Verband kommunaler Unternehmen e.V.

STATEMENT

ON THE ESMA DISCUSSION PAPER ON DRAFT TECHNICAL STANDARDS FOR THE REGULATION ON OTC DERIVATES, CCPS AND TRADE RESPOSITORIES

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General Remarks

We welcome the public consultation of ESMA's consultation paper on Draft Technical Standards for the Regulation on OTC Derivates, CCPs and Trade Respositories and would like to take the opportunity to make some statements regarding some key issues of the consultation.

We would like to emphasize that the envisaged changes should only be applied to firms that pose a systemic risk. The financial market crisis was not triggered by OTC derivatives from corporate hedgers. Before any regulation on OTC derivatives is implemented it has to be proven that this is going to bring a major positive effect to market stability.

We are in favour of supporting improvements streamlining OTC processes and potentially to reducing overall risk, but at the same time we do not want to see convenient and flexible hedging instruments for non-financial sector companies banned. The dangers are that, in attempting to reduce systemic risk, ordinary non-financial companies:

- are put off using derivatives and therefore end up with more commercial risks unhedged or
- have to hedge by more inconvenient or expensive means, affecting the conduct of their businesses or
- face the liquidity risk introduced by margining now, when the hedged cash flows which will offset the derivative position which hedges them occur some (possibly long) time in the future.

For years the enterprises use well established credit risk mitigation techniques in the OTC market and have never been confronted with severe credit risk problems. Even if there had been any they would have never destabilized the whole financial system.

To summarise our position, we would like to emphasise that the clearing threshold has been introduced to prevent especially small and medium sized non-financial counterparties from high regulatory and thus costly burdens. Therefore the clearing threshold should be defined in a way not to restrict business which is legitimate and in volume irrelevant for the stability of financial markets.

Questions in Detail:

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

Basically, the definition of reducing risks is a suitable one. As stated in the paper it is useful to enter OTC derivative contracts for hedging direct risks (production, value of assets, liabilities etc.) and that those quantities have to be deducted when calculating the threshold.

We appreciate ESMA's view that not only transactions which comply with the strict rules of IFRS 39 can be accepted but also the wide definition of 29 can be chosen to make use of the hedging privilege.

However for reasons of completeness the cash flow risk, addressing the risk which arises from executing contracts and the risks arising from planned business, as well as the quantity risk should be added to the list in paragraph 29 a and b.

ESMA should consider the fact, that especially small and medium sized companies don`t use European accounting rules, like IFRS, because of the higher costs compared to national GAAP. Therefore it is necessary that the Technical Standards allow the application of national GAAP like HGB and BilMoG, in the German case, to meet the requirements of EMIR concerning risk reduction, as long as the follow the intention of paragraph 29.

Local and regional energy companies hedge various risks in their particular field of acitivity. We therefore propose that the requirements should be defined in a wide manner and include following proposals:

I. Hedging of various portfolios

- Trade/hedging of sales portfolios

As a general rule, energy trading companies use commodity derivatives in order to minimize the risks of their sales portfolio
A risk-minimised purchase of the sales-volume or the volumes according to client demands means that a sales plan and a trading strategy is set up for several tradeable years ahead that enables:

- Price fluctuations to be mitigated by a portfolio
- Reactions to price changes on the market

- Reactions to changes of the sales forecast

This approach should be seen as the most successful way to ensure that end-customers receive a well-priced energy supply.

- Trade/hedging of production portfolios

Energy companies use analogical portfolio-strategies for their production portfolio as above mentioned in respect of sales volumes. This has to be looked upon as a state of the art approach: A risk-minimisation makes it necessary to sell defined parts of the portfolio for several years in advance. Also in this case the option must be left to buy back already sold volumes if the market prices change. This would ensure a trustworthy portfolio optimisation that counteracts price fluctuations and helps to balance out extremes.

- Trading of the residual amounts required due to cascading in order to fulfil delivery commitments

An accurate purchase of forecasted sales volumes and an absolute accurate sale forecasted production volumes is impossible with the available trading products. It is impossible to trade short-term products during the years ahead. Therefore it is important to include under the wording of “hedging” the purchase of those volumes due to differences between forecasted sales and production volumes and those needed/produced at the time of delivery.

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

Additionally to the definition above explained under cipher I. 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 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 organise 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 guarantying 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. In addition X guaranties the optimisation for C. The portfolio-structure may be just the same as explained above under cipher I., example 2.

For companies, which organise their trading in this manner, it is essential that – as is usual für the ancillary activity exemption in MiFID – , when it comes to estimate 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 manner.

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. 1 i) 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 view, 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?

Generally, we agree to ESMA's approach to provide a broad definition of activities reducing commercial risk. Nevertheless we consider it inappropriate to state, that a broad definition of hedging activities could lead to a low threshold. As long as the exact definition of hedging is unclear ESMA should meet the specifications of EMIR. Concerning the clearing threshold, ESMA should only take into account the systemic relevance of positions and exposures. The definition of transactions reducing risk is a fundamental element of the Regulation and should therefore remain the main criteria whether non-financial parties should be treated like financial ones.

However, it is difficult to evaluate the current proposal as ESMA has not provided a concrete value of the threshold level. Moreover, the definition of risk reducing transaction has remained vague as well.

In the discussion paper, ESMA has not included a substantiate argument why it has opted for a single threshold across all asset classes. We do not believe that difficulties to implement are more sophisticated approach is a valid argument as the discussion paper foresees a wide range of other measures that are definitely difficult to implement (e.g. portfolio compression and reconciliation, time limits for confirmations etc.) as well. However, these other measures lack the prominent importance of the definition of the clearing threshold. At this stage, we would like to remark that the term "asset class" currently even lacks a meaningful definition.

We agree that the clearing threshold should be set across asset classes. Especially small and medium sized companies could in this way easier meet their clearing obligations and account for risk reduction.

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 confirmed generally able to be confirmed more quickly than one that is not?

Whereas these considerations are focused on rather formal questions, there are substantial problems in terms of content as well. In derivative trading business, the confirmation procedure is an important first level of control. Especially, failures that are obvious or easy to be identified can be corrected by the back office or any comparable department at this initial state. In our opinion, this level of control should not be removed. Setting tight time limits is likely to cause more mistakes; hence a higher quantity of confirmations will have to be corrected. As a consequence, higher efforts would be imminent.

Although the local and regional energy companies, consider that EMIR should not apply to them, we would like to state, that, when it comes to deadlines to be set for trade confirmations, the distinction between electronically executed, electronically processed and other transactions is reasonable. However, transactions that are entered into electronically and transactions that are processed electronically only need to be treated more differently. Moreover, the term “processed electronically” requires a more detailed definition. According to current knowledge, it would still imply that data is entered manually for further electronic processing. Of course, any manual operation would mean that the process is not fully automated. In such case, the period of 30 minutes after the conclusion of a non-electronically completed electronically needs to be questioned. Incidentally, it could be difficult to determine the point in time of the conclusion of a non-electronically executed contract in the aftermath.

Generally, time limits need to allow for some flexibility. If a trader is also obliged to enter the data of a contract manually to be further processed, it is unreasonable to believe that concluding and processing a contract is done strictly gradually. It must still be possible that a trader enters into more than a single transaction to fulfil the orders he/she is in charge of and that this trader provides for this data to be electronically processed afterwards.

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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.

Finally, it is important to discuss whether reporting to the authorities and sending confirmations to the counterparty should be combined in any way at all. In our opinion, it would be more reasonable to submit a report to the competent authorities after the counterparties have agreed on the details of a transaction without any reservations. This is unlikely to happen before confirmations have been exchanged.

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

At least, this period should be above the limits discussed in paragraph 38 and 39.

Q15: 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.

Q18: What are your views regarding the procedure counterparties shall have in place for resolving disputes?

A wide range of master agreements concerning the trade of derivatives (ISDA, IETA, EFET, German Master Agreement) already include detailed rules on this subject. Since these rules already exist, some inflexible rules, for instance the setting of time limits, appears superfluous and should be deleted. The provisions of the agreements go much further than the current proposals; additionally, they have already been tested. Moreover, the one-covers-all approach as outlined in 54 is not considered

suitable as the types of transactions and derivative classes differ considerably. At best, global minimum standards could be imposed.

Furthermore, the parties' intentions to select a specific settlement procedure need to be considered. Generally, they try to avoid carrying on their controversies in public. In fact, a mandatory notification to the authorities would just result reduce both value and practical effect of these formal procedures to settle a case. At the same time, the additional value for the integrity of the respective market has to be questioned. Therefore, the involvement of the regulatory authorities is not considered to bring additional benefits.

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

Offering reasonable approaches and mechanisms to settle disputes effectively should have priority. Again, the market has already developed a wide range of such instruments (i.e. mediation, expert determination, postponement of pricing date, fallback price sources etc.). Restricting these approaches to three routes is therefore not considered useful.

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

In our opinion, involving the competent authorities generally does not offer considerable benefits. Therefore, if an involvement is considered at all, the threshold needs to be very high (i.e. systematically relevant).

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 item 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.