 Charles House

5-11 Regent Street

London

SW1Y 4LR

Tel: +44-20-79309390

**European Securities and Markets Authority**

103 rue de Grenelle

75013 Paris

FRANCE

3rd August 2012

Dear Sir/Madam

**ENERGY UK[[1]](#footnote-1) RESPONSE TO ESMA CONSULTATION PAPER ON DRAFT TECHNICAL STANDARDS FOR THE REGULATION ON OTC DERIVATIVES, CCPs AND TRADE REPOSITORIES (EMIR)**

Energy UK welcomes the opportunity to respond to ESMA’s consultation on draft technical standards for EMIR. The clearing obligation and the clearing threshold for non-financials set out in EMIR raise important issues for the UK electricity and gas sectors and our comments therefore focus on that particular aspect of the draft standards.

We are pleased to note that ESMA has addressed a number of industry concerns in these proposals, particularly in respect of the hedging definition (though see our further comments below). However, we remain concerned that the current proposals could impose a highly onerous clearing obligation on energy companies which are not systemically important. This could dramatically increase costs, reduce market liquidity, and increase risks by discouraging companies from hedging their exposure. It is difficult to quantify the financial impact given the uncertainties about the scope of EMIR, but clearing and margining costs for larger UK energy players would be likely to exceed £1bn per company. Such funds tied up in collateral would no longer be available for capital investment, which would run counter to a major objective of UK energy policy – the need to boost investment to meet security of supply and low-carbon objectives.

Energy regulators and market players across Europe have been devoting considerable efforts to develop liquid wholesale markets in electricity and gas, which are crucial to allow companies to manage their commercial risks. If financial regulation such as EMIR is applied to the energy sector in a disproportionate way, liquidity is likely to reduce substantially as companies seek to curtail their trading activities, thus impeding the development of a competitive EU energy market.

Energy UK believes that the following issues need to be addressed in the final version of the Standards and/ or in ESMA’s further work:

* Greater clarity is needed about the derivative contracts covered by the Regulation; physical forward contracts should be excluded from the scope;
* Further guidance is needed on the scope of the hedging exemption;
* Intra-group transactions should be more clearly excluded from calculation of the clearing threshold;
* A net rather than gross approach should be used to calculate the threshold;
* Exceeding the threshold in one asset class should not result in a requirement to clear transactions in all asset classes;
* The energy sector should be allowed to make continued use of bank guarantees as collateral;
* Reporting requirements under EMIR and under REMIT should be aligned.

While we understand that the revision of MiFID will affect the scope of EMIR, it is important that ESMA provides clarity on the contracts which are covered. Physical forward contracts are an essential part of the energy market and should not, in our view, be classified as financial instruments. Transactions relating to the physical delivery of power and gas therefore should not be subject to the clearing obligation. If such transactions were deemed to be within the scope of MiFID and thus EMIR, this would have the bizarre effect of giving financial regulators responsibility for the greater part of the energy markets. We also take the view that contracts traded on a regulated market or which are already cleared or margined under existing ISDA agreements should also not be covered by the clearing obligation under EMIR.

Energy UK welcomes the work done by ESMA in relation to the hedging definition, e.g. the inclusion of proxy hedging. We agree that transactions qualifying for hedge accounting treatment under IFRS should automatically be deemed to meet the “objectively measurable” test. However, we are concerned that it may prove difficult in practice to find an alternative test that can be consistently applied, which could mean that IFRS could become the only way to obtain a hedging exemption. As it is widely accepted that the rules surrounding hedge accounting for IFRS are too prescriptive, any attempt to apply similar rules to portfolios of energy products could prove to be disastrous. For instance, UK generators need to hedge freight costs for energy for their fuel supplies, but these do not qualify for hedge accounting under IFRS. Energy UK therefore strongly urges ESMA to provide guidance on the tests to be applied to determine hedging transactions.

Intra-group transactions that are objectively measurable as reducing risks do not have an effect on the market and should not count towards the clearing threshold, nor have to be cleared in the event that a non-financial firm exceeds the threshold. ESMA should clarify that such transactions are excluded from the calculation of the threshold.

It is clear that basing the clearing threshold on gross notional value has the benefit of simplicity, but in Energy UK’s view this does not accurately reflect firms’ risk exposure and is therefore not appropriate for assessing the systemic relevance of a particular counterparty. Energy UK prefers the use of net values and notes that the calculation of netted exposures is the basis of even the simplest trading system, so that such an approach should be feasible. This would also align more closely with Article 10.4b of EMIR, which states that the threshold should be determined “taking into account the systemic relevance of the sum of net positions and exposures”.

If ESMA does finally decide on a gross-value approach, it is important that the level reflects the high notional value of commodity derivative contracts. Given the lack of clarity about the products to be covered and the rules on hedging, it is difficult to comment on the threshold figures, but a commodity limit of €3bn would be likely to catch even smaller energy players and is therefore far too low. The limits in respect of foreign exchange and interest rate products also appear inadequate.

It is proposed that, if a non-financial player were to exceed the clearing threshold in one asset class, this would trigger clearing (and thus margining) requirements for all asset classes. Energy UK believes that this approach has serious disadvantages, as it would place significant burdens on the commercial treasury and foreign exchange activities of firms. In our view, breaching the threshold should therefore only trigger clearing of transactions related to the asset class in question.

The ESMA proposals contain a number of onerous requirements in relation to the use of bank guarantees by non-financials, e.g. bank guarantees have to be fully backed by collateral that can be realised on a same-day basis. Non-financial players do not have access to the same financial resources, and notably cash collateral, as banks. Consequently, to avoid excessive financial burdens, it is essential that energy market participants remain able to use bank guarantees as collateral.

ESMA has set out a comprehensive list of reporting requirements, which is helpful in terms of promoting clarity. Our concern, however, is that the data required seems very different from ACER’s proposals for transaction reporting under REMIT. It is important that further efforts are made to ensure compatibility between the two sets of requirements, so that unnecessary reporting burdens are not imposed.

I hope that the above comments are useful. Please contact me if you require any clarification.

Yours sincerely,



David Porter

Chief Executive

1. Energy UK represents a wide spectrum of interests across the sector. This includes small, medium and large companies working in electricity generation, energy networks and gas and electricity supply, as well as a number of businesses that provide equipment and services to the industry [↑](#footnote-ref-1)