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Comments to ESMA draft technical advice (DTA) to Section C 7 of Annex I of Directive 2014/65/EU on market in financial instruments (MiFID II) in relation to electricity balancing markets

1. Introduction

This document aims at providing guidance to ESMA and at clarifying why MiFID II should not apply to the transfer of the balancing contracts which are concluded on the one hand by transmission system operators (TSOs) as provided in the Third Legislative Package for an internal EU energy market[1], and national energy legislation (see more detailed below under section 2) and on the other hand by market participants providing balancing services (so called "balancing service providers"). The transfer takes place by one market participant to another whereas the TSO remains always the other counterparty.

TSOs have an obligation based on Article 15 Directive 2009/72/EC to operate the electricity system in their area and thus proceed to the balancing of their transmission systems.

Regarding the classification as financial instruments Section C 7 of Annex 1 of MiFID II classifies as financial instruments the "*options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments*".

According to ESMA's draft technical advice (DTA) *"a contract should be considered to be for commercial purposes if:*

> *i. it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network **and** it is necessary to keep in balance the supplies and uses of energy at a given time,*
>
> *ii. it is… (ESMA will consider adding other examples of contracts for commercial purposes following the consultation)."*

In the DTA's wording a clear exemption for contracts for balancing purposes is included, where one of the contracting parties is a transmission system operator. The question arises whether the transfer of balancing contracts from one balancing service provider to another can be classified as a financial instrument.

Due to the technical specificities of the balancing system the terms used in MiFID II do not necessarily cover the technical and contractual specificities of the balancing markets. We therefore give a short description of the balancing market and of the TSOs' obligations.

[1] Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC and Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003..

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2. Elements of the balancing market and the TSOs' obligation

Technical description of the balancing services

Due to technical developments such as the increasing volume of volatile renewable energy, **keeping the balance of the interconnected electricity system becomes more and more challenging for TSOs. Therefore, sophisticated solutions and forms of international cooperation have to be elaborated** keeping in mind also the targets of the internal energy market. The **primary aim of the balancing contracts is to prevent and keep the security of the system** including where TSOs have to restore the system security within a very short timeframe. Based on Regulation (EC) No 714/2009 (Regulation) ENTSO-E (the European Network of Transmission System Operators for Electricity) is preparing **network codes**, to be adopted by the European Commission (EC), on topics related to operation or connection to the transmission system or to the organisation of the electricity market. One of the 10 network codes is on Electricity Balancing (NC EB), which is on the crossroad of system operation and market related network codes with many technical specificities. The description below mirrors the present practices and the future targets under the NC EB, as well.

Electricity cannot be stored as such and other forms of energy storage are economically not efficient, therefore the generation shall be equivalent to the consumption in real time. If the generation is less/more than the total actual consumption in a given area (in general one country which is called the control area) the TSO has to use the so-called electricity balancing reserves available to it, based on the balancing contracts the TSO concludes with balancing service providers. This is necessary in order to keep the frequency of the system within a specific range. The amount of reserves that can be used for balancing purposes is limited and if they are exhausted, this can lead to black-outs. The NC EB provides balancing market rules to cover among others how these balancing products and the related services can be procured and used by TSOs and how they can be transferred from one balancing service provider to another.

Transfer of balancing services contracts

Electricity systems are interconnected throughout Europe. The security of the system is therefore of great importance. Each TSO has to maintain continuously a certain amount (MW) of contracted reserves in its control area for maintaining (frequency containment reserve – activation within 30 seconds) and restoring (frequency restoration reserves – activation within 15 minutes) the frequency and/or replacing generation or consumption units falling out of service (replacement reserves – activation within a few hours). These obligations are now based on the Third Legislative IEM Package and on multilateral agreements between TSOs and with entering into force of the Network Code on Load Frequency Control and Reserves (NC LFC&R) this will be a concrete legal obligation for TSOs. Thus, it is very important that **TSOs have contracts with balancing service providers who have the necessary means to offer the balancing services in real time to ensure system security. The TSOs have the primary responsibility of keeping the necessary amount of contracted reserves continuously at their disposal.**

How this is ensured is described hereafter: when a balancing service provider (generator or consumption facility itself or someone on their behalf) would like to provide balancing services to the TSO and conclude a balancing contract, it has to pass a technical prequalification test. During these tests the TSO has to obtain certainty that the generation or consumption facility will be able to provide those services according to given technical criteria (e.g. ramping rate) because those services are used as last resort. In case the facility is not able to be at the disposal of the TSO during

the given time period or cannot provide the required service it has to pay a penalty, whereas this technical capability can be regularly controlled by TSOs.

After the conclusion of a balancing service contract with a TSO, a balancing service provider has the right to transfer its rights and obligations from this contract to another balancing service provider. This is especially important when the transferor foresees that it will not have the necessary balancing reserves available to fulfil its obligations. On the other hand the TSO remains the contractual party of this contract. The transfer of a contract for balancing services between two balancing service providers is only possible, if also the transferee has passed successfully the prequalification tests mentioned above and the counterparty TSO has explicitly approved such a transfer because other technical reasons may result in denying the approval for transfer. Transfer against the above conditions without the active participation and control of TSOs – both in technical and legal terms – may lead to lowering the amount of reserves for last resort and to serious security problems.

After the transfer has been approved, the transferee is the new counterparty of the TSO. Thus, **this transfer means in legal terms an assignment by the transferor of its rights and obligations to the transferee upon the approval of the TSO and not a transfer in the sense of secondary trading under the financial legislation.**

Difference from other transfer of contracts

As illustrated this transfer of balancing contracts is very different from those of emission allowances for instance. The main difference is that while emission allowances can be freely and validly transferred between two market participants without any consent of a third party the **transfer of balancing reserve contracts between two balancing service providers requires always the involvement of the concerned TSOs in legal terms into their contractual relationship**.

Therefore, the participation in the transfer of balancing services contracts is very limited. It is restricted to generators and demand facilities (and persons on their behalf), who fulfil a set of approved technical conditions, prequalification tests. As a consequence, financial investors, who by their nature cannot be compliant with these technical criteria and therefore do not receive approval by the TSOs simply cannot participate in the transfer of balancing contracts to provide balancing services. Transfer of these contracts based upon the above technical characteristics is also not adapted to frequent trading.

Note: due to the inherent economic uncertainty of the balancing services contracts (the effective use of balancing products depends on system conditions) it is not excluded that financial risk hedging contracts are concluded by balancing service providers with financial counterparties based on the balancing services contracts concluded with the TSOs (as the underlying contract) and that those financial risk hedging contracts are transferable. Such contracts are different products, not assessed herein and they should be subject of another analysis under the scope of MiFID II.

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3. Exemption of transfer of balancing services contracts from MiFID II

As already explained the transfer of balancing contracts cannot validly happen without the legal involvement of TSOs – in order to ensure the continuity of the provision of those services at every moment – and this procedure always ends in a trilateral contractual relationship with the TSOs.

It is our understanding that the approval of the transfer by the TSOs and their legal involvement into the transfer meet the criteria of Section C 7 according to which the transfer from one balancing service provider to another is a transaction for the purposes of the balancing services to the TSOs whereas the new balancing service provider *enters into a contractual relationship "with [or by] an operator or administrator of an energy transmission grid";* thus being for commercial purposes and as consequence exempted from MiFID II.

Considering that ESMA adds examples of contracts for commercial purposes in Annex 1 Section 7 of MiFID II, in order to avoid any legal uncertainty whether the transfer of balancing services contracts by one market participant to another is a financial or not, we request to include explicitly also the transfer of electricity balancing contracts in the example of contracts for "commercial purposes" as follows:

"a contract should be considered to be for commercial purposes if:

i. it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network ***and*** *it is necessary to keep in balance the supplies and uses of energy at a given time, including when the counterparty of this contract assigns its rights and obligations from this contract to another party with the consent of the operator or administrator of such grid/energy balancing mechanism/pipeline network.*

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