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## **Annex: Material Concerns on the DG TREN proposals for transparency in gas and electricity markets**

### **Introduction**

This annex is intended to further elaborate on some of the key concerns raised by the proposals of DG Transport and Energy (DG TREN) in relation to transparency in gas and electricity markets. As noted in the cover letter to this document, because the signatories have not been involved in the consultative process we are unable to respond directly to any specific proposals. As there is as yet no document in the public domain outlining DG TREN's approach, we are instead responding to information gained from recent conversations with officials familiar with the likely proposed approach. Obviously we will be pleased to provide more detailed information with regard to specific proposals once they are made available to us.

### **Content of DG TREN proposals:**

We understand that the proposals from DG TREN will impose transparency (disclosure) and reporting obligations on all 'physical' electricity and gas markets and electricity and gas market participants (which are established in the EU) in respect of physical and derivative (financial) products, which are traded on exchanges or on the OTC (Over-the-Counter) market. Consequently, reporting and transparency requirements would fall on both physical power and gas products (spot and forward) and on power/gas derivative products (financial instruments), independent of whether they are traded on exchanges, multilaterally on other platforms or on the OTC-markets.

These requirements would have to be complied with as close to 'real time' as possible. We understand that it is proposed that the proposals will propose that physical power and gas products (spot and forward) will be reportable to energy regulators and power/gas derivative products to financial regulators. The proposals would fall on "suppliers" and "wholesale customers", which appears to be a definition able to cover everyone in the power and gas (derivatives) markets, i.e. energy and investment firms alike.

### **Proposed way forward**

The concerns outlined below reflect, we believe, the need for a more careful consideration of the types of transparency that are most appropriate to ensuring increased efficiency in wholesale gas and electricity markets. We recognize that DG TREN has concerns about transparency in these markets, but we believe that these issues are complex enough to warrant more comprehensive review.

While all parties support the principle of promoting transparency, participation and liquidity in these markets, we believe that the European Commission needs to carefully consider the compliance burden associated with transparency requirements, and whether these are proportionate to the benefits that will ultimately accrue. This requires a thorough examination of costs and benefits. Therefore we suggest the creation of a forum involving all of the Directorates-General dealing with these issues (or related issues) in the European Commission – with participation and input from industry. We believe that a pooling of responsibilities within the Commission on these issues will promote an approach taking account of all considerations necessary for efficient electricity and gas wholesale markets.

We believe strongly that, given our concerns as to the possible impact of these proposals, and the reservations we have about the policy formulation process (detailed in the cover letter to this document), the **proposals should not be adopted in their current form**, particularly if they contain the proposals outlined above, for transparency requirements and transaction reporting requirements on “suppliers” and “wholesale customers” in *physical* electricity and gas markets, and markets for derivatives of electricity and gas.

Involving a wider sweep of all of the interested industry stakeholders in a more considered review of this issue will not only ensure a detailed knowledge of the strengths and weaknesses in European electricity and gas wholesale markets, but will also promote industry confidence in this process. This confidence would be of benefit, we believe, to the quality of the European Commission’s eventual proposals, the final legislation, national transposition and implementation, and industry compliance (if regulation were proven to be necessary).

The co-signatories would also like to underline that they are very keen to cooperate in a through cross-Directorate-General review of these issues, and would also be willing to consider commissioning of independent research on these issues (in collaboration with the European Commission).

### **Material Concerns about the DG TREN proposals**

#### **1. Concerns regarding evidence of market failure or inefficiency in OTC trading of electricity and gas derivatives**

As discussed more fully below, we believe that a proper understanding of the role of transparency suggests that different market segments call for different forms and degrees of transparency, and that attempts to impose a one-size-fits-all model will in the end lead to less efficient markets.

We have seen no evidence of persistent market inefficiency in derivatives activity. The growth of derivatives activity, along with an increase in the diversity of market participants, suggests that derivatives markets are becoming more efficient. With regard to energy markets, we believe that market efficiency will increase as investors enter the market to provide the liquidity to hedgers. To the extent, however, that mandated transparency reduces the attractiveness of commodity markets to investors and traders, OTC derivatives activity could become less efficient.

We believe strongly that the European Commission should be able to demonstrate a clear business case to justify these proposals. We remain to be convinced that any such business case has yet been proven. We rather have concerns that imposition of more stringent transparency and transaction reporting requirements would imply major costs to firms forced to comply, at limited benefit to the market. Naturally, we believe cost-benefit assessment should be carried out in this regard.

## **2. Transparency Requirements in OTC electricity and gas derivatives markets may not increase market efficiency, and could result in unintended negative consequences, including a reduction in liquidity, and increased volatility**

We query the notion that market efficiency requires that certain types of information be provided either voluntarily or by regulatory mandate. We believe that transparency is not an end in itself, but rather a means to an end, namely, market efficiency:

The DG TREN proposals have been drafted with a view to improving the quality of the electricity and gas (trading) markets places in terms of liquidity of the markets, regulatory oversight and prevention of market manipulation/abuse – by increasing transparency in the markets. In doing this, DG TREN hopes to increase confidence in price formation and to increase competition in these markets, keeping power and gas prices for consumers at reasonable levels.

The associations drafting this document strongly support initiatives, proposals and measures aimed at further improving the reliability of open and competitive energy markets. Progress in this regard will improve the trust participants have in the market and its price building mechanisms. Confidence in transparent and fair energy trading/wholesale markets will attract more market participants and will increase liquidity. We fully support creation of framework encouraging the development of markets that will attract competition and liquidity.

While sharing the general objectives of DG TREN, and their vision for the development of these markets, we believe that the proposals for transparency and reporting

requirements in the gas and electricity trading/wholesale markets may have a counter-productive effect on these markets.

It is our belief that the goal of any regulation of transparency in commodity and commodity derivative markets should be an 'optimal' level of transparency for commodities and commodity derivative markets – and what this optimal level should be requires careful consideration of the nature of these markets and the complexities therein.

Co-signatories to this letter addressed such questions in their comments in the context of the DG Internal Market review of Pre- and Post-Trade Transparency Provisions in MiFID<sup>1</sup> in 2006. In relation to OTC derivatives, for example, mandated transparency could have the unintended consequence of reducing liquidity and raising the cost of useful forms of financial intermediation, thereby impairing market efficiency. Although this view was expressed by ISDA (in its September 2006 submission on the MIFID review of transparency), with financial markets in mind, we believe the arguments apply even more strongly to commodity markets because of the inherently less liquid nature of the underlying commodities. We believe that there is an argument that (to a degree) opacity can encourage participation in markets by customers and liquidity providers. We equally accept that (in certain cases) transparency can promote competition, fairness and investor protection (although we remind the European Commission that commodity and commodity derivatives trading is characterized by the presence only of wholesale, sophisticated investors).

The type of disclosure proposal being proposed by DG TREN is aimed at reproducing the same kinds of informational transparency now mandated for organized exchanges such as futures and stock exchanges to the market as a whole. But while such disclosure requirements may be desirable for certain organized exchanges, it may be impractical, and even undesirable, to attempt to impose the same type of structure on decentralized markets. Exchange clearinghouses, for example, monitor large open positions with a view to ensuring they are not over-exposed to large losses. Transparency requirements here are not intended to make the market more efficient, per se.

The question, then, is whether these rationales apply to OTC energy derivatives or to energy spot markets. First, in the OTC and cash markets, there is no centralized exchange or central clearinghouse. Individual market participants already manage counterparty credit risk by establishing their own credit limits and by requiring collateral to ensure contract performance, much as an exchange clearinghouse would.

In addition, since a number of OTC derivatives are not standardized, disclosure of information may in fact be misleading.

The rationale for disclosure on stock exchange trades would seem even further removed from the world of OTC energy derivatives. There, the major rationale is to enable monitoring of trading activity to ensure against insider trading. There is an argument that

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<sup>1</sup> Market in Financial Instruments Directive (Directive 2004/39/EC)

rigid disclosure requirements could arguably cause more volatility in the market, as market participants exploit, or are affected by news about their market positions.

We believe that a stringent, one-size-fits-all disclosure policy could affect market behavior very differently than intended - and we firmly believe that all of these issues require more careful consideration, in cooperation with industry participants.

In addition, we believe it is very important that there be absolute clarity as to how and when government agencies will use information acquired due to transparency and transaction reporting. If regulators are to benefit from transparency requirements, they need to have the right kind of information. Ideally transparency and reporting requirements will be cost-effective, both from the point of view of maximizing the resources of local regulators, and from the point of view of firms that have to supply this information, should it be required. Provision of the information by firms, and analysis of it, by regulators, could require prohibitive deployment of resource, if not handled carefully.

As noted earlier, exchange clearinghouses use information on market positions to restrict credit exposure or otherwise restrict the positions of large traders. But the underlying cash and OTC markets are more decentralized and more diverse than the futures and equities markets, and the imposition of economy-wide restrictions on open positions, given the scale of the exercise, would require cost-benefit assessment. No such assessment has been carried out to date. In addition, as noted earlier, speculation on imputed motives of market participants by other market participants could lead to more market volatility rather than less.

Liquidity is a primary requirement for market efficiency and safety. As argued earlier, certain markets are by their nature illiquid, and market participants will supply liquidity to such markets only when they have the incentives to do so in the form of a return on liquidity provision.

Further, mandated transparency may reduce liquidity provision for reasons related to the behavior of liquidity suppliers, that is, traders. This point is made forcefully in a recent book on financial markets by risk manager Richard Bookstaber:

“Beneficial though it may be for the liquidity demander and the investor, for the liquidity supplier transparency is bad. The liquidity supplier does not intend to hold the position for a long time, like the typical liquidity demander might. Like a market maker, the liquidity supplier will come back to the market to sell off the position—ideally when there is another investor who needs liquidity on the other side of the market. If other traders know the liquidity supplier’s positions, they will logically infer that there is a good likelihood these positions shortly will be put into the market. The other traders will be loath to be the first ones on the other side of these trades, or will demand more of a price concession if they do trade... This means that increased transparency will reduce the amount of

liquidity provided for any change in prices.” (Richard Bookstaber, *A Demon of Our Own Design*, Wiley 2007, p 226.)

Although the above analysis refers to financial markets, we believe it applies equally to commodity markets. As liquidity decreases, the markets may become gradually less efficient and be characterized by wider bid-offer spreads, greater price movements in response to large trades, lower resiliency in the face of price movement, and generally less informative pricing. Market participants will thereby face higher costs and reduced availability of risk transfer instruments, which ultimately could have the unintended consequence of reduced market stability.

We would also like to make the point that any transparency proposals adopted by the European Commission should be checked to ensure that they do not stifle innovation in electricity and gas physical and derivatives markets. One of the major benefits realized in regulation of financial markets via MIFID, has been encouragement of innovation in terms of trading venues. It would be unfortunate if the European Commission were now to adopt proposals which unintentionally prevent similar innovation in the developing commodity derivative markets.

**3. There is no case for imposition of transaction reporting for wholesale physical or derivatives transactions – and such requirements could imply considerable cost implications for regulated firms**

The co-signatories would feel very disappointed if these proposals re-open discussion on transaction reporting, when industry is close to conclusion of an extensive dialogue protracted dialogue with the European Commission and financial regulators on the detail of transaction reporting requirements for commodity derivatives (minimum standards are laid down under MIFID).

We would also like to underline that the DG TREN proposal to require reporting of transactions in spot and forward markets is a very *new* development, and not one that was discussed/tested at any point with industry, either in the course of the ERGEG consultation, or in the consultation around the White Paper on Energy. We believe that power and gas market participants, whether banks or suppliers or producers, are content with the price and volume data they currently source through trade publishers, exchanges and brokers.

The "physical" market disclosure which EFET has advocated to regulators since 2002, relates not to "physical transactions" but to the use by incumbents of physical infrastructure (including electricity transmission and generation; gas transportation and storage facilities which are open to third party access) hitherto in an opaque manner. Thus measures enforcing the publication of such data *about use of infrastructure* (equating to items 1 through 4 of the ERGEG guidelines), which we expect DG TREN to include in the Third Package of power and gas internal market legislation, are absolutely to be welcomed.

We are unsure as to the value of individual transaction reporting data to regulators. If these requirements are to prove of real benefit to regulators, clarity concerning the objectives underpinning the data collection, and the precise nature of the information needs to be provided. The reporting requirements should further the policy objectives underpinning the proposals.

The co-signatories are also extremely concerned about the reporting compliance burden that could fall on "suppliers" and "wholesale customers" – and again, we do not believe that any cost-benefit analysis has been conducted on this point. We consider that it is important that a specific cost benefit analysis is conducted.

#### **4. These proposals imply significant conflict/overlap with the EU Market Abuse Directive**

We believe that DG TREN's proposals could have a significant impact on the financial markets and participants in those markets.

The Market Abuse Directive (MAD) requires member states to prohibit market participants who possess "inside information" from trading in financial instruments admitted to trading on a "regulated market" (and from disclosing that information or encouraging others to deal in those instruments, except in very limited circumstances). As from 1 November 2007, the Markets in Financial Instruments Directive (MiFID) will extend the scope of the MAD to cover regulated markets that trade commodity derivatives, including derivatives on electricity.

Thus, a person will be regarded as having inside information if he has non-public information of a precise nature relating, directly or indirectly, to the derivatives if the information is routinely made available to the users of the regulated markets or is "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" (Directive 2004/72/EC implementing MAD).

In addition, firms regulated by the MAD, because of the extension (in MiFID) of its scope to markets trading commodity derivatives, could now face a new and overlapping set of rules under the DG TREN proposals – with considerable complexity and further compliance costs resulting.

The creation of new disclosure requirements concerning these commodity derivatives will automatically extend the scope of the insider dealing restriction. Those persons who have or have pre-publication access to that information (for example, in draft form), or possibly the information from which it is derived, may be restricted from dealing in the commodity derivatives on the basis of that information until it has been made public.

This puts those firms who are targeted to supply information to the market at a potential commercial and trading disadvantage as against other market participants who are not

similarly constrained. Those firms would either have to find a way of segregating the information (which may not always be easy) or accepting that at times they will have to suspend their dealings pending release of the information.

Therefore, we urge the European Commission to consider very carefully any new proposed measures to require publication of information to determine whether they are proportionate to the risk that is sought to be address. We believe it is vital to consult with market participants so as to identify any unintended consequences.

We also highlight that there is an existing workstream on inside information/commodity derivatives, with DG Internal Market and the Committee of European Securities Regulators looking at the issue. We believe that this further underlines the value of a comprehensive, multi-DG approach to looking at all of these issues.

## **5. Consideration of European competitive position and cooperation with third countries**

As part of a full impact assessment for electricity and gas derivatives in EU Member States, we would furthermore advocate an international benchmarking of appropriate measures. This is particularly relevant for wholesale markets *within Europe* in the case of Switzerland, given the degree of concentration of cross border and derivatives trading activity in that jurisdiction. Furthermore, a careful investigation of the possibilities of international cooperation beyond the boundaries of our own continent, in making any necessary changes to regulation and improvements in transparency, would be appropriate for commodity markets which are *partly or wholly worldwide* in nature.

Regulatory arbitrage (under these proposals) would also seem to be possible in a number of different ways of which the following appear to be most relevant:

- Not all players active in the European Market place are affected in the same way, as EU-transparency requirements for market participants may not be extended to players active in third countries (e.g. Switzerland).
- Markets outside of the reach of EU-regulation could start to become increasingly prominent places to trade power and gas for marketplaces in Europe (the EU and national regulators would have limited power to prevent this).
- Market participants (energy firms, banks, etc.) and/or operators of market places (exchanges, platforms) may consider moving their activities/operations to less onerous regulatory environments, e.g. to non EU-jurisdictions.

There is therefore a danger that regulatory arbitrage could put European players and markets places into a competitive disadvantage vis-à-vis other non EU-jurisdiction. This would further reduce liquidity in physical and commodity derivative markets, underlining the potentially counter-productive nature of these proposals.

## **6. Concerns regarding broad and untested scope of transparency requirements in wholesale power and gas transactions**



We think that measures proposing compulsory disclosure to national regulators (or indeed publicly) of details of market participants' OTC wholesale power and gas transactions will be of considerable surprise and concern among the energy trading community across Europe.

Among the signatory associations to this letter, EFET has been in periodic contact with ERGEG groups and DG TREN and DG COMP about power and gas market transparency over the last year or so. However it had not previously understood any possible intention on the part of the Commission to mandate obligations falling directly on all "suppliers" of power or gas within each Member State, nor on "wholesale customers" (e.g. banks or commodity firms buying power/gas or derivatives on power, and gas, with a possible view to resale). No such intention was indicated, either in dialogue with EFET, in the consultations held by ERGEG during this period, nor in the European Commission's White Paper on Energy of January 2007. Indeed item 5.2 in the table in Appendix 1 to the ERGEG advice to the Commission on transparency in June this year spoke of power exchanges and brokers as sources of *aggregated price reference and market depth data*, not of traders as sources of *individual transaction data*.

The focus, in consultations on these issues between the Commission, regulators and EFET (but no other co-signatories to this letter) had been on the use by electricity and gas market incumbents of physical infrastructure in these sectors (including electricity transmission and generation; gas transportation and storage facilities which are open to third party access). In this context, co-signatories welcome(d) the intended measures to enforce the publication of data about use of infrastructure. The co-signatories have major concerns, however, about the proposal to apply transparency requirements and transaction reporting so widely (e.g. to "suppliers" and "wholesale customers" as defined in the Electricity and Gas Directives) in wholesale electricity and gas markets, including derivatives markets. Extension of transparency requirements to these market participants and markets should only come after lengthy consideration, involving *all* relevant stakeholders, of the merits of this step.

Banks and Investment and commodity firms share major concerns about the unjustified and precipitate extension of the scope of DG TREN's proposals on wholesale markets including derivatives markets. We believe that imposing such a requirement on the market, without proper impact assessment and dialogue with the market, could have significant negative unintended consequences for European wholesale energy markets.

The co-signatories wish to underline the importance of a proportionate approach to realizing the objectives behind this proposal. We believe there are existing regulatory instruments to monitor and supervise regulated markets, which safeguard these objectives, and that it is questionable if these new obligations are really necessary. We also believe there are much less onerous regulatory instruments that can fulfil these objectives. Appropriate and proportionate financial market regulation in this context would be one possible choice, for example, through a review of the MAD.