce British Trading and Transmission Arrangements and extends the existing wholesale electricity market arrangements to Great Britain. It is expected that such arrangements will be introduced on 1 April 2005. Ofgem is of the view that such exemptions should remain and where appropriate amendments should be made to exemptions, in relation to participation in Balancing and Settlement Arrangements, to facilitate the introduction of a GB market. Ofgem considers this to be particularly appropriate given the roles and responsibilities of the individual companies within the trading arrangements and Ofgem's ability to regulate such mechanisms through licences and modifications to industry codes.

Please feel free to contact either myself or Jo Witters (on 020 7901 7159) if you would like to discuss any aspects of this letter.

Yours sincerely,

Kyran Hanks
Director, Wholesale Markets