



AEP¹ Response to CESR/ERGEG Consultation on Market Abuse

GENERAL COMMENTS

The Association welcomes the opportunity to comment on this consultation from the financial and energy sector regulators. AEP can support a number of the conclusions of the paper, notably that binding transparency rules are needed at EU level and that energy market issues cannot be dealt with through extending the application of the Market Abuse Directive. However, we do not believe that the paper provides convincing evidence of the need for a European framework covering market abuse.

AEP does not support the development of an additional sector-specific market abuse regime and takes the view that existing EU competition law and national/regional market rules are amply sufficient to deal with this issue. Very careful consideration is needed before the EU even contemplates moving down this route. While it might be assumed that a sector-specific regime would automatically promote greater competition and thereby serve the customer interest, this is not necessarily the case. Indeed, such a regime could introduce substantial uncertainty, with adverse effects for the proper functioning of markets, for competition and even for security of supply. The related issues were extensively examined during the UK Competition Commission's inquiry into Ofgem's proposed Market Abuse Licence Condition during the year 2000. This Condition, which seems very similar to the type of regime being suggested here, was rejected and we refer to the findings of the Competition Commission below.

AEP believes that it is crucial that generators are able to optimise their plant, as this promotes increased market efficiency to the benefit of customers. AEP strongly objects to the implication that it could constitute market abuse if a generator does not disclose an unplanned outage to the market until it has balanced its position. This would expose generators to significant additional commercial and operational risks, which will push up marginal costs, deter investment and lead to higher prices for customers.

¹¹ The Association of Electricity Producers (AEP) represents large, medium and small companies accounting for more than 95 per cent of the UK generating capacity, together with a number of businesses that provide equipment and services to the generating industry. Between them, the members embrace all of the generating technologies used commercially in the UK, from coal, gas and nuclear power, to a wide range of renewable energies.

Given the risks of imposing duplicate regulation and in line with Better Regulation principles, AEP would expect to see a thorough regulatory impact assessment and further consultation before any sector-specific regime is proposed.

The Association would like to record its disappointment at the timescales adopted for this consultation (publication on 21st July with a deadline of 29th August). To allow five weeks for comment, in the main holiday season, seems to AEP to be wholly inadequate, given the substantial issues underlying this consultation.

Background - Proposal for a Market Abuse Licence Condition in the GB Market

In late 1999 the GB energy regulator, Ofgem, proposed that a Market Abuse Licence Condition (MALC) be imposed on all the major generators. Two of the generators concerned refused to accept the Condition and the issue was referred to the UK Competition Commission for determination.

After a lengthy inquiry the Competition Commission concluded in its report of January 2001² that there was no public interest case for imposing the MALC. The Commission laid particular emphasis on the difficulty companies would have in determining whether or not their conduct complied with the MALC; the damaging impact of this uncertainty on investment and on the market; and the potential for double jeopardy. An extract from the Commission's findings is quoted below.

(Paras 2.258/259)

"We consider, therefore, that the problem of uncertainty, both for generators and for other market participants, over the interpretation of a prohibition of substantial market power is substantive... Because of the difficulty of distinguishing between abusive and acceptable conduct, there is a risk that such a prohibition will deter normal competitive behaviour and thus inhibit the operation of the market.... There is a danger that the introduction of a prohibition of substantial market power would amount to over-regulation. This could deter new investment and new entry, with harmful effects on consumers in the long term."

AEP accepts that the Competition Commission's decision relates to a particular case and to a particular formulation of the MALC. It can of course be argued that a market abuse regime can be devised which would overcome the objections raised by the Competition Commission. Nevertheless, in AEP's view, this directly relevant example shows that there are substantial risks in seeking to combine competition law with an overlapping sector-specific regime, and that this can work against the public interest. This issue of

² AES and British Energy: A report on references made under section 12 of the Electricity Act 1989

overlap does not appear to be acknowledged in the CESR/ERGEG paper. It should also be noted that, if it is difficult to devise a clear and proportionate regime at national level, this is likely to be substantially more challenging at European level.

The GB electricity and gas markets continue to operate successfully without a sector-specific market abuse regime and were recognised in the Sector Inquiry as the most competitive in Europe, alongside the Nordic electricity market. Furthermore, the Competition Commission has very recently reviewed in detail the findings of its January 2001 report and concluded “The CC’s decision not to support the introduction of the MALC in 2001 seems well-justified by subsequent market developments in Great Britain”³. It can therefore be seen that competitive markets can flourish without specific market abuse rules.

SPECIFIC COMMENTS

Q1. Do you agree with the analysis of the market failures in the electricity and gas markets as described above? If not, please provide reasons for your disagreement.

Analysis of Market Failures

AEP accepts many of the criticisms made of the EU electricity and gas markets in the 2005/6 Sector Inquiry. However, it should be noted that the situation has now evolved: there has been some further progress, particularly in continental Europe, towards a more competitive and integrated energy market. Trading volumes and liquidity are increasing across Europe, reflecting greater confidence in the market. Since the Inquiry, DG Competition has initiated a number of cases for alleged breaches of the competition rules and negotiations on the Third Liberalisation Package are now well advanced. The Third Package should bring further substantial improvements by tackling the problems of insufficient unbundling, lack of transparency and inadequate regulatory powers.

The CESR/ERGEG analysis of market abuse focusses primarily on three issues: information asymmetry (which we discuss below), scope to withhold capacity and scope to price excessively. However, the latter two issues can clearly be tackled through existing competition law and do not require an additional sector-specific market abuse regime. In the GB market, a concept of temporal dominance is applied, which means that a market player can be considered dominant over short periods of time (and thus subject to sanctions if this dominant position is abused). The issue of market power outlined in Para 40, for instance, could readily be dealt with in this way. If this were not deemed to be effective, then specific and tightly defined changes to the relevant market rules would be more appropriate than a broad abuse

³ Evaluation of the Competition Commission’s past cases: Final Report January 2008; Para 4.82

prohibition, as the Competition Commission concluded in its inquiry into MALC.

AEP does not have detailed knowledge of the single example quoted of trade-based market manipulation (Para 36). However, this case appears to relate to the electricity futures market rather than to physical or OTC markets and could thus be tackled through financial regulation or changes to specific market rules.

AEP does not believe that the CESR/ERGEG analysis substantiates the need for further regulation at EU level beyond the existing regulatory framework and the competition rules. Indeed a market abuse framework would bring the risk of duplicate regulation, introducing uncertainty about which route regulators would pursue. This would be likely to deter new investment and new entry.

Information Asymmetries

The consultation document highlights information asymmetries as a particular problem and implies in Para 29 that it is unacceptable for a generator not to disclose details of a generation outage to the market until it has balanced its position. AEP strongly objects to the implication that this could constitute market abuse and does not believe that the UK regulators hold this view. Indeed, it is regarded as accepted market practice in the UK, as provided for by MAD and the FSA Market Code of Conduct, for a generator to cover the physical loss from an unplanned outage before declaring its position to the market.

Information asymmetries will exist in any market but the key issue is whether they are unfair and distort competition. Owners of power generation clearly have better information on their assets than other market players. However, it should be noted that non-physical traders also have information which is not available to other market participants, e.g. on customer demand and speculative interest.

Transparency requirements for physical infrastructure are already significant and these will be augmented as a result of the Third Package. AEP welcomes this development. Conversely, there are currently no requirements on non-physical traders to disclose investor demand for commodities, which can also have an impact on price formation.

It is crucial that generation owners are able to use information to optimise the operation of their plant. If they are unable to do so, this will result in inefficiencies and in higher prices for customers. Generators should not be placed in the position of distressed buyers when outages occur and should be able to trade out their position before information is released to the market. Restrictions on such activity place the generator at a significant disadvantage to other market players and mean that the generator is exposed to all operational risk without the corresponding advantage of having a financial position. This will reduce incentives to invest in infrastructure at a time when

new capacity is needed both to promote competition and maintain security of supply.

Q2. What is your opinion on the analysis provided above on the scope of MAD in relation to the three different areas: disclosure obligations, insider dealing and market manipulation?

AEP agrees with much of the analysis relating to the scope of MAD and also agrees with the conclusion that it would be inappropriate to expand the scope of MAD to the physical markets, given the specific features of the energy sector, e.g. non-storability of electricity.

It can be argued that there is a lack of consistency in the way in which national regulators currently apply the MAD regime to the electricity and gas markets. It would be helpful if CESR and ERGEG could undertake a review in this area with a view to identifying any discrepancies.

It should be remembered that traded volumes and liquidity in energy markets across Europe are generally increasing, which indicates that risks are viewed as manageable without an additional market abuse regime. As mentioned above, AEP thinks that there are considerable risks in developing such a regime, which could inhibit further increases in competition and liquidity. As a result, a comprehensive regulatory impact assessment is needed before any proposals are made. It is crucial that any new regulatory arrangements do not create barriers to entry and disincentives to invest.

As outlined in the response to Question 1, any definition of insider trading must allow generators to use information on their assets to optimise the operation of these assets. Only the asset owner is able to undertake this optimisation, so access to this information should not be seen as an asymmetry relative to other players. The current MAD definition of inside information is not appropriate for the energy sector, as a requirement to publish information under energy sector law would automatically be treated as inside information.

If disclosure requirements alter the balance of risk and reward between generators and other market participants, e.g. financial institutions, this will reduce the incentive to hold assets and to make further investments. It will also call into question the asset-based trading model

Q3. Do you agree with the conclusion above that greater pre -and post trade transparency would not be sufficient in the context of market abuse?

AEP accepts the case for greater market transparency and EU minimum standards and believes that these will make a major contribution to reducing the scope for market abuse. AEP, however, does not agree with the conclusion that increased transparency must be supplemented with other

measures to ensure market integrity. We note that Para 57 simply makes this statement without any supporting justification.

In AEP's view, increased transparency together with appropriate use of the existing EU competition rules and national regulation (including specific rule changes where appropriate) are amply sufficient to deal with the issue of market abuse.

Q4. Do you agree with the analysis above on the importance of the transparency/disclosure of fundamental data? If yes, would you consider it useful to set up at a European level a harmonised list of fundamental data required to be published? Is an exhaustive list conceivable or is it necessary to publish additional data on an ad hoc basis if it is considered to be price sensitive?

AEP supports the need for mandatory minimum transparency standards across the European Union. AEP believes that disclosure standards should be raised to levels comparable with the most open markets, notably GB and Scandinavia. The level of detail should be sufficient to ensure consistent implementation across all Member States. Disclosure should encompass generation, network and demand data and specific deadlines should be included. Disclosure obligations should ensure a level playing field between all categories of market participant. In the case of gas, AEP supports the removal of the 3-minus-shipper rule. In addition, suitable governance arrangements should exist to allow detailed changes to transparency rules.

A harmonised list would be helpful and could be drawn up on the basis of the ERGEG Good Practice Guidelines. This is certainly preferable to a system of ad hoc disclosure, which is likely to produce uncertainty and to be implemented in different ways across Europe. There should nevertheless be some flexibility for individual markets where differences in standards do not adversely affect trade. For instance, the existing ERGEG Guidelines require data on generation schedules (not applicable to the GB market, which has self-dispatch) and on hydro reservoir levels (unnecessary in a market with little hydro capacity). In the case of gas, the ERGEG Guidelines envisage the publication of daily aggregate day-ahead nominations. This information is not published in the GB market, but is not felt by market players to be necessary, as the relationship between nominations and flows is less strong than on the Continent.

Q5. Which information retained by specific participants of the electricity and gas markets (e.g. generators, TSOs) should be published on an ad hoc basis if it is price sensitive?

As mentioned above, clear transparency requirements should be set out in EU legislation and this is preferable to an ad hoc approach.

It should be noted that regulators, through their market monitoring powers, will in any case be able to obtain commercially sensitive data from market participants for analysis. A clear distinction should be made between the information routinely provided to the market for transparency reasons and that provided to regulators for market monitoring purposes. Commercially sensitive information should not be published.

6. What is your opinion of the proposals of CESR and ERGEG in the three different areas: disclosure obligations, insider trading and market manipulation?

Transparency/Disclosure obligations

AEP supports the proposal for energy-specific disclosure obligations at EU level, which would be legally binding. There should be some flexibility to tailor these obligations to individual markets provided that trade is not significantly affected, in particular if the benefits do not justify the costs.

AEP questions whether it is necessary to require disclosure via a single platform and would prefer a more market-driven solution, whereby information services are developed to meet market needs.

Insider Trading

AEP agrees that the extension of MAD to cover physical products is not appropriate, given the specific features of the energy sector. However, the CESR/ERGEG document does not in our view provide convincing evidence of the need for an EU framework covering insider trading. AEP is not aware of any regulatory concerns about insider trading in the UK market, or of this being a major issue on the European energy market. It does not feature to any great extent in the Sector Inquiry, for instance. In our view, an issue of this order could be dealt with through existing national regulation, including the use of competition law.

The Association recognises that the Nordic market has many positive features, but does not agree with the statement in Para 99 that the Nord Pool market conduct rules should serve as a model for the EU as a whole. The Nordic market differs from other European markets in many respects, e.g. in having a high proportion of smaller and flexible (mainly hydro) plant. This means that there are fewer problems in covering unplanned outages than in systems based on large thermal power stations.

AEP has concerns about the Nord Pool definition of inside information and the trading restrictions placed on asset owners, which would effectively increase the operational risk of generation if applied to other markets. These arrangements would, in our view, prevent generators from optimising their plant effectively and have the effect of raising costs and deterring investment, with likely adverse effects on customer prices and security of supply.

In the GB market, unplanned outage information is made available to the market near to real time and the Grid Code requires generators to update and submit a variety of planning data on a rolling basis. This planning data is published to the market in aggregated zonal form. In general the market will therefore know very rapidly about unplanned outages, and within a day or two whether this is a longer-term unplanned outage (which cannot be accurately predicted at the point of trip in any case). In AEP's view, a market-rules-based approach of this type strikes the correct balance between transparency and commercial confidentiality.

If a definition of "inside information" is adopted, this must recognise that optimisation of a generation portfolio does not constitute market abuse.

Market Manipulation

The EU competition rules provide substantial scope to address market manipulation and it would have to be shown convincingly that these rules were insufficient if additional sector-specific regulation were to be justified. The consultation paper provides little evidence of this, simply stating in Para 35 that abusive practices are related "in some cases – but not necessarily – to the existence of a dominant position".

The Competition Commission addressed this issue in its review of the MALC. It concluded that (Para 2.330):

"We see manipulation of the market as conduct for which a sufficient remedy would in principle be the modification of market rules or mechanisms."

The Association takes the view that market manipulation can be dealt with effectively by a combination of EU competition law, national regulation and national or regional market rules.

AEP does, however, agree that regulators must have the powers to monitor the market effectively and that close cooperation between energy and financial regulators should be promoted.

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