UNION OF THE ELECTRICITY INDUSTRY
eurelectric

Brussels, 01 August 2008

CESR/CEBS Consultation on Commodities (published 15th May 2008)

Dear Sir/Madam,

EURELECTRIC, representing the European electricity industry, welcomes the opportunity to comment on the CEBS/CESR Consultation on the "Review of Commodities". As such, please find attached an annex containing EURELECTRIC's detailed answers to the questions posed by CEBS and CESR in this consultation. In summary, the most important aspects of our position are as follows:

- There is no comparable financial systemic risk between energy firms and financial institutions:
  - EURELECTRIC believes energy firms involved in trading energy derivatives pose a very low level of systemic risk to the financial system;
  - If banking-sector style rules are disproportionately applied to energy firms this will have the effect of reducing liquidity and may encourage firms to move their trading businesses outside the EU;
  - There is no direct involvement of unsophisticated private customers in electricity wholesale trading markets.
- Current specific exemptions in both MiFID and CRD are important for the energy industry and should be maintained:
  - If a decision is made to alter the specific exemptions in MiFID (Art. 2 (1)i & Art. 2 (1)k) then it needs to be ensured that the content of the current exemptions are maintained;
  - If a decision is made to alter the specific exemptions in CAD (Art. 45 & 48) then a special prudential regime should be put in place for commodity firms, which provides sufficient built-in flexibility to accommodate specific sector issues relevant for the electricity industry;
  - If a decisions is made to amend the commodity-specific exemptions, possible inconsistencies should be avoided;
  - In any case, own account trading must stay exempted.
- The specific MiFID exemptions should be implemented and applied in a harmonised way throughout the EU.
- We do not see the need to change the current definitions of commodity derivatives.

If you have any questions on this response, please do not hesitate to contact Niall Lawlor (nlawlor@eurelectric.org; phone: +32.2.515 10 27).

With best regards,

Bernhard WALTER
Chairman, SG Financial Regulation

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Encl.

Consultation Paper on CESR's/ CEBS' technical advice to the European Commission on the Review of Commodities Business

EURELECTRIC RESPONSE

Part A. EU COMMODITY DERIVATIVES MARKETS

1) In practice, what proportion and/or amount of *OTC commodity derivative* transactions are financial instruments falling within the *MiFID* and what proportion are spot? (a breakdown in terms of the underlying would be helpful)

We do not have specific information on proportions and amounts. We also like to point out that the consultation paper appears to confuse the role of OTC trading and MTF trading (paragraph 25: OTC excludes MTFs,). In fact, most of the trade going through MTFs is known as OTC trading to the electricity industry (para. 43 & 68). Hence, pure OTC trading is unusual.

Part B. MARKET FAILURE ANALYSIS

2) Do you agree that the level of direct participation by unsophisticated investors is mainly limited to corporate clients such as producers or wholesale distributors (with a lack of experience and knowledge in derivatives markets but not in trading in physical *commodity markets),* that participation by private clients is very low, and that most other participants in *commodity derivatives markets* are sophisticated firms?

Yes. In addition, we consider that corporate clients such as producers or wholesale suppliers are no longer unsophisticated participants, since they have significantly increased their knowledge of derivatives markets, their risk and credit management capabilities, etc. and have implemented advanced tools and procedures. Therefore, the vast majority of participants are sophisticated, including producers.

3) What informational advantages persist in *commodity derivatives markets*, and in particular to what extent do those also active in the underlying physical market have informational advantages?

An appropriate level of transparency is important for a well-functioning market. In this context, the recent Commission's energy Sector Enquiry raised a number of concerns regarding transparency on certain aspects of the underlying markets, such as the use of the transmission network, the availability of production and consumption, etc. *On the other hand, the Sector Enquiry did not identify any specific informational advantages on the derivatives markets.* In any case, the concerns identified in the Sector Enquiry are being addressed via a number of initiatives currently being undertaken by the electricity industry[1], by the energy regulators and by the Commission itself, namely in relation to data on generation, consumption and transmission line availability[2].

[1] See EURELECTRIC Position Paper on market transparency (as further to the request of the 12th Florence Forum) February 2006.

[2] In any case, the specific issue of record-keeping and possible transparency arrangements concerning public-availability of information on energy and energy derivatives trading is being looked at in the ongoing ERGEG/CESR mandate.

4) Do information asymmetries in *commodity derivatives markets* lead to mis-selling concerns, or to other concerns about potential client detriment?

In our view, there are no information asymmetries in commodity derivatives markets. See also answer to question 3 above.

5) Do you have any transparency-related concerns relating to the trading of non-electricity and gas *derivatives*? If so, in which markets and why?

No EURELECTRIC answer required.

6) Do you have evidence of informational asymmetries in *commodity derivatives markets* in relation to market abuse?

In our view, there are no information asymmetries. See answer to question 3 above. For electricity and gas, this is also part of the current CESR/ERGEG consultation on this issue.

7) Please provide any information you may have on the levels of lending and trading exposures between *specialist commodity derivative firms* and *institutions*.

We do not have quantitative information on levels of lending and trading exposure.

8) What level of risk do *specialist commodity derivative firms* pose to the financial system?

(i) Impact of Electricity firms as Specialist Commodity Firms on Financial Markets

EURELECTRIC believes that electricity and other energy firms involved in trading commodity derivatives pose a very low level of systemic risk to the financial system. In particular, the level of financial systemic risk posed by electricity firms, whose trading activities is supported by physical assets and customer sales is non-comparable with that posed by "pure" traders of commodity derivatives and financial institutions.

For the electricity industry this is a strong argument for the maintenance of the relevant exemptions in MiFID/CAD. However if a decision is made to alter the exemptions then a special regime should be put in place for commodity firms, one which provides enough built-in flexibility to accommodate specific sector issues relevant for the electricity industry.

(ii) Impact of Electricity firms as Specialist Commodity Firms on Underlying Markets & on Electricity End-Customers (although this is not one of the questions posed by CESR/CEBS, in our view the assessment made by CEBS/CESR, especially in section B.II.2, is both incomplete and inaccurate as regards the electricity sector, therefore we have added some comments on this topic)

As companies who are subject to stringent sector-specific regulations regarding continuity of supply, and whose trading activities is closely related to physical assets and customer sales, we believe that electricity firms acting in electricity derivative markets pose a very low level of risk to end-users of electricity, both in terms of affecting availability and prices of electricity.

We consider that the analysis done by CESR/CEBS of this issue is incomplete as it ignores the fact that electricity firms trading in financial products is undoubtedly positive for electricity

customers in that financial markets allow electricity producers and suppliers to hedge or 'trade around' their physical assets[3].This allows a wider range of conditions of supply.

In addition, the assessment is inaccurate for several reasons. In particular we believe that the assertions made in paragraph 98 (*'the failure of such [commodity] firms, in addition to generating credit losses for their counterparties, could affect the price and availability of commodities'*) as well as the claim made in paragraph 101 ("*firm failure can have a significant price impact and may temporarily lead to higher or lower prices in the underlying commodity market. For example Amaranth's failure is estimated to have resulted in an $18 billion increase in consumers' energy bills. A sharp raise in prices was also observed in the German electricity market following the failure of Enron*") are not justified or inaccurate.

- *Firstly, in terms of physical availability of electricity*, while the paper correctly notes that electricity flow is guaranteed due to the existence of mechanisms to balance supply and demand, existing sector-specific regulatory and electricity system safeguards also provide for continuity of supply when an electricity supplier exits the market (e.g. goes bankrupt). In this case the contracted electricity usually has to be provided by another electricity company (whether this is a generation company or the transmission system operator). One example of how this works in practice was the exit of TXU from the British retail electricity market. In this instance, customers were transferred, without disruption and with 'deemed contracts', from TXU to other suppliers. In addition, another peculiarity of the electricity system is that customers cannot be cut-off by a generator or supplier– unlike other industries, only a network operator, and not a supplier/producer, can disconnect a customer. Moreover, even when a producer/supplier goes into financial difficulties (as was the case in the past, for instance, with British Energy) the generation assets continue to produce. Therefore, for all customers physical supply continues regardless of what happens in the derivatives market.

- *Secondly, in terms of the correlation between availability and underlying prices,* as the amount of physical capacity available in the market stays the same (electricity generation plants are sunk and 'do not walk'), the amount of physical electricity to be generated, as well as the cost of generating it, should stay the same so long as the market is liquid, fuel prices are stable and demand stays the same, all of which are outside companies' control. Therefore, the failure of any electricity company trading derivatives on own account on a commodity derivatives market should not have any direct causative negative repercussions for the functioning of underlying physical markets.

- *Thirdly, as regards the example of Enron used in paragraph 101*, and the supposed effect which its failure had on Europe's fledgling electricity markets back in 2001, we believe that this case is precisely the proof of the resilience of energy markets. Enron was, by far, the largest and most active electricity and gas trader. However, its failure did not cause any supply disruption and only temporary and very limited price fluctuations that did not affect end-customers. As the report states, and as referred above, other market participants stepped in to assume the natural position of the defaulted participants, or adjusted their own natural position by changing production processes or plans.

Concerning trading exposure for electricity companies (and customers), exchange- and MTF-based OTC-trading – which accounts for most of the activity in electricity and gas markets, is frequently cleared through a central counterparty – means that CCR is reduced.

In addition as electricity companies have large (non-liquid) physical asset portfolios, they can back their positions by leveraging these assets as collateral in terms of letters of credit,

[3] The management of physical assets with optionality, such as power plants, typically requires 'trading around them'. For example, a gas- or coal-based generator can be considered as an option to buy power at a strike price equivalent to its variable cost (fuel plus CO2 emission allowances). When the forward market price is above the variable cost, the producer will sell its production forward. However, when the forward price is below the variable cost, the producer should buy back what he had previously sold, and sell the fuel and emission allowances instead.

appropriately managed parent company guarantees and warrants or commodities. This is common practice in energy and energy derivative markets. In fact this practice has been in existence for many years and has, as such, proven to be robust.

Overall, and given the above comments, we believe that the statement made in paragraph 102 – '*even if the risks arising from commodities business are not different from those arising in the wider financial markets, the financial impact of a failure from a specialist commodity derivative firms appear to be lower than an equivalent failure from a financial institution'* – is a considerable understatement, at least for the electricity industry. In our view the risks posed by electricity companies are significantly different *from those arising in the wider financial market with* much lower financial impact.

9) To what extent does the level of systemic financial risk posed by *specialist commodity derivative firms* differ from that generated by banks and *ISD* investment firms?

In addition to the points already raised in question 8 above, there are a number of additional reasons why energy trading companies do not create the same systemic financial risks as purely financial institutions.

- energy firms have a different client base to financial institutions: energy firms only serve professional wholesale customers while investment firms and banks for the most part deal with both professional wholesale customers as well as retail customers.

- electricity companies main business is the supply of energy which is based on physical assets. The latter is also the fact that there can be a 'run-on-the-bank' situation in the financial sector, there cannot be a run on a 'coal power plant' in the electricity sector.

In EURELECTRIC's view, the differences highlighted above are pivotal to the question of whether exemptions should be removed.

10) Do the risks generated by energy-only investment firms differ materially from those posed by investment firms engaging in other commodity derivative activities/services? If so, how do they differ?

The risks generated by energy-only investment firms differ materially from those posed by financial institutions engaged in financial derivative activities/services. However the difference between energy and other commodities do not appear substantial enough to require fundamentally different regulatory regimes.

Therefore, as suggested above, EURELECTRIC believes that, if the current specific-exemptions in the CRD are not maintained, a special prudential regime for commodity firms should be put in place which includes enough built-in flexibility to accommodate the different characteristics of different commodities.

PART C. REGULATORY FAILURE ANALYSIS

11) Do you have any transparency-related concerns relating to the trading of non-*energy commodity derivatives*, and, if so, in which markets, what are the concerns, and what solutions could be applied?

No EURELECTRIC answer required.

12) Do you believe that for non-electricity and gas *derivative*s contracts, the transaction reporting requirements in the *MiFID* support market regulation? If so, can you explain why you think they do?

No EURELECTRIC answer required.

13) Do you have any evidence on potential problems, and if so, on the scale of these problems, that are posed by current client categorisation rules?

Although having not analysed this issue in great detail, we feel that the current client categorisation rules in MiFID may have negative implications for both commodity firms and, indirectly, for their potential clients. The European energy market is heterogeneous in nature, with many smaller firms that are well experienced but may not qualify as professionals under MiFID. This, in turn, will cause that commodity firms (having a MiFID license) to be more hesitant about doing business with these small firms (i.e. due to the additional regulatory burden that they would thereby incur). This limits the potential for growth within commodity markets as many of these potential clients are producers of the underlying commodity needing to hedge their physical positions.

14) Do you have any evidence that regulation according to the main business of the group may cause competitive distortions?

We do not have any evidence that regulation according to the main business of the group may cause competitive distortions.

15) Do you agree that full application of *CRD* capital requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their potential systemic impact?

Yes. As noted above in question 8, the question as to whether to extend the capital requirements to specialist commodity firms is premised on whether commodity firms cause systemic risk for either or both the underlying physical market or for the commodity market in question. Therefore, for electricity, if electricity firms trading in commodity derivatives do not cause financial systemic risk, then there is no need for full application of CRD.

In terms of what would happen if CRD requirements were – for whatever reason – fully applied to electricity firms that fall under the MiFID requirements, then the answer is yes, this would impose an unnecessary and disproportionate regulatory burden, thereby resulting in increased costs for all firms, especially for smaller firms who cannot move, and possible relocation for larger firms.

16) Do you believe that full application of *CRD* large exposure requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their business and their potential systemic impact?

Yes. For electricity companies these concerns relate to (i) structural differences in the energy market, (ii) how transactions are settled, and (iii) how long-term contracts are designed:

- *Structural differences in the energy market:* Many energy companies have set up specific trading units that serve as a platform to purchase and sell electricity and gas from and to participants of the electricity wholesale market. They have structured their business to create a single trading entity that presents one face to the market and centralises risk management expertise. Naturally, this entity will enter into a large number of transactions with group

companies such as the group's generation or distribution entities, which under the Large Exposure Directive could either give rise to additional capital requirements, or at worst reduce the potential for intra-group trading, thereby destroying the risk management benefits that go with it. Without specific rules on the issue of Large Exposures that take the peculiarities of the energy markets into account, the risk exposure will be overstated resulting in overly restrictive capital adequacy requirements for energy companies.

- *Unsettled Transactions:* According to the Large Exposure Directive capital requirements may also be met in relation to so-called unsettled transactions. It is, however, common practice that e.g. electricity is supplied throughout the entire month with the metering of the actual usage and the issuing of the bill at the end of the month. Further, the supply company then usually allows for a deferred payment (i.e. a specific time after issuing the bill). In Germany, for example, the established practice of delivery and payment modalities are one month plus 20 days post delivery. This could lead to the fact that the upper limits for Large Exposures are quickly reached and exceeded. As a consequence, the capital requirements to cover Large Exposures would also have to be met. In other words, if an energy supplier is also active in "MiFID-licensed" trading, the usual commercial operations like supply of electricity, gas or heat would cause an inappropriate additional need for capital adequacy due to the capital requirements for Large Exposures. On the other hand, the commercial customs and established procedures can only be changed with major efforts and cost, while alternatively additional equity will be difficult or almost impossible to obtain. Thus, the undifferentiated application of the requirements for Large Exposures to energy companies will be prohibitive for future "MiFID-licensed" energy derivatives trading.

- *Long term contracts:* In energy trading longer term supply contracts are commonly used as "normal" trading products. However, for MiFID-licensed energy companies, the positive market values of these contracts would also be classified as credits with the result that the limits of the Large Exposure Directive would be quickly reached and exceeded. Again, this would lead to a significant increase in regulatory capital (for credit risk purposes) for energy markets where the contracts are typically long dated (up to several years) and payment can occur some time after delivery reflecting the payment terms used in the underlying physical market.

17) Do you believe there is a potential for regulatory arbitrage? If so, can you provide evidence?

The consultation paper correctly confirms that regulatory arbitrage between the EU and outside the EU can lead to the re-location of business. Therefore, any regulation should be aimed at dealing with actual market failures, and no more. A heavy burden will cause firms to seriously consider relocating. We also see the potential of regulatory arbitrage resulting from non-harmonised implementation of e.g. specific exemptions. This is also recognised by the paper criticizing that Member States' discretion to introduce super-equivalent gold-plated measures can distort trade. Therefore we reiterate our point made in responding to the CfE that discretionary implementation should be excluded. As such, the implementation exemptions need to be harmonised throughout the EU.

PART D. *MiFID*

18) Do you believe that the application of the *MiFID* organisational requirements support the intended aims of market regulation when applied to *specialist commodity derivatives firms*, or *commodity derivative*s business? If not, what aspects of the organisational requirements do you believe do not support the aims of market regulation when applied to such firms and why?

MiFID organisational requirements were designed for financial institutions, not for electricity companies.

19) Do you believe that there is a case for changing the client categorisation regime as it applies to *commodity derivative*s business? If so, do you have any evidence on the scale of the problem or potential problem posed by the existing rules?

Yes. See answer to question 13.

20) Do you believe that the conduct of business rules in the *MiFID* effectively support the aims of regulation with respect of *commodity derivative*s business? If not, can you explain why and in what respects, and whether your response is contingent upon the client categorisation definitions applied to *commodity derivative*s business?

See answer to question 14.

21) Do each of the following elements of the criteria for determining which commodity derivatives contracts are financial instruments offer sufficient clarity to market participants to understand where the boundaries of the *MiFID* lie?
a) the phrase "...that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event)";
b) the phrase "traded on a regulated market and/or MTF"
c) the definition of a spot contract in Article 38(2) of the *MiFID* implementing regulation:
d) the criteria in articles 38(1)(a),(b), and (c);
e) the definition of a commodity in Article 2 of the *MiFID* implementing regulation; and
f) the list of underlyings of exotic derivatives mentioned in Section C(10) of Annex I to the *MiFID* and Article 39 of the *MiFID* implementing regulation.

Given the complexity involved, the 'phrases' and definitions provided above are reasonably clear.

22) Do you have any evidence of physically-settled commodity OTC contracts being written in a way that removes them from the definition of financial instruments?

We do not have detailed information on this issue.

23) Do you believe there are sufficient similarities between different *commodity derivatives markets* to make it inappropriate to differentiate the regulatory regime on the basis of the underlying being traded?

As per question 8, for the electricity industry this is a strong argument for the maintenance of the relevant exemptions in MiFID/CRD.

However if a decision is made to alter the current specific exemptions in the CRD then a special regime should be put in place for commodity firms, one which provides enough built-in flexibility to accommodate specific sector issues relevant for the electricity industry.

24) If the capital treatment of *specialist commodity derivative firms* is resolved, do you think there is still a case for retaining both of the exemptions in Articles 2(1)(i) and (k)? If not, how do you think the exemptions should be modified or eliminated? If the exemptions in Articles 2(1)(i) and (k) were eliminated, what effect do you think this would have on *commodity derivatives markets*?

Yes, we think that in any case both of the exemptions in Articles 2(1)(i) and (k) should be retained; otherwise we see significant negative effects on the further development of the electricity wholesale market as entities trading on own account in energy derivatives may no longer do this without a MiFID-license; however, as described before, this activity is vital from a risk management point of view. One could consider a modification of the two exemptions in such that a single "consolidated" exemption is drafted. One such proposal has recently be made by the CDWG who considers that the second limb of article 2(1)(i) and article 2(1)(k) may be replaced by a new single exemption covering persons (other than operators of an MTF or of a regulated market) whose main business consists of dealing on own account with professional counterparties in relation to commodities and/or commodity derivatives or other non-financial derivatives contracts covered by MIFID (under points 5, 6, 7, 9, and 10 Section C, Annex I). For further details see CDWG paper on CESR/CEBS Call for Evidence on Commodities (March 2008); op.12-13.

PART E: CRD

25) Do you believe based on the above analysis that the application of the *CRD* large exposures regime to specialist *commodity derivatives* firms is disproportionate?

Yes. See our response to question 16.

26) Do you agree that the maturity ladder approach is unsuitable for calculating capital requirements for non-storable commodities? If yes, are the proposed alternatives better suited to that task?

Yes we agree that the maturity ladder approach is not suitable to calculate the capital requirements if applied for non-storable commodities such as electricity (and also exotics). We agree with the report's analysis on this topic (particularly on the issue using spot prices to transform physical positions into financial positions). The alternatives proposed under paragraph 268 seem to be more appropriate to account for the specificities of non-storable commodities.

27) Do you believe that the shortcomings identified in 2. b. and c. and 3. are relevant? Are there others that need consideration?

Regarding to shortcoming identified in 2.b., this is not relevant to EURELECTRIC as our business is not related to ancillary agricultural commodities.

Concerning the shortcomings identified in 2.c., we agree with CEBS/CESR's assessment of this issue.

Finally, in relation to the shortcoming identified in 3, in line with the Directive, and as stated in the consultation, we are of the opinion that competent authorities must continue to be free to allocate resources to the approval process.

28) Do you think that the solutions outlined above are adequate to address these problems?

Yes

29) Do you agree with the conclusion above?

We agree with the conclusion in paragraph 282.

a. Option 1: no regulatory capital requirements but qualitative risk management
b. Option 2: Pillar 2-type approach
c. Option 3: Recalibrated *CRD*
d. Option 4: Full application of *CRD* to relevant *specialist commodity derivative firms*

30) Which of the options presented above do you consider appropriate for the application to *specialist commodity derivative firms*?

Again we believe the current exemptions should remain and be made permanent. In case it is decided to replace them, the appropriate option would be to go for option 1 as presented in the paper. In this regard we fully support the respective argumentations as put forward by the CDWG proposals on this issue.

Generally, we would like to point out that we do not consider option 4 as a real option. As also outlined by CERS/CEBS, the full application of CRD to relevant specialist commodity derivative firms will cause major problems and cause them to cease providing financial services/activities.

31) Do you think a complementary opt-in or opt-out regime could be helpful?

We support the idea of a complementary opt-in /opt-out regime.