Efficient regulation of wholesale energy markets requires a comprehensive approach to physical commodity and financial trading says Walter Boltz, Managing Director of E-Control and Vice President of CEER.

Comprehensive Approach Needed for Market Regulation

SETTING THE SCENE

Commodity trading is a regulated business with the focus on the potentially adverse effect on efficient price formation of speculative trading. The arsenal of controls includes elements such as data transparency reporting and limitations on open position-trading.

The objectives are twofold: to increase the efficiency of trade (by making available pre- and post-trade information) and to try and ensure that market prices reflect fundamental demand and supply conditions (through record-keeping requirements and limits to speculation).

Concerns have been voiced that in EU gas and power markets fundamentals have been weakened by the increased involvement of financial traders in the derivatives markets.

In many respects, the US is far more advanced in the regulation of commodity futures, because it has been driven by the long history of agricultural price speculation. Still, the recent experience of the US-CFTC when trying to differentiate between "beneficial" risk management strategies and "adverse" speculation showed that a clear-cut distinction is hard to find. The role of speculation is therefore still unclear.

The European Parliament recently launched a debate on hedge funds. The first reactions from the industry but also from sector regulators mirrored the problem encountered in the US, namely that there is no clear distinction between good and bad investors and traders. Still, some limitation to speculative trading may be needed, as European power and gas markets may be too small to support high volumes of financial trading.

SOME NECESSARY CONTROLS

Record-keeping and reporting obligations as well as limits on financial trading are necessary to allow regulators to intervene in cases of alleged market abuse or to reduce the risk of such abuse.

This objective has to be distinguished from the aim of facilitating efficient price formation. In forward markets expectations and risk also enter the equation. The present legal framework establishes a required level of pre- and post-trade information, but this only covers trade subject to MiFID. In contrast to trading in shares, commodities are mainly traded via non regulated markets, i.e. OTC.

This has two main consequences:
First, trading information is dispersed over a multitude of places. Information has to be collected from broker screens, PXs, and through market reporters. These information providers hold different levels of information. On PXs traders have access to demand and supply curves, whereas for OTC markets only (more or less representative) information on individual trades is reported. In some cases the lack of liquidity even prevents the formation of reliable price indicators. There are solutions to this such as obligatory clearing of OTC contracts might contribute to increased coverage and accuracy of price information.

Second, the dominance of non-financial OTC trade implies that price formation is largely not subject to regulation, only to general competition law. Financial regulation instead provides a bundle of directives which include subjects such as insider information, market abuse or transparency requirements.

The unique features of power, and to some extent gas markets, indicate that underlying physical constraints have to be taken into account more directly than might be the case for other commodities. Future demand and supply strongly depend on external factors such as weather, hydrology, problems in infrastructure, etc. Non-existent or reduced storability contributes to high price risks in electricity and, to a lesser extent gas balancing markets.

Summing up, for electricity and gas trading comprehensive information on underlying demand and supply of the commodity has to be available to market participants. At the moment this is not the case. There are either no obligations at all on producers and suppliers to publish data or they are quite vague, so that format, location and time of publication are unclear.

A WAY FORWARD?

In principle two alternative solutions exist. First one could enlarge the scope of financial regulation to non-regulated markets and include transparency obligations for underlying markets.

However, this contaminates the financial market regulation with goals of commodity price formation, which is not its primary or even secondary objective. Financial market regulation is concerned with the stability of financial markets, the protection of investors and the prohibition of abusive behaviour.

Second, one adopts a comprehensive framework for the two commodities, where transparency requirements are established irrespectively of the exact character of the market participant. Transparency in this sense encompasses the underlying physical market as well as the financial market and also the fundamental data which govern demand and supply.

In order to develop an efficient system of regulatory oversight, co-operation between sector regulators (financial and energy) will be necessary, because what we are discussing here is the influence of the financial market on commodity prices and/or the influence of physical restrictions on derivatives. Only a comprehensive approach can affect market behaviour. At the moment, there is no such approach.