Lord Mogg KCMG
CEER President

Brussels, 19 March 2015

Lord Hill
Commissioner for Financial Stability, Financial Services and Capital Markets Union

Mr Maroš Šefčovič
Vice-President for Energy Union

Mr Miguel Arias Cañete
Commissioner for Climate Action and Energy

Ref: MiFID II and the potential negative impacts on European energy markets and the goals of the 3rd Package

Dear Sirs,

I write to you on behalf of the Council of European Energy Regulators (CEER) to share with you our views about the latest developments in the level 2 negotiations for Markets in Financial Instruments Directive (MiFID II) [1], especially as regards their impact on energy markets.

Background

CEER has followed the developments in MiFID II with interest. One of our main objectives is the completion of the Internal Energy Market (IEM) and to deliver the 3rd Package goals of competiveness, sustainability and security of supply for European consumers ultimately to increase the choice and benefits for consumers.

We therefore are deeply concerned about what we view as an attempt to redraw the so-called 'REMIT carve-out' in Section C6, Annex I of MiFID II, as well as the unintended consequences of revisions to Section C7. This letter and its annexes set out more detail on these risks and potential options to mitigate them.

[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

Energy regulators remain fully supportive of the goals of MiFID II to improve conduct in financial markets. We welcome the good cooperation between financial and energy regulators which will only increase going forward. We must note, however, instances where financial regulation is either not appropriate for gas and electricity markets, or duplicates what is already covered by the 3rd Package and the Regulation on wholesale market integrity and transparency (REMIT). This duplication may also create confusion among market participants, for instance, sometimes wholesale energy contracts that have to be settled with physical delivery are understood to be derivatives when they are not.

We have strong concerns that the proposed developments in the Level 2 negotiations on MiFID II would have serious detrimental impacts on these goals, increase barriers to market entry, and make the recent proposal for an 'Energy Union' more difficult to realise. In particular, we note the numerous references to jobs and growth throughout the Energy Union Communication[2] and believe that the potential damage to wholesale energy markets would have a tangible impact on the competitiveness of European industry (already disadvantaged compared to US industry as noted by the Commission) as well as European consumers.

Furthermore, the environmental goals of the Energy Union package may become more difficult to achieve in a world which has more volatile wholesale prices due to more renewable generation yet has fewer possibilities for market participants to hedge against that price volatility. In keeping with the various actions points of the Energy Union Communication and the Commission's 'Better Regulation' agenda, it is important that the goals of sector specific energy regulation and financial regulation work in tandem to improve market conduct and transparency.

We echo the concerns in the recent Recommendation by the Agency for the Cooperation of Energy Regulators (ACER) No.01/2015 which you have received in parallel, and wish to highlight further concerns shared by Europe's energy regulators.

A key feature of a competitive liberalised energy market is liquidity. Unlike many financial markets, European gas and power markets often still suffer from low levels of liquidity. Liquid wholesale gas and power markets remain a central aim of the 3rd Package and are intrinsically linked to the recent Energy Union Communication.

As energy regulators, we often hear liquidity used as an argument against specific regulation. However, we would urge the Commission, Council and Parliament to take our arguments with regard to the potential impacts on liquidity for what they are – a reflection of our genuine concerns. We firmly believe that what is being proposed in the Level 2 texts of MiFID II could seriously undermine the work of the last 10 years by the Commission, ACER, national energy regulators and the industry to promote and build well-functioning markets for gas and electricity. You will find more details regarding the reasons for why liquidity needs to be protected in Annex 1 of this letter.

Our main concerns

Our most pressing concerns relate to the European Securities and Markets Authority's (ESMA) Technical Advice to the European Commission[3] and the DG FISMA non-paper with respect to Section C6 and C7 of Annex I of MiFID II. We have additional concerns around the exemptions available to firms trading energy on exchanges. We have provided our views to the recent ESMA consultation on this last point.

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[2] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank a Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy

[3] ESMA's Technical Advice to the Commission on MiFID II and MiFIR

On Section C6, we are deeply concerned about the last minute addition to the Technical Advice with respect to the definition of '*must be physically settled*' which ESMA admits it did not consult on, and where the strong concerns of energy regulators are also noted in the Technical Advice. It is disappointing that the views of energy regulators and DG Energy were not sought much earlier in this debate as the very matters being discussed impact on the core of wholesale gas and power trading in the EU.

Exemptions

Our concerns regarding the proposals are twofold. Firstly, we have questions regarding whether it is possible to extend and redefine aspects which were previously negotiated and agreed for the Directive itself (i.e. Level 1). For us, the exemption provided for wholesale energy products which must be physically settled applies to the contract. Any attempt to further define this to exclude certain market participants, based on which physical assets they hold, goes against the intent of the exemption in the Directive. This new definition may also appear rather arbitrary and has the potential to distort price signals in the market. Our first preference would be to delete the reference to proportionate arrangements from the Technical Advice as the subsequent three articles (1 (ii), (iii) and (iv)) offer more objective criteria to define this issue for wholesale gas and power markets.

Definition of 'must be physically settled'

Secondly, regarding what '*must be physically settled'* means in practice, we agree with the arguments outlined in ACER's Recommendation. There is a standard practice for firms trading energy across the EU to be party to a balancing and settlement agreement with a Transmission System Operator (TSO). This is the most relevant, and only, criteria needed to define *'must be physically settled*'.

Section C7

With regard to Section C7, we are concerned with the revision to the text in the Technical Advice for contracts that are deemed to be '*equivalent*'. Although there is a later paragraph which refers to commercial purposes, this would still potentially capture several commercial gas or power contracts entered into by large industrial consumers as Financial Instruments within the scope of MiFID II.

With regard to the notion of commercial purpose, despite the fact that a proper application of the Level 1 legislation would probably require an examination of the parties and their intention concerning delivery, we understand that ESMA favours a very narrow application of this notion in the context of energy markets. Taking this into account, and by looking at the specific case considered in the ESMA's Technical Advice, CEER wishes to highlight that, in relation to contracts entered into with or by the Transmission System Operator, similar consideration should be given to those contracts entered into either to keep in balance the supplies and uses of energy at a given time ***or for the purpose of ensuring security of energy supplies***. These are both key tasks of many TSOs across the EU which usually stem from network operational rules and/or sector specific regulatory obligations.

Our concerns on these issues relate to the significantly increased burden and cost to both market participants from MiFID II, as well as the 'European Market Infrastructure Regulation' (EMIR) and Capital Requirements Directive (CRD IV)[4] which would increase the barriers to entry in wholesale gas and electricity markets and impact on liquidity, consumer prices and security of supply. Further detail on these, including specific proposals and wording, can be found in Annex 2 of this letter.

We understand that ESMA's Technical Advice largely reflects the aim of MiFID II to find a balance between the risk of regulatory arbitrage and the very broad extension of the definition of commodity derivatives to physical contracts. However, in doing so, we must ensure that the efforts of the last 10 years to build a functioning Internal Energy Market will not have been in vain.

I conclude by noting again our strong concerns, which are shared by colleagues in ACER and DG Energy, and on which we would be very happy to meet to discuss further with representatives of the European Commission, Council or Parliament.

Yours sincerely,

Cc:

Mr Jerzy Buzek MEP, Chair of Committee on Industry, Research and Energy

Mr Roberto Gualtieri MEP, Chair of Committee on Economic and Monetary Affairs

Mr Mihails Kozlovs, Latvian Presidency, Head of Division (ECOFIN Council, Economic and Monetary Union, Eurogroup, EWG)

[4] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

Annex 1 – Importance of the liquidity

As noted previously, the 3rd Package aims to promote competitive and liquid wholesale gas and electricity markets which benefit European consumers. Poor liquidity makes effective competition in the generation and supply markets more difficult to achieve and so promoting liquidity was one of the main aims of energy market liberalisation in the EU (third party access, unbundling, etc.)

New entrants need to secure access to wholesale gas and electricity supplies in order to supply retail consumers. The ease with which they can do this is referred to as market liquidity. Liquidity can be measured in a number of ways: the number of trades, the variety of products on offer, traded volume, delivered volume, tightness of the bid-offer spread and churn. In essence, liquidity is the ability to quickly buy and sell a commodity without a significant change in its price and without incurring significant transaction costs. **The benefits of a liquid market include:**

- allowing buyers and sellers to buy and sell the products they need and reliably make transactions in a timely way at a cost-reflective price; and
- firms can effectively pursue hedging or portfolio optimisation strategies to manage risk; and it provides long-term price signals which encourage investment.

It therefore helps market participants (including small players) to compete effectively. In general, the more liquid the wholesale market, the easier it is for:

- non-vertically integrated entrants and competitors to participate on the same terms as vertically integrated firms;
- new entrants to be confident that the wholesale markets are not artificially distorted by vertically integrated players;
- all market participants to respond to and compete around the risk and hedging preferences of their customers;
- all market participants to secure the full range of products required to hedge their specific profile of risk exposure; and
- all market participants to make long-term hedging and investment decisions on the basis of the traded wholesale price.

Summarising **these advantages,** it can be concluded that **all of them are likely to result in lower and competitive prices to consumers and industrial users**.

On the other hand, the negative impacts of an illiquid market include:

- **Deterring entry and growth of new players in the market** – Poor liquidity limits the ability of entrants and small firms to buy and sell electricity in the wholesale market. This may prevent them from selling their output or sourcing energy to supply to their customers. This barrier to entry and growth in the market removes a competitive threat to incumbent firms.

- **Inhibiting competition between existing players in the market** – Poor liquidity in the electricity wholesale market limits opportunities to trade, acting as a barrier to firms seeking to increase their market share and reducing the scope to identify optimal hedging strategies that provide customers with the best possible deal. It could also encourage business models that reduce the need to trade in the wholesale market, such as vertical integration and long-term contracts. Poor liquidity therefore inhibits competition between incumbent players.

- **Weakening price signals that help to ensure security of electricity supplies –** In order to make decisions about investment in new generating plant and about when to carry out maintenance, generators need robust and transparent forward market prices. Poor liquidity may obscure or weaken these price signals, potentially having a negative impact on the security of consumers‟ electricity supplies.

- **Poor liquidity can be self-reinforcing –** Poor availability of products and price signals can deter firms from trading in the market, which then further reduces the availability of products and prices. The market therefore becomes locked in a low-liquidity equilibrium.

Summarising **these disadvantages,** it can be concluded that **all of them are likely to result in higher prices to the detriment of consumers as well as industrial users**.

Further details on the importance of liquidity may be found in the recent publication from the Commission de Regulation de l'Energie's (CRE) recent report[5] and the Office of Gas and Electricity Markets' (Ofgem's) 'Secure and Promote' liquidity intervention[6]. Furthermore, liquidity has been referred to consistently throughout the most recent ACER Market Monitoring Report[7].

[5] Le fonctionnement des marches de gros de l'électricité, du CO2 et du gaz naturel 2013-2014

[6] Ofgem-Electricity-Wholesale Market-Liquidity

[7] ACER-CEER Annual Report on the Results of Monitoring the Electricity and Natural Gas Markets 2013

Annex 2 – Analysis of Technical Advice and DG FISMA non-paper

	Current proposal (text or concept)	CEER Analysis of impact on energy markets	CEER Alternative proposal or wording
Recital	None	Since the exemption for REMIT under Section C6 at Level 1 is for the contract (and not the party trading that contract) we believe a recital is necessary to further specify what is meant by 'proportionate arrangements' in that contract (if this is, in fact, to be included in the Technical Advice). This will allow for no doubt or inconsistent application across the EU and ensure that all parties which are permitted to trade physically-settled wholesale gas and power on an OTF are governed by the same rules (i.e. the 3rd Package and REMIT).	For the purposes of defining 'wholesale energy products traded on an OTF that must be physically settled' in Section C6 of Annex I of EC 2014/65/EU, proportionate arrangements to make or take delivery of the underlying commodity is equal to being signatory to a balancing or settlement agreement with a System Operator as specified in the contract [Required for Option 2 below].
C.6	1. For the purposes of further specifying wholesale energy contracts under Section C6 and C6 energy derivatives contract, a contract must be physically settled if: i. it contains provisions which ensure that parties to the contract have proportionate arrangements in place to be able to make or take delivery of the underlying	As noted in our letter, this goes against the spirit and the intent of what was agreed at Level 1. ESMA has been mandated to further specify must be physically settled within the relevant contracts. Instead, the Technical Advice attempts to specify which parties may trade those contracts which would effectively split the liquidity in markets where it already worryingly low. **We would therefore prefer to entirely**	1. For the purposes of further specifying wholesale energy contracts under Section C6 and C6 energy derivatives contract, a contract must be physically settled if: i. *[Option 1 – deletion]* ~~it contains provisions which ensure that parties to the contract have proportionate arrangements in place to be~~

	commodity; ii. it establishes unconditional, unrestricted and enforceable obligations of the parties to the contract to deliver and take delivery of the underlying commodity; iii. it is not possible for either party to replace physical delivery with cash settlement; and iv. the obligations under the contract cannot be offset against obligations from other contracts between the parties concerned, without prejudice to the rights of the parties to the contract, to net their cash payment obligations. 2. Operational netting in power and gas markets shall not be considered as offsetting of obligations under a contract against obligations from other contracts as described in 1 iv and does not preclude a contract from being considered as must be physically settled 3. Operational netting shall be understood	**delete this first criterion, leaving the remaining three which are sufficient to determine 'must be physically settled' for the purposes of the exemption under Section C6**. Recitals 9, 10, 29 and 35 of MiFID II all deal with particular exemptions for firms trading energy or involved in the regulatory space of gas and power. Recital 35 in particular, the exemption for Transmission System Operators, refers to the relevant European framework for gas and power – i.e. the 3rd Package and associated network codes and guidelines. There already exists, as referenced in these recitals, a strong and robust framework of regulation specifically catering for gas and power trading in the EU. We agree with Recital 10 that regulatory loopholes and the potential for arbitrage needs to be avoided. However this goal is achieved through the sector specific 3rd Energy Package and REMIT. There is no loophole when it comes to the contracts as they are set out in Level 1. If they are wholesale energy products traded on an OTF that must be physically settled they are governed by REMIT which is equivalent to MAD/MAR in terms of prohibitions against market abuse and	~~able to make or take delivery of the underlying commodity~~; *[Option 2 – retain previous text and move text from point 8 + add Recital as above]* **or another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods** ii. it establishes unconditional, unrestricted and enforceable obligations of the parties to the contract to deliver and take delivery of the underlying commodity; ii. it is not possible for either party to replace physical delivery with cash settlement; and iii. the obligations under the contract cannot be offset

	as any nomination of quantities of power and gas to be fed into a gridwork upon being so required by the rules or requests of a Transmission System Operator as defined in Article 2 No. 4 of Directive 2009/72/EC or an entity performing an equivalent function to a Transmission System Operator at the national level. Any nomination of quantities based on operational netting must not be at the discretion of the parties to the contract. 4. (unchanged) 5. (unchanged) 6. (unchanged) 7. (unchanged) 8. Contracts that are physically settled can have a broad range of delivery methods including the following: i. physical delivery of the relevant commodities themselves; ii. delivery of a document giving rights of an ownership nature to the relevant commodities or the relevant quantity of the commodities concerned (such as	manipulation, and includes several additional provisions tailor made to the specifics of energy markets. CEER therefore considers the Level 1 goals of avoiding the scope for regulatory arbitrage met for gas and power trading in the EU. If they do not fall within REMIT, then they fall under MiFID II. The intention of the legislator was to clarify the scope of the respective legislations based on the character of the contracts. We should not create additional criteria at Level 2 based on a desire to capture certain parties using criteria/characteristics irrelevant to the contracts they are trading. A second option (Option 2) would be to rearrange some of the text and to indicate in a recital what is meant by 'proportionate arrangements'. This could address our concerns but may leave open elements of interpretation at national level. We would therefore prefer to completely delete the reference as indicated under Option 1.	against obligations from other contracts between the parties concerned, without prejudice to the rights of the parties to the contract, to net their cash payment obligations. 2. Operational netting in power and gas markets shall not be considered as offsetting of obligations under a contract against obligations from other contracts as described in 1 iv and does not preclude a contract from being considered as must be physically settled 3. Operational netting shall be understood as any nomination of quantities of power and gas to be fed into a gridwork upon being so required by the rules or requests of a Transmission System Operator as defined in Article 2 No. 4 of Directive 2009/72/EC or an entity performing an equivalent function to a Transmission System Operator at the national level. Any nomination of quantities based on operational netting must not be at the discretion of the parties to the contract. 4. (unchanged)

	a bill of lading or a warehouse warrant); or iii. another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.		5. (unchanged) 6. (unchanged) 7. (unchanged) 8. Contracts that are physically settled can have a broad range of delivery methods including the following: i. physical delivery of the relevant commodities themselves; ii. delivery of a document giving rights of an ownership nature to the relevant commodities or the relevant quantity of the commodities concerned (such as a bill of lading or a warehouse warrant); or ~~iii. another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.~~

C.7	1. A contract should be considered as having the characteristics of other derivative financial instruments if it is standardised and if it trades in line with conditions outlined in the following paragraphs. The contract must neither be a spot contract nor a contract for commercial purposes only in line with the conditions outlined below. Contracts within the scope of the exemption in C6 should not be tested again under C7. 2. A contract should be considered as standardised if parameters such as 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. 3. A contract should be considered as traded in such a way as having the characteristics of other derivative financial instruments if: i. it is traded on a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF;	As noted in the letter, there are many physical bilateral contracts that are important for large industrial consumers in optimising their energy consumption – which benefits not only the firm concerned, but also the wider economy and security of supply. We are concerned by the implications of certain non-exchange traded products achieving a level of liquidity that facilitates their move on to an exchange. This could in effect capture any similar products 'left behind' even though they are not suitable for exchange based trading. Moreover, the merits of imposing centralised clearing (under EMIR) on gas and power contracts are dubious. This is because importation into the EU of gas is governed by complex commercial arrangements extending over many years (and gas is, of course, used to produce electricity). Such gas importers, with arrangements for balancing and settlement with the Transmission System Operator, commoditise gas at hubs where it is sold and hedged by all market participants. However, if centralised clearing and margining only applied to the sell side at the hub and not the buy side's commercial arrangement, then there is clearly no reduction in risk	1. A contract should be considered as having the characteristics of other derivative financial instruments if it is standardised and if it trades in line with conditions outlined in the following paragraphs. The contract must neither be a spot contract nor a contract for commercial purposes only in line with the conditions outlined below. Contracts within the scope of the exemption in C6 should not be tested again under C7. 2. A contract should be considered as standardised if parameters such as 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. 3. A contract should be considered as traded in such a way as having the characteristics of other derivative financial instruments if: i. it is traded on a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF;

	ii. it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF, an OTF or such a third country trading venue; or iii. it is equivalent to a contract traded on a regulated market, an MTF, an OTF contract or such a third country trading venue, with regards to the price, the lot, the delivery date or other terms. 4. (unchanged) 5. (unchanged) 6. A contract should be considered to be for commercial purposes and as not having the characteristics of other derivative financial instruments for the purposes of Sections C7 and C10 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.	whatsoever and unnecessary costs are added to end-consumer bills. This market dynamic of the role of gas hubs and how this interacts with the production of electricity is important to understand. It has the potential to create erroneous and expensive margin calls during periods of constrained supply due to geopolitical activity. It may have the effect of freezing out small/medium energy suppliers for whom the market was formed and as a result, the dominance of large firms could grow. For these reasons, we would propose that the Commission adopts Option 1 to ensure that it is only truly equivalent contracts which are captured. Option 2 would also be workable for bilateral gas and power contracts] Finally, we are concerned that the definition of commercial purposes is very narrowly applied in the context of energy markets. Regarding the specific case considered in the ESMA Technical Advice, CEER wishes to highlight that, in relation to contracts entered into with or by the TSO, similar consideration should be given to those	ii. it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF, an OTF or such a third country trading venue; or iii. it is equivalent to a contract traded on a regulated market, an MTF, an OTF contract or such a third country trading venue, with regards to the price, the lot~~,~~ **and** the delivery date or other terms. *[Option 1]* **iv.** it is equivalent to a contract traded on a regulated market, an MTF, an OTF contract or such a third country trading venue, with regards to the price, the lot, the delivery date or other terms, *[Option 2]* **except for when:** **a) the contract is equivalent to a contract traded on an OTF which is not a financial instrument** **b) the contract must be**

		contracts entered either to keep in balance the supplies and uses of energy at a given time or for the purpose of ensuring security of energy supplies. These are both key tasks of many TSOs across the EU which usually stem from network operational rules and sector specific regulatory obligations. We have therefore added text to point 6 as indicated, which is a separate point to the one made above.	**physically settled other than in circumstances of force majeure of bona fide inability to settle** 4. (unchanged) 5. (unchanged) 6. A contract should be considered to be for commercial purposes and as not having the characteristics of other derivative financial instruments for the purposes of Sections C7 and C10 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 **or for the purpose of ensuring security of energy supplies.** ***[Change necessary to cover TSOs with a role in security of supply]***