CEER Response to European Commission Consultation on EMIR[1]

13 August 2015

1 Hedging

(related to consultation question 2.4)

The definition of hedging is of crucial importance for two reasons. Firstly, it is an obvious necessity that firms are able to manage adequately the risks of trading in the wholesale energy markets as well as their exposure to other risks of the business. There has been some impact on the hedging activities of firms as a result of EMIR with some liquidity shifting to cleared markets. The European Commission should assess whether the burden on energy firms of the EMIR obligations is proportionate.

For example, gas suppliers are often locked into fixed sales contracts with their customers and need to be able to hedge their exposure to future wholesale price moves. In the absence of a functioning and liquid wholesale gas market, they can either hedge through bilateral contracts (often with the dominant monopoly incumbent) or buy capacity at a gas hub which does have forward liquidity[2] and then try to buy transit capacity to ship the gas to customers. However, suppliers located several entry-exit zones away from a liquid hub would face operational risk and transaction costs to hedge in this way. While neither option is ideal, they are preferable to remaining unhedged.

The ACER Gas Target Model[3] further reveals that outside the NBP and TTF forward trading liquidity is severely limited, reaching only less than half a year into the future, while the NBP and the TTF trade up to two years into the future in a liquid market environment. This is a problem for new entrants and demonstrates why liquid wholesale markets are crucial for the IEM to deliver consumer benefits.

Secondly, the definition of hedging is linked to the calculations of both the clearing threshold under EMIR and the proposed ancillary business exemption under MiFID II (as these trades can be discounted from both calculations). While the definition of hedging in the relevant EMIR secondary legislation[4] (and further developed in the ESMA Q&A[5]) would suggest a broad interpretation is possible, it is important that the European Commission ensures a consistent approach guaranteeing that hedging prevails across all EU markets, and that subjective readings of the ESMA Q&A do not prevail.

[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

[2] The Netherlands TTF and Great Britain NBP are currently the two most liquid gas hubs in the EU.

[3] ACER European Gas Target Model Review and Update, January 2015

[4] Commission Delegated Regulation (EU) No 149/2013

[5] ESMA Questions and Answers (Implementation of the Regulation (EU) No 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR) – OTC) Question 10

2 Status of Non-Financial Counterparties (NFCs)
(related to consultation question 1.2)

There appears to be a large disparity among NFCs. It does not seem proportionate for a firm that, for example, trades three or four derivatives with small contract values per year, to be treated similarly to a firm trading large numbers of commodities in amounts that take it close to the clearing threshold. Where the former type indicate that EMIR is burdensome and would deter them from entering into such contracts, the European Commission should examine alternative methods to ensure the necessary transparency for regulators while allowing firms to avail of the benefits of OTC derivative trading.

3 Clearing thresholds
(related to consultation questions 2.1, 2.2)

Clearing represents a cost for firms trading gas and electricity across the EU. We believe that gas and power should be combined as a single commodity class or the so-called ‘breach one, breach all’ principle should be revised. Furthermore, voluntarily cleared derivatives should be excluded from the calculations as this will incentivise such activity by market participants.

In addition, there are obvious linkages with the ancillary business exemption currently under development for MiFID II. Therefore, it may be an opportune moment to examine the usefulness of the clearing threshold given that the market in OTC derivatives is essentially a subset of what is being calculated for the MiFID II test. A more proportionate regime would help to protect and promote liquidity in gas and electricity markets for the benefit of energy consumers.

4 Bank guarantees
(related to consultation questions 2.1, 2.5)

As noted by ACER in its input to the EMIR Draft Regulatory Technical Standards, it is crucial for energy firms that bank guarantees can be used as collateral at exchanges and clearing platforms without restrictions on the denomination of the collateral. In this regard, CEER supports the arguments of the Ministries of Sweden, Denmark, Finland, Norway, Estonia, Latvia and Lithuania (17 April 2015) for an extension of the exemption in EMIR related to the use of bank guarantees in the energy sector.

The energy sector is characterised by capital-intensive investments and the need for long-term financing. CEER believes efficient risk management is crucial to encourage new investment as well as to avoid firms exiting the market. The ability for energy companies to hedge their price volatility risk is hence a fundamental feature in order to ensure well-functioning and liquid markets.

By withdrawing the possibility for NFCs to use non-fully backed bank guarantees as collateral, CEER fears this will have damaging consequences for energy markets, especially for many small and medium-sized companies who are likely to experience increased hedging costs.

CEER cannot find any evidence that the current use of bank guarantees has had any negative impact in electricity markets. On the contrary, in the Nordic-Baltic energy market, the ability to use bank guarantees has been a key feature for the most traded contracts and it has contributed to a liquid, competitive market.

Furthermore, CEER disputes that a ban on using non-fully backed bank guarantees is the right remedy to alleviate the concern over Central Clearing Party's (CCPs) default risk. We suggest that the European Commission examines other remedies that will not negatively affect the Nordic-Baltic energy market.

CEER also urges the European Commission to extend the exemption for the energy sector beyond 2016, and then to evaluate whether the use of bank guarantees in the energy market has had an effect on the systemic risk in the broader financial sector or not. If, as we suspect, the system of using bank guarantees is proved acceptable, the exemption should be transformed into a permanent solution allowing non-fully backed bank guarantees in the energy sector.

5 Conclusion

We remain very much in favour of the extra transparency for competent authorities provided under EMIR and MIFID II. However, with regard to clearing and other requirements in EMIR we consider that the potential for higher trading costs, reduced liquidity and reduced competition outweigh any benefits to energy consumers from a reduction in systemic risk (which is on an order of magnitude lower than in the financial system). Perversely, the extra costs actually impose additional risks on energy markets, many of which are particularly fragile.

We have taken this view on the basis of the differences between energy and financial markets which mean that the nature of risk is different and as such the potential benefits from greater regulation are likely to be reduced. Energy firms operate in a supervised market and are subject to an existing regime to ensure continuity of service, and tend not to use the complex financial products which have played a role in systemic risk in financial markets.

Furthermore, REMIT focuses on wholesale energy trading (both commodities and derivatives) in gas and electricity using similar methods to MAR[6] (prohibition of insider trading and market manipulation; obligation to publish inside information). The aim is to promote integrity and enhance transparency, making it possible for consumers across the EU to reap the benefits of a liquid, competitive and well-functioning energy market.

[6] Regulation (EU) No 596/2014 on market abuse (market abuse regulation)