

EU LEGISLATIVE PROPOSALS IMPACTING WHOLESALE ENERGY MARKETS AND TRADING ACTIVITY

Overview:

Traded natural gas markets are a prominent feature of the European energy economy. The development of wholesale energy markets has received strong policy support from Commission, Parliament and Council in recent years, and they are seen as a major contributor to the development of the internal market at regional level.

Eurogas members are active participants in the energy markets, as buyers and sellers of gas, in particular for on-sale to customers. Our members use derivative products in wholesale markets to help manage the commodity price risks that they and their customers would otherwise face.

Eurogas is concerned that certain proposals among the *financial* market reforms now under consideration¹ in Parliament and Council will, unless amended, inadvertently damage the future development of the *energy* market. Worse, some energy-related elements of these (draft) proposals appear likely to reduce the liquidity of the traded gas markets and to increase so-called 'systemic risk' in financial markets themselves.

Specifically, a mandatory requirement for energy traders - or for energy traders of a certain size - to use clearing-houses for their transactions will increase trading costs and could reduce liquidity and the number of participants in energy markets. This will hinder efficient price formation and thus reduce price transparency. Moreover mandatory central counterparty clearing will create financial liquidity risks and credit risks for energy firms.

A reduction in liquidity and an increase in systemic risk would be the opposite of what policy-makers intend. For this reason, it is in Eurogas' opinion essential to address deficiencies in the drafting of the proposals under consideration.

In general, Eurogas believes that when designing financial market regulation, more detailed consideration is required of the specificities of the energy markets in order not to inadvertently harm the development of the internal energy market, or adversely impact security of energy supply and the sustainability agenda. The annex to this note highlights the interactions between financial and energy market legislation, which have to be carefully managed to avoid unforeseen consequences.

Eurogas believes the following points must be taken into account when considering the directives and regulations insofar as the energy market is concerned:

¹ Specifically the Market Abuse Directive (**MAD II**), the Markets in Financial Instruments Directive (**MiFID II**), the Capital Requirements Directive (**CRD IV**), the European Market Integrity Regulation (**EMIR**) that are being prepared by DG Market .

In addition, this paper addresses the Regulation on Energy Market Integrity and Transparency (**REMIT**), which covers wholesale power and gas markets and which is being prepared by DG Energy.

Energy trading does not pose systemic risk

It is generally acknowledged that energy derivative trading does not impose systemic risk, i.e. it is unlikely that the failure of one firm will materially affect the wider energy and financial markets. The Enron and TXU experiences provided clear evidence of this. It is also worth noting that final (retail) consumers were adequately protected throughout these incidents.

In this connection, we would also note the CEBS Advice of 10th October 2007. This clearly states that "...systemic risk concerns.... [arising from commodities business] ... appear significantly smaller relative to the systemic risks posed by banks and ISD financial investment firms. In the commodities case studies examined in this report, systemic concerns were limited and contained." There has been no significant change in this position since this advice was published, so it remains valid.

Eurogas therefore questions why energy firms should be obliged to pay an 'insurance premium', by means of mandatory central clearing or be forced to use certain risk mitigation techniques, to cover a systemic risk which is considered not to result from their activities. Increased costs of trading would feed into higher prices which will ultimately be paid for by end users. Moreover, mandatory clearing and the forced use of certain risk mitigation techniques for bilateral OTC derivative contracts could severely drain cash liquidity in the energy sector which could in turn lead to less investment, with consequent adverse impact on security of supply and the sustainability agenda.

Efficient risk management allows energy firms to protect themselves and their customers against price risks via the use of derivative products. Mandatory central clearing does not reduce the overall level of risk incurred by a firm, but it does remove its ability to balance market, price, cash liquidity and credit risks in an efficient way choosing from a range of established industry risk management tools and would lead to a concentration of risk with central counterparties and their clearing members.

Derivatives - why gas suppliers use them

It is important to appreciate the rationale for the use of derivatives by gas suppliers.

Suppliers use derivatives primarily to mitigate the current and future risks that arise from the physical nature of their underlying operational businesses. While some gas suppliers may also own gas production assets, most suppliers deliver gas to their customers by buying gas in the wholesale energy market – they are balancing their naturally 'short' physical positions. Conversely, gas producers will typically have long physical positions. Such natural positions expose firms to price movements in the wholesale spot market, and this constitutes a price and commercial risk for suppliers which – unless addressed – creates volatility in end-consumer markets. If derivative trading costs are deemed to be too high, companies become reluctant to manage risks in this way and customers could be exposed to more volatile and unpredictable prices. Legislation such as mandatory central clearing should not discourage efficient risk management.

Efficient risk management means that firms seek to insure against these inherent price and commercial risks in the market through derivative products. Energy derivatives are supported by strong underlying physical assets and prices are predominantly driven by physical supply and demand, and as such do not contribute to overall risk in the financial system. This leads to no additional systemic risk and is very different from the use of derivatives as purely financial instruments that have proved disruptive in financial markets in recent times.

Energy Companies do not sell financial instruments to consumers

A further difference that should be noted is that the way gas suppliers use derivatives in the market does not involve the sale of financial instruments to consumers. The CEBS report concluded that in most wholesale commodity markets there is very little direct private client participation and negligible direct contact between private clients and energy trading firms. Unlike some financial institutions therefore, energy trading firms generally do not offer commodity linked investment products to private investors. Thus the concept of consumer protection as designed for the financial sector is not a valid concern in energy trading. Many retail suppliers offer the option of fixed price supply contracts with guaranteed physical delivery to their customers. They are enabled to do this by virtue of their access to dependably liquid wholesale energy markets and the use of derivative products.

Liberalisation of the energy market

Over the last 10 years the energy market in Europe has been liberalised through sector specific regulation. As a consequence, gas markets in Europe are becoming more liquid, and the development of traded markets at regional level has contributed significantly to the establishment of the internal energy market. Eurogas fears that mandatory requirement for energy traders - or for energy traders of a certain size - to use clearing-houses for their transactions could have a negative impact on the continuing development of competition and liquidity in energy markets, and could hinder new entry and investment in the sector, in turn affecting economic growth, consumer prices and employment. These are fundamental considerations within the internal energy market policy of the Community. Legislators must be careful that financial regulation and energy specific transparency and market integrity rules do not work against the development of market competition and liquidity and in this undermine the European Commission's energy liberalisation objectives.

Global consistency

The US Dodd-Frank Act and the proposed EU legislation in this area are broadly similar, and these similarities help reduce the scope for regulatory arbitrage in what is a global gas market.

However in two areas, the Dodd-Frank Act provides for a more advantageous solution than current EU proposals. We would recommend the adoption of these two elements within EMIR:

- o Definition of derivative, where the Dodd-Frank Act contains a specific exclusion of physically settled commodity transactions and where the current EU proposal does not; and
- o Clearing of existing OTC derivative contracts, where the Dodd-Frank Act exempts all such existing contracts from clearing, whereas according to the current EU draft existing contracts will be included in the clearing obligation for companies whose activities exceed a threshold.

Whilst the general shape of the legal obligations will be provided through primary legislation, in both the EU and the US a large amount of detail on the scope and impact of the legislation will depend on second level rules and regulation, to be drafted at a later date by regulatory authorities. Thus some uncertainty will remain for companies until this second-level phase is completed during 2011 and 2012. Throughout the legislative and comitology guideline process, it is essential that EU arrangements do not result in significant additional costs in comparison with other international arrangements.

Transparency

Greater transparency is called for by energy and financial authorities alike in the interest of improving regulatory oversight and managing risk in traded markets. This focus is on transparency within two areas, namely transaction data and the publication of fundamental asset based data.

A number of EU initiatives over recent years have increased transparency requirements, especially via new transparency rules (primarily for transmission and to a lesser degree storage and LNG terminals) contained within the revised Gas Regulation and the record keeping obligation for transactions contained within the Gas Directive. Obligations that would widen this to transaction data reporting by trading firms are now being considered by DG Energy and DG Market. Eurogas supports this general policy direction in respect of transaction data transparency and stresses the need for clear market transparency rules within this area. On cost and efficiency grounds however, it is important to recognise the extensive trade information that is already available in the marketplace and to set up a reporting regime that is balanced in scale. In this, consideration is needed of such issues as how reporting should be made, for example by exchanges and brokers on behalf of their clients, and the extent of data reporting requirements for contracts. Furthermore, it is essential that commercially sensitive transaction information should not be made public.

With regard to fundamental data transparency, it must be recognised that transparency as regards assets such as gas storage facilities and LNG terminals (some of which are not required to be open to third parties) must be balanced in relation to giving investors sufficient incentive for assets to be built and protecting contractual arrangements used to underpin such investments.

To avoid overlap between different parts of the envisaged legislation, to ensure consistency and to reduce regulatory uncertainty, Eurogas stresses that all legislative proposals regarding information transparency rules must be considered holistically. Hence, we would not wish to see a proliferation of data repositories and would urge the standardisation and coordination of reporting requirements and processes wherever possible.

Meanwhile, we consider that trade repositories should not become monopoly services. Competing commercial services are more able to adapt to changing circumstances and respond to industry needs for the provision of a variety of information services.