ESMA consultation paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories (EMIR) (25 June 2012 – ESMA/2012/379)

A EURELECTRIC Response paper

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EURELECTRIC's Response to the ESMA consultation paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories (EMIR) (25 June 2012 – ESMA/2012/379)

The Union of the Electricity Industry – EURELECTRIC, the sector association representing the common interests of the electricity industry at pan-European level, welcomes the opportunity to comment the draft Technical Standards for the Regulation on OTC derivative, CCPs and Trade Repositories (hereafter DTS) prepared by the European Securities and Markets Authority (ESMA).

In order to be able to manage the risks that stem from their asset- and sales portfolio, EURELECTRIC's members are highly dependent on well-functioning and liquid wholesale energy markets. We therefore also closely follow the implementation of EMIR. We believe that this Regulation should recognize the specific needs to manage the commercial risk of electricity companies by imposing proportionate measures, without affecting the overall aim of reducing systemic risk and increasing transparency in financial markets.

We have limited the scope of our response to this consultation to the sections of the DTS that are most relevant to the interests of EURELECTRIC members. We welcome the fact that many of our concerns raised during the consultation on the discussion paper in spring 2012 were taken into account. We do however still have some concerns regarding those DTS which are summarized below.

Overall comments

Over the past decade, the EU has sought to develop a liberalized and more integrated energy market in Europe with an objective of increasing efficiency, reducing energy costs for consumers and strengthening security of supply. Central to this policy is development of liquid and efficient wholesale markets for electricity, gas and carbon products. The European Commission and national energy regulators have deployed considerable resources to facilitate the developments of such markets which will support efficient risk allocation, dynamic cross-border trade, and effective competition.

- Currently, in the European Commission, several financial legislative initiatives are under discussion with the aim of improving the financial market monitoring and enhancing the robustness of the wide financial system. Some proposals intend also to cover commodities derivatives in general.
- Although the energy industry, working alongside the European Commission, has made substantial progress towards the development of wholesale markets, there is still more effort to make to decrease the potential lack of maturity, depth and liquidity of certain geographic and product markets for electricity and gas. The substantial results already achieved remain to a certain degree fragile, and an unnecessary extension of financial regulation to the energy sector might reverse them by introducing disproportionate regulation including significant cash and capital funding requirements, higher transaction costs, and reduced competition and flexibility in trading venues. The impact of the new obligations as will be introduced through EMIR will reduce funds that firms have available for investment in crucial new energy infrastructure and increase the levels of risk in the sector by making it more expensive for firms to hedge their commercial risk.

This could also have an impact on the debt rating and credit rating of the companies. Credit downgrades would further put up the costs through higher interest rates. Those crucial investments would have to take place at those higher rates. In other words, we believe that the costs implied by such proposals can be much larger than just increased costs for holding capital to cover collateral requirements.

Against this background we would like to remind ESMA that the proposals will lead to higher costs at a very critical time of financial crisis and unprecedented need for investments. Thus it is absolutely essential to fully recognize that no additional burden should be placed through new measures for firms that are in no way systemically important to the financial system.

Specific comments

➔ Clarity needed on scope of EMIR

EURELECTRIC believes that it is of crucial importance to identify accurately which type of contracts will be considered in the scope of the regulation. Although we understand that the final scope of EMIR is dependent on the revision of the Markets in Financial Instruments Directive (MiFID 2) and especially on the definition of financial instruments, we believe it is essential for ESMA to already give more clarity on the scope of EMIR, in order to allow a proper assessment of the overall impact of the regulation and the proposed Regulatory Standards. **In particular we believe that physically settled forward products that do not meet the characteristics of other derivative financial instruments defined in MiFID should not be considered in the scope of EMIR.** We also believe that contracts are already cleared and margined under existing ISDA agreements should also not be covered by the clearing obligation under EMIR. We urge therefore ESMA to clarify these issues as soon as possible, possibly by means of a policy paper.

➔ Definition of hedging

EURELECTRIC believes that ESMA has proposed a suitable definition of OTC derivatives that are objectively measurable as reducing risks. We believe that the proposed definition includes all OTC derivatives that are entered into by a non-financial counterparty in the normal conduct and management of the commercial business. Thus we appreciate the inclusion of proxy hedging. We also appreciate that the DTS give some flexibility on how the definition can be implemented. **At the same time, we would however, like to point out that the proposed definition of hedging could produce uncertainties to operators when assessing which contracts they should include in the calculation of the threshold.** A particular point of attention for operators of a diversified energy portfolio is that risk hedging should include a certain amount of 'dynamic hedging': this implies that the concept of risk reduction must be judged on an overall portfolio basis and not necessarily on every single market transaction.

It would therefore be good if the '(asset) portfolio' consideration could be explicitly recognized in the definition. Alternatively a "negative definition" of hedging could be used, as including all operations not designed for speculative trading/investment: this could allow the inclusion of anticipated hedging in the definition and would avoid that change in market dynamics result in a hedging operation being later classified as trading/speculative.

➔ Clearing threshold level

EURELECTRIC appreciates that ESMA partly addressed our concerns regarding the level of the clearing threshold by raising it to a more acceptable level. We believe indeed that the systemic relevance needs to be a key criterion. As also explicitly stated in article 5. 4 (b) of EMIR, « the value of the clearing threshold should be set at such a level that systemically relevant parties are captured. **If the threshold is not set at a systemic level, this might indeed result in market participants that are not systemically relevant to be covered. In turn, this would ultimately running overall higher risks, given that hedging has been made overly expensive for firms that are not systemic, at the same time that it will decrease market liquidity**, as players may be forced out of the market, because of the additional cost and cash liquidity constraints that are triggered by mandatory clearing.

We support ESMA's intention to review the clearing thresholds on a regular basis (paragraph 66 of III.V.). Such reviews should take into account commodities price inflation (for the commodities derivatives threshold), and the overall growth of the global OTC derivatives market (to continue reflecting appropriate systemic levels). It should be taking into consideration that a lot of effort in energy companies is currently required to review the business in light of the upcoming requirements to ensure compliance. The threshold is a major factor for non-financial counterparties. If the threshold is too regularly reviewed, a similar effort (although smaller) will be required each time. We would ask that ESMA allows at least one year after any new thresholds are communicated to ensure sufficient market participants to review their business accordingly.

➔ Threshold per asset class & Entity vs. group level threshold breach

As far as the clearing threshold is concerned, we strongly oppose the idea that crossing a threshold in one asset class will trigger clearing (and thus margining requirements) in all other asset classes and for other entities. This would have a severe impact on the commercial treasury and foreign exchange activities of market parties. We therefore strongly recommend ESMA to ensure that crossing the threshold in one asset class would only trigger clearing of the transactions relating to that specific asset class. In this manner, the non-risk reducing activities of companies having potential systemic relevance would be included under EMIR without putting an additional and unnecessary burden on, for example, commercial foreign exchange and treasury activities. Bearing the systemic relevance in mind, however, a threshold set at EUR 3 billion in notional value for commodity derivative contracts seems too low.

Furthermore, we also strongly believe that the breach of a threshold in a single asset class by a single entity of a corporate group should not lead to an obligation for the entire corporate group to clear all positions in those OTC derivative classes which stay below the clearing thresholds and do not contribute to increasing systemic risk for the group.

To assess whether the proposed threshold is adequate and appropriate it is essential that ESMA clarifies which transactions count towards the assessment of a firm's position against the clearing threshold. In this respect, we believe that the following items should not be considered:

- Any transaction objectively measurable as reducing commercial risk
- Any transaction that it is not defined as an OTC derivative transaction
- Any intra-group transaction once the general exemption for such transactions, which are not objectively measurable as reducing commercial risks, has been granted

- Any transaction that has already been subject to central clearing – as such a transaction does not give rise to any additional credit risk and therefore is irrelevant for the purpose of assessment against the clearing threshold

➔ Threshold metric

We disagree with the proposal of ESMA to use <u>gross</u> notional value of the outstanding OTC derivatives contracts as a measure for determining where companies are against the clearing threshold and believe that the clearing threshold should be express in a <u>netted</u> figure. Calculating positions on a net basis would reflect non-financial companies' exposure to counterparties in a more realistic way, and would much better represent the actual systemic relevance of a specific counterparty. According to ESMA, the main reason for favoring "gross" above "net" values is that the former would be easier to calculate and implement for companies. As calculating netted exposures is at the basis of even the simplest trading system, we do not feel that this should be a decisive argument to choose one or the other approach. The wording of Article 10 (4) (b) of EMIR and recital 31 of EMIR speak also clearly in favor of taking into account the effects of netting of positions under bilateral netting agreement. Therefore we think that the DTS are not in line with the text of EMIR level 1 on this point.

With regard to intra-group transactions, EURELECTRIC strongly favors excluding these from the calculation basis to arrive at an entity's position relative to the clearing threshold, and we would like ESMA to explicitly include this into its recommendations. Intra-group transactions should be excluded, irrespective of the entity type (financial or non-financial) of either one of the contracting parties.

➔ Intragroup Transaction notification and disclosure regime

On the one hand, when applying for an exemption from the requirement laid down in Article 11, paragraph 3 of EMIR, it is not clear that any price-related information is to be explicitly notified (Article 7RM, no.2, page 76). A copy of the relevant contracts is also required to be submitted though according to no.3 of the same Article. On the other hand, a notional aggregate amount of the OTC derivative contracts for which the intragroup exemption applies is to be publicly disclosed (Article 8 RM, Page 78).

- The value of intragroup OTC derivative contracts should not be submitted as the systemic relevance of this information is highly questionable;
- At most, systemic risk concerns only justify the need to submit the aggregate value of those contracts.
- In any case, the public disclosure of that information is inappropriate whether in aggregate form or not. Among other reasons, the commercial strategies of small and medium sized counterparties would definitely become compromised.

→ Timely confirmation

Although we appreciate that ESMA decided to extend the confirmation period in general to two days for non-financial companies not exceeding the clearing threshold, we are of the opinion that this is still too ambitious.

While non-financial companies are in many cases able to confirm their trades quickly, the length of the confirmation process depends on the specifics of the transaction. The confirmation period also depends heavily on the ability of the selling counterparty to facilitate the process and to turn over the contract in due time to the buying counterparty (as a rule the non-financial company). Hence, **the confirmation period for these non-financials should be extended to four business days after the execution.**

→ Portfolio reconciliation

Portfolio reconciliation is looking beyond counterparty to counterparty risk. It looks how trades can be offset between more than two counterparties.

We would like in particular clarification from ESMA on the following point: the wording of the proposed DTS does not seem to exclude cleared OTC contracts from the scope of the portfolio reconciliation. We do not see any reason why cleared OTC contracts should be reconciled with the counterparty.

Generally, EURELECTRIC does not see the need for a mandatory portfolio reconciliation as market participants will apply it anyways if the potential benefits outweigh the costs. If however ESMAs till decides to introduce this measure, we believe that portfolio reconciliation should only be required as of a minimum number of transactions, otherwise commodity companies would be obliged to remind all their industrial clients about the conditions of the underlying derivatives on a frequent basis. We would propose to adopt a specific number of transactions per counterparty in a specific timeframe to avoid a lot of useless effort.

→ Portfolio compression

Regarding portfolio compression we also believe that there should be no mandatory measure for non-financial companies. We would rather support an approach which allows counterparties to assess the opportunity to conduct a portfolio compression if they decide so. In this context, we agree that the reasons for not conducting a portfolio compression should neither be actively notified nor be agreed with ESMA and/or NRAs. It is sufficient if the counterparties can explain the reasons upon request of the regulators. Nevertheless, the process to explain ESMA and/or NRAs the reasons for the deviation should be kept as lean as possible especially for portfolios of non-financial companies including almost exclusively risk-mitigating derivatives. A clear exclusion of hedging deals in the wording of the DTS would be helpful and avoid the need for long explanations and possible discussions. We also believe that intragroup transactions must be excluded from this obligation.

➔ Collateral requirements: commercial bank guarantees

For non-financials it is extremely important that bank guarantees can continue to be used as collateral to cover initial and variation margin at clearing houses. This is for instance common practice in the Nordic market. ESMA should propose rules sufficiently attractive for non-financials to clear. If not, energy companies will have to face a tradeoff between posting or reserving significant amounts of cash for margining requirements, thereby substantially limiting their ability to invest in their main business, or to hedge less.

Indeed, the current ESMA proposals strongly restrict the use of bank guarantees by only allowing fully backed bank guarantees. ESMA should acknowledge the different nature of financial counterparties compared with non-financials, in particular with regard to access to cash collateral. Bank guarantees are a very important tool for non-financial companies to manage liquidity requirements. The use of bank guarantees in the energy clearing space is mainly related to the characteristics of end user participating in these markets. Electricity producers, energy exploration and energy distribution companies do not possess the same levels of readily available liquid assets as do the main users of a financial derivatives clearinghouse which tend to exhibit a member base more heavily weighted towards financial institutions. Consequently, bank guarantees have become normally used as collateral for the energy markets participants. They allow energy companies to manage their working capital in a more efficient manner and avoid that cash is tied up at CCPs for margining requirements, instead of being put to productive use, e.g. for investments in production assets.

We strongly believe that ESMA should propose rules to incentivize non-financials to make more use of clearing services. Indeed, if collateral requirements are reasonable – and CBG can be accepted – non-financial counterparties will decide to clear to a larger extent and this would reduce counterparty risks.

The consultation paper mentions the CPSS-IOSCO Principles for FMIs as the grounds for putting restrictions on the use of bank guarantees. However, the principles don't seem to limit the use of commercial bank guarantees, nor mention them as risky collateral. We can see that some of the requirements ESMA sets are according to the principles. However, there are some criteria that we do not agree are necessary to comply with the CPSS-IOSCO principles and which make it remarkably more difficult for non-financial counterparties to post collateral.

As already said, we are in particular concerned by the requirements for commercial bank guarantees proposed by ESMA on page 113 in Chapter XI, article 3. Subsection c. vi, vii and viii.

Regarding subsection vi, we understand that the wording "providing essential services to CCP" would imply that a firm can often not use a bank guarantee's from its preferred bank. For example: a company which actively trades on the Nordic market would most likely use a bank from the Nordic market to support its clearing. Given that there may not be many local banks in the Nordic market, excluding those that are CCP's may leave no alternative local bank. Non-financials would then have to rely on banks not active in the region and/or less familiar with the market. This would likely result in higher rates/costs of bank guarantees.

Regarding subsection (vii) "is not otherwise subject to significant wrong way risk" is mentioned as a limitation. This is clearly a requirement in the CPSS-IOSCO Principles, but ESMA needs to explain clearly what does this mean in relation to a bank guarantees. We are assuming this is not meant to be interpreted in a way which hinders banks that themselves are members of a CCP provide bank guarantees for other CCP members.

Finally, subsection (viii), requires that bank guarantees should be fully backed by collateral that can be realized on a same day basis. This does not seem to be required in the CPSS-IOSCO Principles. It is also not clear, whether this means that a bank must have earmarked funds for each bank guarantee they issue, or just that they need to have enough capital as a whole, as currently. A requirement to have earmarked funds would be excessive and very harmful for the liquidity in markets with many non-financial counterparties as posting collateral would be very challenging and expensive without the option to use bank guarantees. The impact of these new obligations will reduce funds that firms have available for investment in crucial new energy infrastructure. This could also have an impact on the debt rating and credit rating of the companies. Credit downgrades would further put up the costs through higher interest rates. Those crucial investments would have to take place at those higher rates. In other words, we believe that the costs implied by such proposals can be much larger than just increased costs for holding capital to cover collateral requirements. In our view, the proposals are increasing costs at a very critical time of financial crisis and unprecedented need for investments.

➔ Trade reporting regimes

1. **Alignment on trade reporting regimes between especially EMIR and REMIT is urgently needed.** It is absolutely essential that there is a close cooperation between ESMA and ACER; both are working on setting up a transaction reporting system. We fear that if not coordinated it will cause a mess, huge additional burden, double reporting, etc.

   It is fundamental to ensure that counterparties are given at least one year to prepare IT systems before the reporting start date obligations come into force, for any given derivative class.

   The deadlines stated on no. 4&5 of pag.170 of the public consultation text should be changed. These should only be enforced from the date when all technical standards are approved and provided that counterparties have at least one year to adapt their systems.

   Therefore it is of the utmost to ensure consistency format standardization among EMIR, MiFID and REMIT information requirements.

2. **In our opinion, reporting obligation should not apply to intragroup transactions, as they hardly impact market prices.** In fact, provided that the regulator knows which entities are members of a group, the only relevant things as far as market impact are concerned are the transactions of the group with the external markets. Intragroup transactions do not have any impact in the market. Obviously intragroup transactions can influence the behavior of group entities in the market. But it is this behavior towards the outside world what is relevant from the point of view of assessing possible market impact.

3. **The reporting obligation of counterparty and common data comprises 80 data fields for each single transaction, and extent of data provision which creates huge administrative burdens especially for non-financial counterparties.** In our view, reporting of derivative contracts should not be used as a means for monitoring the adoption of risk mitigation techniques, as otherwise the number of fields to report would grow disproportionately and delegation of reporting to third parties would be impossible (due to the existence of a number of fields that only the counterparty itself can report). Monitoring of risk mitigation techniques is necessary, but it should be carried out in other ways than loading market participants with extensive reporting obligations (for example with specific audit procedures). Given the comments above, we suggest that the following fields are excluded from reporting: 11, 12, 16 and 20-36.

➔ EMIR Implementation timing

Last but not least, it is of crucial importance that ESMA provides more clarity on when the EMIR obligations would enter into force. The requirements introduced by EMIR will indeed have a substantial impact on business practices of non-financial entities dealing with financial derivatives. Companies thus need flexibility in the implementation period. We call on ESMA to provide quickly more concrete timeline and implementation guidance and also to involve stakeholders in the definition of the implementation phase.

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