ISDA®

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AO
Tel: 44 (0) 20 3088 3550
Fax: 44 (0) 20 3088 3555
Email: isdaeurope@isda.org
Website: www.isda.org

FOA

2nd Floor
36-38 Botolph Lane
London EC3R 8DE
Tel +44 020 7929 0081
Fax +44 020 7621 0223

1 September 2008

CESR-ERGEG advice to the European Commission in the context of the Third Energy Package

Draft Response to Question F.20 – Market Abuse

ISDA-FOA Response to Consultation Paper

ISDA and the FOA welcome the opportunity to respond to the CESR-ERGEG Consultation Paper on their draft response to Question 20 of the European Commission call for advice on the Third Energy Package – dealing with Market Abuse.

These organizations have been cooperating as part of the Commodity Derivatives Working Group (CDWG) and the Commodity Firms Regulatory Capital Working Group (CFRC WG), to engage in the EU review of commodities regulation as mandated under MIFID and the CRD. The members of these working groups are mainly risk officers, compliance officers, and lawyers **from major commodity firms** active in the EU.

On this occasion, EFET, the European Federation of Energy Traders, is publishing a separate response to the consultation paper. EFET has until now been cooperating with ISDA and the FOA as part of the CDWG. Nevertheless, the EFET response and the ISDA-FOA responses have been subject to coordination, and we expect the cooperation between these three associations to continue.

All of these organizations were involved in discussions around transparency requirements for wholesale electricity and gas markets prior to the adoption of the 3rd Energy Package in September 2007, which led to this Call for Advice from the European Commission to CESR and ERGEG.

ISDA represents participants in the privately negotiated derivatives industry and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the

businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial risks inherent in their core economic activities.

The FOA is the industry association for 160 international firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.

Executive Summary

ISDA and the FOA welcomes the opportunity to provide its views to CESR and ERGEG on its draft advice to the European Commission on market abuse.

ISDA and the FOA would like to underline its belief that any new regulation should only be considered and conceived subject to adherence to better regulation principles. Any proposals should be subject to wide consultation and discussion, rigorous impact assessment and cost-benefit analysis. Unnecessarily burdensome regulation should be avoided. Regulators must also take care to ensure that new legislation does not create conflicts or overlap with other legislation, or other unintended consequences.

Further to the above, we query whether any material market failure concerning market integrity in electricity and gas markets has been established in the CESR-ERGEG consultation paper. We believe that where such market failures are indicated in the consultation paper, no real evidence is provided. Elsewhere, the paper seems to misunderstand the reasons for certain responsible practices undertaken by industry, suggesting that some of these practices represent abusive behaviour of some kind (producers balancing their position before informing the market, when faced with an outage, for example)

In previous submissions (in cooperation with EFET) to regulators, as well as to the European Commission, ISDA and the FOA have expressed strong support for increased disclosure requirements around price sensitive fundamental data in physical markets. ISDA and the FOA remain supportive of such proposals, although, we believe that the detail of these proposals needs to be considered carefully. In particular, we feel that it is important that it is understood that this disclosure is made to the market, and that some flexibility should be allowed in the means of disclosure of this data.

In general, we believe that a principles-based approach to setting out disclosure requirements for regulated firms would be the optimum solution in this context.

Further to the above, ISDA and the FOA would like to make it clear that they strongly oppose any suggestion that either transaction reporting or pre- or post-trade transparency requirements should be imposed on energy market participants. As detailed in our submission, we question whether these would be of any benefit to either regulators or the market, and they would impose unnecessarily burdensome and costly requirement on firms providing badly-needed investment in European electricity and gas markets.

We would also like to remind regulators that we remain supportive of the proposal to require participants in these markets to keep records of transactions undertaken, which regulators can request as appropriate (e.g. when they question the integrity of a market participant).

ISDA and the FOA welcomes the paper's conclusion that revision of the Market Abuse Directive to extend to physical markets should not be considered, in light of the scope for unintended consequences of such a step, and the limited benefits it would provide.

We are wary of the proposals to create a new insider trading and market manipulation regime in energy sector legislation for physical markets. While we can, in principle, see some of the benefits of such a regime, we believe that supposed behaviours that such a regime would seek to confront could be adequately addressed via a proportionate disclosure regime. We are also

unclear as to exactly how burdensome such a regime would be. As such, we reserve our judgement on these proposals for the moment. Again, any move to draw up such a regime should only be undertaken subject to adherence to better regulation principles.

The commodity firm members of ISDA and the FOA would like to thank CESR and ERGEG for the work they continue to do on these issues, and for their continued cooperation with industry in addressing these issues.

For further questions please contact Roger Cogan (rcogan@isda.org).

Responses to questions

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.***

ISDA and the FOA query whether there is any clear evidence of market failure highlighted in this consultation paper, nor any other study (including the European Commission's sector Inquiry into energy markets).

In this context, we underline, for example, that the (CESR-ERGEG) draft response to Question 1, when quoting from the European Commission Sector Inquiry report, can only refer to a 'general perception' that generation data of vertically integrated incumbents is being shared with affiliates of those incumbents before it is shared with other market participants. The draft response suggests that electricity and gas markets are 'vulnerable' to manipulation, and that other abusive practices 'could' be applied 'in some cases – but not always necessarily' to the existence of a dominant position.

We believe that, in principle, it is disproportionate for regulators to propose legislation based on insubstantial evidence of market failure. We believe that both the content of this consultation paper and the tone of the draft response are indicative of the fact that no such evidence has been identified.

Further to the reference to the existence of a dominant position, we recall that there is nothing wrong with holding a dominant position, as long as the dominant market participant adheres to competition rules. We believe that competition rules are the key to ensuring competitive markets where dominance is a factor.

In its submission to the CESR/ERGEG working group of 26 March 2008, the CDWG highlighted that even the European Commission's Sector Inquiry report did not produce evidence of market failure as regards transparency in wholesale supply contracts and derivatives contracts in electricity and gas. Where that report calls for action to combat a lack of transparency in electricity and gas markets, it refers not to transparency in wholesale electricity and gas supply contracts or derivatives contracts, but rather to use of essential infrastructure, such as gas transit pipelines or electricity interconnectors.

ISDA and the FOA make the following comments concerning the detailed analysis of market failures in electricity and gas markets in paragraphs 26 to 42:

- This section discusses information asymmetries related to generation data and their impact on the market. ISDA and the FOA agree with the view of the UK Treasury and the Financial Services Authority that such asymmetries can, to some extent, be seen as an 'economic rent' obtained in reward for investment in the physical market. Such information asymmetries are only intrinsically 'wrong' when they are abused by market participants.
- We repeat that neither this consultation paper, nor the Sector Inquiry points to any clear evidence of abuse in this context. The examples used in paragraph 27 are hypothetical,

for example (e.g. a group with worse/less information 'may' make poor trading decisions and such information asymmetry 'can' lead to market abuse), while paragraph 28 refers only to a 'perception' (as described in the Sector Inquiry report) that data is not shared equally with all market participants by vertically-integrated incumbents.

- We are concerned with the inference in paragraph 29 that market participants experiencing power outages not informing the market about these outages until they themselves have balanced their position is, in some way, abusive behaviour. When these firms take these steps, they take them for responsible reasons, related to the orderliness of the market and the financial position of their counterparties in the market. It should also be underlined that such an action is entirely legal in the main energy-trading jurisdictions in Europe. We object strongly to the tone of this paragraph, which we believe is based on a misunderstanding of the motivations of such firms.
- We underline again that market power (ref paragraphs 31 to 35) should be primarily regulated via competition policy – market power is only a concern when this power is abused and competition policy is not applied.

Despite these concerns, ISDA and the FOA would like to highlight that it is supportive of the proposals to apply disclosure requirements around price sensitive fundamental data. ISDA and the FOA remain concerned to examine the detail of these requirements, and warns against an overly prescriptive approach.

ISDA and the FOA are firmly opposed to any suggestion of transaction reporting requirements, and have some concerns about the idea of a 'single platform' referred to in paragraph 81, in this context.

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 trading and market manipulation?

ISDA and the FOA agrees broadly with the analysis of the scope of MAD in relation to the three areas mentioned.

ISDA and the FOA observe however, that the definition of inside information for commodity derivatives was discussed at length in the context of the drafting of MIFID and believe that re-opening of the matter will require further lengthy consultation, discussion and consideration for a satisfactory solution to be found.

We note the reference to the difficulties that securities regulators may have in defining information that users may receive in accordance with accepted market practices, in this context. We would suggest that it may not be necessary or optimal to define these accepted market practices through legislation.

While the current scope of MAD may not address every market-integrity concern that regulators have, we believe that a *proportionate* disclosure-based regime (agreed following thorough discussion with industry, impact assessment and cost-benefit analysis) applying to physical markets may be the most (cost-) effective and efficient means of addressing these concerns.

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?

ISDA and the FOA are opposed to any suggestion of imposition or pre- or post-trade transparency requirements as a means to tackle supposed market abuse in these markets, for the following reasons:

- Transparency requirements in equity markets have been proposed with protection of retail investors in mind, while voluntary industry solutions in some bond markets have similar aims. We remind regulators that retail investment is not a factor in electricity and gas wholesale markets, and that no such requirements are justified;
- As mentioned, no clear evidence of market failure in this context has been produced;
- CESR and the European Commission have already concluded that, at least for derivative markets, there is no case for imposition of transparency requirements.
- Such requirements would create an excessive and prohibitive burden for smaller participants and potential new entrants in these markets.
- Much such information is already available on commercial terms from commercial data providers (Platts, Bloomberg etc).
- It is not clear to us what the aim of new transparency requirements would be. Would they be designed to boost market integrity or to protect investors? If so, how would this be achieved?

ISDA and the FOA accepts the general point made by CESR and ERGEG that transparency requirements are of little benefit in tackling market abuse in physical markets if there is no scope in legislation to tackle such abuse, where transparency requirements reveal potential abusive behaviour.

ISDA generally supports the focus on disclosure obligations in the physical market, subject to the condition that such a regime be proportionate and drawn up after thorough discussion with industry, impact assessment and cost-benefit analysis.

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 the 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 believe that market participants need information facilitating prediction of the likely evolution of supply and demand fundamentals and an ability to move energy around the transmission system. Access to information about electricity transmission and generation, gas transportation and gas storage allows new entrants to benefit in practice from third party access. Data about the use of this infrastructure assists efficiency and liquidity in the market and reduces risk.

We believe that regulators should focus their efforts in this context.

While we understand the need for a certain degree of harmonization in fundamental data to be disclosed, we are wary of the suggestion of a 'single platform' in this context (ref paragraph 81). ISDA and the FOA would like to underline their strong opposition to an overly prescriptive approach to disclosure of this data (we believe that market participants should be afforded a certain degree of license in the methods of disclosure).

We underline again that we are strongly opposed to the any suggestion of transaction reporting, which we consider burdensome, costly and disproportionate.

We also make the general comment that market participants should not under any circumstances be required to disclose/report to regulators in different Member States (we underline our opposition to transaction reporting and, in particular, to the idea of transaction reporting in different formats, according to different rules in different Member States).

Again, we emphasize the importance of close and wide cooperation with the industry in drawing up disclosure requirements that would fall upon physical market participants, and the need for cost-benefit and impact assessment to ensure an effective approach is taken.

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

In the gas market, we support disclosure of data on planned and unplanned outages of transportation capacity, interruptions, balancing decisions (i,e, where a TSO takes action to restore system balance, either by acting on a balancing market or by drawing on prearranged flexibility, then the TSO should explain the reasons behind the action and the extent of the corrective behaviour), and changes in capacity availability.

It is necessary to clarify what do ERGEG and CESR mean by "ad hoc". There should be no "ad hoc" solutions, but a set of clear principles for such disclosures.

Disclosure of information on availability/outages of power plants is a complex issue. If such information is treated as inside information, plant owners will not be able to trade before disclosing outages. In this context we make the following points:

- Privately owned power plants are commercial concerns: nobody should be obliged to disclose changes in their commercial position until they have had the opportunity to protect themselves commercially.

- Power plants should be viewed differently to transmission assets. Information about the status of interconnections should be known to everybody, since everybody has access to the network. That is not the case for power plants.

- Disclosure of outages information would be detrimental to small generators, who may only have a limited number of alternatives to procure intraday power. Such generators should be able to disclose their position.

- The justification provided for obligatory disclosure of plant outages appears to be the possibility of market manipulation. But this is a market monitoring problem and not related to transparency. System operators are immediately aware of plant outages and can inform the regulators, who can check for manipulation.

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

Disclosure obligations: We support the idea of disclosure of specific types of information, though do not necessarily feel that detailed legislation prescribing the form of such disclosure form is appropriate.

We would propose that a principles-based approach, leaving some flexibility for physical market participants to determine the methods of disclosure (according to agreed principles) should be examined. We certainly believe it is important to avoid a patchwork of disclosure obligations applying across different EU Member States. Subject to the above concerns, we support option 3. Again, we underline the need for broad and thorough consultation, cost-benefit and impact assessment in drawing up proposals.

We strongly agree with the reasoning given by CESR and ERGEG for not supporting revision of the Market Abuse Directive to address disclosure around physical markets.

Insider trading: Of the options listed, Option 3 is preferred. We are strongly opposed to options 1 and 2 and are wary of the potential pitfalls of option 4.

However, we believe that if a suitable disclosure regime around physical markets can be achieved, this may obviate the need for a legal instrument applying insider trading rules to physical energy markets (if the disclosure is set at the right level, the scope for 'insider information' may be diminished).

It is difficult for ISDA and the FOA to say that it 'supports' the idea of a tailor-made insider information framework (in energy sector legislation) for products not covered by the Market Abuse Directive when it is not at all clear how burdensome a regime would apply. As such, ISDA and the FOA reserve their judgement on this issue for the moment.

Naturally, any project to draw up such a regime should be undertaken according to the principles of better regulation, involving extensive consultation, impact assessment and cost-benefit analysis.

ISDA and the FOA note the positive view expressed by CESR/ERGEG on the Nordic model for transparency requirements and insider trading rules.

We feel it appropriate to point out, however, that whilst there are many commendable features of the Nordic regime, it regulates a market characterised by a large number of relatively small installations, with limited impact (respectively) on price discovery. Unlike that market, the wider European market comprises a smaller number of much larger players. We believe that applying such a regime to the wider European market may be inappropriate. In particular, the definition of inside information and the restrictions on producers' ability to trade significantly would increase operational risk incurred by producers – in particular, for example, in the electricity market, when faced with an outage. A Nordpool-style market abuse regime would create obstacles to hedging, resulting in increased end-costs and investment costs, which would actually undermine market liquidity and investment levels.

Market manipulation: Of the options provided, ISDA and the FOA prefer option 3. However we believe that the primary legal barrier to market manipulation should be application of competition policy.

ISDA and the FOA support the suggestion that energy regulators and securities regulator work closely together.

ISDA and the FOA believe that consideration should be given to the idea that MTFs and brokers might be delegated market monitoring duties (thus avoiding an unwelcome regulatory burden being placed on market participants). Any such move should only be agreed after thorough discussion and consultation involving regulators, market participants, brokers and MTFs

It is difficult for ISDA and the FOA to say that it 'supports' the idea of a tailor-made market manipulation framework (in energy sector legislation) for products not covered by the Market Abuse Directive when it is not at all clear how burdensome a regime would apply. As such, ISDA and the FOA reserve their judgement on this issue for the moment.

Naturally, any project to draw up such a regime should be undertaken according to the principles of better regulation, involving extensive consultation, impact assessment and cost-benefit analysis.