

**FUTURES & OPTIONS ASSOCIATION**

**THE COMMERCIAL CASE AGAINST APPLYING FINANCIAL SERVICES  
AND MARKETS BILL (AND FSA REGULATIONS) TO WHOLESALE  
ENERGY MARKET PARTICIPANTS**

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## THE COMMERCIAL CASE AGAINST APPLYING FINANCIAL SERVICES AND MARKETS BILL (AND FSA REGULATIONS) TO THE WHOLESALE ENERGY MARKETS

### 1. The Rationale for Additional Regulation

1.1 Before considering the very real commercial issues and consequences of extending the Financial Services and Markets Bill ("FSMB") and FSA regulation to cover wholesale energy market participants, it is appropriate to consider the original purpose of the reform of financial service regulation, and then to determine whether the proposed extension of the FSMB to energy market participants will in fact help achieve that purpose.

1.2 When the Labour Government came to power, it set about the task of creating a new unified regulatory framework with a view to:

- rationalising the existing regulatory bodies into one, thereby increasing efficiencies, reducing costly overlaps and benefiting financial service suppliers and consumers alike;
- eliminating opportunities for "regulatory arbitrage"
- securing more efficient protection for consumers against a background of a growing number of scandals (e.g. BCCI, Barings, pensions mis-selling, Morgan Grenfell).

1.3 The extension of FSMB and FSA regulation to cover wholesale energy market participants will do little or nothing to achieve these objectives:

- The gas and electricity markets are already subject to detailed regulation and licensing by one newly merged regulatory regime (OFGEM)
- Far from reducing the opportunities for "regulatory arbitrage", the proposals will mean that firms will have to balance two quite distinct regulatory regimes, one for the physical delivery of energy, the other for the hedging (and possible physical delivery) of energy supplies
- Individual investors do not participate (and never have participated) in the wholesale energy markets. Regulations designed to protect them have no place in a market where the typical contract size is measured in £ million and which has never experienced scandals of the scale or with the impact on retail consumers seen in the financial markets
- Transactions are entered into with a view to (a) taking physical delivery of otherwise unregulated non-financial products in order to meet physical trading needs (i.e. the economic purchase and sale of power) and/or (b) hedging the exposure arising from such transactions

1.4 While it is recognised that the factors set out in Clause 2 (3) of the FSMB apply to the FSA, it seems entirely appropriate that they should be taken into account also by HM Treasury to determine the scope of the Bill itself, i.e:

- "The principle that a burden or restriction which is imposed on a person... should be proportionate to the benefits... expected to result from the imposition of that burden or restriction";
- "the desirability of facilitating innovation..."
- "... the desirability of maintaining a competitive position in the United Kingdom"
- "the principle that competition between authorised persons should not be impeded or distorted unnecessarily".

The Better Regulation Guide refers also to the principle of proportionality and that regulation should be applied only where it is necessary.

## **2. The Commercial Consequences of the Extension of Financial Services Regulation into the Energy Markets**

2.1 The drive to create a single harmonised system of regulation is designed for financial services institutions (particularly those servicing the retail sector) and not for the professional dealings of wholesale energy market participants

2.2 This section lists some of the commercial arguments against extending financial services regulation into the energy markets, and then gives a short explanation of those arguments.

- Increased costs and increased bureaucracy
- Reduced competitiveness
- Reduced attraction of UK as a place to do business
- Duplication of regulation

### *Increased costs and increased bureaucracy*

2.3 At the moment it is possible for energy companies to trade with each other outside the FSA or subject to OFGEM licensing and oversight or as Permitted Persons or, in the case of the oil markets (whether for physical delivery or for related "paper" transactions) under the current SFA specialist code for Oil Market Participants (OMPs). The additional cost imposed under the current OFGEM regime or the SFA's Code (currently under review) is not so high as to make it uneconomic to transact the business. In this context, it is worth bearing in mind that this sector is already tightly controlled by various licensing, environmental and other government agencies.

2.4 So far as the proposed FSA Code of Conduct for inter-professional businesses is concerned, there is no doubt that (a) while the OMPs hope that the Oil Market Participant regime will remain unchanged, that is unlikely since it will become part of a harmonised and more burdensome Code of Conduct and (b) the proposed abolition of Permitted Person status will bring into regulation organisations and institutions that have no place in a financial services regulatory environment. The personnel and systems implications in terms of internal compliance, monitoring, supervision and external reporting will have a major cost, resource and structural impact on a significant number of non-financial institutions. A number of commodity houses already within the regulatory regime are actively looking to transfer their positions to avoid (a) burdensome capital requirements and (b) the risk that the "physical" accounts of major commodity houses accounts could, to some extent, be included, via consolidation, in the calculation of regulatory capital requirements.

2.5 Had such a regime been put into place for the IPE's natural gas market, it is highly unlikely that this market could have started - a market which was an integral part of the successful liberalisation process which has been completed so successfully in the gas market.

### *Reduced competitiveness*

- 2.6 The extra costs described above will bear down most heavily upon the smaller players in the market. If these players are inhibited by regulation from joining fully in the development of the energy market then it is clear that the growth of this market and the healthy development of competition will be severely impaired.
- 2.7 OMP groups have a marked preference for engaging in hedging strategies with oil market professionals (i.e. as opposed to broad scope institutions and investment banks). The imposition of a requirement for authorisation and the consequential regulatory cost that flows from that requirement could impact adversely on this aspect of the trading environment.
- 2.8 As government will be aware, one of the beneficial consequences of free competition in the energy market has been the improvement in liquidity and the quality of price formation. OFGEM is, at the present time, and, pursuant to Government policy, attempting to create an electricity market that mirrors the free competition that characterises the natural gas market. However, burdensome and inappropriate regulation will deter market participants with real potential for reducing liquidity, increasing price volatility and, through the passing on of regulatory cost, possibly higher prices.
- 2.9 It can reasonably be anticipated that additional costs that are put onto energy market participants as a result of regulation will almost certainly be passed on to the end consumer.

### *Reduced attraction of UK as a place to do business and increased likelihood of shift of business offshore*

- 2.10 The oil market is primarily international and this is becoming increasingly the case in the gas and electricity markets as a result not only of physical proximity through cross-channel links, but principally because of increasing correlation and similarities across markets.

In the case of the oil markets, while many of the major players are located outside the UK, in trading centres such as Amsterdam, Rotterdam, Antwerp, Geneva, Monaco etc., they still choose to conduct their business through London. In the case of the gas and electricity markets, most of the US groups - such as Dynegy, Enron, Entergy and Sempra - have established their European trading operations to deal in the new deregulated European gas and electricity markets in London. While this is an indication that the UK - to date - has established a sympathetic commercial environment which is attractive to overseas and international wholesale market participants, it would take a relatively small shift to change attitudes. For example, TXU and the Southern Company have established their European operations in Switzerland and the Netherlands respectively. Moreover, other European centres will use every opportunity to secure relocation of such markets into their own countries (e.g. the market in Germany's heating oil is located almost entirely in the UK and it is worth remembering how the impact of cost led to LIFFE's loss of the German bund to Eurex). Already, there are some indications that Germany is considering establishing an energy market to rival that that exists in London.

- 2.11 The potential for regulatory and cost arbitrage between the UK and other European states and between the UK and the US is very real, bearing in mind that, so far as the former is concerned, commodity trading has not yet been brought into financial services type regulation and is, of course, outside the Investment Services Directive and, so far as the latter is concerned, there is the benefit of a regulatory exemption.

### *Duplication of Regulation*

2.12 The gas and electricity markets are already subject to detailed licensing and regulation by OFGEM. The likely consequence of bringing electricity and natural gas market participants within the scope of the FSA will generate significant regulatory overlap and/or conflict between the regulatory authorities which will generate uncertainty, increase cost and deter participants from the UK. If, on the other hand, there is a consensual regulatory approach, then there is surely the need for only one regulator.

### **3. Conclusion**

3.1 Wholesale power participants active in the energy markets are of the view that, as a professional market, with no retail investors to protect, it is simply not appropriate to extend financial services regulation to the energy markets. The firms active in this industry are not seeking to avoid appropriate regulation, but rather are attempting to assist in the definition of what is appropriate in the circumstances in which the government finds itself today.

3.2 In summary, the FOA would urge the government to consider whether inclusion within a financial services regime under the Financial Services and Markets Bill:

- is appropriate for these markets and participants
- runs the serious risk of inhibiting the government's own policy objective of liberalising the gas and electricity markets;
- in the absence of a clear exclusion, will force participants to seek precautionary authorisation, contrary to the government's own expressed wish in this regard, in order to secure legal and market certainty.

3.3 In the circumstances, the FOA would urge the government to counterbalance the removal of Permitted Persons status by replacing it with an appropriately drafted statutory exclusion which could be along the lines suggested in the FOA's companion paper "Wholesale Markets: The Case for Exclusion" (August 1999) or similar to the current US exemption or in such other form as may be appropriate.