ESMA Discussion Paper

Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

Comment by

The Mainova Aktiengesellschaft and the Stadtwerke München GmbH and Syneco Trading GmbH appreciate the opportunity to comment on the Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories.

Q4: What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

We welcome the proposition of ESMA of relevant criteria for the definition of OTC-derivatives in cipher 15. We are of the opinion that these named criteria reflect the nature of concluded transactions in the energy field and permit in the same time a clear differentiation between standardised products -e.g. bands- and non-standardises products –e.g. individual schedule-. The inclusion in the clearing obligation is justified only for the exchange traded standardised products and will lead to the desired results, because only for these exist and can exist reliable prices and a consistent market view.

Q7: What are your views regarding the specifications for assessing standardisation, volume and liquidity, availability of pricing information?

The proposed procedure in cipher 21 and 22 doesn't correlate with article Art 4 para.3 EMIR, which regulates that a public consultation is needed to implement class of derivatives in the clearing obligation. It is not sufficient, to just adjust the classification or to take over a matched classification of a relevant authority of a member state.

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

The definition of "derivative contracts which objectively measurable reduce risk directly related to the commercial activity or treasury financing" in number 29 is very near to the international standards and thus well fits in the idea of harmonisation.

1. Proposition for the differentiation of reducing risk activities, which shall not be included in the calculation of the OTC derivative contracts (number 29) and such activities which shall be included (number 31)

We welcome that ESMA proposes a wide definition for "hedging" and especially that ESMA is open for the question on how the evaluation context of hedging contracts and security reason

according to number 29 could be proved in another manner than the strict requirements of IAS 39.

1.1 Purpose of hedging transactions in the energy sector

Energy generation companies and energy supply companies work on the basis of long-term forecast (normally 1,5 years depending on the market, commodity and security strategy), to hedge the connected pricing risks. A long-term approach is necessary to reach the following goals:

1. to absorb price fluctuations in the portfolio
2. to react promptly to price changes in the market
3. to react to changes in the distribution and generation forecast
4. to secure a reliable pricing of products for clients
5. to determine a competition strategy
6. to determine a budget for sales and distribution and the energy generation for a long-term strategic financial planning for the energy company
7. purpose of collateralising contracts in the energy sector

1.2 Proposition

We therefore propose, that the requirements should be defined in a wide manner: The criteria of „being objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity" should include such activities, that are under local GAAP classified as "hedge accounting" and that according to already established requirements like the Handelsgesetzbuch (HGB) or the Bilanzrechtsmodernisierungsgesetz (BilMoG) in Germany the prove via book structures is possible (like already used when evaluating the own-use activities).

Energy trading companies have normally implemented book structures, both on account level and on riskmanagement level, that map the long-term collateralising strategies described under cipher 1.1. On the basis of these book structures, which are proved or can perspectivly be proved by independent auditing firms, an extern authority is able in an easy and ostensive manner to separate all activities which objectively measurable reduce risk directly related to the commercial activity or treasury financing from all other activities with speculative manner.

Some examples:

Example 1: Small sized Energy company without own production

Possible Book structure on riskmanagement level:

book number 1: sales-portfolio with a maturity of 3 years (starting with the first subsequent year (front-year)). In such a book all activities are covered, that are concluded for the forecasted distribution for the given timeline of 3 years within the determined hedging strategy and the according determined risk frame (e.g. benchmark strategy, path of melting open volume)

book number 2:sales-portfolio for the current year. In such a portfolio all forecast distribution variations on the basis of a changed fundamental situation (e.g. common economy

development, temperature changes like a very strong or very mild winter) are covered. This is operated by physical purchases and sells during the current period.

Example 2: Middle sized Energy company with own sales and generation

Possible Book and risk limit structure:

book number 1: short-term power plant optimisation with a maturity between Intraday and 2 weeks ahead. In such a book the short-term power plant usage is optimised in the market on the basis of an actual analysis of fundamental data (weather, rawmaterial prices, distribution forecast etc.) and within certain determined risk limit structures.

book number 2: long-term power plant optimisation on the basis of a long-term hedging strategy (termtime between 5 weeks and 5 years). In this book all transactions are concluded on the basis of a long-term power plant usage, that considers inter alia the technical availability of the power plant.

book number 3: sales-portfolio with a maturity of 3 years (starting with the first subsequent year). In such a book all activities are covered, that are concluded for the forecasted distribution for the fixed timeline of 3 years within the determined hedging strategy and the according determined risk frame (e.g. benchmark strategy, path of melting open volume)

book number 4: sales-portfolio for the current year. In such a portfolio all forecast distribution variations on the basis of a changed fundamental situation (e.g. common economy development, temperature changes like a very strong or very mild winter). This is operated by physical purchases and sells during the current period.

book number 5: sale: back-to-back contracts (up to 4 years). In this book all pricing risks resulting from already definitely concluded contracts with clients are hedged preferably on a one-by-one basis.

book number 6: book for ”stand alone” trades (“Eigenhandelsbuch” not connected with either sales or generation). In this book trades are reported, which have speculative purposes only. Theses activities follow given risk limits and risk management tools and monitoring of the company.

The above described book structures are usually installed on a risk management level but regularly can also be found in the accounting (either exactly or in a consolidated manner, depending on the complexity of the risk management approach).
On this basis any auditing firm is able to see, which are the company’ s reasons for certain activities on the trading market and which activities are according to the definition of “derivative contracts objectively measurable reduce risks directly related to the commercial activity or treasury financing” of the company.

In example number 1 it is clear that both books reduce objectively measurable risks directly related to the commercial activity. In example number 2 it is clear as well, that the books number 1-5 reduce objectively measurable risks directly related to the commercial activity. In example number 2 it is also obvious, that the company - within the determined risk frame (which is dependent of the risk willingness and the business model of each company)- takes risks clearly

separated and outside of the commercial activity in book 6. Only the amount of this book – book 6 - would than be relevant for the calculation of the clearing threshold.

Both such portfolios and their structure and accounting could and shall be proved and confirmed by the auditing firm to prove and confirm “derivative contracts which objectively measurable reduce risks directly related to the commercial activity or treasury financing”. The result of such an audit should be used and accepted by ESMA in this regard.

1.3 Additional Comment on cipher 31:

Investing

In our point of view it is important to include also the activity of „**investing**“ as “objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity”: Investing and also long-term financial assets serve to reduce risks from the normal business.

Speculation and trading

As explained aforesaid a clear separation between hedging activities and trading without a connection to sales and generation is possible. Transactions which are operated in the book for “stand-alone” trades (“Eigenhandelsbuch” - see aforesaid explanations for book 6) shall be considered for the calculation of the threshold.

The terms „**speculation and trading**“ in cipher 31 should be used as such, that the aforesaid differentiation based on the book-structure can be used, because otherwise the term “trading” could well be understood differently and is not clear. .

1.4 Integration of hedging of activities for companies on a group basis, when the group does not consist of parentundertakings and their subsidiaries but undertakings without consolidation

Additionally to the definition above explained under 1.2 it has to be made clear, that all OTC-derivatives, executed by a trading company in order to reduce the commercial and treasury financing risks resulting from a uniform commercial activity (i.e. energy supply) of its shareholder customers have to be deducted in the same manner when calculation the clearing threshold, even if the term of group doesn’t fulfil the requirements of consolidation.

The term “**objectively measurable as reducing risk directly related to the commercial or treasury financing activity”** is used in two regulatory aspects of the financial regulation, namely in Article 5 para. 3 EMIR as well as in Article 2 para. 3 in the proposal of the MiFID II. For the practical operation it is essential, that a harmonised interpretation is used regarding the activities, which are used for risk mitigation and are proved as such, because they are relevant for the privilege of ancillary activities regarding the MiFID II proposal and for the discounting by the calculation of company specific thresholds regarding the requirements under EMIR:

MiFID aims at permitting nonfinancial companies for their financial instruments trades an exemption from the strict requirements of an investment service permission, as long as these trades are an “ancillary activity” because they are risk mitigation activities for the main business. . The deduction of the volume of risk reducing hedging activities when calculating the thresholds underneath of which a clearing for OTC-derivatives is mandatory, serves the same purpose.

Under MiFID I it is common sense –at least of the German legislative and the German fiscal authority, BaFin- that in the context of the exemption of ancillary activity another, wider term for “group basis” has to be used, than the term “intragroup” (article 2 para 1b , article 4 cipher 24 MiFID and article 2a, article 2 cipher 12a EMIR) which needs the consolidation within the group.

A commercial view has to come to the point that even than a consideration of OTC-derivatives to correspondent risks of commercial manner can and have to take place, when the hedging activities are operated by a trading company which is founded by several commercial companies just for this reason.

A number of municipal energy companies organize their trading jointly in separate companies, the municipal platforms. In these cases all stakeholders of the company are public utility companies, sometimes with own generation. They aim at exactly the same results as in other cases the trading department of an energy company. Usually these constellations are grounded on the fact, that one or more of the stakeholder-companies can not economically reasonably run a trading department on their own. Nevertheless when buying and selling financial instruments these joint trading-houses provide ancillary activities for their stake-holder companies. Their trades and financial deals are concluded to hedge the risks of the stake-holder’s sales-portfolios and generation-portfolios, energy procurement and energy production thus garantying customers a demand-based, market-based, transparent and reasonably priced and competitive supply of energy.

Example:

Three municipal utility companies A,B and C found in common a trading company X. A has electricity customers, B has electricity and gas customers, C has electricity and gas customers and a power plant. X secures via OTC-Derivatives risks resulting
1. from the sales portfolio of A, B and C - for all of them regarding electricity and for B and C regarding gas – and
2.from the production portfolio of the power plant and guaranties the optimisation for C.

The book-structure may be just the same as explained above under 1.2, example 2.

For companies, which organise their trading in this manner, it is essential that – as it is usual for the ancillary activity exemption in MiFID – , when it comes to estimating whether or not the reason of a financial instrument is “hedging” of commercial activities, financial instruments of the joint trading platform can be brought in relation to the commercial activities – in MiFID called “main business” – not only of the trading company but as well of the shareholder companies and their affiliates. In MiFID terms (Art. 2 Abs. 1 i) this has to be “considered on a group basis”, the group being interpreted in a wide

Already when MiFID was put into national legislation in Germany with the Finanzrichtlinienumsetzungsgesetz (FRUG) dated 2007/12/01 it was respected, that only a understanding of “group”, which takes in account the relevant economic context is correct in this case. The official text explicating the text of FRUG (vgl. Begründung zum Gesetzesentwurf Reg.Begr., BT-Drs. 16/4028, S. 58) says:

> *„The term group in this context has to be understood in a wide manner. Also municipal electricity producer and public utility companies, who work with a „municipal procurement company“ to hedge their prices along with their normal economic activity as energy company, form together with this company a group whose main business is not the provision of investment services in the spirit and purpose of this exemption. Therefore the “municipal procurement company” will usually be in the scope of the exemption of No. 9 (which ist § 2a Abs. 1 No. 9 WpHG, the equivalent in german law), if it provides investment services and activities in connection with financial instruments within the meaning of § 2 Abs. 2 Nr 2 or 5 WpHG (= MIFiD Annex I, section C No.2 and 5)”.*

BaFin’s interpretation of „on a group basis“ as stated in an advice paper for energy companies called „Merkblatt – Hinweise zur Erlaubnispflicht von Geschäften im Zusammenhang mit Stromhandelsaktivitäten, Stand Juni 2011) dated June 2011, is exactly based on the above statement of the german government and quotes the same wording.

Thus also communal and municipal energy companies, that use for hedging their prices in the framework of their normal business activity as energy supplier a communal associated purchase company, build together with this purchase company a company on a group basis in the sense of the exemption in article 2 para 1i), and para 3 MiFID. This interpretation is as well needed for article 5 para 3 EMIR, so that companies which operate with the same hedging activities, but are organised in a different way of company law, are allowed to deduct the relevant amount of transactions for hedging activities by calculating the thresholds in the same way and are not treated in a different way than energy companies with an inhouse trading

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

The setting of a suitable clearing threshold can only be decided, if some of the proposed or possible calculating methods are evaluated. We welcome the approach, to use the notional value, because it is simple and clear and it doesn't cause inadequate expenses and imponderabilities. This could easily happen when using a different valuation basis to calculate the threshold.

Bearing in mind the necessity to harmonise European with international standards like the ones of the Commodity Futures Trading Commission, we suggest to take in account the de facto in the market generated risks. Alike the provisions of this Commission we thus propose to consider the following two correlatives when defining the accumulation of the notional values of transactions with different counterparties:

1. Consideration of collaterals:

Contracts are only be afflicted with risks to the extent, to which they are not covered by collaterals. To the height of valid collaterals one counterparty has made available to the other counterparty, these collaterals have to be deducted from the notional value to secure a prudent evaluation of the threshold in regard of the systemic risk, that this position is able to cause.

2. Consideration of netting:

Valid netting agreements between counterparties reduce the risks of the correlating positions between the counterparties down to the netted amount. This aspect has to be considered to come to a valid an suitable evaluation in regard to the risks. For the calculation of the threshold in this cases should only **the netted amount** be relevant.

Both proposed aspects are already approved in the American system in the basis rule „first test of substantial position"[1] in the same manner.

> ***"The first substantial position test*** *in the proposed rules would:*
>
> - *measure a person's current uncollateralized exposure by marking the swap positions to market using industry standard practices;*
> - *allow the deduction of the value of collateral that is posted with respect to the swap positions; and*
> - *calculate exposure on a net basis, according to the terms of any master netting agreement that applies.*
>
> *The proposed thresholds for the first test would be a daily average current uncollateralized exposure of $1 billion in the applicable major category of swaps, except that the threshold for the rate swap category would be $3 billion."*

[1] Commodity Futures Trading Commission, Proposed Rules Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant", page 3.

If the proposed positions under cipher 1 (collaterals) and cipher 2 (netting) are **not discounted**, this may - depending on the portfolio - lead to injustified high amounts without appropriate information value.

We welcome and share the opinion of ESMA, that a low and meaningful threshold is much preferable to a high global threshold, which would tend to blurr different effects . On the other hand it has to be considered that this – welcome – decision pro a low threshold makes it necessary to define well thought over specific, conditions. Otherwise - depending on the calculating method - the amount of the threshold can end up at extremely different amounts with little meaning. Therefore we suggest that the additional effort should not be spared to correctly evaluate the notional value by deducting collaterals and netting clauses thus generating a remarkable benefit of informational value at reasonable expense...

One or more asset classes:

To create an easy and comprehensible operational mode and to avoid needless discussions about the classification we consider it best to define only one adequate common threshold for the portfolio.

Both for the evaluation of the single companies and for the survey via the relevant authority a disproportional expense would be caused when defining an own specified threshold for each asset class.

At least for the beginning of implementation of the EMIR requirements we consider it inevitable to reduce the expense as low as possible.

Calculation on a group basis level (consolidated) vs. calculation on a legal entity

We recommend to implement a global limit on a group basis for the whole group (consolidated level). After defining the global limit on a group basis, the group than can decide for itself how to divide the limit between the participants and to make sure that the global limit will not be exceeded. Reporting to the relevant authority should only be necessary concerning the global limit,.

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

The timeline for the implementation of the proposed requirements is very ambitious. Especially for small and middle sized energy companies, which currently do not use electronic systems for the confirmation the proposed requirements are not acceptable. Even the EEX confirms the transactions only once a day (spot at 4 p.m., long-term in the night). The determining factor

should not be the conclusion of the transaction (named if electronically operated or not), but the organisation (electronically or not) of the downstream processes, starting with the first registration into the trading system and ending with the confirmation.

There are a lot of small and middle sized energy companies which operate on one or several electronic trading platforms, but do not operate processes after the transaction closing electronically.

When implementing the timely confirmation in the proposed way it should be considered in any case, that a lot of energy companies have to start new IT-projects regarding their back-office processes which causes time and expense.

When implementing an electronic system it will only work, if all counterparts use trading systems with normed interfaces and which are able to operate the processes fully automated (with certificates etc.). The definition of the interfaces has to be homogenisied.

Q13: What period of time should we consider for reporting unconfirmed OTC derivatives to the competent authorities?

In our opinion the reporting time should not be more often than „end of Day"; the effective date would than bet he next morning. Even in the big trading companies the short-term transactions are confirmed only the next day (=D+2). Long-term transactions are confirmed even after days.

We recommend a **monthly timeline** for the reporting of unconfirmed OTC derivatives to the competent authorities.

Q 15: Do you think additional criteria for marking-to-model should be added?

No, in our opinion additional criteria aren't necessary. On the contrary: the proposed criteria are already very complex and will cause a high capacity expense for the implementation of IT-systems with according costs.

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

We regard a minimum number of transactions as necessary. Otherwise commodity companies would be obliged to remind all of their industrial clients about the conditions of the underlying supply contract on a frequently basis. We would propose a combined threshold of a certain number (5) and a certain notional value (kWh) between the counterparties as a minimum requirement to avoid a lot of useless effort.

We don’t see the need for a daily reconciliation between the counterparts, especially if there is no change in the portfolio and no new contracts.

The needed frequency of the portfolio reconciliation should be defined an the basis of the added value which is caused by the reconciliation; but this added value is currently not sufficiently defined yet. If it comes to a quarterly portfolio reconciliation like stated under cipher 48b we propose the number of 150 derivatives.

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression

In this regard we see “close outs”, the closing of CSA (credit support annex) or other similar agreements, which shall minimise the bilateral financial risks (and the within combined credit risks) in a regular interval.

But there are in the market service utility companies that offer close outs of total portfolios within a asset class opposite the total portfolios of other trading partners like demonstrated below:

A buys from B 10 MW for x €

B buys from C 10 MW for y €

The tradings from A to B and from B to C could be operated via a financial clearing with the actual market price so that just remains the trade between A and C. This would lead to a reduction of credit risks within the portfolio of a certain asset class, see the enclosed excel-file.

From our point of view it is unclear how transactions with clients are handled that serve the energy supply. For these transactions neither a portfolio compression nor conventional close outs make sense. A portfolio compression for portfolios with commercial clients is not sensible because of the physical structure.

Note 52 uses the broad range of “non centrally cleared derivative transactions” for defining the obligation to use portfolio compression. With this, beside storage and transport agreements also ordinary supply contracts to clients are covered. In principle each municipal entity has to “provide a reasonable and valid explanation to the relevant competent authority for not conducting such an exercise.” This makes of course no sense and is contrary to the “cost and benefit” approach, outlined in Note 4 of ESMA. Also, what will be an effective number for real trading deals to get an exemption?

EMIR Article 6.1aa defines that “…Non-financial counterparties referred to in Article 5(1b) shall have risk management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after the clearing threshold is breached.” We interpret the wording that credit support

appendices have to be concluded/in place. A clear reference to the respective asset class which was breached is missing therefore in principle all classes are covered, including those which are not obliged to clear. However, signing a CSA is of course a bilateral negotiation and is not only a decision of the relevant party. What will happen if the counterparty simply rejects such an agreement? Shall the relevant party be obliged to stop further business and loose clients?

Q19: Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

We see the proposed and additional mechanisms neither as needed nor as sensible, because there is already sufficient legal certainty by the existing instruments. Both the existing EFET agreements offer sufficient rules for arbitration agreements and the normal legal action can also be taken by the counterparts.

Q20: What are your views regarding the thresholds to report a dispute to the competent authority?

As there are very few disputs we are of the opinion that –to reduce expense- all disputes should be reported to the competent authority, especially regading the fact, that the cause for a dispute is mostly that a company is (nearly) bankrupt.

Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

We don’t see the value of a notification.

Q22: In your views what details of the intragroup transactions should be included in the information to be publicly disclosed by counterparty of exempted intragroup transactions?

The numbers 21 and 22 contain important questions, but to answer more concrete a detailed conception is needed to define a clear position for this approach. Furthermore we actually do not see the need for such publications.

Q23: What are your views on the notion of liquidity fragmentation?

We would like to point out that energy markets are in an early development stage. Liquidity fragmentation would therefore be very negative. The amount of accredited CCP's should be aligned with the respective markets at its liquidity.

Q53: Do you consider that CCP should be allowed to invest in derivatives for hedging purposes ? If so, under which conditions and limitations.

Only, if the traded derivatives were centrally cleared.

Q69: What is your view on the need to ensure consistency between different transaction reporting mechanisms and the best ways to address it, having in mind any specific items to be reported where particular challenges could be anticipated?

The energy sector is currently confronted with a high amount of reporting requirements, determined by different rules (e.g. REMIT, MiFID, EMIR). We admit, that every rule has its own approach regarding its reporting obligations. But nevertheless we plead, that ESMA considers these already existing reporting obligations, when implementing further rules so that:

1. first and foremost the data format for the reporting obligations under the different rules can be harmonised; the requirements for the data format will cause large IT-projects in the energy companies. The more data formats are requested the more complicated, time and cost intensive the IT-projects will be.
2. manifold reporting of the same data can be avoided,
3. the periods of data transfer to the different regulatory authorities can be harmonised.

The use of service companies can't be evaluated at the moment because the requirements for the reporting aren't fixed yet. Therefore the concerned companies can't estimate the services to offer.

The need for IT-projects to realize the reporting obligations has to be considered within the implementation of EMIR and other accordant rules.

Q73: What taxonomy and codes should be used for identifying derivatives products when reporting to TRs, particularly as regards commodities or other assets for which ISIN cannot be used? In which circumstances should baskets be flagged as such, or should

their composition be identified as well and how? Is there any particular aspect to be considered as regards a possible UPI?

Regarding question 73 in our opinion it is very important to secure the conformance between EMIR and REMIT. These issue can only be solved in close cooperation between the different market partners (exchanges, trading venues, CCP's other market partners). In any case we prefer a topdown approach by ESMA: ESMA should create a code system and all market partners should have to adopt their system accordingly.

Q74: How complex would be for counterparties to agree on a trade ID to be communicated to the TR for bilaterally executed transactions? If such a procedure is unfeasible, what would the best solution be to generate the trade ID?

See our comment on question 73.

Q79: Do you agree with this proposed approach? What are in your view the main challenges in third party reporting and the best ways to address them?

We welcome the proposition of ESMA for this approach. In our point of view the reporting data can also be transmitted to ACER and the national regulatory authorities. But we want to point out, that as commercial companies acting on liberalised markets we don't see that the competence for the survey of single transaction data should be given to regulatory authorities like ACER or the national regulatory authorities. We see the risk, that these regulatory authorities - first and foremost responsible for monopoly grid issues- could find themselves in a conflict situation and come to a decision which may inflict the market driven energy prices. We stress that it is important to separate the competence between the regulatory authorities like ACER and the national regulatory authorities for the monopoly grid issues and other competent authorities which survey the market driven commercial issues. If ACER or the national regulatory authorities would have the competence to decide about the correctness of energy pricing in the liberalised energy markets, this might open the way to steer the energy prices themselves (and not just only the grid tariff part). This would harm the liberalised markets and its reliability.

Therefore we plead that making available the reporting data to ACER or the national regulatory authorities shall not be combined with the competence to survey the commercial transactions in the liberalised markets.