

Non-traditional business models: Supporting transformative change in the energy market

This paper focuses on questions in chapters 4 and 5 only.

The e-POWER auction is a growing non-traditional business model in the PPA market that may cease to exist as a result of a European regulation called The Markets in Financial Instruments Directive (MiFID) II.

The e-POWER auction has done much over recent years to help many small generators find a route to market for their power. On the bidding side the auction has also supported and provided a flexible route for new suppliers to gain a foothold in the electricity market.

Background to the Non-Fossil Fuel Purchasing Agency (NFPA)

The NFPA was established in 1990 to secure generation from renewable sources at least cost

The NFPA's e-Power auction is a platform where electricity suppliers can bid to enter into Power Purchase Agreements (PPAs) with renewable electricity generators in order for them to physically deliver their electricity onto the National Grid.

Chapter 5: Benefits of NTBMsThe e-Power auction positively contributes to the UK energy market by:

- **Supporting generators and suppliers** – with no direct entry costs or credit/collateral requirements, the e-Power auction supports suppliers to source renewable electricity, particularly those that are independent, new entrants or do not have access to their own generation assets. In the last auction 42% of contracts awarded were to suppliers outside of the Big Six. e-Power also provides an affordable route to market for renewable electricity generators – many of which are SMEs, independents and new market entrants. For generators the auctioned electricity achieves a price of 96-98% of its potential market value. This compares to the 70-90% they can expect to achieve through short- and long-term bilateral PPAs or other PPA tendering alternatives.
- **Providing greater competition and liquidity** – three quarters of all active electricity suppliers now bid on contracts in the e-Power auction. This is because the flexibility and timing of the auction provides suppliers with more regular access to renewable generation at lower cost compared to power exchanges and alternative PPA options. This makes it more attractive for smaller parties in particular, as it creates a level playing field for them to operate on.

- **Lowering consumer bills** - In the e-Power auction the supplier agrees on a fixed price for the output from a renewable generator. Under this system the price paid by the supplier is likely to be at or just below the wholesale traded price on the day of the auction. As well as the lower traded price there are no entry or purchase fees in the e-Power auction. The results are cost savings that can be passed on to the consumer through competitive retail pricing.
- **Working towards a decarbonised economy** – the e-Power auction supports the continued development of renewable projects across a mix of technologies and capacities (30kW – 50MW), promotes distributed renewable generation, helps to assist renewables on the path to becoming subsidy-free and contributes to the UK's EU renewable energy targets.

Chapter 4: Regulatory issues facing NTBMs

Background to MiFID II

The Markets in Financial Instruments Directive (MiFID) II was drafted and agreed in response to the financial crisis. It has been designed to improve the functioning of financial markets, to close loopholes and to ensure that trading in financial instruments, where appropriate, takes place on regulated platforms and on a level playing field.

The European Securities and Markets Authority (ESMA) has been given responsibility to draft Regulatory Technical Standards (RTS) to specify the detail set out in the Directive including the definition of financial instrument and ancillary activities.

The NFPA's contracts are non-financial instruments and should not be covered by MiFID II

The NFPA's commercial contracts, which are traded through the e-Power auction, are already within the scope of the Regulation on the Integrity and Transparency of the Market Wholesale Energy (REMIT) as they are wholesale energy products, which must be physically delivered in the UK. Whether they will be subject to the 'REMIT carve out' under MiFID II will depend upon them being traded on an Organised Trading Facility (OTF) that must be physically settled. If that is the case then these contracts will be non-financial instruments under MiFID II. For this to be the case will require NFPA to make changes to the way in which its auction platform currently operates.

NFPA's role is as an operator of the auction platform, it is not itself party to the relevant contracts. Those contracts are directly entered into by the generators and suppliers over the platform.

The NFPA is not a speculative platform, poses no systemic risk and should not be covered by MiFID II

The objective of MiFID II is to capture speculative trading and market participants that present systemic risk to the integrity of European markets in financial instruments.

Participants in the e-Power auction do not trade speculatively within their PPA contracts. Instead the winning electricity supplier takes delivery of all the power from the generator's site for the entire contract period, usually six-months.

Ancillary activity and the de-minimis threshold

Should any of the NFPA products or contracts not be subject to the 'REMIT carve out' or the 'commercial purposes carve out' under MiFID II that by reference to the proposed trading activity test relevant to the exemption for ancillary activities under Article 2 (1)(j) NFPA's activities would be within the de-minimis threshold. We note that this is the subject of the ESMA consultation published in December 2014 and has not been finalised.

The e-Power auction is de-minimis under ESMA's proposed threshold for the trading activity test of 0.25% of the overall EU market for the asset class. The NFPA's sales are equivalent to 0.03% of the EU market. We believe this is a clear example where it would not be proportionate to apply the requirements of MiFID to such market and its participants.

The impact of MiFID II unintentionally capturing the NFPA could trigger a chain reaction across the energy market

There could be wider unintended impacts for the energy market, energy consumers, energy prices and the real economy of the NFPA being inadvertently caught up in MiFID II. These include:

- **Costs in compliance would lead to participants leaving the market and place prohibitive barriers for entry in front of generators and suppliers, particularly independents.** The regulatory costs for the e-Power auction to operate under MiFID II is estimated to be £350,000 per year with a minimum capital requirement of £500,000 if the NFPA were to be authorised as an operator of a Multilateral Trading Facility. Costs may be less than this if NFPA were to be authorised to operate an OTF, however this would still represent an increase in cost from the current regime. e-Power's commercial fees for 2015/16 are expected to be £400,000. The compliance costs would therefore make the e-Power auction unprofitable, threatening its continuing operation. Charging participants entry and/or purchase fees would make the market less attractive, especially to smaller operators.
- **As participants exit the market there will be less competition, liquidity flight and increased market stability risks.** As competition reduces and liquidity contracts, trading costs would increase while efficiency for production and retail markets would decrease.
- **Higher trading costs from less competition and liquidity would increase consumer energy bills.** This would run counter to UK's and EU's objective to decarbonise the electricity sector at least cost.
- **With these market risks, investment in renewables would be undermined.** Over half of the UK's 20GW of renewable capacity is provided by independent generators with platforms like the NFPA providing them with a route to market to contract with independent suppliers. Undermining the attractiveness of the e-Power auction risks reducing investment in the renewables sector which will in turn increase the risk to security of supply and slow down our progress to decarbonising our electricity sector at least cost.

Next steps

We would like to ensure that NFPA's activities are not inadvertently brought within the scope of MiFID II as we believe that NFPA's PPAs should be non-financial instruments. Either this would be on the basis of being subject to the REMIT carve-out or on the basis that such contracts should not be regarded as having the characteristics of other derivative financial instruments under C7. Furthermore, it would be disproportionate to the scale of NFPA's activities and its participants compared to the electricity market as a whole. To achieve that we believe that the regulatory standards being developed should make clear that where such activities are within the de-minimis threshold proposed by ESMA in connection with the exemption for ancillary activities that the exemption should apply (even where such activities represent the whole of a person's business) and are not merely ancillary to other non-investment activities.