Consultation Response on behalf of SSE plc in Respect of the Draft Technical Standards for the Regulation on OTC Derivatives, CCP's and Trade Repositories

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1. Background Information on SSE plc

SSE plc – formerly Scottish and Southern Energy plc – is the broadest based energy company in the UK, with interests in electricity and gas production, electricity and gas distribution, electricity and gas supply and electricity and gas services. It has a market capitalisation of approximately £12.5bn, placing it around 30th in the FTSE-100 index.

2. Summary of Response

SSE fully understands the importance of dealing robustly with the threat of global systemic risk, but we are deeply concerned about the (possibly unintended) consequences of EMIR on European energy markets generally and the UK energy market in particular. In this respect, we believe that it is essential to recognise and accept that the energy industry is not responsible for systemic credit risk and – unlike the financial services industry – transactions in energy commodities executed by energy companies such as SSE are underpinned by real, physical assets.

Our over-riding concern about the implementation of EMIR is its dependency on MiFID to define its scope. While we understand the rationale for the inclusion of energy derivatives such as swaps, options and futures within the scope of financial regulation such as EMIR, transactions in these instruments are clearly also of material interest to energy regulators. We are particularly worried, however, about the impact on the gas and power industry if, under MiFID II, forward physical trades were deemed to be Financial Instruments and therefore become subject to mandatory clearing and margining. In addition to the potentially substantial cost and cash flow implications associated with clearing and margining, we fear that liquidity in physical markets would be substantially reduced, making it more difficult to manage the risks associated with our - and our industry's - day-to-day business.

It must also be recognised that the energy industry has significant challenges of its own to meet. The unfortunate end result of the introduction of mandatory clearing obligations and reduced market liquidity in respect of energy commodity products is likely to be a very material increase in energy market participants' costs – inevitably impacting on end customer bills - combined with a very material reduction in capital available for investment at a time that this is already at a premium. Barriers to entry for potential new market participants may also rise resulting in fewer energy firms – again, this is unlikely to be in the long term interests of end consumers.

Other concerns that we have surround potential conflicts between financial and energy regulation, and the imposition of excessively onerous reporting requirements - especially if these requirements are not fully and effectively co-ordinated with those resulting from other new legislation such as REMIT.

Our comments are primarily regarding OTC Derivatives and the wider scope and implications of the introduction of EMIR.

3. The Scope of EMIR (Section III – "OTC Derivatives")

(i) Physical Power and Gas Transactions

We understand the rationale for genuine financial instruments such as futures, options and swaps relating to coal, oil, carbon and other energy products to be included within the scope of EMIR and as such potentially become subject to central clearing and margining. As mentioned above, however, it is not appropriate for transactions relating to the delivery of physical power and gas carried out by companies whose primary business relates directly to the production or supply of these energy products to be subject to the clearing obligation under EMIR. Physical deliveries of power and gas are not "Financial Instruments" and must not be classified as such. We believe that the proposed amendment to the definition of Financial Instruments in Annex C of MiFID to include transactions arranged via Organised Trading Facilities ("OTF's") might however cause this to happen, as the scope of EMIR extends in line with the revised definition of Financial Instruments (Annex 1, part C) proposed under MiFID II. This would in turn result in an unacceptable position arising where (a) physical energy products other than "spot" trades would be brought into the scope of EMIR (and therefore potentially subject to mandatory clearing), and (b) financial regulators would become responsible for the huge majority of energy markets regulation (in effect everything other than the "spot" market (ie up to 2 days to settlement)).

Additionally, if physical power and gas are brought within the scope of EMIR, should a non-financial energy market participant of any reasonable size for whatever reason fail to stay within its allocated threshold limits, the consequent margining requirements may be catastrophic to that entity's business and in turn to the wider energy market.

(ii) Forward Foreign Exchange Transactions

Spot and forward purchases and sales of foreign currency must both also remain out with the scope of EMIR. Non-financial, corporate entities such as SSE require to buy (and sometimes sell) very large quantities of foreign currency to support the requirements of their underlying businesses. In SSE's case (and that of most other corporates) there is no element of speculative dealing, but there are a number of good reasons why meeting prescriptive hedge effectiveness tests such as those imposed by IFRS is not always possible. For example, if milestone payment dates on a routine procurement contract change – possibly due to contract amendments or delays – currency bought forward to match the original payment profile may well cease to be deemed effective as hedging the underlying risk for accounting purposes.

Non-financial corporates must not be forced to run the risk that failure to meet an inflexible hedging test results in the mandatory clearing and margining of potentially billions of euros

of treasury business. In SSE's case, an additional "double jeopardy" risk might also exist whereby a failure to secure a hedge recognition in respect of foreign exchange forwards forces mandatory clearing of substantially all of its energy portfolio (or vice versa). This would certainly be a disastrous scenario for SSE, as it presumably would be for most other non-financial organisations. As noted in Section 5 (below), clarity in this regard would therefore be welcomed.

4. Proposed Hedge Exemptions (Section III – "OTC Derivatives")

It is therefore essential that only genuine derivative products are included in the scope of EMIR from the outset; it is not acceptable to allow inappropriate products to be included on the assumption that a currently undefined hedging exemption will be effective in ensuring that no legitimate hedging will end up being counted against a threshold limit.

It is sensible to conclude that qualifying for hedge accounting treatment under IFRS should automatically be deemed to meet the "objectively measurable" test. We are however concerned that it will prove very difficult in practice to find an alternative test or tests that can be consistently applied, and because of this IFRS becomes, by default, the only way of achieving a hedging exemption. It is already widely accepted that the rules surrounding hedge accounting for IFRS are too prescriptive – attempting to apply similar rules to portfolios of energy products would likely prove to be disastrous.

We therefore urgently require further guidance in respect of the tests that may be applied in order to determine that transactions other than those subject to hedge accounting rules may indeed be treated as hedging transactions. As an example of the difficulties that can and will arise when considering this, when SSE procures foreign coal to burn in a UK power station - sometimes well in advance of delivery of the coal - it also needs to contract a ship to deliver it to the UK. Prudence demands that this freight cost (incurred as a direct consequence of our primary business in generating power in the UK) should be hedged. The freight swaps and futures that we enter into, however, do not qualify for hedge accounting under IFRS, but there can be little doubt that transactions carried out to hedge these types of physical exposures should not be counted towards the use of a commodity derivatives threshold. It is therefore imperative that the technical standards provide some certainty that transactions of this type will be considered by regulators to be hedging business.

5. Proposed Threshold Limits (Annex II)

We are unclear as to whether the limits proposed are intended to be Group limits, or will be granted to each relevant legal entity within a Group. It is critically important that this point is clarified without delay, and that comprehensive clarity / guidance is provided more generally as to how it is intended that rules for Groups will be applied. In addition, we

understand that inter-Group transactions will **not** count towards threshold limits – again, it is important that this is confirmed as soon as possible.

In the absence of absolute certainty with regard to (a) what products will be included within the scope of EMIR, and (b) the rules for achieving hedging exemptions, it is in any event very difficult to comment meaningfully on whether or not the limits proposed are adequate. At the highest level and based on our current understanding of how EMIR may work in practice, however, we believe that the limits proposed in respect of foreign exchange and interest rate products are insufficient. A bigger concern, however, is the commodity limit which at €3bn is completely inadequate for an energy utility company of any material size.

Additionally, we understand that it is intended that a breach of any asset category limit would result in all of that entity's trades across all asset categories becoming subject to mandatory clearing. This is too penal an approach and would create too great a "cliff edge", particularly if breaching one limit pushes all companies in a Group over it.

6. The Potential Costs and Effects of Margining (Section III – "OTC Derivatives")

We note the request to provide quantitative data to support responses. Without further clarity with regard to scope, hedging exemptions and at what rates margins may be payable, it is very difficult to calculate what cash requirements may result from the introduction of EMIR.

At present, however, SSE conducts around 20% of its Energy Trading business via exchanges on a margined basis and in volatile market conditions can already face total **daily** margin calls (initial margin and variation margin) of tens of millions of pounds sterling. Based on current positions, if substantially all of SSE's energy (including forward physical energy) and treasury transactions became subject to clearing / margining, SSE would need to have committed bank facilities in place to be able to meet **daily** margin calls of hundreds of millions of pounds; in volatile market conditions, it is quite possible that well in excess of a billion pounds may be required to meet new margin calls during the course of a single week.

In addition, **outstanding** margin (initial and variation margin combined) at any point in time could easily total multiple billions of pounds. While banks and other financial institutions may view this type of requirement simply as a cost of doing business in a particular market that they find attractive, for real energy companies it represents an unacceptable and unsustainable burden. For SSE, monies tied up in cash collateral would no longer be available to the business to use in its capital investment programme, which in turn is intended to help address potential future energy infrastructure shortfalls in the UK ("keeping the lights on"), and meet international environmental obligations (achieving the UK's and EU's carbon emissions and other 'green' policy targets).

There are also several fundamental problems arising from this. It is very difficult to arrange even relatively small bank facilities that can be drawn same day (which is what would be

required to meet margin calls). Arranging the type of vast bank facilities that may be necessary to meet the requirements of EMIR would certainly be very expensive, but in a world where bank lending is so constrained, it may also prove to be close to impossible. At the very least, it would put another material strain on the banking sector and would push costs significantly higher. For energy companies, these additional costs will inevitably need to be passed through to end customers in the form of bill increases, while, as previously highlighted, very substantial amounts of capital will be diverted away from infrastructure investment to act as reserves against potential margin requirements.

While it is necessary to maintain borrowing facilities to meet any given entity's maximum expected cash outflows, variation margin may equally result in huge cash *inflows* which then have to be managed. This will cause huge headaches in respect of credit risk assessment and management – areas in which financial institutions are expert, but non-financials are usually not. We would additionally be very concerned about the potential implications of vast cash movements in the banking system arising from and managed by non-financial institutions.

7. Regulatory Impacts (Section III – "OTC Derivatives")

If physical energy products become classified as Financial Instruments, we believe that responsibility for their regulation would pass from expert energy regulatory bodies (ACER / OFGEM) to financial regulatory bodies (ESMA / FSA). This would potentially leave only "spot" energy transactions subject to the newly introduced REMIT and regulated by energy regulators.

This situation would be both ridiculous and dangerous. The regulation of physical energy must remain the responsibility of organisations and individuals who have proper experience and knowledge of energy markets. Although we understand that energy derivatives may be of interest to both energy and financial regulators, any proposal to introduce joint regulation would be equally, if not more, worrying to us as it would inevitably create confusion, potential conflicts and more generally a disproportionate regulatory burden.

8. Liquidity Issues in Energy Markets (Section III – "OTC Derivatives")

If physical energy products are classified as Financial Instruments and are therefore included within the scope of EMIR, liquidity in energy markets is likely to drop substantially as participants seek to limit their margin swings by curtailing their trading activities. In this respect, it is important to recognise that trading is essential for energy firms to accurately manage their exposure positions across very long timeframes. These exposures are constantly changing due to customer demand, plant availability, prevailing weather conditions etc, and it is therefore necessary to constantly readjust portfolios in response to these changes. If there is insufficient liquidity in energy markets to do this, business risk for

energy firms will increase very significantly. Although not an immediate issue on the initial implementation of EMIR, we are therefore hugely concerned about the potentially very significant impact that MIFID II definitions might have on the scope and application of EMIR.

9. Excessively Onerous and / or Double Reporting Requirements (Section V – "Trade Repositories")

A feature not just of EMIR but also of the wider upcoming changes in European regulation is the introduction of onerous trade reporting requirements. For non-financial firms in particular, this may well require a very substantial investment in new or upgraded IT systems to allow accurate and reliable data extraction, and onward submission. Our specific concerns in this area are as follows :-

(i) **Double Reporting**. It is imperative that trade reporting requirements, when finalised, are uniform across regulators. This will require very close co-operation between ESMA and ACER. Despite assurances to the contrary, we are not yet convinced that this is happening to the extent required and therefore remain very concerned that we may become subject to an unacceptable double reporting burden.

(ii) **Third Party Reporting**. While we are encouraged that it is envisaged that CCP's and certain other relevant third party organisations may take on responsibility for some elements of trade reporting, it is unclear whether or not any liability for late or inaccurate reporting will also rest with these entities. For example, if a third party has received all relevant data in good time (including any that must be provided to it by a market participant), then it must be the third party and not the market participant that is held responsible for any failure to submit the data to the TR accurately and punctually. We would request that ESMA confirm the position on this as soon as possible.

(iii) **Confidentiality**. The passing of detailed and highly commercially sensitive information to any third party will be a concern to all affected organisations. Further clarity is required from ESMA as to how they intend to control access to confidential data, and manage liability issues that may arise as a result of hacking or other events that result in a loss or leak of data.

(iv) **Inter Group Transaction Reporting.** Reporting inter-Group transactions would be hugely onerous in terms of cost and resource. Our understanding is that this will not be a requirement under EMIR, but confirmation of this should be made without delay.

(v) **Retrospective Reporting**. As mentioned above, non-financial firms are likely to face a very substantial investment in new or upgraded IT systems to meet the potential requirements of EMIR and other European regulations. Based on our current understanding of what will be needed, we estimate that no less than 18 months would be required to design, build and implement an appropriate reporting system. Where a firm is not currently subject to transaction reporting, it is probable that its existing systems will not

be capable of holding or collating all of the data items listed in the consultation document. Consequently, it will be a significant task for them to compile and report all of the information required prior to the implementation of a new / upgraded system.

Retrospective reporting (for the period between entry into force of the Regulation and the implementation of Trade Repositories) would be particularly difficult, as the technical standards defining the requirements will not have been finalised before the Regulation comes into force and it will not therefore be known what data will be required. Additionally, if current systems do not store a required data item, it will be very difficult to a) create and, b) store the data for later submission.