Comments on the CESR and ERGEG advice to the European Commission

Draft Response to Question F.20 – Market Abuse Consultation Paper July 2008

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The response avoids the main issue with wholesale markets, which is the lack of confidence, both from market players and from the public in general, in wholesale gas and electricity markets. This lack of confidence is borne not so much from a perception that markets are being manipulated as from the observation that wholesale markets in Europe are controlled by oligopolies and the liquidity of the visible markets is minimal. This means that companies do not need to collude or abuse markets to get the desired result. The UK Parliamentary Business & Enterprise Committee stated the problem very clearly in its July 2008 report. It said[1]:

> ‘We note, however, that no witness has brought forward evidence of active collusion in the wholesale or retail markets. It is clear, though, that in a retail market dominated by six major players, it is easy for those players to make informed judgements about the behaviour of their competitors. This alone can distort competition.’

These sentiments apply equally to wholesale markets as retail markets. The UK market, with six main players is significantly less concentrated than most European energy markets. The result is a lack of trust in the companies because when companies raise their prices, citing increases in wholesale prices, consumers have no way to determine whether the companies are really having to pay more for their wholesale supplies or whether they are behaving opportunistically.

The intuitive response if markets are not working because of lack of liquidity is to force the companies to use these markets. For example, the official UK energy consumer body, energywatch recommends[2]:

> Mandatory trading: firms to trade a defined level of output through the over the counter wholesale markets to enhance liquidity.

The Business & Enterprise Committee was more cautious and recommended:

> The wholesale electricity market suffers from a severe lack of liquidity, which contributes to price volatility and poor price transparency. This, in turn, dulls market signals for potential investors in new capacity, outside of the ‘Big 6’. It also reduces the ability of new energy retailers to compete in the market. As Ofgem has already identified the issue as a serious problem, and in the absence of tangible progress on the Market Design Project, its market probe should propose a solution. As a starting point, and in addition to any increase in transparency that can be achieved as a result of our earlier

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[1] http://www.publications.parliament.uk/pa/cm200708/cmselect/cmberr/293/293i.pdf p 3.
[2] http://www.energywatch.org.uk/uploads/Ofgem_energy_supply_markets_investigation_30_April.pdf p 24.

> recommendation, the regulator should conduct a detailed analysis of the risks and benefits of requiring the ‘Big 6’ firms to trade a proportion of their electricity openly in the forward market. We acknowledge that the regulator must take account of the need to balance the effects that greater regulatory risk might have on the investment decisions of incumbent companies. In principle, however, creating a better functioning wholesale market should facilitate new entry both in supply and generation.

This exposes the heart of the problem. Forcing companies to trade in the visible spot market would make investment in new capacity very risky and could also jeopardise security of supply. If companies building new capacity do not know how much output they will sell and at what price (if they do, there is no market), financiers will see such decisions as highly risky and the cost of capital will be very high if loans are possible. These high costs will of course be passed on to consumers. This means that any benefits of competition could easily be lost to the risk premium on investment.

Perhaps even more seriously, such proposals could compromise security of supply. An integrated generator/retailer can justify building new capacity to supply its own consumers and if all companies ensure their own consumers are supplied, this should result in a secure supply. But why should a company take the risk of building a new plant that will just contribute to the market with no particular benefit to themselves. Indeed, ***not*** investing would lead to higher prices and higher profits so forcing companies to use the market would create an incentive not to invest.

The Commission and Regulators must keep their eye on the objective, which is to provide consumers with a reliable affordable supply of energy. Markets are only worthwhile if they help this objective to be met, there is no merit *per se* in a market.