

The Financial Electricity Market

A Summary

Conclusions

According to studies carried out by Finansinspektionen (Swedish Financial Supervisory Authority (FI)), the financial energy trading establishment leaves something to be desired in terms of its management of communications and manner of dealing with conflicts of interest. It is important to address these shortcomings in the interests of improving the functioning of the market and increasing participation in the market. At the same time, from a regulatory viewpoint, the financial electricity market is not sufficiently significant to justify a higher ranking among FI's priority areas and an intensification of FI's involvement in this area at the expense of its other responsibilities.

Electricity derivatives, electricity-related commercial paper and emission rights are all relatively new phenomena that, despite the differences among them, have two common denominators: they relate to the area of energy and the environment, and they are legally defined as financial instruments. The latter implies that the laws and regulations that apply to other financial trading must also be applied to these markets. It also implies that companies that conduct trading in electricity-related financial instruments and in emission rights are subject to regulation by FI.

Good access to relevant information and to all market participants, as well as a systematic, workable approach to dealing with the conflicts of interest that can arise in trading operations, are important for the proper functioning of financial markets. FI has found indications of shortcomings in these respects. More in-depth analysis is required, focusing on ways of dealing with the functional problems that can arise. Some of this involves cooperation with Swedish government agencies such as the Swedish Competition Authority and the Swedish Energy Agency, as well as with industry organizations, to improve information management in the financial electricity market. It would also increase confidence and improve market efficiency. FI also found a need for more contact with Nordic regulatory authorities, since the electricity market increasingly functions as a common Nordic market. Essentially the same conclusions apply to the market in emission rights.

In other words, the indications of shortcomings in information dissemination and the management of conflicts of interest that were found in these parts of the financial market relate to important matters of principle that are very familiar from other financial markets. So there is good reason to continue to monitor and analyze market development, and to discuss measures by which market efficiency could be improved.

On the other hand, in terms of the financial market as a whole, these markets are clearly not nearly as crucial as, say, the stock market. Shortcomings in the financial electricity market cannot threaten the ability of the financial system to function, and since it is a market for professional players, there is no reason to take the consumer-protection interest into consideration. Consequently, it is neither reasonable nor realistic for FI to increase its relatively limited current activities relating

to the financial electricity market, particularly as regards the substantial, growing requirements placed on FI's market regulation otherwise, where consumer-protection aspects in particular are very clear.

The financial electricity market is dominated by a limited number of securities dealers. These so-called electricity companies in turn focus almost exclusively on trading in electricity-related financial instruments, rather than on traditional securities trading, within the framework of a professional market. Under the EU's coming Markets in Financial Instruments Directive (MiFID), this type of company will probably be exempted from regulation, at least initially. However, it will still be possible to maintain regulation at the national level. It will eventually become necessary to adopt a position, weighing the disadvantages of deviating from the EU standard against the value of ongoing regulation. Our preliminary opinion is that a special Swedish position in this area is not justified.

The financial electricity market

The "financial electricity market" refers to trading in electricity-related commercial paper and derivatives for which electricity is the underlying commodity. There is also a (financial) market for emission rights relating primarily to carbon dioxide emissions, which clearly impacts the physical and the financial electricity markets, since certain electricity production plants generate substantial emissions of carbon dioxide. Consequently, the cost of emission rights influences production costs and electricity prices.

Electricity derivatives are used primarily by companies that conduct electricity trading, mainly to hedge against price movements in the electricity market, which can be considerable. So, the electricity prices contracted with the customers are hedged via the derivatives market. In other words, there is a clear connection between the electricity derivatives market and the price that households and companies pay for their electricity.

FI has reviewed the financial electricity market – to analyze it and gain further knowledge of its component parts, and to determine whether it meets the requirements that FI, as the regulatory authority, imposes on a well-functioning financial market. FI has targeted securities dealers whose operations wholly or partially focus on the financial electricity market – that is, "electricity companies". There are fourteen such companies. Even if the electricity derivatives market in itself involves neither financial stability aspects nor any consumer-protection interests – which are the primary tasks of financial regulation – there is obviously a broad-based public interest in having a well-functioning electricity derivatives market, since it ultimately affects the electricity price that consumers and companies must pay. At the same time, it must be said that – according to the government commission on the electricity and gas markets – in general, price development on the electricity market seems to function relatively well. This indicates that the shortcomings of the electricity derivatives market have not had any tangible adverse impact on market price development and the market price level, at least not to date. However, while from that perspective the problems are neither great nor pressing, this does not mean shortcomings need not be addressed.

The single most important factor of a functioning market is information. A lack of universal access to the same information at the same time leads to an imbalance that affects the efficiency of the market, which is reflected in the competition scenario and the price trend, and in the public's confidence in the market as such. The financial electricity market is affected in both the short and the long term by several external factors, most of which are beyond the ability of the industry to steer – such as the weather, production disturbances in

power plants, events affecting buyer decisions made by government agencies, and political decisions. Granted, obviously all markets are impacted by external factors. The electricity market, however, is directly and tangibly affected, particularly by decisions by government agencies and politicians, to a much greater degree than most other markets and industries.

Due to the structure of the financial electricity market, in which the production companies are major players in the financial market as well, and energy facilities are also jointly owned by several companies, the identification and management of conflicts of interest is a key part of the electricity companies' information management. It is important that conflicts of interest be identified and communicated to the market, to prevent problems of confidence. The slightest suspicion of unequal access to information would affect confidence in the market, which would also affect the liquidity and efficiency of the market.

If a small group of players of equal status creates a natural division of the market, from the point of view of society at large, these problems would still appear to be relatively limited. However, if and to the degree that other players, independent of the electricity production companies, also participate in the market – which to a certain extent is already the case – the problem becomes more significant. If the number of players grows, which is likely and generally desirable as well, demands will also increase. There is reason to believe that the current lack of transparency is a disincentive for players that might actually be interested in participating.

FI's regulatory activities are geared toward creating the necessary conditions for a well-functioning market and ensuring all players can participate on the same terms. Today, the financial electricity market is pan-Nordic and its physical manifestation, Nord Pool, is in Norway. In this cross-border system, FI can only regulate the parts that relate to the Swedish financial market. Accordingly, a well-functioning electricity market requires the continued cooperation of industry organizations and public agencies in and outside Sweden, to build knowledge of the market and the factors that influence the market, and to ensure that it is possible to act effectively.

Hans Bäckström, Editor

Contact persons: Peter Billinger, Helena Ingemarsdotter Haukeland and Erik Saers, Head of Market Conduct