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Prof. S. Maijoor
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Ref. ESMA/2012/379

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Dear Prof. Maijoor,

Consultation Response

Draft Technical standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

BP welcomes the opportunity to respond to ESMA's Consultation Paper of 25th June 2012 (the Consultation Paper) and is supportive of the general approach taken by ESMA.

BP is an active participant in OTC derivative markets and we include information on the nature of our participation and activity in the Annex.

Below, we set out the specific points we would like to raise in response to the consultation, referencing the relevant Consultation Paper reference. [1]

1. Clearing Thresholds (Art. 2 NFC)

We welcome the exclusion of intra-group and hedging transactions from the assessment of whether a participant breaches the thresholds and thank ESMA for taking account of relevant representations made earlier in this process.

[1] BP is a member of and supports the separate consultation responses which are being provided by the International Swaps and Derivatives Association and the Futures and Options Association (FOA). Our purpose in providing a response of our own is to emphasise and nuance certain points, addressed to varying extents in those responses. We do not however provide our own drafting amendments since we support those presented by ISDA and the FOA.

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As a general matter however, we consider the level at which the clearing thresholds have been set to be low and that the proposal is inflexible, necessarily leading to an over-estimation of the systemic risk arising from legitimate commercial activity.

The €3 billion threshold for commodities is low for businesses with significant underlying physical activity and consequent significant portfolio management and risk off-setting activity. We anticipate that many physical commodities businesses, which are by no means significant market participants or centres of systemic risk, will exceed this threshold.

We note that the thresholds would be based on gross notional exposure arising from completed derivative contracts. We consider that this will necessarily and very significantly over-estimate the risk arising from many derivative market participants' portfolios. Particularly for physical businesses, it would be a well-established part of their businesses to take either off-setting positions in OTC and exchange traded derivative markets, or to close out an existing position which was no longer required with an off-setting hedge as opposed to closing it out. These strategies all reduce the overall risk of the portfolio and indeed may cancel it out.

We also assume that, in the absence of indication to the contrary, multi-leg option strategies would have to be counted towards the thresholds as the sum of each leg of the option, even though these are likely to be at least partially and potentially significantly off-setting.

A threshold calculated on a gross basis takes no account of these points and therefore of customary and legitimate market activity. We consider that thresholds based on net exposure would be a better determinant and because they would more accurately gauge the actual underlying risk from participants' portfolios[2], that the complexity and cost of calculating them would be justified even for smaller market participants. It is likely that market service companies would make available relevant services to allow small participants to assess their compliance with net-thresholds.

It is clear from the text of the consultation document that the thresholds for different asset classes are not intended to be treated severally. Accordingly, if a participant exceeds a threshold in one asset class, it must clear all of its activity in all asset classes, even if the thresholds in the other asset classes are not exceeded. We understand that the concern behind this approach is that no participant should be able to take advantage of the full extent of the thresholds for all asset classes that a several approach would allow. Whilst we understand this, we nonetheless believe the inflexible approach adopted is inappropriate. It should be possible for a primarily commodities asset class orientated participant with a genuine underlying physical exposure to participate in certain necessary portfolio management trades in non-commodity derivatives where necessary. Putting in place arrangements for clearing *de minimus* supportive activity in other asset classes by virtue of exceeding the threshold in one particular asset class will be punitively expensive, relative to the attendant activity and risk exposure. We suggest a *de minimus* exclusion should be included in Art. 2 NFC.

We also suggest that the assessment of thresholds would better reflect the associated risk arising from a participants' portfolio if it were clear that closed out transactions were not to be counted, that longer dated maturity contracts (i.e. those which do not settle for e.g. longer than ten years) were excluded from scope and if transactions for which collateral had been posted in bi-lateral agreements were excluded. Again, the thresholds should be measured against the actual risk arising from a participant's portfolio, not the gross exposure arising.

The thresholds refer to asset classes by their common use names. We suggest this should be more precise to assist market participants and regulators in making determinations of

[2] We refer to EMIR Reictal 31 which appears to contemplate that thresholds would be assessed against net exposures.

how to classify non-vanilla transactions. We suggest asset classes should be defined with reference to the definitions in Annex C of MiFID. We also note the additional cost to those participants who would not otherwise have breached the thresholds had they not been set on a gross basis.

We note the key importance of on-going compliance with the thresholds for market participants but that the Consultation Paper indicates at paragraph 66 that they will be reviewed on a regular basis. We suggest it would be helpful if ESMA were to commit to a minimum frequency of review so that participants can prepare for possible changes. We suggest a minimum review period of at least one year would be appropriate.

2. Criteria for establishing which OTC derivative contracts are objectively reducing risks (Art. 1. NFC)

We welcome the overall drafting of this section and the efforts by ESMA to allow participants to undertake legitimate hedging required for their physical commercial operations and their treasury financing activities. We have suggestions to further enhance the drafting of these provisions.

In Art. 1.2 NFC the clarification as to instances where derivative contracts may expressly not be regarded "…*as objectively measureable as reducing risks directly related to the commercial activity or treasury financing activity* …", includes where the purpose *"..is in the nature of speculation, investing or trading*." We are very concerned about this wording since all of our activity, which is overwhelmingly hedging, may be described as "trading". Further, we are concerned about the reference to "investing", which is an undefined and potentially wide-ranging term. There are numerous potential instances where a contract may be both hedging and "investing". We submit that the policy intention was to prevent any instance of a speculative trade as being labelled "hedging" and understand this legitimate purpose. We suggest though that this could be achieved without inclusion of either of the words "trading" or "investing" and stress the key importance of their omission.

In Recital 14 NFC there is reference to the ability for a NFC to use "… proxy hedging and use a closely correlated instrument to cover its exposure." We consider that, as a recognised term, proxy hedging may be unintentionally unnecessarily restrictive. There are instances where a participant may legitimately decide to use a macro hedge to off-set a derivative exposure which would not qualify as a proxy hedge, e.g. using an equity to hedge a derivative position. We submit that the term "proxy hedge" could be deleted without prejudice to the intention of the recital but allowing key additional flexibility for participants seeking legitimate hedging opportunity. Alternatively, although less preferred, we suggest the necessary additional flexibility could be achieved by adding the term "macro hedge" to this text.

Art. 1.b NFC provides necessary accommodation for hedging transactions which are designed to mitigate the changes in value of certain derivative asset class, fluctuations in the value of which may impact legitimate physical commercial or treasury financing activity. We welcome this drafting but consider that the list of asset classes allowed to be taken account of should legitimately be wider to allow for essential portfolio management and should as a minimum include fluctuations in the value of equity, commodity derivatives and of credit and related operational costs.

3. Risk Mitigation Techniques for OTC Derivative Contracts not Cleared by a CCP (RM)

We welcome the decision to exclude intra-group transactions from the assessment of whether a particular clearing threshold is exceeded.

We are concerned however, as to certain practicalities associated with operation of the intra-group transaction. Art. 7 RM requires notification of intra-group transactions for which exclusion is sought, although we are unclear whether this is on a transaction-by-transaction basis. We would welcome clarity in the drafting on this point. If it is per transaction, this is likely to be a highly impractical requirement for many market participants because of the number and diversity of transactions they undertake. We suggest that block notification should be available.

Art. 8 RM requires public disclosure of certain types of information associated with intra-group transactions. It is foreseeable that even the level of data suggested in Art. 8 RM may require disclosure of commercially sensitive information, revealing the extent of exposure of entities and group to certain key aspects of their business, including physical exposures. We suggest that Art. 8 RM should allow for application to the competent authority for exemption and/or redaction from the obligation for public disclosure of information where this is commercially sensitive.

4. Draft implementing technical standards on trade repositories (Annex VI)

We refer to Art. 6 "Reporting start date" and note we are supportive of the principles of the discussion in the Consultation Paper at para 294 – 6. We consider though that the 60 day time period allowed between the registration of a trade repository becoming known and the reporting start date is too short for participants to become familiar with the reporting requirements of the trade repository and to build appropriate systems to satisfy the then in-force reporting obligation. Even if the application to the ESMA by a would-be trade repository is publicised, which is not clear to us from the draft RTS text, the cumulative time period of (a minimum of) 65 days between ESMA receiving the application and making public its decision on registration[3] makes only for a total period for market participants to prepare of 125 days. Again, we submit this is far too little time and that 180 days between registration of a trade repository and the reporting start date would be more practical. We also request clarity as to whether the submission of applications by would-be trade repositories will be publicised.

Art. 6(4) provides for a 90 day period at the end of which participants must report derivative transactions entered in to after the commencement of EMIR but before a trade repository for the particular asset class was registered by EMSA and the Reporting Start Date passed. This presents a particularly concerning dilemma for participants because they will be responsible for retaining data fields, which they may not currently capture, in relation to transactions which they will be required to report to the trade repository but at a time when they will have no definitive knowledge of the requirements of the trade repository or how those fields are to be reported[4].

Also, the publication of the proposed data fields in the RTSs which are the subject of this consultation is not conclusive until final RTSs are published and in force. However, EMIR is likely to enter into force before the RTSs are finalised. This is concerning, because it imposes an unknown and uncertain obligation on market participants

[3] EMIR Art. 56, 58 – 59

[4] There are certain fields where we regard the field classification as unclear, particularly in relation to the collateral provision and to the specific field requirements under s.2h, "Commodities", where some fields appear power market specific and unlikely to be relevant to other commodities. We refer to FOA's response on the detailed reporting requirements.

5. Collateral (Art. 3 COL)

We recognise and support the policy intention that forms of collateral posted should be sufficiently liquid and of suitable quality that in the event they are called upon to cover a default that they are of appropriate utility. We think though that the proposals will lead to an unnecessary and overly tight restriction of types of collateral which market participants may post. We note that by virtue of Art. 3.3(c) bank guarantees are specifically included as potentially eligible collateral but the restriction in point (viii) of that sub-paragraph that the bank guarantee should be fully backed by collateral satisfying the requirements of subparagraph 3(b) limits this significantly. This creates circularity to the effect that bank guarantees will never be a realistic option for posting since it will always be easier and more cost effective to post the underlying financial instruments contemplated by sub-paragraph (b).

Our further concern is that the cash, sovereign-backed instruments and financial instruments which will be acceptable collateral will primarily be in the hands of financial counterparties and that this will necessitate non-financial counterparties entering into costly arrangements with financial counterparties for access to acceptable collateral to post with clearing houses. Further, by making the financial counterparties indispensible facilitators of collateral for all counterparties, financial counterparties will inevitably become significant centres of systemic risk. We suggest this would be an unfortunate and unwelcome consequence of what are well-intentioned proposals and that this should be revisited to allow additional flexibility on forms of collateral, particularly that bank guarantees backed by non-eligible collateral and that letters of credit should both be acceptable.[5]

6. Margins (Art. 1 - 3 MAR)

The cumulative effect of these articles appears to provide, for listed futures and options, for margin to be demanded by clearing houses on the basis of a required confidence level of at least 99%, a liquidation period of at least two days and a look back period equally weighted between the preceding six months and the six months period of highest stress in the past 30 years. This would represent a significant departure from the current margin requirements customary in clearing houses which are dependent on a liquidation period of one day.

Whilst we accept that this increase in margin rates for listed futures and options is proposed with good intentions to reduce risk arising from a default event, we find it extremely significant. We estimate that for us, and we expect the vast majority of participants, margin requirements would increase by around 40%. For BP's listed futures and options this would mean a very substantial increase in margin posted[6]. The combined effect therefore across the market would be to very significantly reduce available liquid capital both for market participation and, in the case of physical market participants, capital for investment in their physical market activities. We consider that these proposals need to be carefully evaluated in terms of whether the anticipated benefits of risk reduction truly outweigh the possible real-terms economic cost.

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[5] We note that ESMA's approach contrasts with that of the CFTC, which has proposed a rule which envisages a far wider acceptability of different types of collateral, subject to appropriate risk mitigations: Federal Register /Vol. 76, No. 82 /Thursday, April 28, 2011 / Proposed Rules: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf

[6] If it would be helpful to ESMA we would be prepared to submit further information on a confidential basis.

We again emphasise that we are supportive of the overall approach taken by ESMA in its consultation and that we appreciate the opportunity to provide further comment on the RTS at this crucial stage in implementing the EMIR legislation. We hope that the matters we have raised are recognised as being important and that we have expressed our views helpfully. We are ready to engage and provide further detail as you may require.

Yours sincerely,

Jonathan Hill

Jonathan Hill

Regulatory Policy Analyst

Annex

Information about BP's Derivatives Market Participation

BP utilises a wide range of both on-exchange and OTC derivative instruments in a variety of ways to manage the diverse nature of risks that are inherent in its core business. To do this, BP maintains a distinctive global supply and trading function that seeks to optimise BP's physical assets through accessing key pieces of oil and gas infrastructure and providing an efficient trading execution service for BP's assets and businesses. In addition to the optimisation of BP's physical assets, the function also performs a critical role in the management of oil and energy price volatility on behalf of the BP group and utilises a variety of both exchange-traded and OTC derivative instruments to protect the BP group from the effects of oil and energy price volatility. BP also uses an array of derivative instruments within its corporate treasury function to manage its exposure to fluctuations in foreign currency and interest rate movements.