

**January 2001**

**Proposed changes to the regulation  
of financial markets pursuant to the  
Financial Services and Markets Act  
2000**

**An Ofgem response to a Treasury  
consultation paper**

## Summary

This document sets out Ofgem's views on proposed changes to the regulation of financial markets and their application to the energy markets. The Treasury has issued a consultation document on the draft orders which will define the scope and application of the Financial Services and Markets Act 2000 (the 'FSMA') which received Royal Assent on 14 June 2000. These changes in financial regulation are taking place at the same time as fundamental changes in gas and electricity wholesale markets.

Ofgem welcomes the proposed application of the FSMA to the wholesale gas and electricity markets. In Ofgem's view appropriate financial regulation will protect users (to the ultimate benefit of electricity and gas customers) through encouraging orderly markets; this will in turn build confidence.

In Ofgem's view some companies in the energy sector will require appropriate safe harbours (other than the hedging and sale of goods/supply of services exclusions). These will be covered in the exemption orders (EOs) for the industries.

Ofgem believes, however, that a number of areas concerning the Regulated Activities Order require additional clarification. Ofgem supports the hedging exclusion but suggests that a number of amendments need to be made to ensure that all hedging activity in relation to physical gas and electricity markets is captured by the exclusion. Ofgem also supports the capital adequacy regime but suggests that this should be developed in such a way that the special characteristics of energy markets are taken into account. Ofgem would also like the Treasury to consider the possibility of transitional arrangements for those companies requiring authorisation who have not as yet had the opportunity to begin the process.

Whether or not the Treasury will have time before the FSMA is enacted to circulate revised drafts of the regulated activities order (RAO) and EO, Ofgem would encourage the Treasury to circulate revised drafts of the hedging exclusion article or articles (and, of course, of the EO article which contains the electricity industry exemption).

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# 1. Introduction

## *Purpose of this document*

- 1.1 In this document Ofgem has set out our response to the Treasury's October 2000 consultation document and our views on the proposed changes to the regulation of financial markets and their application to the energy markets. The document gives background information concerning the development and regulation of the energy market. It explains why Ofgem believes that financial regulation of the wholesale gas and electricity markets is important. The document also outlines particular issues that Ofgem would invite the Treasury to clarify concerning the draft orders to be made under the Financial Services and Markets Act (FSMA).

## *Background*

- 1.2 The reform of financial service legislation is taking place at the same time as fundamental changes in the gas and electricity wholesale markets. The development of New Gas Trading Arrangements (NGTA) and the introduction of New Electricity Trading Arrangements (NETA) is placing greater emphasis on the use of financial instruments.
- 1.3 The Treasury has released a consultation document on the application and scope of the new Financial Services and Markets Act (FSMA). The consultation document invited comments both on the draft orders to be made under the FSMA and on any other issues that have been raised in the consultation document that accompanies the orders.
- 1.4 The draft orders are the:
- ◆ Regulated Activities Order (RAO);
  - ◆ Exemption Order (EO);
  - ◆ Appointed Representatives Regulations;

- ◆ Non-Exempt Activities Order; and the
- ◆ Carrying on Regulated Activities by Way of Business Order (BO).

### ***Ofgem's views***

- 1.5 Ofgem welcomes the proposed application of the FSMA to certain parts of the wholesale gas and electricity markets. In Ofgem's view appropriate financial regulation will protect users (to the ultimate benefit of electricity and gas customers) through encouraging orderly markets; this will in turn build confidence.
- 1.6 However, there are several areas in Ofgem's view that require clarification. Whilst the EO should exempt the short-term balancing and settlement arrangements in gas and electricity markets, exclusions in the RAO should, in Ofgem's view, be wide enough to carve out certain activities which are an integral part of physical markets. In Ofgem's view, the RAO requires clarification, in particular in relation to the hedging and sale of goods exclusions. In addition, the capital adequacy requirements and the possibility of transitional arrangements should be clarified.

### ***Outline of this document***

- 1.7 In chapter 2, we provide relevant background information. Chapter 3 explains why Ofgem considers it important that relevant participants in gas and electricity markets are subject to financial regulation. Chapter 4 outlines particular issues that arise as a consequence of the Treasury's proposals. Chapter 5 outlines Ofgem's conclusions.

### ***Way forward***

- 1.8 Ofgem has had a number of detailed discussions with the Treasury and the FSA about the interactions between the new financial services regime and the revised gas and electricity wholesale trading arrangements - these discussions will continue. Given the potential impact of the new financial and trading regimes Ofgem would encourage Treasury to consult on revised drafts of the hedging exclusion and the electricity industry exemption order. Prior to the introduction of NETA Ofgem will additionally be issuing an information note to market

participants highlighting the key issues relating to financial services regulation of which they should be aware.

## 2. Background

### *Features of the gas and electricity wholesale markets*

- 2.1 The reform of financial service legislation is taking place at the same time as fundamental change in the gas and electricity wholesale markets. With the development of the gas trading arrangements and the introduction of new market-based electricity trading arrangements, it is anticipated that:
- ◆ gas and electricity market trading will increasingly take on many of the characteristics of commodity market trading;
  - ◆ there will be more emphasis on the use of financial instruments and the development of a wider range of such instruments to manage risk; and
  - ◆ increasing numbers of financial traders with no physical assets will enter the wholesale gas and electricity markets.
- 2.2 Of particular relevance is that market and counterparty risks are likely to be relatively pronounced in wholesale gas and electricity markets, in particular because short-term price volatility tends to be greater than other physical or financial market. There are a number of reasons why electricity and gas markets are likely to display high price volatility when compared to other 'commodities' including: limited storage capacity, especially for electricity; energy demand can vary significantly on a minute to minute basis; the physical characteristics of the wire and pipeline networks used for transporting electricity and gas can place significant, transient constraints on market activity; participation by the demand side (large customers etc) is still developing; supply and demand needs to be balanced at all times in the electricity network, with the System Operator obliged to clear the market.

### *Regulatory Background*

- 2.3 Ofgem's responsibilities and duties are described in the Gas Act 1986/1995 and the Electricity Act 1989 (as amended by the Utilities Act 2000). The Utilities Act establishes the protection of customers' interests, wherever appropriate by promoting effective competition, as the Authority's principal statutory objective.

In carrying out this objective, the regulator is required to ensure that all demands for gas and electricity are met, and that companies can finance their licensed activities. Ofgem has concurrent powers with the Director General of Fair Trading under the Competition Act 1998, and various EU treaties and directives.

- 2.4 Ofgem's regulatory powers do not encompass all aspects of the trading environment. Within the gas market, signatories to Transco's network code are required to hold a shipper licence, issued under the Gas Act. Hence only Ofgem-licensed shippers are able to directly notify trades effected at the National Balancing Point (NBP) and participate in the on-the day commodity market (OCM).<sup>1</sup> By contrast, under the New Electricity Trading Arrangements (NETA), traders will not require an Ofgem-issued licence in order to trade as parties to the Balancing and Settlement Code (BSC) (although those parties involved in the actual generation and supply of electricity will continue to require a licence). Moreover, traders in secondary markets including energy forward and futures markets do not require a licence in order to trade.
- 2.5 The Financial Services and Markets Act 2000 (the 'Act'), which received Royal Assent on 14 June 2000, when enacted, will replace the Financial Services Act 1986 (the 'FS Act'). It is expected that this will take effect in the second half of 2001. In addition to making changes to financial market legislation, the Act establishes the Financial Services Authority (the 'FSA') as the single statutory regulator of financial services in the UK.
- 2.6 The FSA has four stated statutory objectives: maintaining market confidence; promoting public awareness; protecting customers; and reducing financial crime.

### ***Application and scope of the FSMA***

- 2.7 In October 2000 the Treasury released a consultation document on the application and scope of the new Financial Services and Markets Act (FSMA). This document invited comments both on the draft orders to be made under the

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<sup>1</sup> However, under the OCM market rules a market participant may enter in to an agency arrangement with a third-party shipper to nominate trades on its behalf. It is therefore possible to trade on the OCM without holding a shipper's licence.



FSMA and on any other issues that have been raised in the consultation document that accompanies the orders.<sup>2</sup>

2.8 The draft orders are the:

- ◆ Regulated Activities Order (RAO);
- ◆ Exemption Order (EO);
- ◆ Appointed Representatives Regulations;
- ◆ Non-Exempt Activities Order; and the
- ◆ Carrying on Regulated Activities by Way of Business Order (BO).

2.9 This document focuses primarily on the RAO and EO as in our view these are the orders most likely to impact on gas and electricity market participants.

#### **Regulated Activities Order (RAO)**

2.10 The existing permitted persons regime will be discontinued under the Act. However, the HM Treasury consultation paper notes that 'we do not intend to require authorisation for firms who carry on regulated activities for commercial, as opposed to investment, purposes'. Accordingly, the draft RAO includes:

- ◆ a hedging exclusion (Article 17) for firms who hedge in the course of a business which is not investment business to be able to deal in derivatives for hedging purposes;
- ◆ exclusions from the definition of "futures" (Article 78). These exclusions are not new and continue the notes set out in the definition of "futures" in the FS Act; and
- ◆ an exclusion (Article 63) for firms whose main business is to sell goods (or supply services) and not to carry on investment activities.

2.11 In Ofgem's view, the sale of electricity is the sale of goods. The structure of electricity contracts will determine whether they are contracts for the sale of

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<sup>2</sup> Ofgem has not within this response reviewed the HM Treasury consultation regarding 'Repeals, Transitional Provisions and Savings' published on 7 December 2000.

electricity or derivatives. However, one of the main reasons for the gas and electricity industry exemptions in the EO is the risk that what are essentially physical sales of electricity may fall within the scope of the derivative instruments defined in Articles 77 to 79 of the RAO.

- 2.12 The key features of the hedging exclusion, which only applies to dealing as a principal, not as an agent, are:
- ◆ transactions are entered into solely or mainly for hedging purposes;
  - ◆ the firm's hedged business consists mainly of activities that would not otherwise be Regulated Activities (as defined in the draft RAO, or which would appear in the draft RAO but for an exclusion); and
  - ◆ the transactions are not conducted with or between individuals.
- 2.13 The hedging exclusion is specific to certain types of investment: options (Article 77), futures (Article 78), Contracts for Differences (CfDs) (Article 79), and rights to or interests in investments insofar as they are relevant to options, futures and CfDs (Article 83). It is understood that participants will not be required to submit a formal application to be eligible under the exclusion.

#### **Exemption Order**

- 2.14 The implementation of the FSMA is not expected to alter the regulation of short-term balancing and settlement arrangements. Articles 41 and 42 of the draft EO carry forward the existing exemptions for the gas industry found in the Financial Services Act 1986 (Gas Industry Exemption) Order 1999 and the proposed electricity exemption order covers the Balancing Mechanism, imbalance settlement and Balancing Services under NETA. However, the FSMA appears likely to affect existing and potential gas and electricity wholesale market participants in the longer term markets.

### 3. The need for Financial Services regulation in the wholesale gas and electricity markets

#### *Building market confidence and increased liquidity*

- 3.1 Ofgem believes that it is sensible for financial regulation to be applied to certain parts of electricity and gas markets, where this appropriately reflects the particular characteristics of these markets.<sup>3</sup> We outline our reasons below.
- 3.2 Ofgem considers that the reassurance provided by the application of appropriate financial services regulation may prove particularly valuable in the early stages of NETA, underpinning the development of confidence and liquidity in the new, traded markets. The reassurance afforded by the prospect of orderly markets is likely to be similarly valuable in the continued development of on-the-day and forwards and futures gas trading markets. Ofgem's understanding is that electricity and gas companies that are more active in trading in these markets may need to seek FSA authorisation under the new regime.
- 3.3 Ofgem believes that incumbent electricity and gas companies that maintain significant trading positions in the forwards and futures markets, or who offer trading and risk management services to others, should be subject to the same financial disciplines and safeguards as new entrant traders undertaking the same activities in energy or other commodity markets. Financial discipline can help build confidence in the market and reassure both new and established players that measures have been put in place to minimise the possibility of market abuse or default. This in turn could boost liquidity in futures and forwards if it encouraged the entry of 'pure' financial players into the market.
- 3.4 Ultimately, increased liquidity would be expected to improve efficiency in the wholesale gas and electricity markets and ensure that prices reflect supply and demand fundamentals. Liquidity should also promote innovation by companies by allowing them to develop new products and services to sell to customers with confidence that positions can be unwound if necessary.

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<sup>3</sup> For example, the application of an identical regime to that applied to established traditional financial markets, such as investment banking, is unlikely to be appropriate to electricity and gas markets.

### ***Limitations on Ofgem's Regulatory Powers***

- 3.5 Ofgem's regulatory powers do not encompass all aspects of the new trading environment. In particular:
- ◆ Relatively few licence conditions in generation, supply and shipper licences relate directly to behaviour in the wholesale markets. Ofgem does however have concurrent powers under the Competition Act 1998; and
  - ◆ Parties that are not licensed by Ofgem will be able to enter trading markets.

### ***Capital Adequacy***

- 3.6 Ofgem acknowledges that the FSA's main objectives in setting capital adequacy standards are to protect financial markets and investors (the counterparties and customers of authorised firms), rather than electricity or gas customers.
- 3.7 But, Ofgem believes that the enforcement of capital adequacy obligations by financial regulators could be a useful and important function, complementing Ofgem's customer protection role. Of particular relevance is that market and counterparty risks are likely to be relatively pronounced in wholesale gas and electricity markets, in particular because short-term price volatility tends to be greater than in other physical or financial markets. The electricity Balancing and Settlement Code and the gas OCM provide for only a limited level of credit controls in comparison with other markets.
- 3.8 However, it is worth noting that some of the companies that might be felt in future to represent a risk in this respect (standalone retailers, perhaps) might fall outside FSA oversight by exclusion, if they do no more than buy and hedge for their own needs or if deals are made through an authorised firm.

### ***Participants' internal Systems and controls***

- 3.9 Ofgem understands that the FSA requires authorised firms to maintain appropriate systems and controls. To the extent that electricity and gas trading

arrangements provide the same scope for error and misconduct as in the financial markets, this could be a worthwhile regulatory function for the FSA.

### ***Market Surveillance***

- 3.10 Ofgem has a well established market surveillance team which continually monitors the wholesale gas and electricity markets and has undertaken a series of investigations looking at both the gas and electricity markets. However, under the new trading arrangements considerable trading activity will take place in other market arenas which are not currently subject to Ofgem regulation, such as futures markets. Ofgem is already in discussions with the FSA with a view to co-operation in some areas, particularly market abuse – in relation to which Ofgem may be able to provide relevant information on underlying markets in physical electricity and gas.

## 4. Key Issues raised by the Treasury consultation

### *Introduction*

- 4.1 As set out in the last chapter Ofgem supports an approach that will require electricity and gas companies (whether incumbent or new entrants) to be subject to financial services regulation where appropriate. Nevertheless Ofgem is concerned that unless there are appropriate exclusions there is a risk that the new regulatory regime could in some circumstances have an adverse impact on customers and competition. Ofgem believes that appropriate extensions of the proposed exclusions may be made without prejudicing the achievement of the objectives for the new financial regulatory regime. The issues that Ofgem has identified associated with both the RAO and EO are examined in turn below.

### *Regulated Activities Order*

#### **The Proposed Hedging Exclusion**

- 4.2 In principle Ofgem welcomes the proposed hedging exclusion. If the scope is correctly identified the exclusion should mean that those electricity and gas companies that trade only for commercial purposes – to hedge their underlying physical business activity – will remain outside the scope of financial services regulation and therefore avoid the associated administrative costs and burdens.
- 4.3 Ofgem believes that the exclusion for hedging should apply not only to own-account dealings, but to agency dealings/other arrangements on behalf of third parties and advisory services provided to third parties. Ofgem considers that this should not be problematic provided that the hedging exclusion itself is appropriately circumscribed. Ofgem does not support a broadening of the exemption to cover ‘risk management’ in its widest sense, whereby ‘risk management transactions’ might be permitted which would increase rather than cap or decrease exposure.
- 4.4 Ofgem believes that the exclusion will be difficult to apply on a transaction by transaction basis. Ofgem would encourage greater flexibility so that transactions which cover or limit the risk undertaken by (or exposure of) a person (or

affiliated companies in a group) could benefit from the exclusion. This would necessitate the broadening of Article 17(c) from the current draft.

- 4.5 Ofgem considers that Article 17(c) should be broadened also in terms of the types of exposure which are the purpose of the hedging to include volume or amount (i.e. where "B" will be affected by changes in the extent of supply or demand in the market). One possibility would be for the types of exposure referred to in the exclusion to be stated expressly to be indicative only so that the risks mentioned can be clearly covered under the exclusion.
- 4.6 Ofgem considers that it is critical that Article 17(e) be amended so that the primary transaction may comprise the carrying on of an activity of a kind specified by the RAO even if that is an activity in respect of which the person (referred to as "B" in the exclusion) is exempt (or, in the circumstances described in 4.7 below, even if the activity is excluded).
- 4.7 Ofgem considers that it should also be possible for any companies which benefit from the sale of goods or supply of services exclusion (Article 63) to hedge or provide hedges in relation to those activities, without needing to argue that the hedge may fall within Article 63(2), (3), etc. This, too, would require some differentiation of the kinds of exclusions referred to in the parentheses in Article 17(e).
- 4.8 The reference to "a business" in Article 17(d) should include not only the business of "B", but the business of the member of the group which has entered into, or will be entering into, the primary transaction (or, if our suggested approach in 4.4 above is adopted, which has the exposure).
- 4.9 The provision of "load management services", which are essentially advisory services, should be excluded. To the extent that the advice relates to the sale of goods (i.e. electricity) by the advisor or an affiliate of the advisor it may come within Article 63, but often such services are provided on a standalone basis. Ofgem does not suggest that all kinds of derivatives advice in gas and electricity markets should be excluded, rather that such advice relating to exempted activities and excluded hedging should be excluded.

- 4.10 Small generators in particular may operate in the market through "aggregators" who collectively manage the generators risk. Ofgem is considering the extent to which the activities of these aggregators should be excluded or exempted, and will make a further submission on this point.
- 4.11 In light of the above points, Ofgem believes that an exclusion similar to the hedging exclusion (but broader as outlined above) should apply to activities specified in Articles 19 (dealing in investments as agent), 22 (arranging deals in investments), or at least 22(1), 49 (advising on investments) and possibly 33 (managing investments) and 36 (safeguarding and administering investments).

#### *Contract for Differences*

- 4.12 Ofgem would also urge consideration be given to a broader commercial purpose exemption in Article 79 for CfDs, equivalent to that for futures in Article 78. This would provide a safe harbour for CfDs if either of the parties (or both of them) intended to take delivery (i.e. tracking the words of Article 78) of any property to which the contract relates (which tracks the wording in Article 79).

#### **Capital Adequacy**

- 4.13 Traditional measures for determining capital adequacy requirements in financial markets are sensitive to market and counterparty risks. As already stated, these risks are likely to be pronounced in electricity and gas trading markets.
- 4.14 Ofgem has some concerns with applying traditional measures formulaically, without considering what might be appropriate by way of detailed modifications for the specifics of electricity and gas markets. In Ofgem's view, a regime is required that ensures relevant participants to maintain capital adequacy appropriate to the risks of the market. On the one hand, it should not offer 'escape routes' whereby participants can effectively avoid the issue, which would put the market at risk of failure and default. On the other, it should not be so blunt and onerous that participants are driven from the market, or never enter the market in the first place, which would undermine the development of competition and liquidity, or structure their activities offshore to escape UK regulation.



- 4.15 Ofgem recognises that the design of a capital adequacy regime for energy companies will need to be driven by the FSA to the extent it raises issues within the scope of FSA's statutory duties as set out in Section 2 of the Act.

#### **Transitional arrangements**

- 4.16 Finally, Ofgem has some practical concerns over transitional arrangements. At present, only five organisations involved in physical electricity and gas markets are authorised under the FS Act. We understand that existing and potential market participants that wish to apply for authorisation or exclusion under the new regime may face an application processing time of up to six months. If large numbers of participants submit applications within a short space of time this would presumably lengthen the processing time.
- 4.17 A possible solution to this issue would be the creation of a transitional period whereby parties making applications within certain time limits would be able to trade, pending the outcome of the applications. Ideally, such transitional arrangements would also allow participants to trade under the existing FS Act until the new FSMA comes into effect. This would allow participants that do not currently have permitted person status to enter the market, provided that they apply for authorisation under the FSMA. Ofgem is of the view that such arrangements should be genuinely transitional.

#### ***Exemption Order for gas and electricity***

- 4.18 Ofgem supports the continuation in the draft EO of the present exemption order for gas and the proposed exemption order (under the FSMA) for gas and the proposed exemption order for electricity.
- 4.19 The exemptions overlap with Article 14 of the draft RAO (exclusion from dealing as principal). Gas shippers may be entering into OCM transactions with or through an authorised or an exempt person. But some counterparties may not be authorised or exempt, and in such instances, gas shippers who are not themselves authorised will have to rely on Article 42 of the draft EO. In the electricity market, balancing mechanism "trades", for example, will be through NGC and with the BSC Clearer, i.e. with or through an exempt person, relying

on a combination of EO Articles 41(1) and (2) with RAO Article 14 or, alternatively, relying on EO Article 41(3).

- 4.20 The exemptions overlap to a more limited extent with Article 20 of the draft RAO. Article 20 excludes only dealings as agent with or through an authorised person, not dealings as agent with or through an exempt person.
- 4.21 Ofgem believes that these overlaps are acceptable. The gas industry exemption and proposed electricity industry exemption are already highly technical and Ofgem considers that it would not be fruitful to redraft to seek to remove such overlaps.

## 5. Conclusion and way forward

- 5.1 This document has presented Ofgem's views on the proposed changes to the regulation of financial markets with regard to its application to the gas and electricity wholesale markets. Ofgem is supportive of the application of appropriate financial services regulation to relevant participants in gas and electricity wholesale markets.
- 5.2 Ofgem believes that financial services regulation should apply to certain aspects of the electricity and gas trading markets for the following reasons:
- ◆ Market confidence and liquidity is likely to be improved via financial market regulation.
  - ◆ Ofgem's regulatory powers do not encompass all of the new trading environment. For example, non-licensed participants and certain aspects of the forwards and futures markets.
  - ◆ Given the likely relative volatility of the gas and electricity wholesale markets, enforcing capital adequacy obligations would complement Ofgem's consumer protection role.
  - ◆ Regulation of participants' internal systems and controls is desirable.
- 5.3 While Ofgem considers that financial markets regulation would be beneficial to the energy markets, we also believe that appropriate exclusions should be granted to physical trades and certain risk management activities. Ofgem believes that such exclusions would facilitate competition in these markets without undermining the objectives of the FSA regime.
- 5.4 With regard to the Regulated Activities Order, Ofgem welcomes the proposed hedging exclusion. If the scope is correctly identified the exclusion should mean that those electricity and gas companies that trade only for commercial purposes – to hedge their underlying business activity – will remain outside the scope of financial services regulations and therefore avoid the associated administrative costs and burdens. Ofgem believes, however, that there are a number of areas which it would be beneficial for the Treasury to amend and

provide additional clarity to market participants. In addition, Ofgem supports a capital adequacy regime applicable to the energy market that does not represent a significant barrier to entry. Ofgem suggests that there should be transitional arrangements if the timescales involved in processing authorisation applications (whether under the Financial Services Act 1986 or the FSMA) is likely to prove to be problematic. However, Ofgem believes these arrangements should be genuinely transitional.

- 5.5 With regard to the Exemption Order, Ofgem supports the continuation of the present exemption order for gas and the proposed exemption order (under the FSMA) for gas and the proposed exemption order for electricity. Ofgem also believes that the identified overlaps with the RAO are acceptable.

### ***Way Forward***

- 5.6 Ofgem will continue its discussions with Treasury and the FSA. Ofgem would encourage Treasury to consult on revised drafts of the hedging exclusion article or articles and the EO article which contains the electricity industry exemption. Ofgem will in addition shortly be issuing a guidance note to market participants concerning the impact of financial services regulation.