EDF Trading

29 August 2008

CESR and ERGEG advice to the European Commission in the context of the Third Energy Package: Market Abuse

EDF Trading welcomes the opportunity to respond to the above consultation. A summary of our key points is set out below. More detailed comments, in response to the specific questions raised in the consultation, are in the attached annex.

Summary

1. Scope of the MAD regime

- We do not agree there is evidence of market failure. Traded volumes and liquidity are generally rising across all markets, indicating that firms (1) are confident to trade and (2) judge risks as being manageable. The absence of a market abuse regime specific to the whole commodity sector does not appear to be hindering trade;

- Some of the examples identified in the consultation paper are competition issues, rather than market abuse, and therefore should be pursued more naturally under competition law. Any new market abuse requirements should not lead to duplication, inconsistency or overlap with existing legislation which would lead to additional risk and uncertainty;

- If regulators decide to bring forward new measures, the wholesale application of the Market Abuse Directive (MAD) to power and gas is not appropriate for a number of reasons relating to the specifities of the sector;

- Any new market abuse regime must also include all relevant commodities – not just power and gas. Coal, oil and emissions are for example vital inputs to understanding the pricing of power and gas, and an incomplete regime will not be effective.

2. Transaction reporting

- We do not fully understand the rationale for introducing transaction reporting requirements (regulators may already today receive this information if they purchase the same software and IT infrastructure to which market participants have access);

- However, if regulators want to introduce transaction reporting requirements to monitor the market they should ensure a common approach across the EU that does not lead to undue costs and creation of barriers to entry particularly for smaller companies..

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3. Transparency

- Legally binding transparency requirements for the use of infrastructure are welcomed as long as it is a pan EU regime with the same requirements for all firms throughout Europe;

- We do not think publishing information on all our trades on an anonymous basis will benefit the market. Regulators may already receive the majority of this information, and market participants have a range of information sources to meet their specific needs (e.g. traders having live pricing through broker screens, with other market participants being able to make use of price reporting services);

- Transparency should not be confined to infrastructure. There must be equivalent transparency requirements for financial institutions in connection with investor demand for commodities. The financial institutions are currently able to "front run" customer orders – such activity will have a significant impact on pricing. In our view, transparency needs to apply to all commercial activity which may affect prices – such activity has to include customer demand information available to financial institutions. The flow of customer information to financial institutions can have a distorting effect on price formation, way beyond supply and demand fundamentals. Disclosure of such information is required to monitor for price distortion and take action against market abuse;

- Any transparency requirements must also be extended (subject to appropriate changes) to other commodity sectors given the relationship between input fuels and power and the oil-gas price link; and

- Any further transparency requirements being introduced must take account of the issues we raise under point 4 below.

4. MAD regime for power and gas

- We recognise politicians and regulators may perceive there is a gap in the application of MAD to commodities – and in the gas and power sector particularly;

- However, great care must be taken so as not to distort what is a developing market through new and burdensome regulation and legislation that is not appropriate;

- It is especially important that any regime does not artificially skew the balance between risk and reward for asset owners compared to other market participants such as financial institutions (for example, by not allowing asset owners to cover their position before information is released to the market). This would significantly diminish the incentive to hold (and further invest) in infrastructure crucial for the development of a competitive EU power and gas market with the consequent security of supply impact;

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- An appropriate definition of inside information must be developed to underpin any market abuse regime tailored to the commodities sector. This may include distinguishing between the use of information on own assets and that which is gathered in an unauthorised way or relates to more general market information;

- If the definition of inside information is not appropriate, asset owners will not be able to optimise the assets they control. This will lead to market inefficiency and higher prices for customers;

- Failure to address these important issues will destroy the asset based trading model. There will be market withdrawal (and the imposition of significant barriers to entry) effectively forcing producers to become customers of financial institutions, who will then control the wholesale electricity and gas markets, in the same way as the oil markets. Asset owners will then be charged for any wholesale trading as customers, and will have no choice but to pass on such additional costs to end users.

- We note that CESR/ERGEG has looked favourably at the Nordic model as a template for pan-Europe transparency requirements. Whilst there are many commendable features of the Nordic model, these are best suited to a market consisting of a very large number of relatively small installations, each of which individually will have a very limited effect on price formation. By way of contrast, the wider European market consists of a relatively small number of large units, each of which individually will have a much greater effect on price formation;

- We also believe that in the Nordic model the definition of inside information and the restrictions placed on asset owners in how they trade, effectively increases operational risks of production – and in particular the risk of not being able to cover an outage – which leads to significantly higher marginal costs and higher prices to customers.

We would welcome the opportunity to discuss these issues in more detail.

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Annex 1: Detailed comments

1. Do you agree with the analysis of the market failures in the electricity and gas markets as described above? If not, please provide reasons for your disagreement.

We do not agree for the following reasons.

Information asymmetries

Information asymmetries can exist for a number of reasons - the key is whether they are unfair and if so whether they lead to market distortion.

In this respect it is not appropriate to draw a distinction between firms that are active in the underlying physical market and those that are not. Information advantages exist on both sides. Owners of physical assets clearly have access to better information on their assets than other market participants. Similarly, banks or hedge funds will have access to information on customer positions or speculative interest that is not accessible to other market participants. Information on both sides can impact price formation.

In any case, there are already significant transparency requirements on the use of physical infrastructure and more is envisaged by the 3rd energy package. Taken together, there will be a high level of transparency on physical infrastructure in the near future. Conversely, there are currently no requirements for disclosure of investor demand for commodities (for example on banks to disclose information on customer positions) - this is a more important regulatory gap given the requirements already in place (and envisaged) for transparency on physical infrastructure.

Definition of inside information

Any definition of inside information must allow asset owners to use information on their assets in order for them to be utilised and optimised efficiently (as is the case in other markets). Suboptimal optimisation results in inefficiencies and higher prices to customers. No other party than the asset owner can undertake the optimisation, so having access to this information should not be seen as an asymmetry compared to other market participants. As optimisation is crucial to the efficient operation of the market, such activity should not be defined as market abuse.

Asset owners should also not be placed in the position of distressed buyers if outages occur. In a market that may not be fully liquid (and where it would not be possible immediately to trade out remaining positions without a significant impact on prices) the asset owner must be allowed to take steps to cover its position before information is released to the market. Restrictions that prevent such activity place the asset owner at a significant disadvantage to other market participants, and will lead to a distortionary impact on prices in the market and negative impacts on security of supply as asset owners may be reluctant to take corrective actions to cover position for fear of being caught under market abuse conditions.

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The interaction between transparency requirements under energy sector regulation and any market abuse requirements is therefore crucial. The development of clear guidance and/or exemptions will be needed to provide clarity to market participants about how they can use information. In this respect, we point out that existing MAD requirements already recognise the concept of delaying publication of inside information for legitimate reasons - *Article 6.2 of Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003* and *Annex II of Commission Regulation (EC) No 1287/2006 of 10 August 2006.*

Further restrictions on information use will result in additional risks for owning assets and reduce incentives to invest in new infrastructure (including generation assets), primarily because the asset owner will be exposed to all operational risk without a corresponding advantage compared to having a financial position. This is at a time when significant new investment in infrastructure needs to be encouraged if a competitive EU power and gas market is to be realised.

An overly restrictive regime concerning asset optimisation will destroy the asset based trading model and mean that asset owners will have no option but to become customers of banks – and will then be charged for any wholesale trading as customers, with no choice but to pass on such additional costs to end users.

To help resolve these issues regulators may wish to explore the important distinction between information that is generated within a company and that which is gathered in an unauthorised way or relates to more general market information.

Evidence of market abuse

We are not convinced there is evidence of market abuse in the power and gas sector. Furthermore, some of the examples identified in the consultation paper are competition issues, rather than market abuse, and therefore should be pursued more naturally under competition law – as demonstrated by the current cases being investigated by DG Competition. If the market abuse regime is designed in a way that also captures competition issues it would result in an undue level of double regulation. Any new market abuse requirements should not lead to duplication, inconsistency or overlap with existing legislation which would lead to additional risk and uncertainty.

We also believe that the existence of market power is not a predominant barrier to entry in markets for power producers today. More pertinent issues are the planning issues identified in the consultation paper; the ability to secure the necessary transmission capacity to bring power to the market; unnecessarily restrictive rules (such as requirements to force power to be sold on an exchange) which apply in certain matters; and lack of a clear and stable regulatory environment.

Regulatory gap in monitoring

We agree there is a regulatory gap in relation to market monitoring and that if a market abuse regime is extended to the whole gas and power sector it must be implemented in a harmonised

way across the EU. It should also cover other commodities that have an impact on the level of prices in power – such as coal, oil and emissions – otherwise there will be distortions between the various markets.

If regulators decide that monitoring of the market also needs to be enhanced, then we believe operators of regulated markets and Multilateral Trading Facilities (as currently required under MiFID) should continue to act as 'front-line regulators' for monitoring market behaviour - with a duty to report any suspicious activity to the regulatory authority and cooperate in any subsequent investigations. They could also be required to report information on transactions to the regulatory authority on a regular basis, should this approach be preferred.

It may not be appropriate to prescribe such a role to brokers in the OTC market (where they do not operate an MTF) and here the relevant regulatory authority could take the primary responsibility for monitoring and investigating market behaviour if it deemed it appropriate. However, to ensure a disproportionate burden is not placed on individual firms, brokers should be required to report transactions to the regulatory authority on a regular basis and cooperate in any investigation instead of requesting firms to develop bespoke regulatory reporting systems.

There are also a small number of bilateral trades between market participants that are not concluded through the organised markets above. As with all transactions, records are kept of these transactions in line with existing obligations. These transactions could be requested by regulatory authorities if required.

2. What is your opinion on the analysis provided above on the scope of MAD in relation to the three different areas: disclosure obligations, insider dealing and market manipulation?

We recognise there is a perception of a regulatory gap in the current application of the MAD regime in the power and gas sector in the areas identified. However it should be recognised that traded volumes and liquidity are generally rising across all markets, indicating that firms are confident to trade and obviously judging risks are manageable. The absence of market abuse requirements across the whole commodity sector does not appear to be hindering trade. It is crucial, as explained above, that any arrangements do not lead to a reduction in liquidity, the creation of barriers to entry and disincentives to invest.

3. Do you agree with the conclusion above that greater pre -and post trade transparency would not be sufficient in the context of market abuse?

Transparency in power and gas

We generally agree with the conclusions in the document. There is a need for additional binding transparency requirements for both power and (particularly in) gas. The less than 3 shipper rule is of particular concern in gas and must be removed. The 3rd energy package should deliver significant improvements in this area. It is crucial that the issues identified in our

response on inside information are taken into account before new requirements are implemented. This is because a requirement to publish information under energy regulation will currently mean it will be automatically defined as inside information under financial regulation with the consequences described above in our answer to question 1.

Demand side financial transaction transparency

There is also an urgent need to consider the lack of transparency on investor demand and speculative interest for commodities, as this has a significant impact on prices. For example, there are no transparency requirements the disclosure by financial institutions of investor demand for commodities. Focusing solely on transparency in infrastructure will not give regulators and market participants a clear view on the various factors driving prices – and make it impossible to effectively monitor and take action against market abuse. A holistic approach is needed for effective regulation.

Transparency in other commodities

We also believe that transparency requirements should be introduced in other markets that impact on power price formation (i.e. coal, oil and emissions) to ensure a holistic approach is taken. We encourage CESR/ERGEG to work together now with the relevant authorities to ensure that such measures are introduced at the same time as any market abuse regime in power and gas.

4. Do you agree with the analysis above on the importance of the transparency/disclosure of fundamental data? If yes, would you consider it useful to set up at a European level a harmonised list of fundamental data required to be published? Is an exhaustive list conceivable or is it necessary to publish additional data on an ad hoc basis if it is considered to be price sensitive?

We agree that greater transparency and disclosure arrangements will help improve the efficiency and integration of markets, but only if they are implemented in a harmonised way across the EU.

Any additional requirements should be set out in legislation to a sufficient level of detail to ensure consistent implementation across the EU. We do not think it would necessarily help if the relevant data was published on a single platform as it is likely that companies will enter the market to provide such a service in a way that best suits the different needs of market participants.

The interaction between energy sector regulation and financial regulation needs to be considered carefully in introducing any additional ad hoc arrangements for transparency. This is because even voluntary arrangements could be considered inside information under financial regulation if introduced through a voluntary regime such as ERGEG's regional initiatives. We

would therefore strongly advocate that any transparency requirements must be implemented through new legislation at an EU level taking into account the issues around the definition of inside information.

EFET has published its views on the necessary transparency requirements for both power and gas[1] – and EDF Trading would welcome these being translated into binding commitments – subject to the issues around the definition of inside information being resolved.

5. Which information retained by specific participants of the electricity and gas markets (e.g. generators, TSOs) should be published on an ad hoc basis if it is price sensitive?

As explained above, we do not believe there should be ad hoc publication arrangements for power and gas markets.

6. What is your opinion of the proposals of CESR and ERGEG in the three different areas: disclosure obligations, insider trading and market manipulation?

Transparency/disclosure obligations

We agree with the conclusion that transparency requirements should be introduced through energy sector legislation. However, it will be important to ensure information on customer demand and speculative interest for commodities is included, by placing requirements directly on other market participants (such as banks or hedge funds).

We also agree that the primary obligation to disclose the required information should also primarily lie with the entity responsible for the relevant activity although we do not believe that publication through a single platform would necessarily be the most effective way of meeting the different requirements of market participants.

As explained above, we believe operators of regulated markets and Multilateral Trading Facilities (as currently required under MiFID) should continue to act as 'front-line regulators' for monitoring market behaviour.

It may not be appropriate to prescribe such a role to brokers in the OTC market (where they do not operate an MTF) and here the regulatory authority should take the primary responsibility.

We would also support the introduction of MAD Article 6 disclosure requirements in power and gas as long as they were suitably modified for the specifics of the sector and do not impose an undue level of costs.

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[1] "Transparency and availability of information – updated position", EFET, May 2006 and "Gas transparency requirements", EFET, May 2007. Both documents are available on the EFET website www.efet.org

We urge that a fully quantified impact assessment of any new requirements is undertaken as part of the consultation process.

Insider trading

Any market abuse regime for power and gas will probably need to be sector specific. However, as explained above it should also cover other commodities that impact on the price of power. It is crucial that the definition of inside information, which will underpin the market abuse regime, takes account of the issues identified in our response to question 1.

We do not believe that the NordPool model provides an appropriate model for the rest of the EU. The definition of inside information and the restrictions placed on asset owners in how they trade effectively increase the operational risk of production – and in particular the risk of not being able to cover an outage. If producers are not allowed to hedge financially this risk (because of the market abuse regime) it will result in significantly higher marginal costs and/or investment in additional (and inefficient) plant to provide a physical hedge. The result will be higher prices to customers.

We agree that an extension in MAD to the physical gas and power market would not be the most appropriate approach and that any dedicated, sector specific regime should be introduced through new legislative requirements.

In developing a sector specific regime it will be important to avoid duplication of regulation – for example through both competition law and any market abuse regime. Duplication of regulation will create uncertainty as to which legal framework should apply including the appropriate authority to pursue any cases.

As with transparency/disclosure obligations we expect to see a fully quantified impact assessment as part of the consultation process.

Market manipulation

We agree that the Commission should introduce a tailor made market abuse framework for power and gas if it decides new requirements are necessary – although as explained above this must be extended to all commodity sectors. Any regime must also take account of the issues identified in our response to question 1.

We also agree that the interaction between energy and financial regulators will be crucial to making any regime work effectively. Clear obligations and responsibilities must be outlined in any legislation. Any new market abuse requirements should be brought forward as part of a dedicated legislative package (i.e. either as a new Directive or ideally a Regulation). The existing and envisaged transparency requirements under energy sector legislation could be transferred to this new instrument to ensure the important interactions identified above are properly taken into account.