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Position Paper

BDEW Response

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

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The German Association of Energy and Water Industries (BDEW) represents 1.800 members of the electricity, gas and water industry. In the energy sector, we represent companies active in generation, wholesale markets, transmission, distribution and retail.

We welcome the opportunity to comment on the “Discussion Paper - Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories”. Before we get to the questions, we would stress the following key issues for the German energy industry:

1 Initial Remarks

Duration of breach of the threshold and transitional period

We believe that a breach of the clearing threshold should occur during a specified timeframe (such as 90 consecutive days) before the clearing obligation is triggered. This is necessary to avoid that a short term breach of the clearing threshold, e.g. based on a volatile market price situation, will trigger the clearing obligation.

After the date of such a continuous breach of the clearing threshold, the non-financial counterparty should be granted an additional time span (such as another 90 days) before the clearing obligation comes into force. EMIR should make it possible for non-financial counterparties to manage the transition to the mandatory clearing regime and the cash liquidity for posting margins at the CCPs.

The obligation should result in a commitment to bring to CCPs only OTC derivative transactions concluded after the clearing threshold is breached. The clearing obligation shall only apply to those OTC derivative transactions which are concluded after the clearing threshold has been breached during the above-mentioned first time period. In other words, the clearing obligation shall not apply to those OTC derivative transactions that have been concluded prior to this date and up to the threshold amount.

Otherwise, if a non-financial counterparty has to clear all of its existing OTC derivative contracts (immediately) after a relevant breach of the clearing threshold, then this will impose a clearing obligation for all companies’ transactions already for minor and temporary breaches of the threshold. In practice this would result in a “clearing shock” because the nonfinancial counterparty has to clear the entire OTC derivatives portfolio at once. This clearing shock will expose a non-financial counterparty to considerable cash liquidity risks, because it has to post margins at CCPs for its entire OTC derivatives portfolio. Also, these firms will face an enormous operational challenge to bring all their OTC derivatives contracts on CCPs, which represents a disproportionate compliance burden and causes resource constraints. The limitation to new OTC derivative contracts is further necessary, because it would be difficult to apply the clearing obligation to pre-existing OTC derivatives contracts which were negotiated on terms which do not take the requirement concerning central clearing into account. In addition, it is disproportionate to disregard hedging transactions objectively linked to commercial activity in assessing a company’s systemic importance, but then require the same commercial hedging transactions to be cleared if the clearing threshold is breached.

Finally, this amendment is also necessary to take into account one of the key differences between the US Dodd-Frank-Act and EMIR: Existing contracts do not have to be centrally cleared under the US Dodd-Frank-Act (once they are reported), while under the EMIR proposal, they would. This implies that non-financial counterparties forced to clear their OTC derivatives in EU CCPs will face huge extra costs in comparison with US firms.

The clearing obligation shall cease to apply, if a non-financial counterparty's positions/ exposures fall below the clearing threshold. A non-financial counterparty should always be exempted from the clearing obligation if its positions in OTC derivative contracts are below or fall below the clearing threshold. Otherwise, there exists discrimination between non-financial counterparties which are not breaching the clearing threshold and those non-financial counterparties who – after they have breached it – fall below it, because the clearing obligation would create an unjustified burden for the latter.

We welcome the current wording that such OTC derivative transactions should not be taken into account in calculating the positions and exposures, "which are objectively measurable as reducing risk directly related to the commercial activity or treasury financing activity of that counterparty or of that group."

This leads to an appropriate exemption for OTC derivative transactions from mandatory CCP clearing entered into for hedging purposes. However, it is unclear how a non-financial counterparty would establish that an OTC derivative is „objectively measurable as reducing risk directly related to the commercial activity or treasury financing activity " of that entity. It would be helpful to provide for the adoption of delegated acts by ESMA or the EU Commission to supplement and clarify this obligation. These delegated acts should allow for a multi-step approach to establish legitimate hedging, optimization and mitigation of commercial risk: Hedge accounting applicability (IAS 39) and national balancing possibilities for hedging purposes for example according to the German commercial code (HGB) are however not the only determinant for hedging derivative transactions. There are numerous derivatives linked to the commercial business that do not qualify for IAS 39 hedge accounting due to its strict formal requirements. An analysis of the other, non-IAS 39 derivative transactions should be performed. This analysis would be carried out by the company itself and certified by an independent external auditor. It would result in a binding report submitted by the company to the relevant supervisory body, either the national one or ESMA.

To ensure the maximum quality and seriousness of these reports the supervisory body may have the right to carry out sample inspections and ask questions that the company would be legally obliged to answer.

The competent authorities should be provided with adequate discretional powers to exempt non-financial counterparties or a type of OTC derivative contract from the clearing obligation in cases, where there is no systemic importance. A clearing obligation based on an automated quantitative test is not necessarily the best approach to assess systemic risk because it could lead to over-regulation, unintended consequences and hardship for market participants. The clearing obligation shall not apply to a non-financial counterparty or a type of OTC derivative contracts if the competent authorities determine that they are unlikely to present a

threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU.

Appropriate criteria for the definition of the clearing threshold and for the authorities' assessment of the systemic importance of non-financial counterparties

In its current wording EMIR gives ESMA the power to define the clearing threshold. We are of the opinion that EMIR should contain itself the main criteria for determining the clearing threshold as the clearing threshold is the core element of Article 7. Therefore, the definition of the clearing threshold should not be left entirely to ESMA and implementing Level 2 measures. We propose appropriate criteria, which will bind ESMA in its determination of the clearing threshold. In respect of the above-mentioned discretional powers for regulators, we propose that the same criteria will bind competent authorities when deciding if a non-financial firm is on systemic importance or not.

These criteria should not only be of quantitative, but also of qualitative nature: While a quantitative clearing threshold may be used as an indicative basis for establishing the systemic importance of a non-financial firm, an assessment based on a pure quantitative test is not necessarily the best approach to assess systemic risk of non-financial firms. A more accurate approach to capturing the systemic importance of positions / exposures held by non-financial firms is a combined quantitative and qualitative assessment. The mandatory clearing obligation should only capture those OTC derivative positions and non-financial firms that are capable of creating significant risk exposures that could have serious adverse effects on financial stability. Hence, the determination of the clearing threshold should be based primarily on a non-financial firm's risk exposures based on OTC derivatives to systemically relevant financial institutions.

In addition, we propose below some quantitative and qualitative criteria which could be used to help ESMA when determining the clearing threshold and competent authorities when deciding if a non-financial firm is on systemic importance or not.

Examples of quantitative criteria:

- The risk limits/ exposures ratios in respect to systemic relevance. This would identify any significant counterparties that are likely to be particularly affected by the nonfinancial firm's detail triggering potential contagion.
- Risk management figures in comparison to the asset base. In comparing for example the value at risk with the asset base, this can be used as an indicators of the extent of the commodity related risks in the context of the whole organisation and the consequent systemic risk presented by the non-financial firm.
- Ratios illustrating the mitigation of risks by hedging (externally and internally to the business), clearing and collateral. This would already be contained in any measure of profit or value at risk, but add additional granularity.
- Ratios showing the risks posed by non-financial counterparties, e.g. the size of trading business relative to size of production and supply business or to equivalent business of their parent companies, producers/distributors or customers; the amount of risk

capital or parent company guarantees assigned to business relative to its balance sheet.

Examples of qualitative criteria:

- The non-financial firm's business model, strategy and capital structure. The degree of systemic risk depends on whether the non-financial firm is mainly hedging its natural exposure or the natural exposure of their parent companies or customers. A strategy to optimise the physical and logistical delivery chain of an energy portfolio should be differentiated from a focus on proprietary trading.
- In terms of private investor protection it does matter if the non-financial firm deals with private retail investors or solely with other professional non-financial and financial counterparties. In energy wholesale markets for example these are mostly professional actors.
- Hedging of "natural" commodity assets and positions. As CEBS recognized in its advice, "in all commodity markets commodity trading firms, producers, industrial customers and distributers use derivatives contracts to hedge natural long/ short positions against risks arising from changes in these positions (e.g. through a power plant failure), market price risks, climate, etc." Indeed for many energy trading firms, the only potential systemic risk that they pose is via the financing of their assets rather than their hedging activity which actually serves to reduce - not increase - systemic risk. This analysis could be supported by comparing speculative positions to the asset-based hedge position.
- The diversity and range of the non-financial firm's OTC derivatives positions. In term of systemic risk it does matter if the non-financial firm is a large power generator with a natural position on one side of a single national market or if it is a diversified integrated utility managing a range of commodity positions across a range of countries. The potential for systemic risk depends on how are aggregate risks and exposures of a non-financial firm are likely to correlate (positively or negatively) with significant financial events.
- The size and scale of the non-financial firm's trading business and the potential for unintended consequences stemming from compulsory clearing. Mandatory CCP clearing could even have unintended consequences as it will impose resource constraints and cash liquidity risks on the non-financial firm which would be sufficient to reduce hedging activity and increase the credit risk that the firm presents to others (financial firms) via financing agreements.
- Corporate governance, procedures and systems. If an non-financial firm adopts appropriate corporate governance, procedures and systems, including appropriate oversight by the executive board and senior management, it will reduce the potential of imposing systemic risk to the wider financial system:
- Mitigating factors in the event of a default. The strategic importance of power plants, gas fields etc. means that administrators are likely to keep up production and deliver-

ies which can mitigate the knock on consequences both directly to counterparties and indirectly through the reduced impact on the product market.

2 Answers to detailed Questions

As BDEW represents non-financial counterparties, we limit our answers to the questions which directly apply to our member companies.

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

BDEW considers that for the decision to be taken by ESMA on whether a class of derivatives should be subject to the clearing obligation, criterion b. Evidence of the degree of standardisation of the relevant class of OTC derivatives' contractual terms and operational processes is of vital importance, since only standardised derivatives should be eligible for central clearing. Indeed, the inclusion in the clearing obligation of only standardised products is justified and will lead to the desired results, because reliable prices and a consistent market view can and do exist only for these products.

When assessing the liquidity of a class of derivatives, due account should be given to the bid and offer spread of such class, since it is the main indicator of liquidity used by energy market participants.

BDEW welcomes that ESMA acknowledges all the information required in detail above may not always be available immediately, especially for new products. When analysing additional information provided by market participants, ESMA should nevertheless bear in mind existing confidentiality requirements and the sensitivity of the information received, in particular regarding information required under point 16 e) and f) above.

BDEW furthermore welcomes that ESMA will give due consideration to the evidence provided in the course of the public consultation of stakeholders, since a thorough and robust consultation process has been clearly identified by the legislator as a major and important prerequisite for defining and assessing the eligibility of classes of derivatives for central clearing.

Criteria to be assessed by ESMA under the clearing obligation procedure

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

BDEW agrees with ESMA that it is appropriate to consider a range of indicators when deciding whether a class of derivatives should be subject to the clearing obligation. We recommend that the clearing obligation should not automatically be extended to all products that are listed on exchanges. As such, the fact that a product is traded on an exchange does not, in and by itself, imply that it is sufficiently liquid to be subject to the clearing obligation.

Furthermore, we would also recommend that ESMA liaise with sectoral regulators when assessing the liquidity of commodity derivatives, especially in the energy sector. National energy regulators typically have market monitoring units that are well placed to offer unbiased advice on liquidity. They will also understand the implications of the clearing obligation for competition in the market (for example in terms of the impact on smaller players).

Non-financial counterparties (Article 5/7)

Criteria for establishing which derivative contracts are objectively measurable as reducing risk directly related to the commercial activity or treasury financing

29. By reference to European accounting rules, ESMA considers that an OTC derivative entered into by a non-financial counterparty is deemed to be objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of that non-financial counterparty or of that group, when, whether individually or in combination with other derivative contracts, its objective is to reduce the following risks:

> a. The potential change in the value of assets, service, inputs, products, commodities, liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the ordinary course of its business; or
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> b. The potential change in the value of assets, service, inputs, products, commodities, liabilities referred to in letter a, resulting from fluctuation of interest rates, inflation rates or foreign exchange rates.

30. ESMA also considers that an OTC derivative entered into by a non-financial counterparty is deemed to be objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of that non-financial counterparty or of that group, when, the accounting treatment of the derivative contract is that of a hedging contract pursuant to IFRS principles as referred to in IAS 39 paragraph 71-102 on hedge accounting as endorsed by the European Commission.

31. Nevertheless, ESMA considers that an OTC derivative which is used for a purpose in the nature of speculation, investing, or trading should not be an OTC derivative objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of a non-financial counterparty or of a group as provided above.

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

BDEW welcomes the general approach of ESMA to consider a broad definition of OTC derivatives to be objectively measurable as reducing risk directly related to the commercial or treasury financing activity and which therefore do not enter the calculation of the clearing threshold for non-financials. The risks mentioned by ESMA under point 29 a) and b) are supported by BDEW as being directly related to the commercial activities of energy companies.

However, BDEW believes clarification is needed with regard to the reference to "European accounting rules" (first sentence of point 29 above). Neither the reference as such nor the exact content of "European accounting rules" seems clear, in particular if mentioned with respect to the energy markets.

Furthermore it does not seem appropriate at all to refer under point 31 to the purposes of an OTC derivative "in the nature of speculation, investing and trading" basically as one and the same thing, and consequently treating OTC derivatives of such "nature" as not objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of a non-financial counterparty.

ESMA does not elaborate further on what it regards as speculation, which is in BDEW view a purpose of OTC derivatives entirely different from the purpose of trading OTC derivatives by energy companies (non-financials), which use these OTC derivatives mainly for hedging their commercial risks, therefore following an entirely different objective (which has already been acknowledged under EMIR) and being clearly distinguishable from "speculation" or mere "investment" in OTC derivatives. This difference should be pointed out by ESMA.

Clearing Threshold

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

A broad definition of the activity directly reducing commercial risk or treasury financing activity per se does not justify a low threshold but it should rather be integrated with some additional considerations. As explicitly stated in the article 5, 4 (b) of EMIR, "the value of the clearing threshold shall be determined taking into account the systemic relevance of the sum of net positions". Similar to the proposals under the Dodd-Frank Act the clearing threshold should be based on an assessment of what are systemically relevant positions that could endanger the financial system and the economy. The goal of EMIR is to avoid another financial crisis and consequently only market parties whose default could lead to such a financial crisis should be caught by the clearing threshold.

If the threshold is not set at systemic level this might decrease market liquidity, as many more players will become subject to mandatory clearing and may be forced out of the market be-

cause of the additional cost of doing business and the cash flow constraints that are triggered by mandatory clearing.

It is widely accepted that for a derivative the nominal amount or notional principal amount of the transaction is not the sole measure, rather it is the mark to market (MTM) value at any one time that better represents the risk to the parties. However in practical terms this will be changing continuously so that a threshold could be exceeded or not exceeded from day to day.

In BDEW's view, other methods of measurements of the degree of risk mitigation, as routinely adopted by financial and non-financial counterparties as well, should be considered in order to properly take into account the context of normal business activity (i.e. a derivatives instrument would be qualified as hedging if it reduced the level of a financial risk indicator, like Value at Risk, associated to the portfolio it belongs to).

In any case, none of this includes a measure of likelihood of default, i.e. the credit worthiness of the party. While hedging transactions do have characteristics that make them less systemically risky by and large, the significance of a derivative position for financial stability will depend on its size, the degree of interconnectedness of that party within the financial system and the probability of default or some measure of the party's credit risk.

The above shows that ESMA's approach, whereas because of a broad definition of the OTC derivatives that do not enter into the calculation of the clearing threshold because they relate to the non-financials' activity directly reducing commercial risks or treasury financing activity, the clearing threshold should be set at a low level, requires further elaboration.

Therefore only through careful assessment and consideration of all necessary and available market data and risk exposures, after consulting the market participants and also taking into account possible hardship for "borderline cases" (in particular medium sized companies with limited OTC exposure and hence limited risk for the market that might under a too strict regime still be above a threshold set too low and hit improperly hard by mandatory central clearing) will ESMA be able to define a threshold reflecting the needs of the market.

Risk mitigation for non-CCP cleared contracts (Article 6/8)

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

BDEW welcomes ESMA's detailed suggestions regarding the timing for the confirmation.

However, this framework appears unrealistic especially for non financial counterparties' normal business activity, with a potential economic impact on IT infrastructure. An End-of-day or End-of-week confirmation should therefore be considered.

BDEW also believes that any decision should be based on an in-depth cost-benefit analysis with full involvement of all interested stakeholders. In other words, any proposed measure should be proved as clearly able to bring net benefit to the stability of the system.

With regard to the sharable aim of “reduction of risk of potential legal disputes”, there is a need of clarification in particular for those “unconfirmed OTC derivative transactions”. In BDEW’s view, a standardised contract (i.e: ISDA master agreements) reached between parties, is an efficient risk mitigation instrument.

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