WHOLESALE ENERGY TRADING LICENSES IN THE EU

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1 Executive Summary

The Council of European Energy Regulators (the CEER) has commissioned The Brattle Group and Skadden, Arps, Slate, Meagher, & Flom (UK) LLP (Skadden) to study licensing requirements for wholesale gas and electricity trading in the EU.

One objective is to determine whether existing requirements serve important policy goals, or harm competition by serving as unnecessary barriers to entry. We have been asked to identify best practices, provide any recommendations for reform, and in particular to assess the appropriate level of harmonization among countries.

We analyze three dimensions of licensing regimes:

- The criteria for obtaining licenses;
- The administrative process involved in applying for licenses; and
- The ongoing obligations imposed by licenses;

Purpose of a license

We examine whether a trading license should be required at all. Some member states, including Germany, do not require wholesale trading licenses. However, we see several benefits of an EU passport-style energy trading licence.

- At the most basic level, a license would establish a record of who is active in the market. It would therefore enable energy regulators to better fulfil their monitoring tasks stipulated in the 3rd energy package.
- An EU license would harmonise existing requirements and remove barriers to traders wishing to enter new markets. Currently there exist different national licensing regimes in energy wholesale markets, and our interviews with traders confirm that these differences increase the costs of entering new markets. A harmonized EU licensing regime could be an effective tool to increase harmonization in the EU energy market.
- Similarly to MiFID, a passport feature could be implemented also for a EU licensing regime for energy wholesale markets. In MiFID, a "passport" feature permits a MiFID investment company to offer its services, remotely or through a corporate establishment (‘branch’), in any of the 27 countries of the EU and the EEA without having to obtain "authorization" from any financial market regulator except that of the firm's home state. This eliminated the previous onerous requirements of having to be separately licensed to do business in each country in which one wish to conduct regulated financial market activity. Rather than negotiate 27 different licensing regimes, with a single application a trader would be ready to enter all the markets of the EU – we explain below the process of applying to trade in different jurisdictions.
- The license should also provide a safety net to ensure a minimum quality of the firms active in the market. This is not aimed at predicting the success of applicants,

but rather avoiding criminal entities from gaining trading licenses. The criteria for securing a license should not seek to prejudge which firms would be the most successful traders, but rather to prevent criminal or bankrupt entities from becoming traders. While we do not think that the license application process should attempt to predict, for example, which traders are likely to go bankrupt, it should identify traders that are in the process of going bankrupt.

- Finally, a license would require traders of European natural gas and electricity to have a legal presence in at least one Member State, submitting themselves to effective enforcement of relevant legislation. Therefore an EU licensing regime could be an effective legal tool for enforcing the provision of information necessary to monitor market performance, for avoiding market manipulation, and for investigating fraud.

Although securing a license entails a cost, a simplified process would offer benefits that outweigh any costs created for traders.

We consider the relative merits of licenses to other forms of legislation that could seek to achieve the same goals. One recommended goal of a license is to require the provision of information to regulators. An alternative to a license might be legislation requiring the provision of information, backed by the threat of fines for non-compliance. However, the threat of withdrawing a license can provide a better enforcement mechanism than a system of fines. Where fines are involved, authorities typically seek to make them proportional to the costs imposed on society. Failure to provide information undoubtedly imposes a cost on society, but the authorities might not be able to estimate accurately the costs in particular situations. Estimation difficulties would risk the emergence of decisions that appear inconsistent, and could invite prolonged debates over the appropriate magnitude of fines in individual cases. Moreover, fines can unwittingly invite market participants to make trade-offs of the benefits and costs to non-compliance. Instead of fines it seems better simply to threaten the withdrawal of a license. In the absence of a license regime we could ask courts to impose injunctions that prevent trading by parties who fail to comply with relevant laws for the provision of information. However, withdrawing a license is a simpler administrative procedure. However, we recognise that license withdrawal should respect the principle of proportionality. It would not be proportional to withdraw a trader's license simply because they are a day late in providing information to the regulator for example.

An alternative to creating a separate EU trading license would be to extend the coverage of MiFID. However, we do not recommend this approach, because MiFID would not address several of the issues which we identify below and which a separate trading license would address. For example, we have identified gaps with respect to transaction reporting and market abuse, which MiFID does not address (and was never intended to address). A tailor-made EU energy trading license is preferable to an extension of MiFID.

Scope of the license

We recommend a separate EU trading passport would cover all forms of wholesale gas and electricity trading, whether financial, derivative or physical. The EU Trading licence would replace and supersede all national forms of energy trading licenses. To avoid duplication with existing financial regulations under MiFID, we propose that firms currently covered by MiFID would not

require the new EU trading passport. Therefore investment firms that are currently authorized by any EEA authority to trade energy-related derivatives, and energy contracts on regulated markets, would not require the EU trading license to trade those same products. MiFID already covers physically settled energy contracts that are traded on a regulated market or a multilateral trading facility ("MTF"). However, MiFID licensed traders would require our recommended EU passport to undertake transactions not covered by MiFID, principally physical OTC trades. Firms with a MiFID exemption would also require the EU trading license to trade energy-related derivatives.

We recommend that there would be a single EU trading license for both electricity and gas. None of the issues that we have identified, and which the license would address, are specific to either electricity or gas. Concerns regarding record keeping, transaction reporting and market abuse apply equally to both gas and electricity. Having a single license would reduce the administrative burden of applying for separate licenses.

The energy trading passport would allow wholesale energy trading only. Member States could require separate licenses for the supply of end users, which we call 'supplier licenses'. We recommend separating the license regimes for trading and supply. A separate trading license would avoid imposing onerous conditions that are only relevant to the supply of smaller end-users.

Licensing requirements

Any person undertaking transactions in wholesale gas and electricity in, or into, any EEA jurisdiction, or purporting to do so, must be licensed to do so by a recognized EEA Wholesale Energy Authority ("Authority"). Before licensing any person to undertake such transactions ("License"), the Authority shall determine that the applicant:

(1) Is, having regard to the character and background of the applicant, a fit and proper person to undertake such transactions;

(2) Has adequate systems and controls to undertake such transactions as an ongoing business;

(3) Is organized so that it may adequately fulfil the regulatory requirements mandated by the relevant Authority and any other relevant statutory or regulatory obligations;

(4) Agrees that it will not engage in, or aid or abet, any conduct which may have the effect of disrupting, manipulating the supply, price or transactions in gas or electricity; or which may have the effect of creating a misleading impression as to the present or future demand for or price of wholesale gas or electricity.

Administrative and ongoing requirements

A key administrative requirement is that the person licensed ("Licensee") by an Authority must be available to be subject to the "home" supervisory authority of that Authority. Consequently, any Licensee will be compelled to comply with the following administrative requirements. Each Licensee shall:

(1) Have its home or registered office in the same jurisdiction as the Authority;

(2) Make all records relating to relevant energy transactions available, on request, to inspection by the relevant Authority;

(3) Make all records of personnel involved in the conduct of business of the Licensee relating to transactions in wholesale gas and electricity available to inspection by the relevant Authority on request;

(4) In the event the Licensee intends to undertake wholesale gas and electricity transactions in an EEA jurisdiction other than it's "home jurisdiction", the Licensee shall notify the Authority in its home jurisdiction describing the types of transactions it intends to undertake in other EEA jurisdictions and identifying the jurisdictions in which it wishes to undertake such transactions ('host' jurisdictions). The Authority shall then inform the relevant host Authority of the intention of the Licensee to trade in the host jurisdiction. The host jurisdiction shall have 20 days within which to lodge a written objection with the home Authority. If no such objection is raised the Licensee will be free to undertake transactions in the relevant host jurisdictions after 30 days from the date of the Licensee's notification to the home Authority.

An Authority's responsibility for supervision of a Licensee continues as long as the Licensee undertakes wholesale gas and electricity transactions under license from the Authority. To fulfill its supervisory duties, the Authority should make a number of requirements of the Licensee. For example the Licensee should keep the Authority informed as to any significant changes to its business, provide the Authority with an Annual Report describing its business for the previous calendar year, notify the Authority of any step taken which may result in the acquisition of 10% or more of the share capital of any Licensee. The above is a brief outline of what the licensing requirements will include. Further detail as to why they are proposed as set forth in the report. To implement any such requirements will require detailed plans that are not within the scope of this Report to describe exhaustively.

We propose that separate energy regulatory Authorities implement the regulations described above. Although consistency and efficiency may be better served by establishing a single EU energy regulator to administer such licensing, it would be a massive undertaking to task a single EU regulator with the job of licensing and supervising each person who seeks to trade wholesale gas and electricity within the EU. Many national energy regulators already take responsibility for issuing and enforcing trading licenses in their Member State.

We propose requiring licenses for the trade of wholesale gas and electricity both within the EU, and into the EU from non-EU countries. Including trade into the EU would ensure a level playing field. Otherwise traders might sit outside the EU, perhaps in jurisdictions that involve less rigorous licensing regimes, and then trade into the EU in competition with traders licensed by EU Authorities.

We recognise that Switzerland is an important centre of energy trading, and that jurisdiction of an EU license would not automatically extend to Switzerland since it is outside of the European Economic Area. To ensure the smooth continuation of trading between Switzerland and EU Member States, we recommend that Switzerland sign a bilateral agreement with the EU to adopt the EU trading passport and all of its provisions. This would avoid Swiss traders having to sell to a licensed subsidiary within the EU, which would create accounting and tax issues similar to having a branch office.

2 Introduction

The Council of European Energy Regulators (the CEER) has commissioned The Brattle Group and Skadden, Arps, Slate, Meagher, & Flom (UK) LLP (Skadden) to study the licensing requirements for wholesale energy trading in the EU. The Terms of Reference[1] for the study expressed concern that different licensing requirements between Member States may currently impede the development of more liquid energy wholesale markets.

- Against this background, the objective of the study is to advise whether the requirements for wholesale market trading should be:
- Simplified by the removal of unnecessary steps;
- Harmonised, creating common principles/requirements if useful for levelling the playing field for traders;
- Reformed to avoid "super equivalence" – eliminate any additional requirements beyond the harmonised level deemed necessary for addressing public policy goals.

The ultimate objective of the study is to inform ERGEG and the European Commission of a possible EU licensing regime for energy trading (single EU-wide licence), as well as the appropriate level of harmonisation of administrative trading requirements.

In some countries licenses may form administrative barriers to wholesale market entry. Some Member States do not require a wholesale trading license, instead making other agreements and institutions responsible for implementing administrative requirements. We take a broad interpretation of a 'trading license' – we have also looked at other institutions or contracts which perform or could perform similar functions to a license, including bilateral trading agreements, and agreements with Transmission System Operators, Power Exchanges and Clearing Houses.

We address three aspects of the licensing process:

- The licensing criteria –conditions that an applicant should meet to secure a license;
- Administrative requirements – for example who should issue the license, the time take to issue the license, costs etc.
- Ongoing license obligations – such as providing information to the regulator;

Our terms of reference focus on trading electricity and gas. Carbon trading is growing in importance. The European Commission has recently launched a major study to assess whether the market for emission allowances is sufficiently protected against market manipulation and insider dealing. After the study's completion we would recommend reviewing its results to assess whether our recommendations for electricity and gas trading should extend to the carbon market.

Skadden's legal adviser on this project is Professor Edward Swan (PhD, JD), Visiting Professor at University College London, Faculty of Law, with over 30 years experience in studying,

[1] See Appendix I.

analyzing, commentating and advising on the regulation of financial markets, including energy markets. His experience leads to the following conclusions[2].

Energy transactions operate to secure assets distant in time. Because there is usually no "instant" transfer of assets, it is important to understand that wholesale gas and electricity transactions are essentially sales of "promises". One party promises to sell on certain conditions and the other party promises to buy on certain conditions.

Legislation and regulation involve choices as to who will be allowed to buy and sell such promises. Such choices potentially restrict access to a useful economic tool. The decision about which entities/market participants will be permitted to attempt to make a contribution to the economy through the use of this tool should not be made lightly.

Energy markets are largely international markets. They seek to secure the benefits of energy assets distant not only in time but also in geography. It is difficult for national regulation to chase an international market, particularly because international traders have the option to move their business. History suggests that international systems have been the most consistently effective in regulating financial markets. An appropriate regulatory regime should achieve a balance between local and international regulation.

A number of regulatory models have been tried. The optimal choice depends on the goals, priorities, and context. However, the recent success of the Markets in Financial Instruments Directive (MiFID) should be noted. It offers a "passport" to the traders throughout the EEA and has been successfully implemented in all EEA jurisdictions with a reasonable minimum of difficulty.[3]

The issue of potential market misconduct (particularly in the forms of insider dealing and market manipulation) presents another regulatory challenge. Market participants sometimes complain that a market abuse regime does not provide sufficient clarity for them to understand fully what they may do and what is prohibited. However, it is naïve for market participants to expect that there will be no ambiguity in a market abuse regime. An effective market abuse regime requires a certain level of flexibility. The regulator needs flexibility to deal rapidly and effectively with market disruptions in the rapidly changing environment of international markets. Some open texture to the regime is necessary to cover unexpected and unforeseen developments.

In any regulatory environment, there are two types of behaviour which the regulators seeking to control. The first consists of well-known and clearly understood methods of market misconduct which have been seen many times in the past (such as the misuse of non-public information gained from one's employment or position; and "corners", "squeezes", and "wash sales"). However, a second category of market abuse offences includes previously unknown or cleverly disguised ways of rigging the markets in one's favour. It is not always possible for a regulator to anticipate what forms these disruptive techniques may take. A significant amount of ambiguity needs to be built into the market abuse regime to allow its prohibitions to be flexible

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[2] During the course of this study Dr. Swan moved from Skadden and became a Partner in the London office of the US (Boston) international law firm, Brown Rudnick. For purposes of continuity, Dr. Swan is still contributing to this project under the supervision of Skadden Partner, Douglas Nordlinger.

[3] Edward J. Swan, Building the Global Market: a 4000 Year History of Derivatives (London: Kluwer Law International, 2000), pp. 299-305.

enough to stretch to cover unforeseen situations. Indeed, the Market Abuse Directives (MAD) expressly command such flexibility, saying at Article 1 (2)(c):

"The definitions of market manipulation shall be adapted so as to ensure that new patterns of activity that in practice constitute market manipulation can be included."

Any regime intended to prevent market misconduct in the energy markets must seek to preserve a similar level of flexibility.[4]

2.1 Methodology

A trading license can be:

- A general control of the 'quality' of market participants, and a way of ensuring that participants have sufficient collateral;
- A method of ensuring that traders keep records that would facilitate the investigation of potentially anti-competitive behaviour;
- A mechanism to elicit information on trades;
- A way to manage security of supply issues.
- A tool that the regulator can use to ensure compliance with various rules, by for example threatening to withdraw the license;

We consider two criteria to assess the desirability of covering these points and other like them in a license regime:

- The license condition should address some kind of 'economic market failure'. In the context of this study, a market failure means that the unregulated behaviour of market participants does not lead to a socially desirable outcome. For example, market participants would probably not provide information on trades to the regulator absent a requirement to do so – yet this information is useful for market monitoring and preventing or investigating the abuse of market power. We would say that asking traders to provide trading records addresses a market failure.
- It is not sufficient that the license condition should address some kind of 'economic market failure' – the license should also be the best mechanism by which to address this failure. In other words, we need to assess whether other institutions and laws could address the market failure more effectively and at lower cost than a trading license regime.

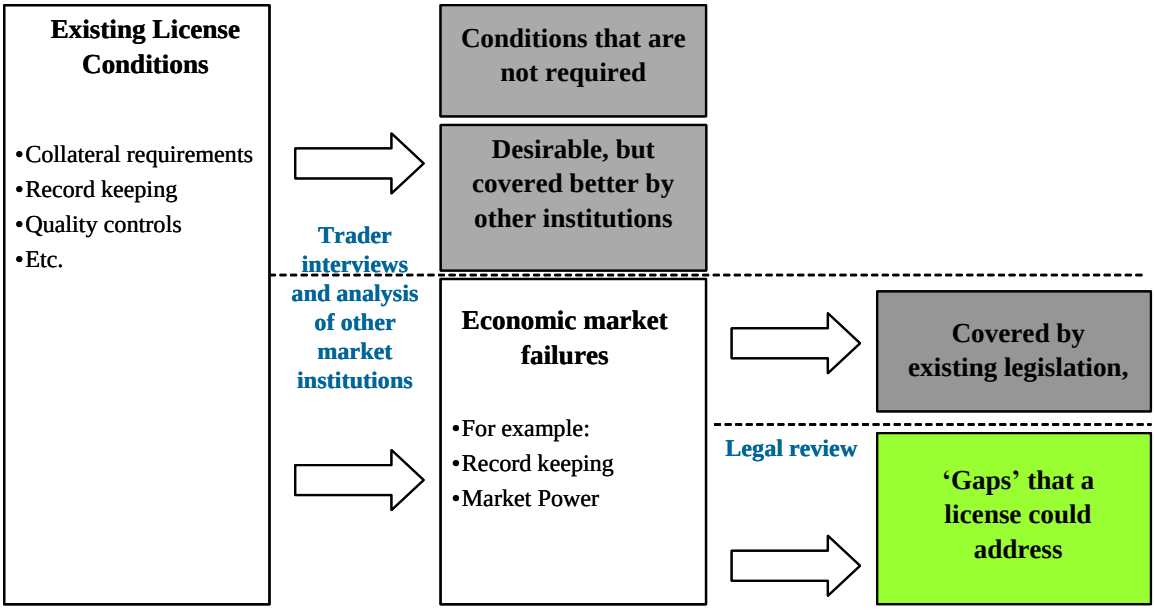
Figure 1 provides a visual overview of our methodology. We begin with a review of existing license conditions. We review other market institutions, and we interview market participants. We then divide the license conditions into three sub-categories:

[4] Edward J. Swan, John Virgo, Market Abuse Regulation, second edition (Oxford: Oxford University Press, 2010), pp. 32-34.

- License conditions that do not address a market failure and do not seem to serve any purpose;
- License conditions that address market failures, but which other arrangements seem best placed to address. For example, the network codes that govern the transportation of natural gas and electricity tend to contain several terms and conditions that address possible market failures.
- License condition that address market failures not currently addressed elsewhere, such as the requirements to keep and present trading records.

We perform a 'gap' analysis to identify market failures that existing or proposed legislation do not seem to address. Skadden has reviewed how derivatives on commodities are currently regulated under Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 (The Markets in Financial Instruments Directive or 'MiFID') and Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 (the 'Market Abuse Directive'). Market failures that are not addressed by existing or proposed legislation could be dealt with by a condition in a trading license, possibly on an EU level.

Figure 1: Overview of study methodology



We agreed with CEER to look at licensing regimes in the following countries:

- Germany;
- Czech Republic;
- Hungary;
- UK;
- Spain;
- Norway

This sample of countries includes a proper range of market designs, market maturities and a reasonable geographical coverage of Europe. For comparison with the EU, we also give a short overview of energy trading arrangements in the US.

Our research relies on documents in the public domain and interviews with parties active in the above markets. The Brattle Group has interviewed about 10 EFET Members, including the EFET Secretariat, CEZ, Alpiq, GDF Suez, Sempra, Lumius, RWE, EDF, and Centrica. The Brattle questionnaire is included as Appendix VI. Skadden has interviewed trading, legal and compliance personnel at BP, Shell, Statoil, Vitol, Eon, Centrica, Morgan Stanley, Barclay's Capital, Merrill Lynch, Goldman Sachs, and Deutsche Bank.

2.2 MiFID and its limits in the energy wholesale market

The Markets in Financial Instruments Directive ("MiFID"), which came into force on 1 November 2007, is the main directive currently governing the regulation of financial services in the European Economic Area ("EEA"). MiFID sets outs an EEA-wide system of market integration and regulation using the "passport" model.

MiFID establishes organizational and customer relations standards for entities wishing to engage in investment services and activities, including the buying and selling of financial instruments. The standards established by MiFID relate to, among other things, conflicts of interest, best execution, investor suitability and investor classification.

We provide a detailed discussion of MiFID here for two reasons. First, MiFID is the main piece of existing legislation with which an EU trading license will interact, and second MiFID is a possible 'passport' license model on which to base an EU trading license.

2.2.1 Undertakings Regulated by MiFID

The purpose of MiFID is to cover undertakings whose "regular occupation or business …is to provide investment services and/or perform investment activities on a professional basis".

However, achieving this goal is not completely straight-forward when dealing with wholesale contracts related to the energy commodities of gas and electricity. Coverage by MiFID of this area is principally focused "investment" activity, and seeks to exclude much of what can be defined as "physical" trading. An additional problem is that the definitions of what "investment" or "physical" trading are not always precise enough to enable one to have a clear understanding of how these two types of trading can be separated.

In its attempts to differentiate between the regulatory coverage of these two activities, MiFID specifically excludes (among other things):

(a) persons which provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings;

(b) persons who do not provide any investment services or activities other than dealing on own account unless they are market makers or deal on own account outside a regulated market or an MTF on an organized, frequent and systematic basis by

providing a system accessible to third parties in order to engage in dealings with them;

(c) collective investment undertakings and pension funds whether coordinated at Community level or not and the depositaries and managers of such undertakings. This can be relevant to collective investment schemes which are "energy funds";

(d) persons dealing on own account in financial instruments, or providing investment services in commodity derivatives or derivative contracts included in Annex I, Section C 10 to the clients of their main business, provided this is an ancillary activity to their main business, when considered on a group basis, and that main business is not the provision of investment services within the meaning of this Directive or banking services under Directive 2000/12/EC;

(e) persons providing investment advice in the course of providing another professional activity not covered by this Directive provided that the provision of such advice is not specifically remunerated;

(f) persons whose main business consists of dealing on own account in commodities and/or commodity derivatives. However, this exception shall not apply where the persons that deal on own account in commodities and/or commodity derivatives are part of a group the main business of which is the provision of other investment services within the meaning of this Directive or banking services under Directive 2000/12/EC;

(g) firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets;

From the above list of exemptions, it can be seen, that there are a number of areas in which the trading of gas and electricity will not be covered by MiFID regulation, a number of areas in which it will be covered, and a number of areas in which the coverage will be unclear.

This is particularly relevant for determining whether the trading will benefit from the MiFID "passport."

2.2.2 MiFID Passporting and Home Member State Regulation

Under MiFID, any entity based in the EEA that carries out investment business as a regular occupation or business on a professional basis is required to have authorization from its home state in order to continue its investment business activities.

MiFID states that, once an investment firm is authorized in its home Member State, it

> "should be entitled to provide investment services or perform investment activities throughout the Community without the need to

> seek a separate authorization from the competent authority in the Member State in which it wishes to provide such services or perform such activities."

Accordingly, once an entity has been authorized by its home state, it will be then able to rely on the MiFID "passport" to provide investment services to customers throughout the EEA.

As a general rule, MiFID requires investment services to be regulated by the home state of each authorized entity. However, MiFID also states that

> "by way of derogation from the principle of home country authorization, supervision and enforcement of obligations in respect of the operation of branches, it is appropriate for the competent authority of the host Member State to assume responsibility for enforcing certain obligations specified in this Directive in relation to business conducted through a branch within the territory where the branch is located, since that authority is closest to the branch, and is better placed to detect and intervene in respect of infringements of rules governing the operations of the branch."

However, the question of whether a firm's electricity and gas trading will be able to benefit from the MiFID "passport" will be dependent on whether that activity is MiFID investment business.

In short that energy commodity trading that is regulated by MiFID will benefit from that passport, that trading which is not regulated by MiFID will not be able to benefit from the passport.

2.2.3 MIFID Definition of Financial Instruments and Regulation of Commodities

MiFID does not attempt to regulate all types of derivatives on commodities, but does state that

> "it is appropriate to include in the list of MiFID regulated financial instruments certain commodity derivatives and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments."

The definition of financial instruments, which is set forth in Section C of Annex I of MiFID, is as follows:

1. "Transferable securities;
2. Money-market instruments;
3. Units in collective investment undertakings;
4. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other

derivatives instruments, financial indices or financial measures which may be settled physically or in cash;

5. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);

6. Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;

7. Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C(6) and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, *inter alia*, they are cleared and settled through recognized clearing houses or are subject to regular margin calls;

8. Derivative instruments for the transfer of credit risk;

9. Financial contracts for differences.

10. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, *inter alia*, they are traded on a regulated market or an MTF, are cleared and settled through recognized clearing houses or are subject to regular margin calls."

Sections C(5),(6) and (7) of Annex I of MiFID are clearly particularly relevant to the analysis of what types of derivatives on energy commodities are currently regulated by MiFID and Section C(10) may also be relevant to this analysis.

While it is important to carefully analyze the exact wording of MiFID, it can be said that MiFID is primarily intended to regulate derivatives on commodities that are non-spot and are not physically settled.

2.2.4 MiFID Coverage of the Energy Markets

The difficulty with applying MiFID coverage to the energy markets is that the coverage of MiFID is not completely clear within the realm of energy commodities.

As pointed out above, MiFID is intended to cover certain types of commodities transactions. However, there are, as noted above, a number of exemptions to MiFID's coverage and, beyond that, there are exemptions to the exemptions. In addition there is a complexity added

by the fact that the application of the exemptions is interpreted different ways within different EU Member States.

MiFID is a tool intended to enhance the aim of the legal framework of the Community to "encompass the full range of investor-oriented activities." (MiFID, Recital (2)).

To that end, the Directive notes:

> "It is appropriate to include in the list of financial instruments certain commodity derivatives and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments." (Recital (4)).

In general, MiFID covers both MiFID "activities" and MiFID "services" relating to energy derivatives and some "physical" energy transactions.

Part of the difficulty in separating transactions that are covered from transactions that are not is that MiFID covers:

1. Certain persons;
2. Certain products; and
3. Certain markets.

There are different exemptions that apply to each of these three transaction elements, some of which overlap.

With respect to persons, there is no comprehensive framework within MiFID (or any other EU legislation) regulating commodity (including energy) derivatives, or physical commodity firms.

It is certainly the intention of MiFID that the exemptions should exclude many commercial producers and consumers of energy including energy suppliers, commodity merchants and their subsidiaries.

However, exemptions that exclude people (including firms) do not necessarily exclude products or markets. Consequently, the exempt status of certain physical commodity firms can be diluted or nullified depending on what and where they trade.

For example, although MiFID article 2 (1)(k) excludes persons whose "main" business is dealing on own account in commodities and/or commodity derivatives, these persons can lose that exemption if:

1. Their dealings become predominantly devoted to other investment related products;
2. They become part of a group whose main business is provision of banking or other investment services; or
3. In the view of UK regulators, for example, they provide additional MiFID services such as providing advice or arranging deals in commodity derivatives.

With respect to products, it is the intention of MiFID to exclude physical or "spot" energy transactions from its coverage. However, the definition of what constitutes physical or "spot" transactions is flexible and, to a significant extent, ambiguous. This is exacerbated by the fact that MiFID does wish to cover commodity transactions that resemble traditional financial instruments and can generate the sorts of market failure which financial regulation is intended to cover. These can include transactions traded on a regulated market or MTF, cleared and settled by recognized clearinghouses or which are subject to regular margin calls. Also, so-called "spot" transactions which are not physically settled within the time generally accepted for physical delivery within the relevant market can also come within coverage.

In addition, "markets" are subject to regulation. These include traditional, regulated, markets as well as the newer multilateral trading facilities ("MTF's"). Both types of venues are subject to MiFID requirements and the scrutiny of financial regulators. In general, regulators are seeking to regulate venues that interpose themselves between the traders (rather than taking the individual transaction risks on their own account) and facilitate transactions through the maintenance of nondiscretionary trading rules (MiFID, Recital (6)). If a contract which would otherwise be an exempt "spot" contract is traded on a regulated market, an MTF or, in some cases, within a facility that performs similar functions or is traded subject to the rules of such a market or facility it can cease to qualify for the MiFID "spot" exemption pursuant to Article 38 of Commission Regulation 1287/2006/EC.

Any precise determination of which persons, which products, and which trading facilities will be covered by MiFID under any particular circumstances can necessitate a complex analysis. However, Figure 2 below provides a good approximation of the coverage of MiFID, with the green boxes indicating MiFID coverage and the red boxes that reading is not covered by MiFID. The rows represent products, while the columns represent the various exemptions which are possible.

Figure 2: Coverage of MiFID and an EU Trading License

	MiFID general rule	Own account exemption	Parents' or Subsidiaries' exemption	Commodity business exemption	Hedging and locals exemption
Spot/Physical					
Physically settled non-standardized derivative					
Physically settled standardized derivative					
Cash settled derivative					

3 Existing license conditions

The following selection of national licensing regimes gives an overview of the variety of different approaches in licensing energy wholesale trading activities. We use these case studies to inform our analysis of what should and should not be in an EU trading license.

3.1 Great Britain

Relevant Licences

Two licenses can apply to energy trading in Great Britain: the gas shipper license, which is required to use the gas transport network, and the electricity supply license. Ofgem, the GB energy regulator, is responsible for issuing and approving licenses.

Licenses are only required for physical trading, not financial trading. However many traders, even those with no intent to supply, hold licenses for physical trading. Holding these licenses allows traders to take physical delivery of gas or electricity if they are unable to trade out of their positions in the forward market. For electricity about half the traders hold the supply license, but for gas we understand all financial traders hold a shipper license.

License fees

There is a one-off charge for both the electricity supply license and the gas shipper license. At the time of writing the shipper license has a one off charge of £350. The electricity and gas supply license has a one off cost of £450.[5]

Branch office

No branch office is required for trading in the United Kingdom.

Collateral requirements

There are no collateral requirements in the license conditions. Network codes impose collateral requirements in the case of physical injection of gas or electricity into the networks. Central exchanges or counter parties require collateral in the case of financial trading.

Costs aside from license fees

Traders did not complain about the costs.

Necessity to sign the Grid Code

The licenses do not require the applicant to have signed the Grid Code.

Detailed criteria for securing a license

Only limited information needs to be supplied to obtain the licenses. The main points are:[6]

(a) A list of company directors;

(b) Whether any of the directors have had criminal convictions;

(c) Past insolvency of a company;

(d) Any previous refusals of licenses;

In the case of a refusal of an application, Ofgem will inform the applicant of the reason for the refusal, and grant 21 days to respond.

Good behaviour

The license itself does not contain any 'good behaviour' clauses.[7] In the UK the Financial Services and Markets Act 2000 addresses any suspected market abuse. Ofgem also has powers to

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5 "Gas and electricity licence applications – Guidance", Ofgem, October 1, 2008, p. 6

6 A condition exists in the license that a supply license requires details of the geographic area that the applicant is intending to supply. Identifying a geographic area helps enforce obligations for the supply of vulnerable customers. However, in practice this is no longer applied. It only applies to some existing licensees and reflects arrangements from several years ago. The definition of Supply Services Area appears to relate only to PPM (pre-payment meter) infrastructure – whereby the Distributor must have applied to the ex-PESs (Public Electricity Suppliers). Otherwise, licences are national and new licensees are not required to provide this information.

initiate competition investigations independent of the license, but faces a more rigorous burden of proof than for a suspected license breach.

There are a number of reasons that a license could be revoked. These are:

(a) Non-use for a 5 year period;

(b) Insolvency;

(c) Unpaid fees;

(d) Serious breach of a license

Application in national language

The application process is only available in English. Requiring English is unlikely to deter traders from other countries, since traders tell us that English is the common language for international trades.

Length of application

Ofgem's current target is to decide on 90% of properly completed licence applications within 8 weeks of receipt. Ofgem notes that any delay in providing information or responding to requests for clarification may delay the process.[8] Once a license has been issued it remains indefinitely; there is no requirement to reapply.

Combined trading and supply

For natural gas there are separate licenses for wholesale trading, supply and "shipping" which is the transport of natural gas on the pipeline network. Provisions in the shipper licence relate to the continuity of supply.[9] There are two scenarios in which these apply; the failure of another shipper or the failure of a supplier[10] to fulfil their obligations. In both cases Ofgem can direct a shipper to transport a gas supply provided by the 'Supplier of Last Resort' to a location affected by the failure.

The only license relevant to electricity trading is the electricity supply license, which contains provisions relating to security of supply.[11] The authority can direct the licensee to provide electricity to a location as the 'Supplier of Last Resort', should another supplier be unable to fulfil its obligations. The supplier is only required to comply for the areas specified in the license.

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7 It should be noted that Ofgem are currently trying to put good behaviour clauses in the Generation license. The market is very unhappy with this as it is felt that there are enough checks and balances in the system and that the rules being put in place are unduly onerous.

8 *Loc. cit.* footnote 5 ¶2.8 p.7.

9 Standard Condition 12, "Provisions Relating to Continuity of Supply" Gas Shipper license - Consolidated 15 June 2005

10 This can occur, for example, by the revocation of a license or financial failure of a company.

11 Standard Condition 8, "Obligations under Last Resort Supply Direction", p.25, Electricity Supply License - Consolidated 18 January 2010

Reporting

The only ongoing requirement of the licensee is to keep a record of costs and revenues of trading. Trading companies would in any case have to compile this information for tax and commercial purposes, so there is no extra cost, although the requirement seems redundant. There is a requirement to keep track of trades under the rules of the financial regulator (the Financial Services Authority or FSA), but this is not one of the license conditions.

3.2 Czech Republic

Relevant Licences

The Czech Republic requires trading licenses for the wholesale physical trading of electricity and natural gas.

Financial trading does not require a license, though it is only recently that financial settlement of trades has been made available on the Prague exchange. Currently all active traders hold licenses for physical trading. Most traders in the market are still primarily concerned with physical trading only, and only a few participants – mainly banks – are interested solely in financial trading. Trading licenses are necessary for cross-border trading, where only physical delivery is possible. The Czech energy regulator, *Energetický regulační úřad* (ERU) grants the licenses. To trade electricity physically, traders must sign network agreements with the Czech TSO, *Operator trhu s elektrinou* (CEPS).

License fees

There is a one-off cost for the licenses of approximately €3,850 (100,000 CZK)[12].

Branch office

While it is not a license condition, Czech commercial law requires any trader to have a branch office in the Czech Republic. There seems to be little political will to change the requirement. The regulator is not responsible for enforcing adherence to the commercial code.

The registration of a branch office is for VAT purposes only. The branch is not required to have employees or physical premises in the country, though the named director or compliance officer must also have Czech nationality or legal status.

Collateral requirements

There are no collateral requirements in the license conditions. TSOs address collateral requirements for physical trading, and exchanges do so in the case of financial trading.

Costs aside from license fees

The one-off cost of setting up branch is estimated at €20,000, though there are also ongoing costs with maintaining a branch office. As discussed below, the license application must be in the

[12] Item 23 of the Administrative Fees Tariff, a schedule of Act No. 634/2004 on Administrative Fees.

Czech language. Market participants estimate that it costs €2,500 to translate documents from other languages into Czech.

Necessity for signing the Grid Code

To secure an electricity trading license, the applicant must provide a transmission agreement with the TSO, or a declaration of the intent to do so.

Detailed requirements

The information required for the application includes:

(a) An extract from the criminal register;

(b) Last audited annual report;

(c) Proof of funds for five years of operating under the licensed activity;

(d) A five-year business plan.

(e) The nomination of a responsible qualified person.

Documents submitted must be in Czech language legalized (with an apostille) under Czech law. The most burdensome of these requirements is the five-year business plan. However, traders feel that the provision of a business plan is largely a 'box ticking' exercise. The plan is not scrutinised and is not referred to again, and so this requirement does not represent a material barrier to trade. The future direction of the trader need not bear any relation to the business plan and there is no reprimand. Overall traders view the license application process as overly-bureaucratic.

Good behaviour

There are no good behaviour clauses in the license agreement.

Application in national language

The application and reporting must all be carried out in Czech.

Length of application

The license can take from two to four months from the initial application to being issued, including the set up of the branch office. The time frame depends on how complete the forms were when submitted. Applications take more time when the regulators find problems or require more information. While traders appreciate that an incomplete or incorrectly filled application can delay the process, they feel that the Czech licence application is particularly complex and therefore vulnerable to error and delay. Licenses are granted for a minimum of five years, but this may be longer depending on the application.

Combined trading and supply

There are separate licenses for energy trading and supply.

Annual reporting

There are no burdensome ongoing requirements that must be satisfied to retain the license. License holders are obliged to submit reports upon the request by Regulator or other relevant institution.

3.3 Hungary

Relevant Licences

In Hungary, licenses are required for the physical trading of electricity and natural gas. There is a single license for supply and trading gas, but it is possible to get a 'restricted' license for electricity which does not permit the holder to supply. The Hungarian energy regulator, the Hungarian Energy Office (HEO), grants the license. Physical trading requires network agreements with the Hungarian network operator *Magyar Villamosenergia-ipari Átviteli Rendszerirányító* (MAVIR) for electricity and FGSZ (*Földgázszállító ZRt*) for natural gas.

License fees

There is a one-off cost for the license of approximately €16,000. Ongoing fees are then 0.05% of the previous year's turnover. Since the 1st of July 2009 the license is issued for an unlimited period of time.

Branch office

Since the introduction of the restricted trading license for electricity, traders are not required to establish a subsidiary. All that is needed is a representative within the country, to whom the regulator can direct mail, as if the representative were the licensee.[13]

Collateral requirements

Until 1st of January 2008 the license required posting collateral. This is no longer the case.

Costs aside from license fees

There are costs associated with translation of documents from Hungarian.

Necessity for signing the Grid Code

There is no requirement in the license to sign up to the grid codes.

Detailed requirements

<u>*Electricity*</u>

(a) The applicant must provide information on the balancing group which the applicant intends to join or on the establishment of its own balancing group. The Balancing

[13] Removing the requirement to establish a subsidiary has been of benefit to large foreign traders because the minimum capital requirement applied to the subsidiary undertaking the trading, not the parent company. It therefore took a large extra investment to trade.

Agreement with the System Operator must be entered into subsequent to obtaining the trading license.

Natural Gas

The applicant must:

(b) Prepare 'Business Conduct Rules'. These rules detail the terms of any contract required by the licensee's trading activity including contracts concerning technical or commercial aspects of the business, settlement of accounts and payment conditions.

(c) Have a business plan approved by an independent expert;

(d) Have an 'appropriate' independent structure and management to supply natural gas reliably. As we noted above there is no separation between supply and trading in the Hungarian licensing regime for gas;

(e) Provide 'appropriate and qualified' staff for the trading, managing and controlling activities;

(f) Provide the appropriate tools, methods and technology for the trading, managing and controlling activities;

(g) Ensure that it is able to continue licensed activity under extraordinary circumstances, for example a gas supply emergency. Again this requirement seems to relate to supply rather than trading;

(h) Have a data communications and information system described by the Operating and Commercial Code;

The traders consider many of these requirements to be excessively detailed and bureaucratic.

Good behaviour

There are no good behaviour clauses in the license agreement.

Application in national language

The application and reporting must all be carried out in Hungarian.

Length of application

Issuing the license can take from one to three months from the initial application. We understand that the regulator commits to process the application within 90 days after submission to the HEO for a full license. In case of the restricted trading license, the administrative deadline of HEO is 22 working days. Errors in the application process can delay the process. Traders have told us that there the application's complexity creates significant scope for errors, so that in reality the application process can take longer.

Combined trading and supply

The license required for gas and electricity trading combines trading and supply. A "restricted" license is available, which is valid only for trading wholesale electricity and not supply. This reduces the burden on applicants by avoiding applying criteria that are only relevant to supply.

Annual reporting

A range of statistics must be reported quarterly, semi-annually and annually. For example traders must provide:

- Monthly reports on acquired cross-border capacity;
- Monthly report on trading volumes, import/export, prices, costs;
- Quarterly P&L account for Hungarian trading activities;
- Annual report on employee data;
- Semi-annual report on the shareholding structure;
- Annual audited financial statements, balance sheet and profit & loss;
- Annual delivered and turnover in previous year plus a business plan for the subsequent 5 years.

Many of these statistics are collated in a manner that would not normally be done by the trader. Submission is done though a form on the website of the regulator. We spoke to two traders who complained that the form is highly technical and in Hungarian. The regulator does not ask for the data to be presented in any particular way so the traders do not format the data or check its quality. Another trader revealed that the form is not clear on whether the regulator wants the data for trades that are initiated or closed out during the period in question. The trader had never received feedback on any data submitted. The traders felt it unlikely that the regulator could sort the data for all companies, and they questioned whether the regulator reviews the data. Neither trader understands why it is needed. They estimated that about 40 working days per year were spent on preparing data for submissions to the regulator.

Even though it is not clear to traders how the data is used or why it is required, the HEO has indicated that all the data collected is required to carry out its functions of market monitoring and price regulation in addition to licensing. Much of the information is distributed within the HEO which could create the impression that it is not used. Accordingly, there seems to be a problem of perception or communication between the traders and the HEO.

3.4 Germany

No trading licenses are required in Germany, for either financial or physical wholesale trading. For physical trading the trader must enter into balancing agreements with the network operators.

Prior to 2002 the German regions issued licenses to energy traders. Following the introduction of the second gas and electricity directives in Germany, there was no common view on the need for licenses. It was felt that many of the intended functions of the licenses were either

ineffective, or best carried out by other contracts and institutions. Since 2002 it has not been necessary to hold a license for wholesale energy trading in Germany. While it was still required that notification had to be given upon the commencement of trading or supplying, in 2005 this requirement was abandoned for those purely involved in wholesale trading. Currently anyone can trade energy in Germany if they have a willing counterparty.

The national energy regulator asks companies once a year for all trading data in an aggregated format.

However, trading at the European Energy Exchange (EEX) requires a license for the market participant and passing a trader exam at the energy exchange as stipulated in the German Exchange Act and the Admission Regulation of EEX (see Appendix II).

3.5 Spain – Current System

The trading arrangements for electricity and gas are currently undergoing significant change in Spain. In December 2009[14] new laws were approved making several important amendments. Changes to the detailed regulations for trading licensing were implemented in February 2010.[15]

Below we consider the state of the licensing regime under the new regulations. In the following section we then describe the previous licensing regime and its problems.

Relevant Licences

The activity of wholesale trading and/or end user supply is referred to as 'commercialization'. There is no license, but rather a 'notification' procedure. This procedure, created by Law 25/2009, is based on a "responsible communication system" in which the firm that wants to commercialize electricity or natural gas communicates to the *Dirección General de Política Energética y Minas del Ministerio de Industria, Turismo y Comercio* that it has started, or stopped, and that it complies with the requirements of Spanish law. Once the form has been sent the firm can start trading immediately, without waiting for acknowledgement of receipt. This effectively means that the initial requirements are identical to the ongoing requirements.

The new procedure is based on the recommendations of European Directive 2006/123/EC, concerning services in the internal market (although the Directive includes gas and electricity supplies on the list of exempted sectors). As an exemption the Government retains a veto possibility for gas trading companies from outside European Union who do not have TPA reciprocity. The conditions for being a commercialization company in Spain allow the company to

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[14] Ley 25/2009, de 22 de diciembre, de modificación de diversas leyes para su adaptación a la Ley sobre el Libre acceso a las actividades de servicios y su ejercicio.

[15] Real Decreto 197/2010, de 26 de febrero, por el que se adaptan determinadas disposiciones relativas al sector de hidrocarburos a lo dispuesto en la Ley 25/2009, de 22 de diciembre, de modificación de diversas leyes para su adaptación a la Ley sobre el libre acceso a las actividades de servicios y su ejercicio.

Real Decreto 198/2010, de 26 de febrero, por el que se adaptan determinadas disposiciones relativas al sector eléctrico a lo dispuesto en la Ley 25/2009, de modificación de diversas leyes para su adaptación a la ley sobre el libre acceso a las actividades de servicios y su ejercicio.

operate inside the MIBEL. Article 14 of the agreement between Spain and Portugal states[16] that: "The recognition by one of the Parties of the capacity as a participant implies the automatic recognition by the other Party. The administrative procedures regarding the authorization and registration of participants for exercising the different activities in Portugal and in Spain shall be harmonized in accordance with the reciprocity principle".

License fees

There is no direct fee for obtaining the authorisation. There is, however, an indirect fee related to Gas Third Party Access –not trading– that must be paid to *Corporación de Reservas Estratégicas de Productos Petrolíferos* (CORES), which is currently €3.42/GWh of sales. While this is not a direct requirement of the license, the CNE can take the license away if the fee is not paid. Therefore the license is used as a tool to ensure payment of this fee.

Branch office

The legal requirement that the commercialization company has a branch office in Spain was removed in December 2009 by Law 25/2009.

Collateral requirements

Natural Gas

Collateral may be required in the future, but this obligation is not currently in place.[17]

Electricity

It is part of the authorization condition that the company posts collateral with OMEL. The commercialization company has to give three guarantees[18]:

- *Garantía de operación*: This amount is decided by the Market Operator (with the approval of the *Comité de Agentes del Mercado*) and it cannot be less than the maximum purchases that the operator can make over 9 days.[19]
- *Garantía extraordinaria*: This is for payments that were still due to the Market Operator that were calculated under the Royal Decree 1454/2005.

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16 Convenio Internacional relativo a la constitución de un mercado ibérico de la energía eléctrica entre el Reino de España y la República Portuguesa, hecho en Santiago de Compostela el 1 de octubre de 2004.

17 Real Decreto 942/2005 and Real Decreto 197/2010.

18 The exact definition of the collateral is contained in the Resolución de 14 de febrero 2003 de la Secretaría de Estado de la Energía, Desarrollo Industrial y de la Pequeña y Mediana Empresa que modifica la regla 23 de Funcionamiento del Mercado de Producción de Energía Eléctrica. Additionally, the Royal Decree 198/2010, of 26 February, also specifies obligations regarding guarantees.

19 The guarantee due is calculated in March, June, September, and December, using the following procedure. The market operator examines the credit balance and the debit balance of periods of 50 days for the previous two years of operation. The amount of the guarantee is set equal to the maximum value of this series, excluding 10% of the maximum values.

- *Garantía complementaria*: This is an additional collateral requirement for traders that are, for whatever reason, not considered creditworthy. It is applied by the *Comité de Agentes del Mercado*.

The guarantees can be paid via different means, i.e. cash, authorization to use a credit facility, or the transfer of the right to collect the income generated through the sales of electricity in the market. This is not an additional requirement as collateral would have to be posted with OMEL anyway. It merely appears to be a restatement allowing the removal of authorisation if the company does not.

Costs aside from license fees

Costs have been significantly reduced due to the removal of the necessity for a branch office. There remain costs associated with the translation of documents from Spanish.

Necessity for signing the Grid Code

The authorization does not require the applicant to have signed the Grid Codes.

Detailed requirements

To start trading activities for both gas and electricity the applicant has to present the following documents:[20]

- The "Communication form". This must include the company name, address, fiscal identification, and the starting date of trading activities.[21]
- Include a signed statement declaring that the applicant complies with Spanish trading requirements.

The trader must then ensure they comply with all requirements on an ongoing basis:

<u>*Natural Gas*</u>

To uphold the authorisation the commercialization company is obligated to do the following:[22]

(a) To satisfy the requirements in terms of security of supply and in terms of diversification. In particular, these articles require a minimum storage (*existencias mínimas de seguridad*) equal to one day of "firm" sales in Spanish and minimum diversification (maximum import from a single country of 60%).

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[20] Royal Decree 1434/2002 (article 14), amended by Royal Decree 197/2010. For electricity, Royal Decree 1955/2000 (article 73), amended by Royal Decree 198/2010.

[21] As indicated in Royal Decree 197/2010 (gas) and Royal Decree 198/2010 (electricity), the communication form is sent to the General Directorate of Energy Policy and Mining (belonging to the Ministry of Industry, Trade and Commerce). Then this information is forwarded from the Ministry to the Spanish Energy Regulatory Agency (Comisión Nacional de Energía, CNE). The CNE keeps an updated list (one list for gas and another one for electricity) of the commercialization companies in the CNE website. Therefore, the commercialization companies are not obliged to registration. The sole obligation is now the communication of the beginning and cessation of their activity to the General Directorate of Energy Policy and Mining.

[22] Article 81 - Ley 34/1998, del Sector de Hidrocarburos.

(b) To give sufficient guarantees for the payment of access tariffs.

(c) To provide a report to the Ministry of Industry, Trade, and Commerce about the company's past and future operations in the gas sector.

Real Decreto 1434/2002 provides further details concerning the rights and obligations of natural gas commercialization companies. Article 14 of the decree defines the requirements that have to be fulfilled in order to receive the authorization. These criteria cover legal, technical, economic, and of supply capacity.

(e) The commercialization company may not directly operate in re-gasification, storage, transport or distribution.

(f) The company must be able prove the ability undertake the 'commercialization', being the supply or trading of gas. There are two methods available to achieve this. The first option is that the firm be able to present a report that shows the technical resources and employed work force. The second option is to demonstrate that the firm, or a partner of the firm with at least 25% of share capital, has been distributing or selling natural gas or electricity for at least 3 years. The law does not specify whether this criterion refers only to Spain/EU experience or to experience in other countries.

(g) The firm must be able to demonstrate its ability to satisfy demand in normal conditions. It must show, first, that it has signed enough contracts with gas suppliers (or pre-contract agreements, or guarantees of supply).

(h) The company must obtain insurance to cover the risk related with the commercialization activities.

Electricity

The following requirements have to be met to keep the authorization to trade electricity:[23]

(a) The company cannot operate directly in the regulated operations of the electricity sector (transportation and distribution).

Good behaviour

The conditions for both natural gas and electricity authorisations contain good behaviour clauses.[24] Serious infringements listed include:

- Fraudulent manipulation of prices and quantities of gas sold;
- Applying incorrect prices or access tariffs that are higher at least by 15% and that create total damages of at least €300,000;
- Avoiding inspection by the Ministry or national energy regulator;

[23] Article 4 - L*ey 2019/1997.*

[24] Natural gas: Article 109 - Ley 34/1998, del Sector de Hidrocarburos. Electricity: Article 60 – Ley 54/1997.

- Repeatedly avoid sending annual information;
- Not following the instructions of the system operator;

If the trader is found guilty of any of the infringements above it can be fined up to €30 million.

Application in national language

The application and reporting must all be undertaken in Spanish.

Length of application

With the introduction of the new licensing regime the applicant can begin trading as soon as the necessary forms are filed, and the trader does not have to wait for any form of approval. As the system is new no trader had direct experience of how long is required to get the forms in order. It is likely to be a short period of time.

Combined trading and supply

In Spain there is a single license for wholesale trading and supply for both gas and electricity.[25] However, wholesale gas traders can apply for a restricted license which exempts them from a number of requirements associated with consumer protection.

Annual reporting

Natural Gas

For natural gas there are monthly reporting requirements. The trader must submit a monthly report on gas trading activities (transported volumes, booked capacities, prices, downstream portfolio structure) to CORES[26], the Industry, Trade and Commerce Ministry and to the Spanish regulator, CNE. In addition, each year the firm will have to send to the Ministry a report that explains the volume of sales reached in the last 5 years, and a forecast of sales of natural gas in the next 5 years[27]. Furthermore, it will have to present a report on the operations during the previous year, as well as the two previous years' independently audited balance sheets. Finally, the authorizing body can ask for any other document to prove that the requirements have been met. These documents must be translated into Spanish, and sent to the Ministry of Industry, Trade, and Commerce.

Electricity

There are no reporting requirements for electricity trading.

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[25] The commercialization of natural gas is regulated under law 34/1998 (*ley de hidrocarburos*), Royal Decree 1434/2002, and the Royal Decree 942/2005, amended by Royal Decree 197/2010.

For electricity this authorization could be given only when the firm respect the rules identified by law 54/1997, by Royal Decrees 2019/1997 and 1955/2000 (amended by Royal Decree 198/2010), by the *contrato de adhesion* of OMEL, and by the *Resolución de 14 de febrero 2003 de la Secretaría de Estado de Energía*.

[26] CORES stands for "*Corporación de Reservas Estratégicas*" (Strategical Reserves Corporation).

[27] Article 14, Real Decreto 1434/2002.

3.6 Spain – Previous Regime

We have included a description of the previous regime, both because the change in the regulatory regime is so recent, having occurred during the preparation of this report, and because it is interesting to highlight some of the problems with the previous regime. This can provide some guidance as to the issues that an EU energy trading should avoid.

Relevant Licences

As in the current system, a firm wishing to trade had to gain authorisation from the *Dirección General de Política Energética y Minas del Ministerio de Economía* or from the relevant Autonomous region. Aside from the technical requirements detailed below, the difference was that the authorisation had to be granted by the ministry before the firm was allowed to trade.

License fees

The fees are identical to those in the current regime.

Branch office

The legal requirement asked that the commercialization company had a permanent establishment (*establecimiento permanente*) in Spain. This means that the company had been operating through offices or representative in Spain for a period of time longer than six months.[28]

Collateral requirements

Natural Gas

The company was required to prove its financial viability, in particular that its financial assets will be able to cover its likely scale of activities. The Spanish company was required to have issued and fully paid-up share capital that was greater than the larger of the following amounts:

(a) 2,000,000 euros;

(b) 1% of the average of the last two years sales.

In addition to this there was a requirement for a guarantee on the payment of the network access tariff. The company had to guarantee an amount that was equal to 85% of the fixed part of the access fee multiplied by the contracted quantities.[29]

Electricity

The collateral requirements were identical to those of the current regime.

Costs aside from license fees

There were significant legal fees and ongoing fees related to having to set up and maintain a branch in Spain, as well as translation of documents into Spanish.

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[28] For natural gas - Article 14 - *Real Decreto 1434/2002.* For electricity Article 73 - *Real Decreto 1955/2000.*

[29] Real Decreto 942/2005.

Necessity for signing the Grid Code

The authorization did not require the applicant to have signed the Grid Codes.

Detailed requirements

Natural Gas

To apply for authorization, the company (the Spanish branch in the case of a multinational firm) had to present the following documents:

(a) Proof that it belonged to the *Registro Mercantil* (i.e. that is a corporation);

(b) Proof that the firm had paid its taxes (*Impuesto de actividades económicas*);

(c) Accreditation of its legal, technical and financial capacities;

(d) Descriptive report on the medium-term forecast of its activities;

(e) Note on where the firm wants to commercialize natural gas;

(f) Report on capital and loans that will be used in order to finance the activity;

(g) Report on contracts, pre-contract agreements and guarantees of supply.

Furthermore, the competent body (*Dirección General de Política Energética y Minas del Ministerio de Economía* or Autonomous Region's body) was authorised to ask for any complementary document to prove the financial, technical and legal requirements.

The requirements to maintain the authorization were identical to those of the current regime.

Electricity

The following requirements had to be met to both obtain and keep the authorization to trade electricity:[30]

(a) The company cannot operate directly in the regulated operations of the electricity sector (transportation and distribution).

(b) To be registered into the *Registro Administrativo de Instalaciones de Producción de Energía* or in the *Registro Administrativo de Distribuidores, Comercializadores y Consumidores Cualificados.*

Good behaviour

The good behaviour conditions were the same as those of the current regime.

Application in national language

The application and reporting requirements had to be undertaken in Spanish.

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[30] Article 4 - L*ey 2019/1997.*

Length of application

Natural Gas

When the company had complied with all the requirements explained above, it requested to be listed in the *Registro de Distribuidores, Comercializadores y Consumidores Cualificados*. The competent body then had 3 months to decide; if no decision is taken, the authorization was considered to have been denied. Traders estimate that the process took approximately six months overall. The authorization was then valid for an indefinite period.

For natural gas the authorization could be revoked under three possible circumstances:

(a) If the subject does not comply with the criteria for being granted a license;

(b) If the company does not exist anymore

(c) If the firm does not sell natural gas for a continuous period of two years.

Electricity

In order to be able to commercialize electricity, the agent needed to be inserted in the *Registro administrativo de distribuidores, comercializadores y consumidores cualificados* which is maintained by *Dirección General de Política Energética y Minas del Ministerio de Economía*. In order to achieve this, the company had to first enter a period called *inscripción previa*. This period could last a maximum of six months and during this time the company had to satisfy the above conditions. When the firm satisfied the above conditions, it was inserted indefinitely in the register (*inscriptión definitiva*).

For electricity a commercialization firm that does not buy electricity for a period of one year lost its authorization.

Combined trading and supply

The Spanish legal system did not issue separate licenses for physical wholesale trading and sales to final customers of electricity and natural gas.

Annual reporting

The reporting requirements are identical to those of the current regime.

Main concerns with the old regime as expressed by traders

There were several problems recognised with the old system. First, the original laws for electricity and gas defined authorization processes that were not standardized, and that left significant room for discretion as well as delays. For instance, the legislation required compliance with technical conditions that were described only vaguely. This situation created problems for foreign or even Spanish firms that wished to enter the Spanish market. Consequently, a new entrant may have been denied the authorization even though it considers that the obligations of its country are more than enough to prove its technical capacity. In order to avoid this situation, a new commercialization company had to hire (or obtain advisory services from) former employees of Spanish commercialising companies, which can be time consuming and expensive.

Second, the authorization process could have taken up to nine months – six months to obtain the permanent establishment of the firm or *establecimiento permanente* plus up to three months for the concession of the authorization.

Third, and as mentioned above, the authorization process previously did not distinguish between traders and companies supplying final customers. For this reason a company that wished to sell physical gas/electricity in the wholesale market to another company was required to satisfy the same requirements as a firm that sells electricity to final retail customers. This imposed a disproportionate burden on wholesale traders in Spain.

Fourth, and a likely related problem, was that the authorization process required commercialization companies to provide guarantees that may have been excessive for "small" wholesale traders. For example requirements in the physical natural gas market were based on a "minimum capital system". The dimension of these requirements can be so onerous that small players were not willing to operate in the market. Therefore, onerous capital requirements can reduce the number of operators and, consequently, market liquidity. In addition, the minimum capital requirements were based solely on accounting data. This can suffer from evaluation problems; as several financial crises have shown, assets on the balance sheet may have a higher value than can be realized because the market in which they can be sold is very illiquid.

3.7 Norway

Relevant Licences

A concession is required to trade physical power in the wholesale market called "Omsetningskonsesjon". The authority is called Norges vassdrags- og energidirektorat. The concession is required if you want to trade in Norway at the exchange or OTC.

In Scandinavia over 70% of the physical market is traded via the exchange Nord Pool Spot. The financial market is 50 % traded OTC, 50 % via the exchange.

License fees

There are no ongoing fees and no fees required for renewal.

Branch office

A branch office is not required. The company only has to be registered in the Register of Business Enterprises or the Central Coordinating Register for Legal Entities.

Collateral requirements

There are no collateral requirements as part of the concession.

Costs aside from license fees

There are no burdensome costs.

Necessity for signing the Grid Code

There is no requirement to sign up to the grid codes.

Detailed requirements

No detailed information is required.

Good behaviour

There are no such clauses in the concession. Manipulative trades or insider trading are covered by the Nord Pool Spot rule book. The licence can be withdrawn when the company has provided false information when applying for the licence in the first place or if the Norwegian energy law is breached.

Application in national language

The application and annual reporting must all be carried out in Norwegian. It's stated in the license that all communication between the licensee and the licensing authority should be carried out in Norwegian or other language that do not cause additional work for the authorities. It's thus accepted that the initial periodical reporting from new companies are done in English.

Length of application

A license is granted for 5 years and can be prolonged easily. The prolongation is done via an internet based registration tool, and takes less than a day. A trader stated that to gain access to this tool is not straight forward for non-Norwegians. Non-habitants must first acquire login credentials to the central Internet portal for public reporting. To save time and expenses they have used a Norwegian consultant, which adds extra expense.

Combined trading and supply

There is a combined license for trading and supply.

Annual reporting

Special reporting requirements apply to new companies. Every six months for the first 18 months, volumes and prices of imports/exports and domestic transactions must be reported to the regulator. It is estimated that to collate the relevant information takes approximately one day. Further the authority needs to be informed of mergers, major acquisitions or substantial changes to a companies' business. Traders have not complained of overly burdensome reporting requirements.

3.8 The United States

To provide some contrast to trading arrangements in the EU, the CEER have also asked us to give a brief overview of the licensing regime in the US.

In the US, parties wishing to trade wholesale electricity must obtain a Power Marketing License from the Federal Energy Regulatory Commission (FERC). There is no FERC license required for gas trading. However, it is important to understand that the US licensing regime is primarily focused on the prevention of market power abuse – essentially the licensing regime is an instrument of competition policy. There is nothing in the licensing process to check the 'quality' of traders, to check their competence to trade or their likelihood of bankruptcy.

To obtain a trading license, vertically-integrated traders who also own generating assets[31] must show that they do not have the incentive or ability to exercise market power. FERC has developed a number of standardised but sophisticated tests to ascertain whether a party can quality for a Power Marketer License and charge so-called 'market based rates'. Parties that fail this test would not be allowed to trade wholesale power, and would sell their power at regulated rates. This situation is in stark contrast to the EU, where the market is liberalised, and parties are assumed not to be abusing market power unless the authorities can prove otherwise. In the US the burden of proof is reversed, and parties must prove that they do not have the incentive and ability to exercise market power before being allowed to trade.

For a party that does not own generating assets, obtaining a Power Marketer License is relatively straightforward. Essentially the applicant must declare that it does not own or control any generating assets. Once a party has obtained a Power Marketer License, there are a number of ongoing conditions which apply. License holders must:

- Submit Electric Quarterly Reports to the FERC, which gives details of their trades.[32] Specifically, license holder must summarize the contractual terms and conditions in their agreements including power sales and transmission service and transaction information for short-term and long-term power sales during the most recent calendar quarter;
- Inform the FERC of any change in their status, including the acquisition of generation or transmission assets, or affiliation with any entity owning or controlling such assets;
- Notify the Commission of seller name changes, if the seller merges with another entity;
- Notify the Commission if any officers or directors are (a) an officer or director of more than one public utility, (b) an officer or director of a public utility, any bank, trust company, banking association, or firm that is authorized by law to underwrite or participate in the marketing of securities of a public utility, or (c) an officer or director of a public utility and of any company supplying electrical equipment to a public utility.

Essentially, the main condition is the requirement to report transactions data every quarter – the stated purpose of this reporting requirement is primarily for market monitoring purposes. The FERC's Power Marketer License does not contain any requirements regarding collateral, or require the trader to provide any financial information about the trader.

As in the EU, parties that do set down limits on collateral and credit in the US are the market Operators or MOs. The MOs organise and act as clearing houses on exchanges for balancing power, day-ahead power, Financial Transmission Rights and other power-related

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31 Or control generating assets under long-term contracts.

32 FERC (Federal Energy Regulatory Commission) Revised Public Utility Filing Requirements, Order No. 2001, 31043, ¶ 61,107. Docket No. RM01-8-000.

products. However, the MOs do not impose any collateral requirements on bilateral trades carried out outside of the MOs exchange.

3.9 Summary of trader's views on licensing regimes and issues

We interviewed traders from key institutions to obtain a full and candid description of their feelings about the current state of regulation throughout the EEA, and how they believed future regulation should be structured to lower barriers to trading while encouraging market liquidity, minimizing risks of market failure, and preserving security of supply.

To encourage trust, candour and full disclosure, we promised that we would not attribute any particular view to any particular person or trading organization without their express permission. However, we found a remarkable level of common agreement about which issues needed resolution in order to improve markets, and about the most desirable solutions. Consequently, discussing the key issues in general terms rather than with reference to any particular trading group does not compromise the summary.

"Ease of Trading"

Below we organise the analysis of the trading regimes around a number of questions. The questions themselves focus on which regimes are most likely to encourage market entry by traders with the goal of producing an 'ease of trading' characterisation of the markets. Accordingly, *this characterisation represents very much the views of the traders interviewed*. We recognise that elements of the license that discourage entry may nevertheless be required. We will discuss the necessary elements of the license in the later sections of the report.

The survey is focused on the requirements for obtaining licenses for physical trading, rather than financial trading. While there is no universal definition, physical trading is generally taken to mean contracts for delivery within about 30 days, and where the contract specifies that the commodity should be delivered to the other party (rather than settling the trade financially). However, we note a separation between the licensing of physical and financial traders is somewhat artificial. License requirements for physical electricity and gas trading affect even market players who are notionally financial traders. For example some traders may prefer to close out their physical positions prior to deliver, but illiquidity in forward markets means that this is not always possible at a reasonable price. Accordingly, even notionally financial traders tend to hold licenses that enable them to take physical delivery. In the UK about half of the financial electricity traders have supply licenses and all the gas financial traders have shipper licences.

- *License fee – based on trader turnover?* We have found that there seem to be essentially two types of charging philosophies for licences – 'cost-based' and 'revenue-based'. Cost-based licenses are designed to either cover the cost of issuing the license, or else the cost of the energy regulator. Revenue-based license regimes apply a fee according to a trader's turnover, and act in a similar way to a tax. Cost-based licenses – which tend to be lower – are more likely to encourage market entry.

- *Branch office required?* Some Member States require traders to open a branch office, either as an explicit condition of the license or as a *de facto* condition of local commercial law. Opening a branch office is a major impediment to entering a new market. It entails both one-off set-up costs, and ongoing costs associated with reporting,

accounting and transfer pricing. We give more details of the requirements and their background in the specific country sections.

- *Significant collateral requirements?* Some license regimes require traders to hold significant amounts of collateral, which are in excess of what a counter-party would normally demand. This could deter traders from entering the market.

- *Cost of obtaining license high?* This refers to costs other than the license fee, which is dealt with separately. Costs could include the need to hire local lawyers, or to hire local staff specifically to deal with the licensing process.

- *Requirements to sign up to the grid code?* Some licenses requires traders to sign up to the grid code. While those traders contemplating physical delivery to a distribution grid would in any case sign up to the grid code, this question is more an issue of timing and necessity. Given that traders will in any case sign up to the grid code, it should not be required to have this as a condition for obtaining a license. Doing so could lengthen the time required to obtain a license unnecessarily.

- *Highly detailed requirements?* This refers to issues like the requirements to prepare a business plan etc. Such burdens make less likely for new traders to enter the market.

- *Good behaviour clause?* The license could include conditions which forbid market abuse or manipulation. While of course traders should not object to avoiding market abuse, the issues are of duplication of other controls on anti-competitive behaviour, and excessive discretion by the regulator.

- *Application in a national language only?* Traders have made clear that they regard application processes that are only available in a language other than English, French or German as representing a burden to them and a barrier to entry. Traders would prefer that all applications be available in English, and that rules relevant to trading be published in English as well as the local language.

- *Length of application – more than two months?* A long application processes tends to be associated with high costs.

- *Only combined trading and supply license?* Combined trading and supply licenses impose requirements on that are not relevant to wholesale energy trading.

- *More than annual reporting required?* Traders have told us that they do not mind reporting data to the regulator, but would prefer to keep this to an annual report in a format that does not change from year to year.

These questions reflect the main issues that have surfaced during our interviews with traders, and we use them to summarise our findings in a 'traffic light' diagram in Figure 3. A red symbol in our traffic light summary means that the regime is less likely to encourage market entry by new traders. A green symbol means that the regime is more likely to encourage market entry by new traders. Where the answer is more mixed we use an orange symbol. We have also adjusted the height of the cells to represents the importance of each answer. For example, the requirement to open a branch office is seen by traders as a major impediment to establishing trading operations in a new area. Accordingly we give that question more weight. Other issues – for example the

requirements to sign the grid code before obtaining a license – are seen more as being illogical, but are not a significant entry barrier. We therefore give these issues less weight and a lower height/area in the diagram. For most issues the answers for gas and electricity are the same, but in the few instances where they differ we indicate this with a split answer and a G to indicate the gas sector and an E to indicate the electricity sector.

Figure 3: 'Ease of trading' summary of licensing regimes in the countries investigated, according to the traders' viewpoint

In general, all traders were positive about the UK and Germany. The general consensus was that the UK had well-developed markets in gas and electricity with regulatory systems that were not overly burdensome.[33] The view of a number was that the UK should serve as a model for such markets throughout the EEA.

The Criteria for Obtaining Licenses

In the survey, Germany clearly stands out as an exception, because it has no requirement for a trading license. Interestingly, Germany abandoned its licensing regime because it felt that previous attempts to control the quality of participants were ineffective. License conditions failed to detect the problems with Enron's trading business. All traders interviewed favoured the German approach of not requiring licenses to trade. However, they pointed out that the German markets are relatively new compared to the UK and further development would be needed to achieve the ease of trading offered in the UK, especially in gas.

In Germany, it appears that many of the functions that a trading license currently fulfils in other Member States are met either by the requirements of other institutions, or by existing or forthcoming European legislation. For example terms and conditions for access to the gas network allow the TSO to perform a credit worthiness check on the shipper, and the shipper is obliged to provide the network operator with the information required to carry out this check. The agreements with the TSOs also largely deal with security of supply issues surrounding physical wholesale trading. As in most Member States, the TSOs require the counterparty to the network agreement to post collateral to cover imbalance costs. The collateral is proportional to the value of energy transported over the network. In the event that the trader goes bankrupt or is unable to deliver the promised electricity or gas, the TSOs have a 'provider of last resort' function, and will take responsibility for delivering the missing energy, using the trader's posted collateral. These arrangements have been 'stress tested' to a degree during the bankruptcy of Enron and TXU, though we understand that the bankruptcy of Enron in Europe was more orderly than might have been the case. While there is no license requirement to do so, the regulator asks German companies once a year for all trading data.

Norway is a jurisdiction more relevant to electricity trading than gas. Most electric power in Norway is provided by water power. There is no significant wholesale market for gas, even though Norway is home to Statoil one of the world's largest gas producers and traders. Electricity relevant to Scandinavia is traded in Norway through Nordpool. Traders were generally happy with the way that market was conducted.

Our survey also highlights that in some Member States, there is confusion between supply and wholesale trading, and this has introduced unnecessary burdens on wholesale traders. For example, in several CEE Member States, the license conditions were developed with a view to regulating the supply of customers. Wholesale trading was not envisaged. Accordingly not all the license requirements seem relevant to wholesale trading. In Spain there is no separate license for wholesale trading and supply for electricity – a separate license was introduced for gas in February 2010 gas. Prior to February 2010, wholesale traders who imported more than 7% of total gas into

[33] However, there are some concerns that the UK electricity market in particular could be more liquid. However, traders did not raise this in their discussion of the licensing regime and trading arrangements.

Spain faced obligations such as the requirements to ensure a sufficient diversity of gas supply sources, specifically that no more than 50% of the gas supplies comes from Algeria. This requirement seemed only relevant to the supply of end users, rather than for trading.[34]

In Hungary there is no separate license for wholesale gas trading and supply, and traders must demonstrate that they can pursue their licensed activity – trading – under extraordinary circumstances, for example a gas supply emergency. Again, this requirement seems only relevant to supply, rather than trading.

Some traders have suggested eliminating licenses for *trading* wholesale gas and electricity, focussing instead on supply only. The traders perceive three significant advantages. Absence of a license would avoid the imposition of expensive and sometimes anticompetitive conditions on traders from outside the jurisdiction. Second, it would avoid creation of an 'additional' and either overlapping or inconsistent licensing system which occupies, certainly with respect to the financial derivatives trading, the same regulatory space as the financial regulation created by MiFID and the regulations under that directive. If no country imposed licenses, there would be no risk of inconsistencies among different countries. Finally, this solution would reduce the burden on National Regulatory Authorities (NRAs). It would avoid the necessity of setting up complex licensing system to approve licenses, oversee consistent implementation throughout the EEA, and police the enforcement of trading conduct under such licenses. Traders said that once the need for licensing of trading is abolished by appropriate legislation, the regulatory burden both nationally and internationally would be significantly reduced from its present state; markets would be more open to entry, which should improve liquidity and price discovery.

Administrative Requirements

The more recent accession of Members States in the CEE has also created extra requirements in some cases. Before joining the EU, countries in the CEE would require traders to establish a branch office or even a full subsidiary before they could obtain a trading license. This created a significant cost, and the unanimous view of the traders we surveyed is that this requirement should be eliminated. The traders saw the requirement to open a branch office as a way of imposing competitive disadvantages on non-domestic traders by making them bear the costs of establishing and maintaining a local presence.

Traders pointed out that the subsidiary had to sign new trading contracts with counterparties. If a company wants to move electricity from one country to another, it must sell from its local branch and buy from another branch. This creates accounting, tax and transfer pricing issues. Traders report that even after EU Membership, there has been some confusion as to whether a firm needs to establish a branch. For example in the Czech republic we understand that the way the license procedure is set up means that in practise it can be difficult to obtain a license without a branch in the country, even though this is not a specific requirement of the license. Spain was a

[34] We understand that this is also an issue in Italy where there is a requirement in the gas market to prove the source of the gas being offered. This makes it very difficult for traders which source their gas from hubs that takes gas from several jurisdictions.

founding member of the EU, and yet until February 2010 required traders to set up a branch in Spain. New legislation has eliminated this requirement.[35]

Ongoing Requirements

Reporting requirements are another common source of complaints among traders, especially in CEE countries. Hungary was singled out as having burdensome reporting requirements. We understand that traders do not mind reporting trading data to the regulator, but the issue in Hungary in particular was the frequency with which data must be provided and the volume of data required. Traders saw no evidence of what the data was used for, and doubted the point of the exercise which consumed about 40 working days per year. Traders also noted that other Central and Eastern European jurisdictions such as Poland and Romania posed problems such as requiring a local presence, proving a viable business plan, paying local taxes, or taking examinations in the local language. These kinds of things added to the costs of doing business in such jurisdictions and made international competition difficult.

In general, the traders we interviewed thought it was a good idea to improve market transparency. It was expressed to us that this would "level the playing field" between the parties by equalizing the information available to all.

None of the traders have any objection to making their trading records available to any of the responsible regulators within EEA. However, they would prefer that the records be made "available on request" rather than requiring reporting to be done on a regular basis to each separate regulator. The costs are seen as too high. Objections to providing regular reports to a central reporting system are not so strong.

MiFID-type Passport

A system whereby a trader that is permitted to participate in the wholesale gas and electricity markets in one EEA state would be permitted to conduct similar activity in any other EEA state, without additional "licensing" or "authorization" requirements is favoured by all parties that we talked to.

However, traders are not in favour of creating a separate "energy passport". Market participants do not wish to have to qualify for another passport that is governed by a separate set of regulations. All of the traders that Skadden interviewed are already regulated by the financial regulator of their home state in order to permit them to trade commodity derivatives. Consequently, it would be easiest for them if the current passport available from such authorization were simply extended to cover all trading in the wholesale energy markets. One solution may be to extend the MiFID passport to cover both physical trading and trading in commodity derivatives. However, we explain in section 5.2 why we are not in favour of this solution.

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4 Analysis

4.1 Scope of a license

As we described in the introduction to this report, having analysed the existing license conditions we then break the possible elements of a license into three sub-categories:

- License conditions that are not required – these are license condition that do not address a market failure and do not seem to serve any purpose;
- License conditions that are desirable, but are addressed by other institutions.
- License conditions which address market failures – for example the requirements to keep and present trading records.

In this section we describe the license conditions that fall into the first two categories – these are license conditions that are not required, or are desirable, but are addressed by other institutions. In the following sections we describe license conditions which address market failures.

4.2.1 License conditions that are considered not to be required

Screening for Qualified Applicants

In general, the license should not attempt to 'quality control' applicants, in the sense of making sure that they will be successful traders in the market and are generally 'up to the job'. This is because the applicants themselves are already highly incentivised to trade successfully, since they will lose their investment in the firm if they fail.

It is highly doubtful that any requirements at the time of the license application would be successful in screening out candidates that are likely to fail in the market at some point in the near future. The creditworthiness of market players can change rapidly in a way that license conditions cannot keep track of. Other market parties are both better incentivised and have more effective instruments to monitor the financial health of potential traders in the market. For example, the standard EFET trading agreement contains provisions which require a market party to increase its collateral if its financial position deteriorates. TSOs, exchanges and clearing houses have similar requirements. We note that license requirements designed to ensure the financial health and quality of market participants failed to spot the bankruptcy of players such as Enron and TXU. However, the mechanisms applied by the counterparties were also not able to alarm the market on these developments.

The requirement for demonstrating competence and financial health may stem from the relevant authorities' desire to protect consumers against incompetent and insolvent firms. While this desire is understandable, there are already measures to protect consumers in the event of insolvency. For example, TSOs typically require users of the network to post adequate collateral so that their supply obligations (to other traders) can be met in the event of bankruptcy. As we note above, the license covers wholesale trading rather than supply to end users. End users will often already have protection by the TSOs role as a 'provider of last resort'.

We conclude that requirements to demonstrate the competence of the firm's managers and the financial health of the firm are largely unlikely to be effective and impose an administrative burden on the applicant that could dissuade market entry.

Based on the above reasoning, we recommend that applicants are *not* required:

- To demonstrate that the employees of the firm are skilled at trading. Firms are unlikely to deliberately employ incompetent managers, because they will suffer if the managers fail. Later in this report we explain that it is legitimate for the license to establish that relevant employees of the firm are able to carry out their compliance duties, guard against fraudulent behaviour and so on. However, this is not the same as establishing that employees are able to trade successfully;
- To present a business plan – the regulator should not decide whether to issue trading licenses based on the expected profitability of the applicant;
- To demonstrate a minimum level of capitalisation or post any collateral requirements;
- To undertake examinations, for example a trading examination. The relevant exchange can organise exams if it thinks they are required;
- To establish a branch office in the country – however, such a requirement is in any case counter to European law;
- Any other requirements related to the competence of the applicant's staff.

Security of Supply

One possible purpose of a license could be to maintain system security of supply, by blocking 'irresponsible' parties from the market and laying down minimum standards of behaviour.

System security could be threatened by unexpected imbalances – for example a trader failing to deliver a large volume of gas or electricity. This could make it difficult for the system operator to balance the system. This of course means that financial trading and trading in derivatives will not threaten security of supply, since these trades are settled far in advance of delivery or do not involve physical settlement at all.

On balance, our review indicates that security of supply considerations could best be dealt with via existing requirements in network codes. Network operators have the best incentives to develop both the criteria for who can use their networks without threatening supply security and laying down standards of behaviour with respect to use of the network. These for example relate to nominating flows in advance, and paying imbalance or nomination penalties if planned and actual deliveries or receipts deviate from reality. Network operators have to deal with the immediate consequences of any imbalances or threats to security of supply, and have a sophisticated and dynamic view of the sorts of behaviour that is required from network users. It is standard for example for network agreements or network codes to require that network users follow the instructions of the TSO in the case of a declared network emergency for example.

Some of the security of supply requirements that we have seen in existing licenses seem to stem from concerns regarding the supply of end users and small users and households in particular.

For example Spain has a combined gas supply and trading license which lays down requirements that license-holders source gas from several diverse sources. We imagine that this requirement is intended to improve security of supply for the supply of small customers. However, this is not relevant to wholesale energy trading. Wholesale energy traders already have good incentives to ensure that they can deliver their promised gas volumes, because otherwise the trader will be short and may have to pay expensive imbalance costs, or the counter party may have a right to liquidated damages. Moreover, on a trading exchange with anonymous trading the license-holder cannot know where the gas came from. Meeting 'diversity' requirements is not possible with exchange based trading, and these requirements could even hold back development of energy exchanges. We recommend that the energy trading passport not contain any provisions relating to security of supply, and that security of supply considerations and requirements are instead laid out in network use agreements.

4.2.2 License conditions better covered by other institutions

Collateral requirements

One of the possible functions of a license is to provide a 'quality' control on which parties are allowed to trade in a country. In principle this is to ensure that irresponsible, incompetent or criminal traders cannot operate in the market to cause harm or threaten the security of supply.

One potential current market failure is that parties trading bilaterally OTC can determine their own collateral requirements. There is currently a debate whether there should be more control over collateral requirements, to avoid similar problems to those witnessed in the financial markets. Some parties worry that an under-collateralised energy trader might become 'too big to fail' and require public funds to rescue t them. A license could potentially be a tool to specify collateral amounts. However, we do not recommend this for several reasons.

First, it will be more effective to place responsibility for checking collateral requirements on a party who has a direct interest in the quality of the checking procedure. A counterparty has a direct interest in a trader having sufficient collateral to cover a trade, because it is the counterparty that would suffer if the trader went bankrupt.

Second, different parties have different collateral requirements. A counter party will generally be interested in collateral that covers the margin on outstanding trading position. In contrast TSOs, who are responsible for managing the networks, are concerned that network users behave responsibly and have sufficient collateral to cover any imbalance costs in the event of bankruptcy. These two amounts of collateral will be different, and it would be difficult for a licnese to distinguish between the different types of collateral required. As described in Appendix I, organised exchanges and in particular clearing houses have sophisticated rules regarding the posting of collateral and credit. In contrast a regulator or Ministry has a less direct interest in these issues, and therefore has a weaker incentive to carry out effective checks, or even to know which are the most appropriate checks to perform. The collateral requirements in a license would be static and ill suited to the reality of a trading world where collateral requirements are highly dynamic.

We also note that imposing collateral requirements via a license condition would go further than the current proposals on regulation of OTC trades. These proposals only seek to impose collateral requirements on OTC trading of standardised products. Putting collateral requirements in

a trading license would also impose standards on non-standard products traded OTC. In sum, existing institutions and trading arrangements are a better mechanism for setting collateral requirements than a license.

Bankruptcy

An energy regulator with the power to grant and restrict trading licenses will need to be in a position to decide, at some point, that the bankruptcy process so interferes with a party's ability to make reasonable trading decisions that the party's trading license should be suspended or cancelled.

One thing to consider is the fact that the variation in the way that the bankruptcy process is dealt with from country to country makes it impossible to be too prescriptive about the standard to be applied when determining whether bankruptcy procedure has interfered sufficiently with the trader's business to allow that trader to continue to transact wholesale energy business. Consequently, it will be better to use a standard that will allow all license granting energy regulators to monitor a firm's ability to transact business if that firm is in a bankruptcy process or close to being so. Of course, we also recognise that other market mechanisms will interfere with the trader's ability to conduct business if it is close to bankruptcy. As described elsewhere, both bilateral contracts and agreements with exchanges contain provisions to increase the amount of collateral posted if a firm is in financial distress, or alternatively allow the counterparty to cash out its positions with the distressed party. These other 'protection' mechanisms are likely to come into play before the regulator withdraws the license.

One standard that permits the necessary flexibility across all EEA jurisdictions is the so-called 'Fit and Proper' standard. If the relevant licensing regulations permit the regulators to continually monitor the fitness and propriety of licensed traders to continue in the wholesale energy trading business, that gives regulators the power to find that, at any point where a trader's business is severely restricted by a bankruptcy process, the trader is no longer "fit" to continue to conduct the business in the same way. The "Fit and Proper" standard also gives regulators flexibility to moderate how they will treat the continuation of a trader's business over time in light of a trader's changing financial situation.

Such a standard should be usable throughout the EEA regardless of local bankruptcy law. However, regulators should be aware that they may need to examine their relationship to their national government in order to be certain that they can apply that standard as effectively as they may need.

4.2.3 License conditions addressing market failures

As we defined in section 2.1, in the context of this study, a market failure means that the unregulated behaviour of market participants does not lead to a socially desirable outcome.[36] We see two potential market failures that existing institutions do not address:

[36] We do not define problems such as a lack of harmonisation as a market failure, because this is an issue of market design – it is not a consequence of the behaviour of the market participants.

- Information asymmetry between regulators and market participants, in particular the failure of market participants to provide sufficient record keeping and transaction reporting;
- Market Power – Market participants abuse of market power, committing fraud, insider trading etc.

We note that these issues are closely related – the detection and prevention of the abuse of market power depends heavily on the level of transaction information available to regulators and other authorities.

We also note that there already is in force, or proposed, a significant number of EU directives and regulations which address issues regarding transaction reporting and market power. We analyze aspects of the legislation that can apply to the regulation of the wholesale gas and electricity markets, and identify significant gaps which may need to be addressed by a trading license.

4.2.3.1 Record Keeping and Transaction Reporting

"Record Keeping" and "Transaction Reporting" describe two different types of activities. "Record Keeping" refers to the preservation of details about trading transactions in some durable recorded form, but does not by itself imply any obligation to do anything specific with those records. "Transaction Reporting" refers to the periodic transmission of certain information about trading transactions to third parties.

In January of 2009 ERGEG and CESR published advice to the European Commission on how to foster fair electricity and gas trading. These proposals included advice on record-keeping, transparency and exchange of information. Transaction reporting was not included in the mandate for the advice. They recommended that all EU trading platforms publish harmonized post-trade information, on a trade-by-trade basis in close to real time for standardized electricity and gas supply contracts and derivatives traded on or cleared through these platforms.

Record Keeping

With respect to Record Keeping, there appear to be sufficient existing regulations in place to assure preservation of key information about both financial and physical wholesale gas and electricity contracts which would enable national regulators to access information needed to monitor market transactions. Table 1 below summarises the coverage of the existing legislation with respect to record keeping.

Table 1: Existing legal requirements with respect to record keeping

Legislation	**Requirements with respect to record keeping**
Article 44 and Article 40 of the Third Gas Directive and Third Electricity Directive respectively.	Regulators shall require that relevant data relating to all transactions and gas and electricity supply contracts and derivatives with wholesale customers, transmission system operators, storage operators and gas and electricity production systems be preserved and made available to relevant regulators for at least five years. A number of specific details are required including, duration, delivery and settlement rules, quantity, transaction prices, execution details,

Legislation	Requirements with respect to record keeping
	and identity of customers with respect to all unsettled gas and electricity supply contracts and derivatives must be kept.
MiFID and implementing instruments	MiFID related record keeping obligations apply to: • Derivative contracts which have the following underlying assets: commodities, climactic variables, freight rates, the missions allowances, commodity storage capacity, transmission or transportation capacity relating to commodities, allowances, credits, permits, rights or similar assets directly linked to the supply, distribution or consumption of energy derived from renewable resources, and an index or measure related to the price, value or volume of transactions in any asset, right, service or obligation. • Any physically settled energy contracts that are traded on a regulated market or a multilateral trading facility ("MTF"). Consequently, many of the activities and contractual arrangements that constitute trading in the wholesale gas and electricity markets are covered by MiFID. As a result, they can also benefit from the MiFID "passport".

It is also very likely that each EEA financial regulator imposes similar record keeping requirements on financial traders in order to comply with the requirements of MiFID. For example, the UK FSA requires persons it authorizes to keep detailed records for five years setting out a number of the particulars describing transactions including: names, dates, times, prices, instrument descriptions, quantity, types of orders, etc. It should be noted that the FSA recordkeeping requirements apply to all authorized persons, whether or not they are subject to MiFID requirements.

However MiFID often exempts from its scope non-financial firms trading in commodity derivatives markets. Specifically, MiFID exempts firms providing investment services in commodity derivatives to clients of their main business, provided that this is an ancillary activity to their main business which cannot be the provision of investment services. For example the trading arm of an electricity, gas or oil company which provides services to its clients. MiFID also exempts firms whose main business consists of dealing on own account in commodities and/or commodity derivatives provided their main business is not the provision of investment services. For example, this would include the trading arm of an electricity, gas or oil company which only provides services within its group.

The principal regulatory "gap" that a license could address is one of regulatory consistency, for example the format in which records have to be kept.

Transaction Reporting

At present, there is no EU legislation that requires the *reporting* of wholesale gas or electricity market transactions. National regulators do not have access to trades relevant to them if executed in a different jurisdiction. This lack of information may be addressed by two measures:

- First, the European Commission is in the process of considering a tailor-made 'Integrity and Transparency Regime' for traded wholesale markets for electricity and gas, based on the above recommendations;
- Second and as described above, Article 44 and Article 40 of the Third Gas Directive and Third Electricity Directive respectively detail requirements for supply undertakings to keep records of transactions for five years and to make these records available to the authorities on request. There is some expectation that national energy regulators, in order to monitor compliance with the record-keeping requirements discussed above, will introduce some transaction reporting requirements.

These steps would represent significant progress in the direction of creating a level playing field in the markets that allows all traders equal access to important information. However, at present there are no requirements for reporting of wholesale transactions, and (absent one of the above mechanism closing this gap) a license could impose an obligation on traders with respect to transaction reporting.

4.2.3.2 Abuse of Market Power and market manipulation

Taking into consideration the issues raised above with respect to record-keeping and transaction reporting, it is easy to see the overlapping relationship between those issues and the issue of market abuse. Most instances of abuse of market power and market manipulation ("market misconduct") involve imbalance of information. One party exploits its access to information that other parties do not possess.

Table 2, below, summarizes the existing legal instruments which aim to prevent the abuse of market power. Table 2 illustrates that there are numerous categories of information, which affect the prices of commodity derivatives, that are not considered 'inside information' under the Market Abuse Directive (MAD) and can legitimately be used as motivations to trade by those who possess that non-public information. 0 contains more details regarding MAD. In addition to that gap, physical commodities traded OTC are not covered by MAD. Consequently, as discussed above, insider dealing and market manipulation in physical commodities may go unnoticed and unpunished. One possible role for a license is to cover this information disclosure gap.

Table 2: Existing legal controls on the abuse of market power

Legislation	**Controls on the abuse of market power**
EU Competition law	Prohibits the abuse of market power and the manipulation of markets. The Third Energy Directive contains a number of provisions which mandate equal access to energy related transmissions systems and storage facilities. In addition, the Treaty on the Functioning of the European Union (TFEU) prohibits member states from granting state aid which distorts competition and trade in the EU. TFEU also prohibits anticompetitive activities of cartels, monopolies and other anticompetitive behaviour.
Market Abuse Directive	Came into force on 12 October 2004. MAD is designed to target insider dealing and market manipulation, to ensure the integrity of Community financial

("MAD")	markets and to enhance investor confidence in those markets. MAD requires any information affecting the prices of *financial* derivatives to be made public before it can be used as the basis of decisions to buy or sell those derivatives. In the case of commodity derivatives, the only information to which those principles apply is information which a trader in a market would ordinarily expect to receive in that market.

Market abuse regulation

As indicated in Appendix I of this Report, there are important differences between the way the Market Abuse Directive is applied to "derivatives on commodities" and the way it is applied to other financial instruments such as shares. One important difference is found in the definition of "inside information". With respect to financial instruments generally, precise, non-public information which "[i]f it were made public, would be likely to have a significant effect on the prices of ... financial instruments or on the price of related derivative financial instruments" constitutes inside information.

With respect to commodity derivatives, inside information is limited to precise non-public information, "which users of the markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets."

In essence, this means that, with respect to energy commodity derivatives, inside information is limited to information market users would expect to receive in the market in question. The fact that there may be other non-public information which could substantially affect the prices of these derivatives and the underlying energy commodities, for example information about contracts, investment, discoveries, production increases/decreases, etc. is irrelevant.

This gives traders and energy commodities much more scope for trading on the basis of non-public price-affecting information then is available to dealers in other regulated financial instruments. At present, there is a consensus among both financial and physical traders that market abuse regulations are adequate as they are. There seems little support for the idea that market abuse regulations relating to trading in commodity derivatives should be expanded to bring them into line with regulations aimed at dealings in other financial instruments.

The expressed view of the traders is that commodity derivatives are "fundamentally different" than other financial instruments, and should be treated differently. However, we question whether the views of traders reflect the possession of significant price-affecting information by some commodities producers, which it would be disadvantageous for them to reveal to the market as a whole. Failure to disclose such information is a market failure, which a license should properly address.

4.2 Gaps that a license could address

4.3.1 Licensing requirements

Below we discuss two examples of 'quality controls' that could be used as a guide for licensing requirements – in other words, the standards that an applicant has to meet to be granted a

license. We consider which of these elements could be applied to an EU trading passport and which elements might not be required.

UK's 'Fit and Proper Person' test

A trading license could adopt some of the ideas behind the UK financial regulator's definition of a 'fit and proper person'. This is a standard which combines both objective and subjective elements to allow a regulator the flexibility to determine whether a particular (legal) person should be allowed to participate in particular markets under the relevant circumstances.

The critical advantage of the fit and proper person standard is that it allows a regulator to adjust its determination of licensing qualifications to changing market conditions and new situations which may not have been previously encountered, or which have only recently increased in importance. Standards which consist of purely objective measures (amount of capital, years in business, etc.) do not allow enough flexibility to protect the integrity of markets and assure the integrity of market participants in a rapidly changing economy.

As applied by the Financial Services Authority (FSA) in the UK, the Fit and Proper test takes into account a number of relevant matters. It is important to note here that although the FSA describes some matters that it will have regard to in assessing fitness and propriety, the FSA studiously refrains from providing an 'exhaustive' list of the matters it will consider relevant, precisely so that it can allow itself some flexibility.

The principle statutory instrument of UK financial services regulation, the Financial Services and Markets Act 2000 (FSMA) does not dictate which matters the FSA must take into account when judging fitness and propriety.

The FSA devotes a section of its Handbook (the "FIT" section) describing how it applies the Fit and Proper standard. The FSA says that it will have regard to a person's competence and capability, honesty and integrity and financial soundness, but that it will take all relevant matters into account including, but not limited to, the following examples relating to whether the applicant:

1. Has been convicted of criminal offences, offences of dishonesty fraud or financial crime;

2. Has been subject to an adverse finding or settlement in civil proceedings in connection with investment or other financial business misconduct, fraud or setting up or running a firm;

3. Has been subject to or interviewed in the course of any investigation or disciplinary proceedings by the FSA or other regulatory or government bodies or agencies;

4. Has been subject to any disciplinary or criminal proceedings or involved in any investigation which may lead to such proceedings;

5. Has breached any standards or requirements of any regulatory authorities;

6. Has been involved with any organization that has been refused regulated status or a license to carry on the business trade or profession or has had such status or license revoked;

7. Has been involved in any business where the applicant was investigated, disciplined, censured or suspended by any regulatory or professional body, court or tribunal (whether publicly or privately);

8. Has been a director, partner or otherwise concerned in the management of a business which has gone into insolvency, liquidation or administration;

9. Has been dismissed or asked to resign from a position of trust or fiduciary appointment;

10. Has been disqualified from acting as a director or in any managerial capacity; and

11. Has been truthful and candid in dealings with regulatory bodies and has complied with their standards and requirements.

The above list provides examples of the kinds of matters that the FSA will take into account. However, the FSA emphasizes that it considers applications on a case-by-case basis taking into account each applicant's individual circumstances. None of the above matters will 'automatically' disqualify an applicant. In the case of transgressions, the FSA will look at the seriousness of the matter, the applicant's explanation, and the relevance of the matter to the work that the applicant wishes to do.

The FSA also looks at matters relating to the 'competence and capability' of the applicant. However, in this case it is important to emphasise the differences between the firms the FSA is regulating and the licensing of wholesale energy traders. In the UK the FSA applies the Fit and Proper test to investment firms and persons performing certain key functions for their employer or on their behalf. The customers of these firms include individual investors that require more protection than a trader in the wholesale energy markets. Therefore not all of the requirements of the FSA's fit and proper person test are relevant, especially those that relate to the competency of the applicant. Rather the fit and proper person test is a useful idea because it is a flexible standard that establishes a 'base line' of quality for an applicant.

With respect to 'financial soundness' the FSA is not usually concerned with financial resources and does not usually ask for statements of assets and liabilities. Instead this issue relates to financial integrity, inquiring whether:

1. The person has been subject to any judgment debt or award that remains outstanding or was not satisfied within a reasonable period; or

2. Whether the applicant has made an arrangement with creditors, been bankrupt or had assets seized.

With respect to 'adverse disclosures' the FSA expects that candidates will be candid in disclosing any aspects of their background which might be regarded as casting an unfavourable light upon their application. Failure to be candid can result in rejection of the application or its revocation if the lack of candour becomes known at a later date.

Licensing requirements under MiFID

Under MiFID, certain requirements are put in place throughout the EEA with regard to the licensing of firms to be permitted to undertake the relevant regulated businesses. The

implementation and application of those requirements is left to the regulatory authorities of the Member States.

Under MiFID Article 9, Member States are required to determine that persons who direct the business of applicant firms are of sufficiently good repute and sufficiently experienced to ensure the sound and prudent management of the firm. However, as we have stated earlier, such standards are only relevant for wholesale energy trading to the extent that they ensure the managers are competent to fulfil regulatory requirements and ensure compliance with the relevant laws. The trading license requirements need not extend to assessing the competence of the mangers in terms of running the firm profitably. The firm's owners have sufficient incentives to appoint competent managers and will suffer if the firm is not well managed.

Under MiFID Article 10, firms cannot be authorized until the identities of their shareholders, or members and their holdings have been disclosed, or if the Member State is not satisfied with the suitability of shareholders or members that have such holdings to ensure the sound and prudent management of the applicant firm. In addition, under Article 10, authorization should be refused if:

1. Close links between the applicant firm and other natural or legal persons would prevent the effective exercise of the supervisory functions of the Home State regulatory authorities. For example, a firm that is part of an international group, where the parent is subject to regulation in a non-EU jurisdiction which would frustrate the FSA's regulatory control; or

2. The laws, regulations or demonstrated provisions of third countries governing one or more of the persons having close links to the applicant firm would prevent the effective exercise of the supervisory functions of the Home State;

Applying a requirement similar to those described in MiFID Article 10 would address the current market failure we identified in the previous section – that a trading firm could be established in a non-EU jurisdiction that could, for example, refuse to hand over information relevant to an investigation of alleged market abuse.

An additional requirement under Article 10 is that any person proposing to acquire or sell (directly or indirectly) certain qualifying holdings in any regulated firm must first notify the regulatory authority of the Home State of certain changes in control. The relevant regulator shall have up to three months from the date of the notification of the proposed acquisition to oppose the acquisition if it is not satisfied that the person seeking the acquisition can ensure the sound and prudent management of the firm in question. This is a relevant requirement to adopt for an EU energy trading license, since it would avoid a change in status of the applicant that could undermine the ability of the authorities to investigate alleged market abuse.

Under Article 11, applicants must satisfy the Home State that it can meet its obligations under the Investor-Compensation Directive (97/9/EC), and Article 12 states that the applicant must satisfy the Home State that it has sufficient capital to comply with the requirements of applicable European Directives. These provisions do not seem relevant requirements to adopt for an EU energy trading license.

Under Article 13, the applicant must satisfy the Home State that it has in place:

- adequate organizational requirements to ensure compliance with MiFID, to prevent conflicts of interest from adversely affecting the interests of its clients, that any outsourcing of important operational functions will not impair the quality of its internal control and supervision with respect to its regulatory obligations. The conflicts of interest provision does not seem a relevant requirement to adopt for an EU energy trading license;

- appropriate systems resources and procedures to ensure the continuity and regularity of the performance of its regulated activities;

- sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment and effective control and safeguard arrangements for information processing systems;

- arrangements to keep adequate records of its services and transactions to enable regulatory authorities to monitor its compliance under MiFID and to ascertain that it has complied with all obligations with respect to clients and potential clients, that it has adequate arrangements to safeguard financial instruments belonging to clients in the event of the firm's insolvency and to prevent the use of a clients instruments on its own account without the clients express consent;

- adequate arrangements to safeguard a clients funds and not (unless it is a credit institution) to use the clients funds for its own account;

- it has adequate arrangements to allow its Home State adequate access to the records of its branches so as to assure adequate compliance with its obligations.

MiFID Article 8 states that the regulatory authority can withdraw authorization where an applicant firm:

1. Does not take up the authorization within 12 months, expressly renounces it or has provided no investment services or performed any investment act to be for the preceding six months;

2. Has obtained the authorization by making false statements or by other irregular means;

3. No longer meets the conditions under which authorization was granted;

4. Has seriously and systematically infringed the provisions of MiFID relating to the operating conditions for such firms;

5. Falls within any of the cases where national law provides for withdrawal of authorization.

Similar conditions for withdrawal of a license could be adopted for the EU trading passport, except that it would seem reasonable to allow for a longer period of inactivity in energy trading before the license is withdrawn. For example, there may be some market players who only need to trade occasionally, perhaps in winter, and these players might be inactive for much of the rest of the year.

4.3.2 Administrative and Ongoing Requirements

In the absence of a license, a trader could be established outside of the EU in an attempt to avoid the jurisdiction of EU law. The company might not appear for proceedings before a court or regulator, and by keeping assets outside the EU could seek to escape liability for fines or adverse judgments. Furthermore, traders might choose a jurisdiction whose laws prevent the disclosure of information that EU authorities might require to investigate market abuse. We consider it a market failure if a party has the ability to evade law enforcement.

A license requirement can address this market failure, by requiring a presence within the EU. Traders have complained about the need to establish branch offices in separate Member States. However, a license can address the potential market failure simply by requiring a presence in at least one Member State. The "host" jurisdiction could require a legal presence, which would then obviate the need for a second jurisdiction to impose any additional presence requirements.

Administrative requirements raise other issues such as unnecessary expense or delay in securing licenses, and inconsistent application formats and procedures across countries. Our review of practices across countries has revealed considerable diversity, and in some cases unnecessary expenses.

An Authority's responsibility for supervision of a Licensee continues as long as the Licensee undertakes wholesale gas and electricity transactions under license from the Authority. In order to fulfill its supervisory duties, the Authority will need to require that each Licensee shall:

(1) Keep the Authority informed as to any significant changes to its business and/or any significant plans to alter its personnel, business or structure prior to undertaking any such changes or carrying forward any such plans;

(2) Continue to undertake transactions for which it has been licensed by the Authority, and inform the Authority of any interruptions or cessations of the business for which it is a Licensee;

(3) Provide the Authority with an Annual Report describing its business for the previous calendar year, including an audited financial statement and copies of each annual and semiannual financial report produced with respect to the Licensee. Each such document must be supplied to the Authority within 30 days of its production, or in the case of Annual Reports by 31st of January of the next year;

(4) Notify the Authority of any step taken which may result in the acquisition of 10% or more of the share capital (or in the case of an entity without shares, in an opportunity to share in 10% of the profits or contribute to at least 10% of the losses) of any Licensee. The Authority shall have 30 days within which to object to any such change.

The above is a brief outline of what the licensing requirements will include. Further detail as to why they are proposed as set forth in the following report. To implement any such requirements will require detailed plans that are not within the scope of this Report to describe exhaustively.

We propose that separate energy regulatory Authorities implement the regulations described above. Although consistency and efficiency may be better served by establishing a single

EU energy regulator to administer such licensing, it would be a massive undertaking to task a single EU regulator with the job of licensing and supervising each person who seeks to trade wholesale gas and electricity within the EU. The documentary, linguistic and time requirements would impose enormous costs. These costs and logistic problems can be avoided by allowing energy regulators, who are already familiar with local markets and traders to a significant degree, to supervise the proposed licensing procedure. Many national energy regulators already take responsibility for issuing and enforcing trading licenses in their Member State.

We propose requiring licenses for the trade of wholesale gas and electricity both within the EU, and into the EU from non-EU countries. Including trade into the EU would ensure a level playing field. Otherwise traders might sit outside the EU, perhaps in jurisdictions that involve less rigorous licensing regimes, and then trade into the EU in competition with traders licensed by EU Authorities.

5 Recommendations

In this section we summarize our recommendations regarding the scope of an EU trading license or passport, the key elements that it should contain, the recommended requirements to obtain a license, and how the license would be administered.

5.1 Purpose of a license

We see several functions of an EU passport-style energy trading licence. An EU license would harmonise existing requirements and remove barriers to traders wishing to enter new markets. Section 3 has described the differences between current licensing regimes, and our interviews with traders confirm that these differences increase the costs of entering new markets. A simplified harmonised set of licensing requirements would largely eliminate the ability of Member States to prevent new entry and protect incumbents. For example, a major benefit of MiFID, has been the "passport" feature of the directive, which permits a MiFID investment company to offer its services, remotely or through a branch, in any of the 27 countries of the EEA without having to obtain "authorization" from any financial market regulator except that of the firm's home state. This eliminated the previous onerous requirements of having to be separately licensed to do business in each country in which one wish to conduct regulated financial market activity. Rather than negotiate 27 different licensing regimes, with a single application a trader would be ready to enter all the markets of the EU – we explain below the process of applying to trade in different jurisdictions.

At the most basic level, a license would establish a record of who is active in the market. The license should also provide a safety net to ensure a minimum quality of the firms active in the market. This is not aimed at predicting the success of applicants, but rather avoiding criminal entities from gaining trading licenses. While we do not think that the license application process should attempt to predict, for example, which traders are likely to go bankrupt, it should identify traders that are in the process of going bankrupt.

We consider the relative merits of licenses to other forms of legislation that could seek to achieve the same goals. One recommended goal of a license is to require the provision of information to regulators. An alternative to a license might be legislation requiring the provision of information, backed by the threat of fines for non-compliance. However, the threat of withdrawing

a license can provide a better enforcement mechanism than a system of fines. Where fines are involved, authorities typically seek to make them proportional to the costs imposed on society. Failure to provide information undoubtedly imposes a cost on society, but the authorities might not be able to estimate accurately the costs in particular situations. Estimation difficulties would risk the emergence of decisions that appear inconsistent, and could invite prolonged debates over the appropriate magnitude of fines in individual cases. Moreover, fines can unwittingly invite market participants to make trade-offs of the benefits and costs to non-compliance. Instead of fines it seems better simply to threaten the withdrawal of a license. In the absence of a license regime we could ask courts to impose injunctions that prevent trading by parties who fail to comply with relevant laws for the provision of information. However, withdrawing a license is a simpler administrative procedure. However, we recognise that license withdrawal should respect the principle of proportionality. It would not be proportional to withdraw a trader's license simply because they are a day late in providing information to the regulator for example.

Finally, a license could address the market failures that we have identified with respect to market abuse, record keeping and transaction reporting. We expand on some of these themes below.

5.2 Coverage and scope of the license

We recommend a separate EU trading passport would cover all forms of wholesale gas and electricity trading, whether financial, derivative or physical. The EU Trading licence would replace and supersede all national forms of energy trading licenses. An alternative to creating a separate EU trading license would be to extend the coverage of MiFID to include physically traded products. Under this proposal, any party currently authorised to trade under MiFID would also be authorised to trade physical gas and electricity. Persons that trade solely OTC physical gas and electricity, and who are not authorized to trade by an EEA financial services authority, would apply for authorisation under the MiFID rules.

However, we do not recommend the latter approach. This is because MiFID would not address several of the gaps which we identify and which a separate trading license would address. For example, we have identified gaps with respect to transaction reporting and market abuse, which MiFID does not address (and was never intended to address). Therefore, a new and separate licensing regime for wholesale energy trading is preferred.

Nevertheless, the interaction between an EU trading passport and MiFID is important. In particular, we do not think it is desirable that the coverage of an EU trading passport and MiFID should overlap. A person (including a legal person) should be covered either by MiFID *or* the EU trading license. Otherwise conflicts could result, and the resulting bureaucratic burden would be excessive.

We have discussed MiFID's coverage of energy markets and it complexity in section 2.2.4. For purposes of creating an EU-wide license for wholesale gas and electricity trading we think the simplest way to address the complex issue of MiFID exemptions is to require that any person who *claims* MiFID exemptions with respect to trading will be required to obtain the EU trading license to continue to conduct those MiFID-exempt wholesale gas and electricity transactions. Although this may impose a burden in some respects, it offers a significant advantage that transactions which

currently do not benefit from the MiFID "passport" will, in the future, benefit from the passport afforded by the new licensing regime.

Accordingly, any person who claims MiFID exemptions with respect to any wholesale gas or electricity trading (whether physical or derivatives) should be required to obtain the separate EU trading license in order to continue to conduct those exempt wholesale gas and electricity transactions. Accordingly, our definition of coverage is not based on products, but rather on the coverage claimed by the person trading.

We also recognise this recommendation could result in the same product being traded by one person that is covered by MiFID, and another who is covered by the EU trading license, and that these two systems provide differing obligations with respect to information reporting, to name one example. This is not ideal. Nevertheless, we believe it is better than the alternative of defining the EU trading license with respect to the products traded, in which case many market participants would be covered by both MiFID and the EU trading passport. This is a situation we wish to avoid, as discussed above.

We recommend that there would be a single EU trading license for both electricity and gas. This is because none of the gaps that we have identified and which the license would address are specific to either electricity or gas. For example, the concerns regarding record keeping, transaction reporting and market abuse apply equally to both gas and electricity. Having a single license would reduce the administrative burden of applying for separate licenses.

However, we imagine that the detailed requirements for electricity and gas would differ slightly. For example, more detailed information disclosure is likely to be required for electricity trading, because electricity trading is more sensitive than gas trading even to short-lived changes in plant availability, transmission capacity etc. The license could lay-out separate detailed requirements for electricity and gas trading.

We do not see any disadvantage of an EU wide energy trading ‘passport’ for wholesale trading in contrast to national licenses. Its only effect appears to be a limitation on the powers of local regulators to prevent foreign companies from trading energy into their jurisdictions. Although, there are undoubtedly issues of the suitability of particular entities to engage in this trade and of security of supply, it is undoubtedly better (from points of view of fairness, efficiency and market integrity) to address these issues through international regulations rather than leaving it to individual national regulators. International solutions ameliorate the suspicion that foreign companies are being unfairly treated in their competition with local firms.

We have considered whether Member States should have the right to waive the requirement to hold a wholesale energy trading license at all, for example as in Germany. However, we recommend against it for several reasons. First the Member States opting out of a trading license might not have closed the gaps that we have identified. For example, the regulator may have no way of obtaining transaction data from a trader. If a neighbouring regulator wanted to investigate allegations of market abuse which involved trades coming from the ‘unlicensed’ Member State, there might not be a way of obtaining the necessary data. Accordingly, neighbouring Member States could suffer because of the opt out. In theory the Member State wishing to opt out could provide other ways of closing any gaps relating to market abuse, but this could be more burdensome than simply adopting the license, and would undermine the harmonisation benefits of

an EU trading license. Traders in an opted out Member State would not be able to take advantage of the passport feature for trading in other Member States. The only way to address this problem would be to impose an obligation on the opting out State, which would then issue licenses to domestic traders with no other purpose than to serve as a passport for entering other Member States. Given that the opting out State would in any event have to institute the procedures necessary for granting licenses, opting out would not seem to confer any material benefit. Given that the requirements of the license are relatively minimal, we do not support an opt-out option.

5.3 Separation between supply and trading

Our discussions with traders and review of licensing conditions highlighted that sometimes trading licenses impose obligations which are really only relevant to parties supplying smaller customers. The purpose of a supplier license is typically to protect small, relatively unsophisticated customers who could be vulnerable to abuse. These include households, small businesses and light industry. In contrast larger energy customers are generally much more able to protect themselves via tailored gas supply contracts. For example, the Netherlands only requires market participants to hold a license to supply gas customers who use less than 170,000 m3/year of gas, and electricity customers with a current requirement of less than 3 x 80 Amps.

Having a separate trading (as oppose to trading and supply) license will avoid imposing onerous conditions on energy traders that are only relevant to the supply of smaller end users. We acknowledge that finding a workable definition of ‘supply’ is difficult in practise. We could imagine a distinction based on volume as in the Netherlands. For example the trading license could state that the point of delivery for the contract can only be an end user’s premises if the end user consumes more than a given (large) volume of electricity of gas each year. This would ensure that licensed wholesale traders would only deliver to other wholesale traders at a trading hub, or that they delivered to large, sophisticated end users. This would avoid the need to include provisions in the license aimed at protecting small consumers. However, determining a common EU threshold for the appropriate volume would be difficult. Alternatively, the license could only apply to contracts which, despite involving physical delivery, have the option to be settled in cash. In this case we could call the contract a trade rather than a supply.

5.4 Licensing requirements

We propose that any person undertaking transactions in wholesale gas and electricity in, or into, any EEA jurisdiction, or purporting to do so, must be licensed to do so by a recognized EEA Wholesale Energy Authority ("Authority"). Before licensing any person to undertake such transactions ("License"), the Authority shall determine that the applicant:

(1) Is, having regard to the character and background of the applicant, a fit and proper person to undertake such transactions. However, as we describe below, the fit and proper person test will be open to interpretation by more than one regulator. We therefore recommend that the test is more prescriptive and less subjective than the version applied by the UK’s FSA. While this will sacrifice some flexibility, it will be to the benefit of reducing differences in interpretations and conflict between jurisdictions;

(2) Has adequate systems and controls to undertake such transactions as an ongoing business. In financial services regulatory terms under MiFID, the requirement of adequate "systems

and controls" is intended to encourage an investment firm's directors and senior managers to take appropriate practical responsibility for their firm's arrangements relating to regulatory matters. For example, they must take reasonable care to organize and control its affairs responsibly and effectively with adequate risk management systems; to vest responsibility for effective and responsible management to specific directors and senior managers; and to create an effective platform of organizational systems and controls to permit a smooth flow of regulatory compliant business transactions relating to regulated activities;

(3) Is organized so that it may adequately fulfil the regulatory requirements mandated by the relevant Authority and any other relevant statutory or regulatory obligations. However, these requirements would specifically not extend to for example, preparing a business plan, undertaking a trading exam and other activities designed to measure the likely profitability and success of the trader's activity;

(4) Agrees that it will not engage in, or aid or abet, any conduct which may have the effect of disrupting, manipulating the supply, price or transactions in gas or electricity; or which may have the effect of creating a misleading impression as to the present or future demand for or price of wholesale gas or electricity.

(5). Have its home or registered office in the same jurisdiction as the Authority;

An EU trading license could play a useful role in applying a basic level of 'quality control' on the market. The license, employing the requirements above, could be a mechanism to block firms with either possible criminal links and/or that have outstanding tax issues from trading on the market. A trading license would also present an additional hurdle to criminals setting up energy trading firms for the purpose of VAT fraud – we understand that this is a growing issue in the energy markets.

For examples, the above requirements could be used to assure that:

- The representatives or directors of the firm applying do not have criminal records that would ordinarily disqualify them from becoming the director of a firm;
- The applicant does not have any outstanding tax issues – that is the applicant can present a valid tax certificate;
- That the firm is not in bankruptcy proceedings.

In common with the MiFID legislation, the regulator could withdraw a license if the applicant:

- Does not take up the license within 12 months, expressly renounces it or has not traded for a given period of time;
- Has obtained the license by making false statements or by other irregular means;
- No longer meets the conditions under which license was granted;
- Has seriously and systematically infringed the requirements of the license, by for example failing to provide details of transaction when requested;

5.5 Record keeping and transaction reporting

The license should introduce uniform requirements across the EEA for the recording and reporting of wholesale gas and electricity transactions. The key elements to reduce costs and liberalize the relevant markets are license requirements that impose:

1. Uniform regulations for recording and preserving records of wholesale gas and electricity transactions. It would be unfortunate if national implementation of the requirements of the Third Package differed enough to make the record-keeping requirements for each country unwieldy and expensive for market parties trading across several European jurisdictions;

2. Uniform definition of the requirements governing the production of said transaction records for each relevant regulator. Again, consistency with respect to the requirements of each regulator would prevent record production from becoming overly complex and expensive for multi-jurisdictional market parties;

3. Uniform regulations requiring the reporting of certain transactions to appropriate government agencies and regulators; and

Uniform penalties for failure to comply with the above regulations including censure, fines, trading restrictions, or trading bans.

We propose that each Licensee:

(1) Make all records relating to relevant energy transactions available, on request, to inspection by the relevant Authority;

(2) Make all records of personnel involved in the conduct of business of the Licensee relating to transactions in wholesale gas and electricity available to inspection by the relevant Authority on request;

The details of transaction reporting and record-keeping requirements will need to be determined in detail by additional implementing regulations, but it is proposed that such regulations impose harmonized standards across the EEA. Presumably, the records (and the transaction reports) should provide at least the following information in standardized form: parties, product, quantity, price, date of trade, date of settlement, place of trade and applicable law.

5.6 Transparency

To address legislative gaps with respect to information disclosure, we recommend that the license should require traders to disclose any material information which a trader in the relevant market would reasonably consider may have a significant impact on the relevant market price of gas or electricity. The trader would need to disclose the information before undertaking any transactions in gas or electricity or any transactions related to gas and electricity including, but not limited to, any transactions in energy derivatives. For example, a company with a gas production operation would have to report an unexpected outage of production to the market at the same time that information became available to its trading affiliate. We recognise that this is a major change to the current regime and that some parties object to this level of information disclosure. However, on balance we consider that while it is legitimate that market parties attempt to profit from different

expectations of the market, an asymmetry in the information available to players will create mistrust and undermine liquidity. A trader will not know if a counter party is taking a position because he has different beliefs about the market or because he knows something no one else knows. In the example above, profiting from accidental outages could cause firms to deliberately disrupt supply so as to profit from rising prices. Ensuring wider information disclosure would help level the playing field and develop liquidity.

The European Commission has invited ERGEG to give advice on legally-binding guidelines concerning transparency rules, of the type that we discuss above, by the end of 2010.[37] These guidelines should ultimately give precise details about what should be disclosed. There will be a public consultation on the draft Impact Assessment document and the draft guidelines in September 2010. The EU trading license could be the instrument to implement these guidelines.

The license could also contain a provision whereby licensed traders shall be required to agree not to undertake any transactions related to gas or electricity not motivated by considerations of supply and demand, or which use any deceptive or manipulative device or conduct to artificially influence the price of gas or electricity or any energy related derivatives.

Penalties for violation of the above provisions could include censure, fines (in any appropriate amount) and restrictions on or cancellation of the trading license of a guilty party, or any combination of the preceding penalties.

5.7 Administrative Standards

Authority issuing the license

We conclude that the energy regulator is best placed to administer and issue the license. This is because the regulator is 'closest' to the day-to-day operation of the markets and is responsible for market monitoring. It makes sense for the regulator to be closely involved in terms of being aware of who is active in the market. We note that in most of the countries surveyed – with the exception of Spain – energy regulators are already responsible for issuing licenses.

The issuing and withdrawal of an EU trading license could follow the same lines as MiFID. The applicant would apply in the Member State in which the firm has its head quarters (the 'home state'). Once issued, the license holder would be allowed to trade in any other EEA country.

In the event the Licensee intends to undertake wholesale gas and electricity transactions in an EEA jurisdiction other than it's 'home jurisdiction' jurisdiction, the Licensee shall notify the Authority in its home jurisdiction describing the types of transactions it intends to undertake in other EEA jurisdictions and identifying the jurisdictions in which it wishes to undertake such transactions. The Authority shall then inform the relevant Authority in any such other EEA jurisdiction (the 'host' Authority) of the Licensee's intention to trade. The 'host' jurisdictions shall have 20 days within which to lodge a written objection with the home Authority. If no such objection is raised the Licensee will be free to undertake transactions in the relevant host

[37] See ERGEG/CEER Presentation 'Update on the work on ERGEG advice on Fundamental Data Transparency in Electricity' from the 18th meeting of the European Electricity Regulatory Forum, Florence 10 and 11 June 2010.

jurisdictions after 30 days from the date of the Licensee's submission of a written notification to the home Authority.

With respect to revocation or withdrawal or licenses, this would also be handled by the home state regulator. For example suppose a license holder with its home state as 'country A' was found to have breached its license in 'country B'. The regulator in country B would present evidence to the regulator in country A which demonstrated why the license should be revoked.

An alternative to these arrangements would be to have an EU body responsible for administration of the new license. However, we do not recommend this idea. Existing regulator could cope with traders in their own jurisdictions much more efficiently than an EU wide body. The Member State regulators already have much of the information that they require about applicants, and do not face the language issues that an EU regulator would face. Accordingly, the transaction costs of administering an EU trading license will be much lower if the 'MiFID model' is followed and regulators administer licenses for market parties headquartered in their Member State. Financial regulators would have to inform energy regulators on licensees under MIFID.

Given that the license is an EU trading passport, and the requirements for holding a license are the same in all Member States, if a market party was judged unfit to hold a trading license one Member State it would lose its ability to hold a trading license in any Member State. On the face of it, this gives regulators a very strong penalty to apply to traders – the ability to revoke their right to trade physical energy in all EU Member States. There could be some concern that regulators might somehow abuse this power. Mitigating this power would be two factors. First, the revocation of the license would have to be agreed by both the home state regulator and the regulator of the Member State in which the license breach took place. Both the license holder and either of the two regulators involved should have the right to appeal a revocation request/decision to an independent review tribunal in the 'home' state. The independent review tribunal could be a dedicated tribunal or a court. Any decisions by the independent body could ultimately be appealed to the European Court of Justice. A similar system applies in the MiFID regime.

The virtue of having an independent review tribunal is that it allows parties that have received unfavourable decisions from a regulator to have those decisions reconsidered by an independent body not subject to the influence of the regulator. An interesting example of this kind of tribunal is the Financial Services and Markets Tribunal in the UK ('UK Tribunal'). We describe the working of the UK Tribunal in more detail in 0. The tribunal would also act as an arbitrator for cases where two Member State regulators disagree as to whether a license should be withdrawn or not. Regulators should publish their reasoning for a rejection of a trading license application or the revocation/withdrawal of a license in some form of permanent record or database. Again, the applicant would have the right to appeal the rejection of a trading license application.

Fees

License fees are sometimes used as a way of raising revenues. Funding the costs of the licensing process seems a valid way of setting license fees. License fees set in this way allocate the costs of the regulation process to the energy traders in the market – in a competitive market these traders will pass on these fees to their customers, roughly in proportion to energy consumption.

But it would be inefficient to license fees as a more general form of taxation. Doing so would raise the fixed costs of entering each market, and could form a barrier to trading. The goal should be encourage entry into the market, and then tax any profits from trading that result.

Therefore we recommend that license fees – both for the initial application and the ongoing fees – should be cost-based, in the sense that they cover the costs of the licensing process itself. Ideally the regulatory authorities should publish details regarding how the license fees are derived, by for example publishing the relevant costs that the license fees have to cover, and the number of licenses that are expected to be outstanding to cover the costs. Regulators could consider applying an RPI-X type price control to the license fees, in a bid to become more efficient and reduce license fees over time. Ofgem in GB is subject to a self-imposed RPI-X cost-control.

Application time

The regulator should commit to processing all correctly completed license application within a set period of time. From our survey of several Member States, a period of eight weeks or 40 working days would seem to be a reasonable period. We note that under Article 7 of MiFID the Home State has six months from the submission of a complete application to decide if the authorization has been granted. However, based on our analysis of best practice in existing license regimes we conclude that a 40 working day target could be more appropriate. However the exact period should be set once the procedure behind the requirements have been established in more detail. For example self-certification of some requirements would require less time than if the regulator performed independent checks. The key point is to have a period of time that is proportional to the process, and commit to meeting this target.

To make this target meaningful, regulators could commit to reducing or eliminating license fees for applications that take longer than the allocated time.

Regulators should publish, in their annual reports, statistics on the time taken to process the license application, including the total number of applications received, average processing time, and the number of licenses that were not processed within the promised time.

While clearly regulators can only process correctly completed applications, they should not use relatively minor omissions in the application process to significantly delay the process. Where a piece of information is missing, the regulator should contact the applicant and give them the opportunity to correct any minor errors quickly.

Language

We have heard from traders that would prefer to apply for a license in English, rather than in the national language of the country in which they are applying. We note that one of the advantages of an energy trading passport administered along the lines of the 'MiFID model' is that applicants will apply in the state in which they are headquartered, in the language of that state. They are presumably able to prepare documents in the language of their home state, and so the passport largely addresses the issue of having to apply in the host country's language.

When a license holder notifies its home regulator that it wants to extend their trading outside of the home state into one or more hosts states, the license holder's documents would need to be translated into the language of the host state regulator. We propose that, having attested to the accuracy of the original application materials, the license holder would not be legally liable for any

errors in translation. This would mean that the applicant should not require legal advice in the host state to support the notification process, because all legal issues would already have been covered with the home state application. The host state regulator could of course opt to accept applications in English or another language.

5.8 Interaction with future legislation

At the time of writing, there is an EU legislative proposal on transparency and integrity under preparation. We do not know the final (or even draft) form of this legislation. However, a December 2009 presentation by the European Commission on the tailor-made Integrity and Transparency Regime identified similar gaps to those we have identified with respect to transaction reporting and oversight.[38]

For example the presentation identified that there was no comprehensive transaction coverage, since the EU Energy Directives did not require transaction reporting and MiFID reporting obligation only covers commodity derivatives traded on regulated markets. The presentation also identified geographic gaps, whereby EU national regulators do not have access to trades relevant for them if executed in a different jurisdiction.

We recognise that a new 'Integrity and Transparency Directive' could cover many of the gaps that we identify in this report. Therefore, in continuing work on an EU trading license the CEER and other bodies should coordinate closely with the tailor-made Integrity and Transparency initiative to avoid any duplication.

However, even if the tailor-made Integrity and Transparency closed all of the regulatory gaps we identify, it would still be desirable to have an EU trading license for physical energy trading so that it could act as a register of traders and perform a basic quality control of the market participants. We discuss the minimum requirements to obtain a license below.

We recognize that Switzerland is an important centre of energy trading, and that jurisdiction of an EU license would not automatically extend to Switzerland since it is outside of the European Economic Area. To ensure the smooth continuation of trading between Switzerland and EU Member States, we recommend that Switzerland sign a bilateral agreement with the EU to adopt the EU trading passport and all of its provisions. This would avoid Swiss traders having to sell to a licensed subsidiary within the EU, which would create accounting and tax issues similar to having a branch office.

[38] Preparation of a tailor-made Integrity and Transparency Regime for traded wholesale markets for electricity and gas, European Commission TREN C 2 presented at the Florence Forum 10-11 December 2009 by H. Hick.

Appendix I : Terms of Reference (from the CEER)

I.1 Background

The development of liquidity and the number of active market participants in electricity or gas wholesale markets is a factor that promotes the overall competitiveness of the market. There may be, in each Member State, different requirements that trading companies need to meet before they can start to operate on a national wholesale market. These requirements can be linked to:

- the governmental authorisation as a wholesale trader;
- regulatory requirements for wholesale trading activities;
- access to the national transmission grid required for traders to conclude physical
- transactions and necessary (network, balancing, etc.) agreements; and
- rules to become a member at an exchange.

Some of these requirements can be justified by the adequate and secure functioning of the energy market, as well as the secure execution of transactions concluded on trading platforms and for regulatory monitoring of market activities. These requirements could include financial conditions that the applicant has to meet.

Some other requirements may be of administrative nature. For example, traders may be required to establish an additional office in the Member State where they want to be active in order to obtain a license for energy trading. The existence of nationally different administrative requirements may be regarded as an entry barrier and thus an obstacle on the way towards a true pan-European energy market. Common administrative requirements across Member States (*i.e.* a single trading passport) may mitigate these barriers to market entry and increase the number of market participants in the different Member States.

The 3rd Energy Package calls for the creation of a single European market. Also the Regional Initiatives have the objective to pave the way to a Single European Energy Market and harmonise national electricity and gas markets. To achieve a Single European Market for electricity as well as for gas, traders in the whole European Community shall have easy access to every national electricity and gas market. Therefore, another important issue on the way to the Single European Energy Market, and regional markets as an interim step, is the harmonisation of the rules regarding the access to market places and trading for electricity and gas.

It is crucial that potentially unjustified requirements for wholesale market trading do not constitute a barrier to entry to markets. This may inhibit the development of competition and the further integration of markets.

Against this background a study should be conducted by an external consultant to provide advice whether a single and EU-wide binding passport for wholesale trading in electricity and gas is useful for defining appropriate and justified requirements market participants have to comply with and to reduce barriers for trading. If the consultant comes to this conclusion he should provide recommendation how such a passport could be established, so that a wholesale trader has to be licensed only once in an EU Member State under a harmonised EU-wide licensing regime and

could be active as wholesale trader in all other EU Member States through a simple notification procedure.

In addition, the study shall provide advice on how the requirements for wholesale market trading can:

- be simplified – i.e. the removal of requirements that are not necessary in order to establish and operate a wholesale market trading activity;
- be harmonised – *i.e*. the creation of common principles/requirements that will lead to a more level playing field; and
- avoid "super equivalence" – any additional requirements beyond the harmonised level should be assumed to be unnecessary.

The merit of this consultancy is that it will provide comprehensive advice on the legal, physical and financial characteristics of the administrative requirements to trade energy in the EU as well as best practice examples. This information will make it possible to inform ERGEG and the European Commission of a possible EU licensing regime for energy trading (single EU wide licence) and / or the appropriate level of harmonisation of administrative trading requirements and the potential costs and benefits of doing so. Information on the legal and financial characteristics of each trading environment will be collected and explained in such a way that comparisons can be made at least across a number of representative Member States.

The study's results shall provide the basis for an advice on the harmonisation and mutual recognition of trading licenses in the European electricity and gas markets.

I.2 Scope

The study shall be focused on requirements to be met to be able to trade on wholesale energy markets. Wholesale trading means buying and selling power and gas products and CO2 emissions allowances:

- from and to other wholesale traders, retailers, municipalities or any other counterparties not being end-consumers;
- through trading platforms (Exchanges, Multilateral Trading Platforms (MTFs), Brokers) and/or on OTC-markets: and
- on a national, cross-border and/or transit basis, whereas these activities are not conducted with/related to end-consumers.

Authorisations needed for other activities, such as electricity generation, gas production or enduser supply, fall out of the scope of the study.

The study shall focus on administrative requirements including such stemming from crossborder trading, but should not investigate obstacles due to national market designs in different Members States, which may in practice also hinder the development of a single EU wholesale trading market. National "trading licenses" may, in some countries, bring the main administrative barriers to wholesale market entry. Therefore, the study should be mainly focused on these licenses. Yet, some Member States do not require such a trading license. Moreover, most countries may not

have a "trading license" per se and arrangements may be covered in various documents. Therefore, administrative requirements mentioned in grid access codes or contracts should be investigated when applicable.

In addition, it may be that in some cases it is impractical to trade in a country without being a member of an exchange. Exchange rules are designed to ensure the credibility and proper functioning of the exchange. However, they may also include administrative requirements. Therefore, exchange rules should be investigated when relevant.

I.3 Content of the study

On the basis of the current situation (largely to be provided from contacts with market participants) in some relevant Member States regarding trading licensing requirements in the electricity and gas markets the consultant should provide:

1) an assessment of (i) existing barriers to enter the trading market and the licensing process and (ii) best practices identified for licensing processes or similar regimes. This evaluation should include:

- purpose behind the licensing requirements;
- authority (-ies) in charge of the issuance of the license;
- criteria for the issuance of the license: requirement to establish local presence, financial requirements,…;
- timeframe necessary for obtaining the license;
- costs associated with obtaining a license and fulfilling outgoing license requirements;
- (where applicable: analysis of additional administrative requirements, as described in §2 above),

2) a recommendation on whether and;

a) how a EU-wide and binding single licence and passporting regime could be established on the basis of energy sector legislation; and

b) how the requirements for wholesale trading can be appropriately defined and harmonised, considering that unjustified and unnecessary requirements should be avoided. That means developing a checklist of the requirements that are necessary and should be implemented across the EU.

In this context consultant will review any material and consider practical experiences on the above-mentioned issues available to him or provided to him by ERGEG, regulators, market participants or other parties.

The study shall mainly focus on both requirements for obtaining a license and ongoing obligations resulting from the license - in particular reporting requirements. To this aim the consultant should develop an appropriate, harmonised and EU-wide binding:

- list of licensing requirements, which applicants should fulfil and demonstrate;
- administrative standards and proceedings for the application proceedings;
- ongoing administrative and operational obligations, and
- principles for the aimed maximal harmonisation which avoids repetitive measures by member states

Furthermore, it should include a recommendation on which authority should issue a license and what information exchange between the authorities in the different Member States is necessary. Besides the potential benefits, the study should also address potential disadvantages, associated costs or upcoming risks of an EU passporting regime and/or harmonising requirements across the EU.

The study should include experiences with the single trading passport in the financial markets under Directive 2004/39/EC [Markets in Financial Instruments Directive (MiFID)].

Appendix II : Other market controls

II.1 Network and Balancing Agreements with TSOs

To be able to take physically traded gas or electricity, a trader must sign an agreement with the TSO to use the gas or electricity network. The TSOs naturally want to protect themselves against irresponsible behaviour by users that could threaten network stability. TSOs also want to ensure that users will pay for any imbalances which they are responsible for. For these reasons the network agreements contain both provisions to 'quality control' prospective users and also requirements to post collateral to cover imbalance costs.

The conditions in German network agreements are particularly relevant, because in Germany there is no license – therefore there is arguably a greater burden on the network agreements to do an effective job in controlling market participants. For example E.ON's terms and conditions for access to the gas network allow E.ON to perform a credit worthiness check on the shipper, and the shipper is obliged to provide the network operator with the information required to carry out this check.[39] The shipper is also obliged to inform the network operator of any changes in its creditworthiness without delay. If the network operator does not judge the shipper to be sufficiently creditworthy, then the shipper is required to post a security deposit with the network operator. The main purpose of this security deposit is to cover the shipper's imbalance fees in the event that the shipper goes bankrupt.

Similarly, under its electricity network contract, E.ON can perform a credit check on the network user, and is entitled to request collateral from the network user if:

- The network user is repeatedly in default with respect to due payments despite reminder; or
- Enforcement proceedings are initiated with respect to the assets of the network user; or
- Information obtained by E.ON regarding the customer through a publicly accepted credit agency (e.g. *Creditreform*) leads to substantiated reason to believe that the network user will not comply with its obligations under the agreement; or
- If the network user is unable to evidence sufficient liable equity capital.

The amount of collateral shall be considered reasonable if it corresponds to double the amount of the fees which are to be paid monthly under the agreement. In the event E.ON request that the third party makes collateral available, such collateral may be furnished as a directly enforceable guarantee[40] by an EU-approved credit institution subject to an obligation to pay upon first reminder. Collateral in cash shall bear interest at the respectively applicable base rate. If the third party fails to comply with a written reminder to furnish collateral within 14 calendar days, E.ON may disconnect the network use without a further reminder until such collateral has been furnished. If a reasonable period has passed without remedy, E.ON may draw on the collateral

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39 Terms and Conditions for Access to the Network of E.ON Gastransport GmbH dated 1 October 2009 (Version 6.0).

40 *Selbstschulderische Bürgschaft* pursuant to section 771 of the German Civil Code.

without further notice. E.ON is obligated to return collateral, once the conditions described above have been remedied.

The other largest network operator in Germany, Amprion, applies similar conditions. The network user is obligated to provide Amprion[41] with the information that is required to determine the creditworthiness of the third party. If Amprion finds that there is inadequate capital or the conditions listed in the bullet points above occur, Amprion can request the network user to provide collateral. The collateral shall be furnished as a directly enforceable guarantee by an EU-approved credit institution subject to an obligation to pay upon first reminder. If a reasonable period has passed without remedy, Amprion may draw on the collateral without further notice. Amprion is obligated to return collateral, if an above described appropriate case ceases to exist or if the agreement has been terminated and all claims under this agreement have been settled.

The agreements with the TSOs also largely deal with security of supply issues surrounding physical wholesale trading. As in most Member States, the TSOs require the counterparty to the network agreement to post collateral. The collateral is proportional to the value of energy transported over the network. In the event that the trader goes bankrupt or is unable to deliver the promised electricity or gas, the TSOs have a 'provider of last resort' function, and will take responsibility for delivering the missing energy, using the trader's posted collateral.

II.2 EFET Trading Agreements

Our discussions with energy traders have confirmed that, in most EU markets, the vast majority of non-exchange based energy trades use the EFET framework trading agreement.42 This is a standard contractual agreement which controls aspects of the trade including definition of terms, delivery terms, force majeure and so on. These agreements also contain several provisions which are designed to quality-control the counter-party and control credit risk. All EFET Members all sign up to a non-binding code of conduct, which is designed to ensure good behaviour among market participants.43

By default, under the EFET agreement counter parties are required to provide audited financial statements and accounts on the request of the counter-party. The EFET contract also contains provisions which allow for an increase in the amount of credit or collateral the counter party has to post if that counter party under goes a 'material adverse change'. A material adverse change includes: a downgrade in credit rating of the counter party or the counter-party's credit support provider below a pre-agreed level; a reduction in the ability of the counter-party to pay its debts, by for example a decline in the ratio of earnings to interest payments, or an increase in total debt to total capitalisation below pre-agreed levels; a decline in tangible net worth of the counter-party; an expiration of credit support; or a merger that reduces the creditworthiness of the counter party. Parties are free to choose which of these material adverse changes, if any, to apply in their agreement.

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41 Amprion is was formerly the RWE transmission network.

42 The examples in this section come from the EFET General Agreement Concerning the Delivery and Acceptance of Electricity version 2.1(a).

43 The EFET code of conduct is known as the '10 pillars' – it obliges companies not to engage in market abuse, deal with counterparties in a fair and reasonable way, establish effective risk management policies, establish compliance policies, ensure that staff are properly trained and prohibit the taking or giving of bribes.

Many of the features of the EFET contract are optional, and counter parties can agree with one another how much collateral they wish to post to cover a given trade. We understand from traders that this flexibility is advantageous. For example, smaller traders who are more likely to be capital constrained may prefer to take more risks and post less collateral for any given position. Larger trading houses, or utilities for whom trading is not their main activity, will generally be more risk averse and have more cash on hand. These firms will generally want to fully cover their positions by demanding high collateral requirements. Accordingly, it would be difficult to apply a 'one size fits all' policy to collateral requirements in the market, since different traders have different capital availability and different risk appetites.

II.3 Requirements of exchanges and clearing houses

We understand that while many trades are done bilaterally or OTC, most active traders perform at least some trades on an exchange. Therefore the regulations which govern exchanges are another important non-license' control on the behaviour and quality of market participants. The requirements we see for becoming a member of an exchange are similar to those that we see in some licences, especially in the CEE Member States. This suggests that private parties – the exchange – already have good incentives to perform checks on their members especially in terms of the 'quality' of the parties and the collateral they must provide.

APX/ENDEX

APX is a spot energy exchange operating in the markets of the United Kingdom, Belgium and the Netherlands. The exchange supports gas trading in all three countries and power trading in the UK and the Netherlands. ENDEX is the exchange that allows trading in a number of energy futures as well as acting as a clearing house for bi-lateral trades. These include gas and power for both the UK and the Netherlands. In order to trade these products, the following criteria must me met:

- The applicant must have a license as a financial service from the Netherlands Authority for the Financial Markets (AFM) or equivalent institution from the requisite country, or proof that it has energy trading experience to the satisfaction of ENDEX.
- An agreement with a clearing member registered with ENDEX.
- A Member seeking admission as a Proprietary Trader must have the arrangements in place to ensure that its physical deliveries resulting from Open Positions, can be settled or physically delivered. Alternatively it must have an arrangement in place with the Clearing House to close-out Open Positions financially before settlement. These arrangements are designed to minimise counter-party risk in the case of bankruptcy. Requirements for collateral of trades are set by the clearing houses. ENDEX can impose position limits on products and members.

The applicant must also enter into the membership agreement and provide the following information:

(a) Certified copy of trade register

(b) Articles of association of applicant

(c) Most recent annual report

(d) License of financial service or exception

(e) Clearing member declaration

In addition to these initial requirements, there are a number of ongoing conditions the trader must comply with. For example, the trader must: refrain from any action that may jeopardise the proper functioning of the Trading System; have all necessary regulatory authorisations, approvals and consents for trading on the Trading System in place; ensure that those assigned to its trading activities are competent and appropriately trained; and comply with any applicable regulatory rule in force, including the 'Know Your Customer' Rule.

To put the fees for regulatory licensing into context, we also note that the annual fee for being a regular member on one of APX's exchanges is about €10,000 – one can become a member whose trades are cleared through a broker for about €6000.

EEX

The European Energy Exchange or EEX is based in Germany. EEX is a regulated market inter alia for power derivatives and a spot and derivatives market for natural gas. To become an EEX member the applicant must be able to:

- Show that it has at least €50,000 of equity;
- provide proof of personal reliability and professional qualifications of management
    - the assurance of personal reliability is essentially a declaration that the person has no proceedings against them related to assets tax or exchange dealings.
- provide at least one trader who has passed the required EEX examination(s).
- have technical facilities available for trading and settlement of exchange transactions;
- be recognised as a trading participant by European Commodity Clearing AG (ECC).
- Provide copies of the latest set of certified and audited annual accounts;
- Provide copies of ID cards or passports of persons holding management authority.

Clearing Houses

The position of the clearinghouse gives other parties in the market confidence that there will not be market failure due to default of the parties to a transaction. The multiple worries of market participants about the solvency of other participants in the market is reduced to a single focus on the solvency of the clearinghouse.

Because a clearinghouse is party to both sides of cleared transactions, its risk exposure is relatively small. It is exposed to the "net" change in the market price of any particular category of transaction. This exposure is usually covered by both "margin" paid by the parties to a transaction and, as a last resort, by a large guaranty fund -- usually consisting of deposits of clearinghouse members and/or insurance contracts. In exchange for this clearing service, the parties will usually be required to pay a small clearing fee and to make daily "margin" payments to the clearinghouse.

"Margin" is an amount calculated by the clearinghouse that will allow the clearinghouse to "close out" (or sell) a cleared party's market contract and cover any market price shortfall, without loss, in the event of a cleared party's default (inability to perform its obligations to the clearinghouse with respect to a contract) on the date on which performance is required.

The collateral requirements for trading on exchanges are decided by the clearing houses. The clearing house indemnifies one party from the default of a counter party on positions which are open at the end of the trading day. Clearing houses have highly sophisticated rules regarding how much collateral is required, and the collateral requirements change daily according to the trader's position in the market.

For example, Nord Pool Clearing ASA (NPC) requires traders to post collateral based on two elements: base collateral and a daily margin call. The level of the base collateral depends on the trading pattern and credit rating of the counterparty. The base collateral must be covered before trading can begin.

The daily margin call covers the clearing house's market risk in the case of a member default and the close-out of the portfolio. The daily margin call itself consists of a variation margin and an initial margin. The variation margin is the unrealized profit/loss of the portfolio's forward contracts. The profit/loss of the future contracts is settled every day. For forward contracts the profit/loss is calculated during the trading period and settled during the contract's delivery period.

The initial margin reflects a portfolio's market risk during a close-out period. In the case of NPC, the initial margin is based on the worst-case loss a portfolio would have during a close-out period of 5 days, if the prices should move up to 3 standard deviations of observed historical price movements.

Acceptable collateral to NPC is cash on a pledged cash account opened in a bank approved by NPC, and/or an on-demand guarantee according to a standard template. The collateral call for the previous trading day must be covered by the clearing member no later than 11.00 CET the next trading day. If the deadline is not met, NPC will declare a default according to the clearing rules and take all necessary steps to reduce its counterparty risk.

Appendix III : Interfaces between Financial and Energy Regulation

In the wholesale markets for gas and electricity, there are four different spheres of trading that reflect different regulatory relationships between physical and financial trading. They are:

- Over-the-counter ("OTC") trading of gas and electricity derivatives;
- Trading of physical and financial contracts for gas and electricity on regulated markets;
- Trading of physical and financial contracts for gas and electricity on unregulated markets, that "mirror" regulated markets; and
- OTC trading of physical gas and electricity.

In each EEA country there is a division of regulatory responsibility for the trading of gas and electricity between financial services and energy market regulators. In general terms, the responsibility of financial services regulators is more focused on "commodity-related derivatives" and the responsibility of energy market regulators is more focused on the physical supply of energy. However, in the market configurations described above, there are a number of times where their responsibilities overlap, and some occasions where they do not.

OTC Trading of Energy Derivatives

Under MiFID, financial services regulators will always have responsibility to regulate trading of energy derivatives. However, it is important to remember that there are two types of markets operating in the OTC sphere. The first is the type of markets where there is never physical delivery of energy at the conclusion of a transaction. The transactions are always settled by the payment of cash or by the purchase of offsetting contracts ("booking out"). In this first type of market financial services regulators will have sole responsibility. Energy market regulators are unlikely to have any responsibility.

In the second type of OTC market, physical delivery will sometimes occur at the conclusion of a transaction. In these cases, the financial services regulators will, again, always have regulatory responsibility. However, any physical delivery which bears on supply of gas or electricity to a physical distribution network will probably require compliance with regulations administered by energy market regulators.

Trading of Energy on Regulated Markets

Under MiFID, there are three types of regulated markets. The first is "recognized investment exchanges", constituting the traditional types of exchanges, regulated by financial services regulators as "exchanges". Examples of this type would be the London Stock Exchange and the Deutsche Börse. The second type is the "multilateral trading facility" ("MTF") which may be operated either by an established exchange or by a regulated investment firm. The third type is the internal markets operated by investment firms which have chosen to be "systemic internalizers". What each of these markets has in common, from a regulatory point of view, is that each is subject

to regulation by the financial services regulators. In general, the trading on these markets, of themselves, will not be regulated by energy regulators.

Energy regulators may become involved after the conclusion or "settlement" of transactions on these three types of regulated markets when and if any of the transactions result in the delivery of physical energy to energy distribution systems.

Trading of Energy on Unregulated Markets

There is also another category of market which attracts regulation under MiFID. This is the so-called "mirror" or "look-alike" market. This is a market, usually OTC, and usually falling outside one of the three categories listed above that trades contracts which mimic the characteristics and procedures of regulated exchanges. The contracts are "standardized" as to terms and are sometimes "cleared" by a central clearing procedure similar to that employed by regulated exchanges.

In MiFID, these types of transactions are referred to as "having the characteristics of other derivative financial instruments" and they are subject to the regulation of financial services regulators if they are not for "commercial purposes". Contracts are considered to be for "commercial purposes" if they are entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and are necessary to keep in balance the supplies and uses of energy at a given time. This last category of energy contracts will be subject to regulation by energy regulators to the extent they are used to supply energy networks.

OTC Trading of Physical Energy

As can be seen from the above, the one category of wholesale gas and electricity trading that will not be subject to regulation by financial services regulators is the OTC trading of physical gas and electricity which requires the physical delivery of the actual energy commodity to conclude the transaction, where neither party has the "option" to conclude the contract by other means (such as cash payment) and where physical delivery actually occurs at the conclusion of the transactions in question.

Of course, the energy commodities delivered in settlement of these transactions can be subject to regulation by energy regulators where the commodities are used to supply energy networks. This is also the category of energy transactions that cannot benefit from the MiFID passport.

Appendix IV : MiFID Implementing Legislation MiFID Implementing Legislation

Although MiFID does not provide any further analysis of what types of derivatives on commodities will fall within the scope of Section C of Annex I, Directive 2006/73/EC of 10 August 2006 (the "**MiFID Implementing Regulation**") does provide some guidance on when commodities contracts should be considered financial instruments for purposes of MiFID.

As an initial matter, the MiFID Implementing Regulation defines commodities as

> "goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity."

The MiFID Implementing Regulation states that:

> "a derivative contract should only be considered to be a financial instrument under Section C(7) of Annex I to Directive 2004/39/EC if it relates to a commodity and meets the criteria in this Regulation for determining whether a contract should be considered as having the characteristics of other derivative financial instruments and as not being for commercial purposes. A derivative contract should only be considered to be a financial instrument under Section C(10) of that Annex if it relates to an underlying specified in Section C(10) or in this Regulation and meets the criteria in this Regulation for determining whether it should be considered as having the characteristics of other derivative financial instruments. "

Furthermore, the MiFID Implementing Regulation provides that:

> "a derivative contract should be understood as relating to a commodity or to another factor where there is a direct link between that contract and the relevant underlying commodity or factor. A derivative contract on the price of a commodity should therefore be regarded as a derivative contract relating to the commodity, while a derivative contract on the transportation costs for the commodity should not be regarded as a derivative contract relating to the commodity. A derivative that relates to a commodity derivative, such as an option on a commodity future (a derivative relating to a derivative) would constitute an indirect investment in commodities and should therefore still be regarded as a commodity derivative for the purposes of Directive 2004/39/EC."

Article 38 of Chapter VI (*Derivative Financial Instruments*) of the MiFID Implementing Regulation sets forth the characteristics of other derivative financial instruments that will fall under the MiFID definition of financial instruments.

It should be noted that Article 38 creates exceptions for spot contracts (as defined below) and for any contract that is entered into

> "with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network" and that is "necessary to keep in balance the supplies and uses of energy at a given time."

The characteristics of other derivative financial instruments set forth in Article 38 are as follows:

> "For the purposes of Section C(7) of Annex I to Directive 2004/39/EC, a contract which is not a spot contract within the meaning of paragraph 2 of this Article and which is not covered by paragraph 4 shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:

- it meets one of the following sets of criteria:
- it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;
- it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;
- it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;
- it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;
- it is standardized so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

A spot contract for the purposes of paragraph 1 means a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods:

- two trading days;
- the period generally accepted in the market for that commodity, asset or right as the standard delivery period.

However, a contract is not a spot contract if, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the period mentioned in the first subparagraph.

For the purposes of Section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to an underlying referred to in that Section or in Article 39 shall be considered to have the characteristics of other derivative financial instruments if one of the following conditions is satisfied:

- that contract is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of a default or other termination event;
- that contract is traded on a regulated market or an MTF;
- the conditions laid down in paragraph 1 are satisfied in relation to that contract.

A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2004/39/EC, and as not having the characteristics of other derivative financial instruments for the purposes of Sections C(7) and (10) of that Annex, if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time."

In addition to the guidance provided in Article 38 of the MiFID Implementing Regulation, Article 39 of Chapter VI (*Derivative Financial Instruments*) of the MiFID Implementing Regulation expands the scope of Section C(10) of Annex I to MiFID as follows:

> "In addition to derivative contracts of a kind referred to in Section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to any of the following shall fall within that Section if it meets the criteria set out in that Section and in Article 38(3):

- telecommunications bandwidth;
- commodity storage capacity;
- transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;
- an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;
- a geological, environmental or other physical variable;
- any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;
- an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation."

Although less directly relevant to the determination of when a commodities contract will be regulated by MiFID, it may also be of interest that Article 37 (*Derivatives*) of Chapter V (*Admission of Financial Instruments to Trading*) of the MiFID Implementing Regulation sets forth a number of criteria for when derivatives that fall under the MiFID definition of financial instrument will be admitted for trading, as follows:

"When admitting to trading a financial instrument of a kind listed in points of Sections C(4) to (10) of Annex I to Directive 2004/39/EC, regulated markets shall verify that the following conditions are satisfied:

- the terms of the contract establishing the financial instrument must be clear and unambiguous, and enable a correlation between the price of the financial instrument and the price or other value measure of the underlying;
- the price or other value measure of the underlying must be reliable and publicly available;
- sufficient information of a kind needed to value the derivative must be publicly available;
- the arrangements for determining the settlement price of the contract must be such that the price properly reflects the price or other value measure of the underlying;
- where the settlement of the derivative requires or provides for the possibility of the delivery of an underlying security or asset rather than cash settlement, there must be adequate arrangements to enable market participants to obtain relevant information about that underlying as well as adequate settlement and delivery procedures for the underlying.
- Where the financial instruments concerned are of a kind listed in Sections C (5), (6), (7) or (10) of Annex I to Directive 2004/39/EC, point (b) of paragraph 1 shall not apply if the following conditions are satisfied:
- the contract establishing that instrument must be likely to provide a means of disclosing to the market, or enabling the market to assess, the price or other value measure of the underlying, where the price or value measure is not otherwise publicly available;
- the regulated market must ensure that appropriate supervisory arrangements are in place to monitor trading and settlement in such financial instruments."

Appendix V : Market Abuse Directive

The Market Abuse Directive requires Member States to restrict the use and disclosure of inside information and to prohibit market manipulation. The Market Abuse Directive sets forth a definition of financial instruments, which include, *inter alia*, "derivatives on commodities." Unlike MiFID, the Market Abuse Directive does not attempt to draw distinctions between various types of derivatives on commodities.

Pursuant to the Market Abuse Directive, Member States are required to prohibit:

1. any person who possesses inside information by virtue of one of the reasons set forth in the Market Abuse Directive from "using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates."

2. any person who possesses inside information by virtue of one of the reasons set forth in the Market Abuse Directive from:

   (a) disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties;

   (b) recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates; and

3. any person from engaging in market manipulation.

Article 1 of the Market Abuse Directive defines inside information as follows:

> "Inside information shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.
>
> In relation to derivatives on commodities, 'inside information' shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets.
>
> For persons charged with the execution of orders concerning financial instruments, 'inside information' shall also mean information conveyed by a client and related to the client's pending orders, which

is of a precise nature, which relates directly or indirectly to one or more issuers of financial instruments or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments."

Article 1 of the Market Abuse Directive also defines Market manipulation', as follows:

(a) "transactions or orders to trade:

- which give, or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments, or
- which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level, unless the person who entered into the transactions or issued the orders to trade establishes that his reasons for so doing are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market concerned;

(b) transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance;

(c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumors and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading. In respect of journalists when they act in their professional capacity such dissemination of information is to be assessed, without prejudice to Article 11, taking into account the rules governing their profession, unless those persons derive, directly or indirectly, an advantage or profits from the dissemination of the information in question.

In particular, the following instances are derived from the core definition given in points (a), (b) and (c) above:

- conduct by a person, or persons acting in collaboration, to secure a dominant position over the supply of or demand for a financial instrument which has the effect of fixing, directly or indirectly, purchase or sale prices or creating other unfair trading conditions,
- the buying or selling of financial instruments at the close of the market with the effect of misleading investors acting on the basis of closing prices,
- taking advantage of occasional or regular access to the traditional or electronic media by voicing an opinion about a financial instrument (or indirectly about its issuer) while having previously taken positions on that financial instrument and profiting subsequently from the impact of the opinions voiced on the price of that instrument, without having simultaneously disclosed that conflict of interest to the public in a proper and effective way.

The definitions of market manipulation shall be adapted so as to ensure that new patterns of activity that in practice constitute market manipulation can be included."

Pursuant to Article 2 of the Market Abuse Directive, the restrictions on insider dealing apply to any person who possesses inside information:

(i) "by virtue of his membership of the administrative, management or supervisory bodies of the issuer; or

(ii) by virtue of his holding in the capital of the issuer; or

(iii) by virtue of his having access to the information through the exercise of his employment, profession or duties; or

(iv) by virtue of his criminal activities."

Moreover,

> "where such person is a legal person, the restrictions on insider dealing in the Market Abuse Directive shall also apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned."

> Directive 2004/72/EC of 29 April 2004 (the "**Market Abuse Directive Implementing Regulation**") also provides some additional guidance on the meaning on inside information in the context of derivatives on commodities, stating that "it is essential for market participants on derivative markets the underlying of which is not a financial instrument, to get greater legal certainty on what constitutes inside information."

Article 4 of the Market Abuse Directive Implementing Regulation, sets forth the following guidance on the definition of inside information in relation to derivatives on commodities:

> "For the purposes of applying the second paragraph of point 1 of Article 1 of Directive 2003/6/EC, users of markets on which derivatives on commodities are traded, are deemed to expect to receive information relating, directly or indirectly, to one or more such derivatives which is:

> (a) routinely made available to the users of those markets, or

> (b) required to be disclosed in accordance with legal or regulatory provisions, market rules, contracts or customs on the relevant underlying commodity market or commodity derivatives market."

Appendix VI : Additional Issues Identified in the Interviews

In this Appendix we have included concerns and comments that traders raised in interviews, but which do not relate directly to licensing.

Netting

An important issue that traders agree on is the need for consistent "netting" regulations across EEA jurisdictions in the event of contract default. "Netting" means that in the event that a party to an energy contract is in default of its obligations under the terms of that contract, the non-defaulting party has the right to set-off the amounts it may owe to the defaulting party against amounts owed to it and determine a net sum which will be enforceable in a court of law as a final settlement of the obligations owed between the parties under the contract in question.

Although it is usual for traders to enter into standardized agreements (such as ISDA or EFET) for the trading of energy that contain agreed netting provisions, traders are still not confident that such netting agreements will be consistently recognized and enforced in all EEA jurisdictions. Consequently, such doubts can affect the willingness of traders to enter into significant numbers of energy trading agreements in certain jurisdictions. Their concern is that the netting provisions may be voided by local insolvency legislation, and/or that local insolvency tribunals may be permitted to choose (or "cherry pick") which obligations will be enforceable in which are voidable. Cross-jurisdictional clarity on this issue would encourage more traders to enter into more agreements in more jurisdictions within the EEA.

If it was the wish of the CEER to resolve this issue, providing the proper legislation would require coordination with insolvency regulators in each EEA jurisdiction. Consensus would need to be reached on how netting provisions would be treated with respect to EEA wholesale gas and electricity trading contracts.

Clearing

There is a general consensus among both the financial and physical traders that we talked to that although having transactions "cleared" by formal clearing houses (whether exchange-affiliated or independent) adds additional protections against counterparty default, it should not be made "mandatory" in the wholesale markets for gas and electricity.

Although it is true that there are benefits to be gained from having market transactions cleared, there are also costs, which the traders we spoke with perceived to be detrimental to market development and liquidity.

With respect to market development, a key element that is required is flexibility to respond to the needs of the local market for wholesale gas and electricity. This may require trading a relatively small number of specialized "bespoke" contracts which meet local requirements but may not be usable in other locations. These types of contracts are usually not standardized enough or traded in large enough volumes to be traded "on exchange". They are traded "over-the-counter" ("OTC").

These contracts may not easily be made compatible with exchange trading and clearing. However, these days, that may not be an insurmountable problem. There are clearing houses for

OTC energy contracts (most notably, ICE Clearing -- the clearing operation of the International Commodities Exchange) that are willing to clear large numbers of OTC energy contracts (over 300 as of this writing). Nevertheless, there are other problems which make "mandatory" clearing unappealing.

Principally, there is the matter of cost. All of the large physical and financial traders that we spoke to clear many of the contracts they trade in, and they are in a position to afford the costs of clearing. However, there is concern, even among larger financial and energy organizations, that the cost of providing margin payments would harm smaller traders because it would require them to devote cash to margin that could otherwise be spent on building and supporting their energy trading businesses.

The large organizations we spoke to do their own evaluations of counterparty risk. They feel confident that this gives them sufficient protection against the possibilities of counterparty default. The consensus is that any gains from requiring mandatory clearing in the wholesale energy markets would not offset the problems it would cause for market growth and liquidity. It is felt that the costs of mandatory clearing could discourage or drive away smaller traders who are necessary to build and provide liquidity in developing energy markets, such as some of those in Eastern Europe.

In summary, it is believed that clearing is a useful market tool, and should be available, but should not be mandatory.

Access to storage and other "legacy" issues

Traders perceive access to storage as being a particular problem in the gas markets. There are a number of countries in which gas storage facilities have been built in the past with public money and are under the control of either national gas companies or formerly public but now privatized gas companies.

The problem this presents is that in order to effectively compete in a number of gas markets, traders need access to storage facilities. It is not always the case that access is permitted on an equal or "market" basis. It is the view of the traders we spoke with that access to storage facilities should be made available on a commercial "auction" basis rather than being available largely to, or under the control of, formerly state-controlled "legacy" companies.

This problem points to other similar problems in the market where formerly state owned companies have the advantage of access to facilities essential to gas and electricity trading and supply that were paid for with public money. This, in effect, provides a "silent subsidy" to those legacy companies by providing them with facilities at no cost to themselves which their competitors must invest their own capital to pay for.

In order to "level the playing field" in these markets, the traders we interviewed suggest that such facilities should be auctioned on the market.

However, we also note that Article 33 of the Third Gas Directive should go someway to alleviating problems with access to gas storage, because it requires storage operators to make access to storage where the is ‘technically and economically’ necessary for the supply of customers.

Appendix VII : Questionnaire

If different regimes/requirements for physical and financial trading apply please indicate clearly in the answers to which system they refer and try to emphasize differences.

(a) General background to licensing

1. What license(s) are required by law to engage in the activity of wholesale electricity and gas trading? Please answer separately for electricity and gas if needed.

2. We understand that some traders would like to settle their trades financially, but for practical reasons need to be able to unwind their positions physically. For example, traders may hold shipper or supplier licenses to help unwind positions that cannot be settled financially given the bid-ask spread required by the market. Hence we would like to distinguish between licenses that are required by law, and licenses that traders would need in practice to support wholesale gas and electricity trading. Accordingly, for the following activities, please indicate i) whether the law requires a separate license ii) and/or whether a wholesale trader will need such a license in practice to support wholesale gas and electricity trading:

   a. importing electricity or gas,

      required by law_____, obtained in practice to support trading____,

   b. transporting electricity or gas,

      required by law_____, obtained in practice to support trading____,

   c. the sale of gas to end-users, as opposed to on the wholesale market

      required by law_____, obtained in practice to support trading____,

3. At times one licence may cover different activities. Please indicate whether any two or more of the activities mentioned in your response to questions 1 and 2 are covered by just one licence. Please indicate which specific activities are covered by a sole licence.

4. Which authority or authorities are responsible for issuing each of the license(s) mentioned in your response to questions 1 and 2?

Requirements for obtaining licenses

Please answer the following questions for each of the licenses identified in the answer to questions 1 and 2.

5. Does the license holder need to establish a branch office in the Member State, or a subsidiary such as a private limited company? Are there any requirements concerning corporate governance (e.g. is a risk management unit needed) or the number and type of employees? For example, does the licence require the applicant to have a company secretary or a compliance officer or a board of directors?

6. Does the applicant need to provide financial information as part of its application? Are there any requirements to post letters of credit/bank guarantees? If so how are the amounts of money determined? Are there requirements for the licensee to hold a minimum amount of capital, and if so what is this minimum?

7. What other information does the applicant need to supply? For example does the applicant need to provide a business plan? Does the applicant need to provide information concerning its nominated representative, for example showing qualifications and an absence of a criminal record?

8. Sometimes the license(s) listed in question 2 will require the trader to hold other contracts or permits. Can you tell us if there is any requirement in the license to show the commercial or physical ability to import or transport gas or electricity, for example by: having a transport agreement with the network operator, or commercial contracts to import gas, or for the storage of gas?

9. Is there a need to demonstrate any access or control e.g. on generation facilities in electricity or storage in gas as a prerequisite for being able to trade?

10. Are there requirements laid out for the applicant's Information Technology systems?

11. If a license application is rejected, is there an opportunity for appeal? Does the authority have to publish its reasons for rejection?

Cost and timing

12. Is there a one-off charge by the authority for obtaining the license? If so how much is the charge? What are the other costs estimated for obtaining a license, in terms of legal/accounting or other consulting advice, cost of setting up a branch company (if required) etc.

13. If successful, roughly how long does the license process take to complete, from starting the application process to obtaining a license? Are there any obligations on the issuing authority to issue the license within a certain time frame?

14. What is the term of the license (in years)? Does the applicant need to repeat the application process once the term has finished, or can it request to extend the license?

(b) Ongoing requirements

15. Having obtained a license, what information does the licensee have to prepare and provide to the authorities on a regular basis? For example does the licensee need

to provide regular financial statements, copies of contracts, details of trades undertaken or open positions in the market?

16. What is the estimated cost of preparing and providing this information, in terms of professional services required and the costs of the staff engaged in reporting?

17. Is there a requirement in the license to keep records of trades, conversations with counter-parties, or contracts? If so for how long?

18. For each relevant category of information identified in the answers to questions 14 and 16, please indicate whether you would prepare and keep the information as part of normal business practice even if it were not required by the licence.

19. Does the license contain 'good behaviour' clauses, for example prohibiting manipulative trades or the exercise of market power?

20. What are potential reasons for having a license withdrawn by the relevant authority?

21. Are there any requirements in the license which relate to security of supply? Are there requirements to undertake certain actions under a declared 'emergency'?

(c) General

22. General: are there any particular aspects or requirements to obtaining or holding a license which you consider unduly onerous, or aspects of the process which could be improved? Please describe.

Appendix VIII : Physical Gas Trading in the UK

1. Physical trading for gas requires that the trader:

   (a) hold a Shipper licence

   (b) submit a formal application to the Transporter[s].

   (c) accede to Uniform Network Code

   (d) obtain a copy of the UNC and associated documents

   (e) have IXN (UK Link) equipment installed

   (f) appoint authorised representatives

   (g) be assigned a Code Credit Limit

   (h) be assigned a Secured Credit Limit (for the NTS)

Shipper License

2. A shipper needs a license from Ofgem. The application for a license to be a gas shipper is £350, and is designed to be reflective of costs. It is expected that a license will be given within 8 weeks of application. A notice of application must be published within 10 days of making the application, either on the Ofgem website, or on the company's website. Financial information is not required for the license application.

Application to the Transporter

3. All transporters use the same application form. It is available from xoserve upon request. Each transporter has its own Uniform Network Code the shipper must sign up to. These are available from the Joint Office of Gas Transporters. (www.gasgovernance.com). Where an applicant is not registered in England and Wales a Legal Opinion is required by all Transporters to accompany the Accession Agreement. The applicant's appointed lawyers should draw up the Legal Opinion. (An example Legal Opinion will be provided by xoserve.)

IXN (UK link) equipment

4. Every shipper must have the UK link computer system. To access the UK Link systems all Users are required to be connected to the communication infrastructure known as the Information Xchange Network (IXN). This allows all transporters and Users to communicate with each other securely.

5. The IXN equipment must be installed at an address within the UK. The precise requirements for each applicant will vary dependant upon their requirements. This will be determined during a site visit to the intended IXN equipment installation address, which is conducted prior to the ordering of any hardware equipment. The hardware

equipment installed is usually in the form of Telecommunication lines, router (NAP equipment), and file server (gateway).

Credit Limits and Security

6. The Uniform Network Code requires that each Transporter will determine and assign the applicant with a Code Credit limit. Each Transporter has a set of Code Credit Rules, which has been established and is issued to the applicant.

7. All Credit arrangements are made directly with each Transporter as appropriate between the applicant and the Transporter's Credit and Risk Manager. It is also necessary for the applicant to be assigned a Secured Credit Limit in relation to the National Transmission System. This arrangement is managed by xoserve on behalf of the industry and, as with the Transporter Credit arrangements a set of Code Credit Rules has been established and is issued to the applicant.

Appendix IX : Financial Trading of Electricity in Spain

Electricity financial trading is done in particular through the Iberian market organised by OMIP. Through OMIP, parties can trade 3 types of contracts: futures, forwards, and swaps. Three types of agent operate in this market.

First of all, there are traders, which buy and sell these OMIP contracts. In order to be a trader, the OMIP requires that the trader satisfy personnel and technical conditions. In particular, the personnel conditions require that the trading company has an authorized representative and a trading manager. Furthermore, all the traders, the authorized representative and the trading manager need to pass a formal OMIP exam. The technical conditions require that the trading member has an IT infrastructure that makes it possible to execute the orders of the clients in a secure way.

Second, there are clearing members, which: register the positions, constitute the guarantees and settle the positions. The system created two types of clearing member: general members, who can clear their own and their client accounts, and direct members, who can clear only their accounts.

To be a clearing member (general and direct clearing operator) OMIClear requires the fulfilment of the following requirements:

(a) Participate in the financial Settlement Systems or shall have entered into a Financial Settlement Agreement with a Financial Settlement Agent;

(b) Have at their disposal the human resources adequate for the exercise of Clearing Members' functions (in general term they have to nominate the clearing and settlement operators);

(c) Have adequate technical and operational conditions to execute the Clearing Member functions (in general term that they have an adequate IT structure).

(d) Have entered into a Clearing Member Admission Agreement with OMIClear.

In order to be a general clearing member, apart from the requirements just listed for all clearing members, the company must fulfil the following specific requirements:

(a) Be a credit institution or a financial intermediary;

(b) Demonstrate an equity capital in the amount equal or superior to 20.000.000 Euros. If their capital is bigger 20,000,000 but smaller than 25,000,000 they will have to provide guarantees for the difference.

(c) Prove it has a rating not less than "A-/A3", attributed by any one of the following international agencies: Standards & Poors, Moodys or Fitch; or Deposit an Additional Guarantee of 150.000 Euros when its rating is less than "A-/A3" but greater "BBB-/Baa3", or deposit an Additional Guarantee of 300.000€ in case it does not hold a suitable credit rating.

In order to be a direct clearing member, the company must fulfil, besides the regime as stated earlier for all clearing members, the following specific requirements:

(a) They must be: a credit institution or a financial intermediary; or Electric Sector Entities; or Entities that only clear Positions from Electric Sector Entities with which they are in a control or group relationship, following article 21 of the Securities Code;

(b) They must demonstrate an equity capital equal or superior to 8.000.000 Euros. If their capital is bigger 8.000.000 Euros but smaller than 10.000.000 Euros, they will have to provide guarantees for the difference.

(c) They must prove that they have a rating not less than "A-/A3", attributed by any one of the agencies mentioned; or deposit an Additional Guarantee for 150.000 Euros when its rating is less than "A-/A3" but greater than "BBB-/Baa3", or deposit an Additional Guarantee of 300.000€ if they do not hold a suitable credit rating notation. There may be further requirements.

Finally, the OMIP define the role of the settlement agent. There are two types of settlement agent: Financial and Physical. For financial settlement agents two conditions have to be satisfied:

(a) They must participate in the Settlement Systems used by OMIClear and fulfil the specified technical requirements;

(b) They must have entered into a Financial Settlement Agent Agreement with OMIClear.

For physical settlement agents, two conditions have to be satisfied:

(a) They must be member of the Spot Market;

(b) They must have entered into a Physical Settlement Agent Agreement with OMIClear.

Appendix X : The UK Tribunal

The UK Tribunal is an independent regulatory review body not subject to the Board of the FSA. It is important to note that the UK Tribunal is not simply an "appeals" body that reviews whether a decision by the FSA was procedurally correct. The UK Tribunal's powers extend much further. In fact, the UK Tribunal affords any party subject to an unfavourable FSA decision an opportunity to have that decision reconsidered in its entirety. The UK Tribunal is permitted to take any action that the FSA had the power to take. It can hear any witnesses and consider any evidence which the FSA had the power to consider when it made its original decision. The UK Tribunal is not in any way restricted by any limitations the FSA placed on its own consideration of how to make its initial decision. In other words, the UK Tribunal gives parties an entirely new consideration of the original matter.

The UK Tribunal also separates itself from the FSA in the way it perceives its duties. The FSA, as a regulatory body, has a duty to enforce statutory and regulatory provisions as they are drafted. The UK Tribunal, on the other hand, has a duty to judge the enforcement of those statutory and regulatory provisions in light of their compliance with the overall body of UK and EU law. For example, the "market abuse" provisions of the UK Financial Services and Markets Act 2000 were originally intended to create a "civil" administrative procedure allowing the FSA to deal with market misconduct under civil rather than criminal procedures and requirements.

In a procedurally important case (the so-called "Plumber Case") involving alleged misconduct during an initial public offering of shares on a UK market, the FSA found that misconduct had occurred and that the alleged actors should be punished by large fines and FSA censure (which led to the dismissal of some of the alleged actors from their jobs).

In that case, the UK Tribunal ruled that, although the testimony of the key actors was not always credible, the FSA had failed to meet the high burden of proof required under UK and European law in a case of this kind. The UK Tribunal found that in any case where the proposed penalties are severe, such as large fines and censure leading to loss of employment, it was not sufficient for the FSA to show that the evidence satisfied the civil standard of proof by a "preponderance of the evidence".

The UK Tribunal found that the purpose of the "market abuse" provisions was not to compensate losses of victims or to recover unjust gains, which would have brought it within the definition of a "civil" action. The purpose of those provisions was to "deter and punish" market misconduct. Furthermore, they were aimed at the general public rather than a limited population of FSA regulated firms. Consequently, the "market abuse" provisions required the application of the "criminal" standard of proof under the Human Rights Directive (and its UK implementation).

The UK Tribunal went even further. It held that the standard of proof in market abuse cases is on a "sliding scale". In cases where the penalties were severe, the standard of proof would be higher and, indeed, the same as a criminal standard. In less severe cases, it might be possible to apply a civil standard. However, the fact that the UK statute called the "market abuse" provisions "civil" provisions was not determinative as to how they would be regarded by the UK Tribunal.

The UK Tribunal's decision was upheld by the UK Court of Appeals. The FSA regarded this as a serious loss. It goes to show how differently an independent tribunal can view its role from that of a regulator.