

19 March 2012

To: European Securities and Markets Authority (ESMA)
103, rue de Grenelle
75007 Paris
France

Subject: EUROGAS Response to the ESMA discussion paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories (EMIR) (16 February 2012 – ESMA/2012/95)

Dear Madam, Sir,

At the trilogue meeting of 9 February 2012 the EU Commission, Parliament and Council reached an agreement on the European Market Infrastructure Regulation (EMIR). Following this agreement the European Securities and Markets Authority (ESMA) has been asked to draft technical standards for the implementation of EMIR. By means of the Discussion Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories (16 February 2012 – ESMA/2012/95), ESMA is seeking feedback from stakeholders on the proposed way forward for the implementing technical standards.

EUROGAS represents the common interests of the European gas industry and is composed of 50 members from 27 countries, amongst which 33 natural gas companies, 15 federations of natural gas companies, and 2 international organizations.

We appreciate the opportunity given by ESMA to give input to the technical standards for EMIR and agree with several of the proposals ESMA has made. We do however also have concerns stated in our answers to the attached questions.

We look forward to comment on the consultation paper on draft technical standards ESMA will publish in summer 2012 and are at your disposal for any further information you may need.

Yours sincerely,

Margot Loudon
Deputy Secretary General
EUROGAS

Clearing obligation procedure (Article 4)

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?

Eurogas 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.

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.

Besides, it should be clarified how the volume of the relevant class of OTC derivatives will be assessed (sufficient granularity required).

With regard to "request for quotes" more explanation is needed in order to clarify the reason why information about "unconfirmed OTC derivatives transactions" should be part of what the competent authority will notify to ESMA. In our opinion it is not clear how this monitoring measure provides more finance systemic stability.

Eurogas 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).

Eurogas 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, and availability of pricing information?

Eurogas 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.

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
- 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?

1. Analysis of §29

*Eurogas 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. Eurogas is generally supportive of risks mentioned by ESMA under point 29 a. and b. but is of the opinion that the list mentioned in letter b. is incomplete. Eurogas suggests to rephrase the end of §29 letter b. as follows: "... assets, service, inputs, products, commodities, liabilities referred to in letter a, resulting from fluctuation of interest rates, inflation rates, foreign exchange rates **or other variables (e.g. commodity prices or more generally other non-financial items)**".*

In order to scope in both cash flow hedge transactions (hedges of the exposure to variability in cash flows) and fair value hedge transactions (hedge of the exposure to changes in fair value of asset or liability or an unrecognised firm commitment), we would also propose to rephrase the beginning of §29 a. and b. as follows:

a. The potential exposure to (1) changes in fair value or (2) variability in cash flows of (...)

b. The potential exposure to (1) changes in fair value or (2) variability in cash flows of (...)

The identification and assessment of hedging transactions should be performed at the level of each consolidated group of entities.

Due account should also be taken of the intent of the IASB in its IFRS 9 project to align risk management and accounting by proposing a more principle-based (compared to the current IAS 39 which is rules-based) approach for hedge accounting.

*On that crucial point, it should be noted that the problems of IAS 39 in the energy industry are often referred to as "**artificial**" volatility, i.e. profit and loss volatility that is only accounting-driven, but does not exist in economic reality. Indeed, all economic hedging transactions cannot comply with IAS 39 rules while they are, on a risk management perspective, entered into and documented to protect the entity against risk exposure.*

As a consequence, Eurogas is of the opinion that ESMA should work on a principle-based approach (§29 a. and b.) supporting and integrating the accounting reference-based approach (§30), also by taking into account the current revision of the aforementioned accounting principles.

2. Analysis of §31

The concepts of speculation, investing, and trading are not defined in the original text of EMIR and Eurogas therefore feel that this reference in the technical standards may generate confusion. It could be counterproductive with regard to the pragmatic approach designed by ESMA for the definition of risk-reducing OTC derivatives.

Indeed, if a transaction is being performed for hedging purposes, it cannot be then entered for speculative purposes. On this point specifically, it should be noted that utility companies have developed following IFRS adoption in Europe, adequate book structure (or similar tracking structure) to identify management purposes of all transactions so that an entity can easily identify which transaction has been entered into for trading purposes and which other one has been entered for hedging purposes.

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

1. Basis of the clearing threshold

In general, there are complications in defining what method or basis of measurement is appropriate for measuring positions, defining what large is and in the practicalities and processes required.

It is widely accepted that for a derivative the nominal amount or notional principal amount of the transaction is not the sole measure (even if the notional value is weighted by instrument type, maturity, etc.), 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 Eurogas'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.

2. Level of the clearing threshold

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 counterparty risk, 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.

3. Group companies

We believe that application of a global clearing threshold for all legal entities of a group is not appropriate, especially for large industrial companies. Large industrial companies are indeed active on different derivative markets, as diverse as commodities, financial, etc. It should be possible for a group to segregate trading activities in order to avoid consumption of the clearing threshold by one type of activity to the detriment of another.

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?

Eurogas 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.

Eurogas 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 Eurogas's view, a standardised contract (i.e: ISDA master agreements) reached between parties, is an efficient risk mitigation instrument.

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

Further explanations on "portfolio reconciliation" between counterparties are needed.