

Europeans Securities and Markets Authority (ESMA)
103 Rue de Grenelle
75007 Paris
France

30th March 2012

Dear Sir,

**ESMA Discussion Paper: Draft Regulatory Technical Standards On Risk Mitigation
Techniques For OTC Derivatives Not Cleared By A CCP Under The Regulation On
OTC Derivatives, Ccps, And Trade Repositories 6th March 2012**

Global Energy Advisory welcomes the opportunity to pass comment upon this discussion paper.

Global Energy Advisory are energy experts, who work as strategic consultants and provide valuation services. Our business model is to partner with firms who are either market leaders or serial innovators to develop products to support future decision making or mitigate risk. We are differentiated by our fixation with following market dynamics, identifying problems, developing solutions and demonstrating value.

For over seven years Global Energy Advisory has been warning of a future of punishing price volatility for energy. Under such scenarios we propose that front month volatility levels of 150 – 200% may not be uncommon. Therefore having considered future energy markets very carefully, Global Energy Advisory considers future wholesale energy trading dynamics will yield considerable trading/hedging/margin challenges for the existing market participants. Furthermore European energy markets have a concentration risk where daisy chains of failures are common. Therefore this concentration risk which is severe, coupled with a price risk, makes credit risk is an endemic feature of the energy sector. We make our comments to the ESMA RTS consultation within this context.

Generally, we firmly support new Regulations that establish provisions aimed at increasing the safety and transparency of the OTC derivatives markets. Among other matters, the new Regulations introduce a legal obligation to clear certain types of OTC derivative transactions through CCPs. Central clearing involves the CCP interposing itself between two counterparties to a transaction, assuming the obligations of each counterparty to the other CCPs. Non-cleared OTC derivatives will be subject to more stringent capital and collateral requirements, effected by a margining system essentially similar to that for cleared OTC derivatives. We believe that given the risks of European energy trading all market participants should be subject to these RTS. By doing so market integrity would be protected. In this response we show how trading counterparties, large and small, CCPs and cleared and non cleared trades could gain access to alternative sources of margin capital.

While we welcome the CCP as the main tool for risk management and transparency, we are concerned that while clearing can be a part of a solution as it is limited to the cash that the trading companies can provide for margin. This cannot be under emphasised when on the 15 February 2012, Moody's Investment Services announced rating downgrade actions affecting 114 financial institutions in 16 European countries. Moody's also said 'the highly interconnected financial markets and economies imply elevated uncertainty for all banks, even those banks that have shown resilience thus far'. Sourcing margin capital has never been easy. Every financing option should be explored. Failing to meet a margin call tells

the market place that your company is a credit risk, therefore ensuring financial liquidity is paramount.

Therefore we think it prudent to question the European Energy Industry's comment on their reliance of bank guarantees and letters of credit to support their trading from current bank groups. Under such credit conditions, this cannot be assumed as a long term source of liquidity given the financial resource needs of the sector and others. Even if these facilities are secured prices could be very high given the current credit line restrictions; banks would prefer to offer alternative products or financing as they have to 100% weight letters of credit. We therefore propose the use of alternative, more cost effective financial products for the generation of margin capital rather than relying on the European banks alone. We propose the 'Center' financial product as just such an alternative. It is flexible in use both for clearing houses and for non-cleared OTC collateral management. It has global reach, deep liquidity, and is very low credit risk.

An Alternative to Traditional Margining Credit ENhancement of Traded ENergy (CENTER)

Center is an established, proven settlement platform currently used in non-energy industries. To date over \$54 billion has been processed through the platform, 100% error free. Center is a collaborative mechanism whereby two counterparties agree to use the Center settlement platform to generate margin capital. This capital is supplied by approved, high-credit worthy third-party investors who have appetite for the risk profile. The structure is used to dissipate the commodity credit risk into the wider financial markets.

Example: If two counterparts are trading together where the position is subject to a MTM calculation, one party will be in-the-money (ITM)/profit, and the other out-of-the-money (OTM). The counterparty with the OTM position could pose a credit risk to the other trading party, and be asked to post collateral. Traditionally, this in the form of posting cash or a letter of credit, depending upon the size of the risk. However, letters of credit and cash are expensive and use up vital bank lines. By using the Center product, the ITM trader would calculate the amount of collateral required from the OTM trader to restore credit risk to acceptable levels. They would then ask (through back office processes) for the OTM trader to issue a Center "Payment Instruction" through the Center solution in favour of the ITM trader. Once this Payment Instruction request is issued and approved by the Center settlement platform, it becomes available for third-party investors to fund and the discounted cash is passed to the ITM counterparty within two business days.

This whole process can be automated, involving interfaces between the credit trading risk management system, credit management, and Center platform systems. Thus, Center represents a cheaper and more flexible alternative to posting cash or letters of credit against trading positions and will provide a vital source of added liquidity for margin capital.

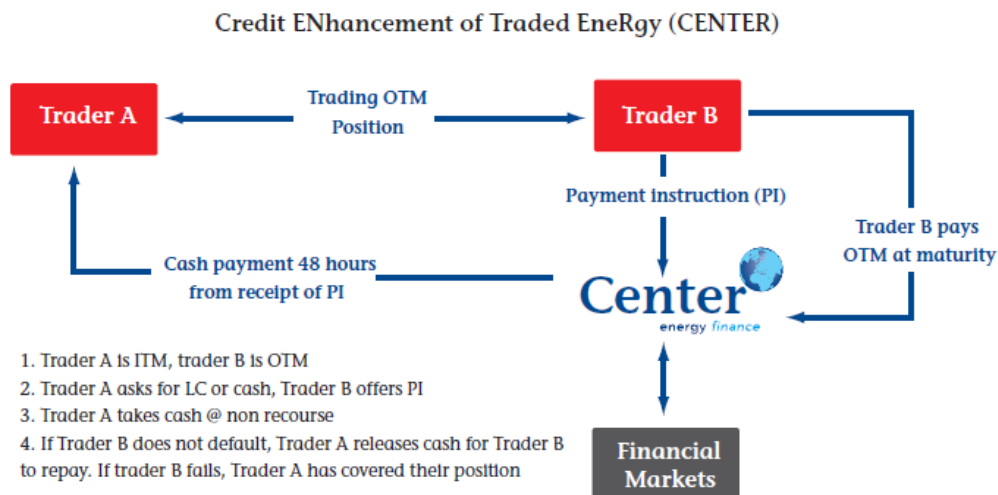
Moreover, the financial structure that supports Center has been widely used for many years. Specialist bank and non-bank investors use the product to take corporate credit payment risk. As an established and reliable mechanism for monetising receivables, Center thus allows counterparts to receive discounted cash within two business days and to keep trading. This is as fast as any financial transaction can be executed.

Centre essentially puts a price on credit and settlement risk where these risks are dissipated into the wider financial marketplace. The banks that support Centre stand

shoulder-to-shoulder to build the capital in a competitive environment, thus ensuring competitive prices.

Moreover, even if a firm is cash rich and happy to post cash against their trading positions, they could use the Center product to earn a superior return by using it to invest in the marketable securities issued by the platform. What could be a safer investment for the Treasury team than a firm's own credit risk? Also this should help incentivise the good risk management practice that the RTS puts into law.

Therefore, by using Center you can mitigate credit risk, be a responsible counterparty, save on financing costs and earn a relatively secure commercial return. And there are no legal costs or arrangement fees for using the Center platform, the cost is the carry, with added margins for the credit risk of the OTM trader and maintaining the system.



Commodity markets have always been volatile and future commodity trading market dynamics will change dramatically. Now that commodity markets are being captured under EMIR, REMIT, and MiFID II, transparency will overcome OTC trading opaqueness and margining practices will be much improved. Global Energy Advisory supports this. Ironically, however, by applying these regulations it will reveal the inherent risks in commodity trading and require billions of new capital which the current banking market cannot support, (even if it wanted to). The Center solution represents a competitively priced workable solution.

However this collaborative Center credit risk product could also provide crucial cash liquidity for the smaller players while eliminating their counterparty credit risk. For example, the stronger credits, with settlement payment or Out of the Money (OTM) positions could allow access to alternative cash funding by posting a simple payment instruction which could then be discounted to cash at the cost of the carry and margin of the strongest players. This could provide a vital and competitive source of working capital for new entry or smaller players without which they would be disadvantaged in the coming years when conventional lenders are tightly constrained. It is also a way of gaining access to margin capital at a competitive price.

We believe that the Regulators need to fully understand the credit and working capital implications of moving commodity OTC derivatives into central clearing, and raising collateral (margin capital) requirements for the affected companies. Given the state of the European banking system, the capital required may simply not be there, or be available at such an excessive cost that many commodity traders are driven out of the market, reducing liquidity. We could see a situation where physical commodity and energy markets are bereft of the very companies needed to make them work efficiently. While this is clearly not the intention of the Regulation, we see a significant risk that it may be the unintended outcome. However, Center can mitigate this risk.

In conclusion, the commodity and energy markets need to consider alternative financial products for funding their margin and collateral requirements under the new Regulation. The Center credit product generates a pool of margin capital which dissipates MTM and/or settlement credit risk to 3rd party investors who have an appetite to the sector and term of this risk. It is also a mechanism for the stronger market players to support the smaller firms but giving them access to the vital cash flow benefits the product also facilitates. There is no reason in terms of management time, setup or operational costs why this product could not be adopted immediately by the European energy industry by market participants, large or small. We hope that ESMA, ACER and other relevant authorities encourage energy and commodity companies to look for such alternative, established products from other sectors of the economy.

Yours sincerely,

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Global Energy Advisory
Advisory, CEO