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for energy consumers

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Ref: Fair and Effective Markets Review

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Response to Fair and Effective Market Review (FEMR) consultation: *How fair and effective are the fixed income, foreign exchange and commodities (FICC) markets?*

Dear Ms Shafik

Ofgem welcomes the opportunity to respond to the Bank of England's consultation on how fair and effective FICC markets are. As the independent regulator of gas and electricity markets in Great Britain, our principal objective is to protect the interests of current and future energy consumers and ensure the energy[1] markets work in their interest.

As you may be aware, as a result of a joint assessment[2] with the Office of Fair Trading (OFT) and the Competition and Markets Authority (CMA) on competition in the retail energy market, on 26 June 2014 we made a market investigation reference to the CMA[3]. The CMA is currently conducting a thorough examination of the supply and acquisition of energy in Great Britain and, if necessary, will be able to use its wide-ranging powers to remedy any features of the market it decides have an adverse effect on competition.

It is against this backdrop that we respond to your consultation. The CMA is due to report its findings in 2015 and pending the outcome, we cannot elaborate further on certain topics covered by this consultation at this time. However, in the annex to this letter you will find answers to a selected set of the consultation questions where it is both appropriate and possible for Ofgem to provide a response at this moment.

It is important to mention the main findings from our State of the Market Assessment[4] which formed the basis for our referral to the CMA, as well as the official submissions we have made to the CMA thus far[5] [6]. These submissions set out some metrics to monitor the effectiveness of the wholesale gas and electricity markets as well as a series of outcomes we would expect a well-functioning wholesale market to deliver.

Broadly speaking our analysis has found that the Great Britain wholesale gas market is performing well against these outcomes. The wholesale electricity market appears to be

[1] Where this letter refers to energy markets, we mean gas and electricity
[2] State of the Market Assessment
[3] Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain
[4] State of the Market Assessment
[5] Energy Market Investigation: Initial submission to the Competition and Markets Authority
[6] Market Investigation Reference: Assessing the Wholesale Market

relatively competitive, and compares well with many other European and international markets. However we have been concerned for some time that market liquidity is posing a barrier to effective competition and entry in the generation and supply markets. We have taken action to try to address this concern which I discuss further below.

It is also important to remember that effectiveness for electricity markets is not just about competitiveness. Market signals from the energy-only market have not encouraged investment to the same scale seen in the gas market. This has resulted in the need for government reforms that are currently underway to stimulate investment. We are proposing changes to certain market arrangements in order to, amongst other things, facilitate effective signals for investment in flexible technologies[7].

There is an open question as to whether the current rules for the wholesale energy market will deliver a truly effective market into the future. We continue to monitor both the rules governing and the overall functioning of the wholesale gas and electricity markets closely.

It is also important to highlight some of the reforms and measures that have been put in place to improve gas and electricity market liquidity and transparency which could be impacted by developments in European Union financial legislation.

Measures to promote liquidity

Given the importance of liquidity in the context of the FEMR, as well as the ongoing work by the Bank of England in this regard, it is helpful to discuss some measures Ofgem has taken to increase liquidity in wholesale gas and electricity markets. Since 31 March 2014 we have put in place a special licence condition on the largest six vertically integrated energy utilities and the two largest independent generators which require them to: undertake market making at certain times; apply customer service standards when dealing with independent suppliers, and report certain trading activity[8]. This intervention, called 'Secure and Promote' is intended to assist our liquidity objectives for the wholesale electricity market to:

- ensure the availability of a range of longer-term products to support hedging
- support robust reference prices that that are widely available to market participants
- promote an effective near term market which enables all companies to buy the power they need for their customers

There has been evidence of some improvement in liquidity since Secure and Promote was introduced, but it is too early to draw any firm conclusions.

Measures to promote transparency

System Operator (SO) Incentives

Ofgem incentivises National Grid in its role as System Operator (SO) of the electricity system and gas network to ensure efficient operation of the systems. We are currently reviewing consultation responses to our latest review[9][10] of this framework which includes options to increase transparency including publication of any (non-commercially sensitive) information that would help drive innovation, competition and efficiency in the market. The Final Proposals are due to be published in February 2015.

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[7] Changes are being proposed to the 'cash out' arrangements under the Electricity Balancing Significant Code Review (Electricity Balancing Significant Code Review - Final Policy Decision)
[8] Wholesale power market liquidity - decision letter
[9] Gas System Operator incentives review: Initial proposals
[10] Electricity System Operator Incentives: Incentives from 2015

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REMIT

As noted by the consultation document, much energy derivative trading takes place OTC via brokers which can result in a lack of transparency. The Regulation on Wholesale Market Integrity and Transparency (REMIT) entered into force on 28 December 2011 with the aims of increasing transparency in these markets and preventing market abuse. It provides a consistent EU-wide framework specific to wholesale energy markets that defines and prohibits market abuse (including insider trading and actual/attempted market manipulation).

It also places an obligation on market participants to publish inside information in an effective and timely manner which will improve transparency for market participants. One of the key types of inside information in these markets relates to the availability and use of facilities for production, storage and transmission of electricity or natural gas. By ensuring that this information is published prior to trading, unfair information asymmetries will be reduced. This is particularly important for those market participants that do not hold physical assets.

REMIT also requires that market participants report records of wholesale energy market transactions, including orders to trade, to the Agency for the Cooperation of Energy Regulators (ACER). ACER and Ofgem will use this transaction data to undertake more effective monitoring to identify suspicious transactions. This will also help improve transparency.

Since June 2013, Ofgem has had civil powers to investigate abuses of REMIT and impose unlimited fines. Parliament is currently consulting on the introduction of criminal powers for the most serious REMIT breaches. These powers coupled with the increased access to data will allow us to protect the transparency and integrity of wholesale energy markets to an even greater extent than previously.

MiFID II

Ofgem is highly supportive of an appropriate regulatory burden for commodity derivatives under the Markets in Financial Instruments Directive (MiFID II). However we welcomed the recognition that energy markets were already governed by a tailor made set of regulations and that wholesale energy products traded on an Organised Trading Facility (OTF) and 'must be physically settled' would be exempt from MiFID II. We are concerned by the developments in the draft Level 2 text which could undermine this exemption for REMIT.

We monitor these and other MiFID II developments out of the need to protect the proper functioning of wholesale energy markets in terms of competitiveness, liquidity and security of supply. As noted by the consultation, regulation can sometimes act as a barrier to entry for new participants. We are working closely with the Financial Conduct Authority (FCA) and colleagues in the Council of European Energy Regulators (CEER), ACER and the European Commission to ensure the boundaries between financial and energy regulation as agreed by the European Parliament and European Council are respected.

Proposed EU regulation on indices used as benchmarks in financial instruments and financial contracts

In June 2013, Ofgem consulted on pricing benchmarks in gas and electricity markets[11] and having reviewed the responses in July 2014 issued our decision that Price Reporting Agencies (PRAs) should voluntarily adopt the IOSCO Oil PRA principles[12] for price assessments for gas and electricity markets (as many have now done).

[11] Pricing benchmarks in gas and electricity markets - a call for evidence
[12] Principles for Oil Price Reporting Agencies – Final Report (IOSCO, November 2012)

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We have followed the developments of the draft EU regulation on indices used as benchmarks in financial instruments and financial contracts with interest. Currently we are working with colleagues in CEER and ACER to engage with the relevant European institutions, and are liaising with the Department of Energy and Climate Change (DECC) and Her Majesty's Treasury (HMT) to ensure that GB consumers' interests are protected as this draft European legislation progresses.

In summary, we believe that the work of the FEMR will be an important contribution to the ongoing debate on how to make FICC markets work in the best interests of consumers and the wider economy. We await the outcome with great interest, and stand ready to assist further should you have specific questions that you wish to discuss.

Yours sincerely,

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Partner, Markets

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Annex – Responses to FEMR consultation questions

Q10: Are there any material barriers preventing greater transparency in OTC commodity derivatives markets? If so, what could be done to remove them?

The introduction of Regulation (EU) no 1227/2011 on wholesale energy market integrity and transparency (REMIT) prohibits insider trading and market manipulation in European wholesale gas and electricity markets. It also places an obligation on market participants to publish inside information in an effective and timely manner.

The obligation to publish inside information will improve transparency for market participants. One of the key types of inside information in these markets relates to the availability and use of facilities for production, storage and transmission of electricity or natural gas. By ensuring that this information is published prior to trading, unfair information asymmetries will be reduced. This is particularly important for those market participants that do not hold physical assets.

REMIT also requires that market participants report records of wholesale energy market transactions, including orders to trade, to the Agency for the Cooperation of Energy Regulators (ACER). ACER and Ofgem will use this transaction data to undertake more effective monitoring to identify suspicious transactions. This will also help improve transparency in OTC gas and electricity wholesale markets.

We note also that most information regarding OTC trading in commodities is public for paid users of various broker-platforms where these products are traded. There is an argument that anonymized data could be made public after a certain period of time has expired. There are ongoing discussions within the industry about progressing such ideas, and we would welcome any move that increases transparency for all market participants.

Q11: Are there any areas of FICC markets where regulatory measures or internationally co-ordinated regulatory action are necessary to address fundamental structural problems that exist?

As the designated National Regulatory Authority (NRA) for the UK, Ofgem works with other energy regulators in ACER on the development of the Internal Energy Market and rules governing cross-border infrastructure.

At a national level, we work closely with the other sectoral regulators, in part through the UK Regulators Network (UKRN), to avoid the possibility for regulatory arbitrage and to ensure best market outcomes for consumers.

Q18: In what ways might competition in any of the key FICC markets usefully be addressed by competition authorities (e.g. by assessing the state of competition in relevant markets)?

Ofgem has powers to enforce competition law and refer market features that are suspected of harming competition for further investigation. As noted the CMA has wide-ranging powers to intervene to ensure markets are competitive and is currently conducting a market investigation into the supply and acquisition of energy in Great Britain.

Pending the outcome of the CMA's energy market investigation it would be inappropriate to comment further on this question.

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Q19: Are there any additional regulatory reforms that could be helpful in promoting competition and market discipline in FICC markets?

Pending the outcome of the ongoing CMA investigation we cannot comment on this question.

Q21: Do current domestic and international initiatives by industry and regulators to improve the robustness of benchmarks go far enough, or are further measures required?

We have followed the developments at EU level regarding benchmarks with interest. It is important to ensure that any regulatory burden imposed by a benchmarks regulation is appropriate. We consider that a piece of financial legislation aimed at regulating financial players providing financial benchmarks may not be appropriate for energy market benchmarks. IOSCO recognised the fundamental difference between financial benchmarks and energy market benchmarks by having separate principles governing financial and energy (oil) benchmarks.

We support the intent behind the proposed regulation but note that the manipulation of an energy benchmark is already effectively prohibited under REMIT. More importantly, we consider that any regulatory burden which discourages voluntary contributors of data on wholesale gas and electricity prices could be detrimental to both the number and integrity of benchmarks for electricity and gas.

Given the important role that energy benchmarks play in providing a picture of what the market is doing, particularly for longer-dated products, we consider that they are crucial for price-discovery and market liquidity and bring with them associated benefits for market efficiency and security of supply.

As per our June 2014 decision following our consultation on price assessments in gas and electricity markets, we strongly support extending the scope of the IOSCO Oil PRA principles to price assessments for gas and electricity markets on a voluntary basis. This would help to preserve the environment in which contributors to those benchmarks can continue to provide their data.

Given the ongoing developments at EU level, for wholesale gas and electricity benchmarks we do not feel further regulatory action by Ofgem is appropriate at this time. We will review this decision at a future point.

Q22: What steps could be taken to reduce the reliance of asset managers and other investors on benchmarks?

It is important to note that energy benchmarks, unlike LIBOR, quote an underlying product and are usually based on actual trades. In addition there are several firms actively providing competing views on prices in the market, which adds to the robustness of the system.

Q26: How can the regulatory framework provide protection to market participants for benchmarks administered in other jurisdictions in a proportionate way?

This is the subject of debate at the European Parliament and European Council and we cannot predict the outcome of those discussions in the final EU regulation. One concern would be that the notion of 'equivalence' is difficult to verify and could introduce uncertainty for market players regarding which benchmarks they could or could not use. Any solution should not impact negatively on EU-based provider or users of energy benchmarks.

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Q44: Is the current supervisory approach and level of intensity dedicated to supervising conduct within the UK wholesale FICC markets appropriate?

For wholesale electricity and gas products, the introduction of REMIT adds to previous measures to ensure a strong supervisory framework. Furthermore, Ofgem's decision to monitor trading activity in addition to ACER's monitoring should lead to an effective and robust approach to identifying potential incidents of market abuse.

In addition to this monitoring activity, Ofgem has been proactive in engaging with, and providing guidance to, market participants to ensure that they are aware of their obligations in respect of appropriate conduct under REMIT.

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