

To:

Ms Nathalie Piscione
Ms Chloé Picandet
Mr Fabrizio Planta

European Securities and Markets Authority (ESMA)
103, rue de Grenelle
75007 Paris - France

Brussels, 24 May 2013

RE: EFET feedback on the macro-portfolio approach to hedging

Dear Ms Piscione, Ms Picandet, Mr Planta,

1. Introduction

As agreed during our teleconference of 23 April 2013, the European Federation of Energy Traders (EFET) welcomes the opportunity to present the European Securities and Market Authority (ESMA) the views of its members on possible approaches to the qualification of OTC derivative contracts as “objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of [a] non-financial counterparty” for the purpose of calculating the clearing thresholds under EMIR, as stated in the ESMA regulatory technical standards on OTC Derivatives, CCPs and Trade Repositories and translated into the European Commission delegated Regulation 149/2013. More specifically, this letter intends to highlight the complexity for non-financial companies (NFCs) of the process of mitigating commodity-related risks and as such why firms can look at their hedging from a macro-portfolio based perspective. It also explains how macro-portfolio based approaches to hedging are strongly linked to the commercial risk associated with the underlying business. It should be noted that while our comments are generally applicable to most NFCs involved in a commodity-related business it should not be seen as representative of arrangements in all firms. In particular, this letter focuses on the specific situation of energy firms and their various underlying activities (production, supply, trading, and retail)¹.

¹ For the purpose of this letter, energy firms refer to all corporations engaged in the energy sector which are not financial companies and which are not unbundled TSOs or DSOs, including corporations undertaking oil and gas production, electricity generation, coal mining, wholesale supply of energy commodities and retail supply of energy.

As mentioned in the Final ESMA Report on the Draft Technical Standards dated 27 September 2012 and as confirmed during our teleconference of 23 April 2013, the definition of risk-reducing OTC derivatives of Article 10 of Commission delegated Regulation 149/2013 provides the possibility for “portfolio hedging”. As risks may evolve over time and in order to adapt to the evolution of such risks, NFCs need to apply the criteria to determine whether an OTC derivative contract would be objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of a NFC to a grouping of OTC derivative contracts, which may therefore qualify as risk-reducing “in combination”.

We appreciate that ESMA welcomes the input of market participants to help the Authority better apprehend how groupings of OTC derivatives may be considered, in combination, as “cover[ing] the risks arising from the potential change in the value of assets, services, inputs, products, commodities or liabilities that [a] non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the normal course of its business”.

2. Use of OTC derivative contracts by energy firms

Energy firms are exposed to a variety of business and asset risks. Producers are particularly exposed to price fluctuations of commodities (e.g. coal, gas, oil), including CO₂, while suppliers and retailers need to mitigate, among others, the risks related to fluctuations of the wholesale power price and changes in customer demand. Whether acting as distinct companies or as departments or entities within one energy firm, these businesses are heavily exposed to economic/price risks. Unless this function is performed by the treasury department of energy firms, the commodity trading entities within a group or the separate commodity trading department within a utility often are the commercial interfaces to the wholesale market for energy commodities. These entities or departments enter into different types of transactions in order to hedge the group/utility commodity asset positions on a proxy, macro and/or portfolio basis.

For this purpose, these entities and departments enter, among other products, into OTC derivative contracts to cover (inter alia) the risk of price fluctuations of commodities (e.g. power, coal, oil, gas and EUAs) for their entire corporate group or part of it. All trading activity by these entities/departments is measured strictly against a risk mandate which is constantly monitored in terms of value at risk (VaR), profit at risk (PaR) and/or exposure/other risk measures subject to strong internal rules based on the “comply or explain” principle. For example, with respect to the power generation business, such entities/departments limit the risks stemming from the natural long position of the power generation entities and hedge the price and supply/volume risks associated with fuel requirements and CO₂ emission allowances (i.e. its natural short positions). These entities/departments may also hedge price risks on behalf of their group’s upstream oil and gas business and midstream or downstream gas business.

3. Dynamics of the macro-portfolio approach

Given the varying levels of market liquidity, product diversity and geography of the commercial activities, commodity trading entities/departments may not necessarily find the optimal hedging instrument available within the market to mitigate the specific risk incurred. As a result, commodity trading entities/departments in the energy sector use multiple instruments to hedge risks related to commercial activities or assets which represent open (long/short) positions across different products, geographic markets and timeframes. The hedging process is also continually optimised against

changing market conditions right up to the point of physical delivery of the underlying product. This dynamic and real time hedging process means that firms are generally not hedging on a purely 'back to back' basis but rather ensuring that the hedging is commercially optimised.

Often, taken individually, a derivative transaction cannot be qualified as risk reducing/increasing given the complex relationship between commodities, products, even asset classes and between entities within the same group as well. Proxy, macro and portfolio-based approaches therefore reflect the way in which NFCs in the energy industry manage the complex risks related to their assets and commercial activities.

The approaches taken to assess the risk-reducing aspect of certain groupings of OTC derivative contracts with regard to the underlying business or assets may vary from one market participant to the other. However, any macro-portfolio risk-based approach is intrinsically linked to the physical and contractual assets/commercial activity held within a firm and the transactions entered into to hedge these risks. Various methodologies could be used to assess the classification of hedging activity, such as:

- comparing the portfolio (a combination of asset positions) positions in each of the relevant commodities on a volume basis with the overall OTC derivative positions on a volume basis
- applying a certain risk metric (VaR, PaR, alternative exposure measures) to the asset/commercial positions and comparing it with the same metric following the hedging process (i.e. taking into account OTC derivative transactions);
- combining either or both of the above-mentioned methods with further internal risk management instruments and processes.

(The above list is not meant to be exhaustive and is only meant to highlight examples of different approaches.)

Although differing by the applied methodology, the adoption of each of these approaches guarantees that proprietary position in OTC derivative contracts, compared to a firm's underlying asset or commercial positions, will be identified and not allowed to be qualified as risk-reducing according to Article 10 of Commission delegated Regulation 149/2013. Any proprietary positions will be identified and the gross notional value of the relevant transactions calculated and monitored against the relevant clearing threshold.

4. Risks and opportunities of a disaggregated methodology

In order to make the link between these approaches and the underlying commercial risk the entity is hedging more readable, it may be possible to look at an assessment at a more disaggregated level to supplement the overall company level assessments outlined above. While this is technically feasible, we draw ESMA's attention to our concerns about a systematic drive towards disaggregated comparisons:

- As already mentioned, hedging the risks linked to energy businesses and assets entails a number of transactions being entered into to mitigate specific risks. These transactions may spread over different categories of product, business segment, geographical location etc. and are often interlinked. Therefore, an insistence on disaggregated approaches may contradict the way in which risk management is naturally and most efficiently performed within companies, and thereby send potentially incorrect messages.
- Depending on each national regulator's attitude, we see a danger that NFCs are progressively compelled to increase the granularity of the disaggregation they perform, thereby de facto reducing the option given by ESMA to use portfolio and proxy hedging to a mere concept.

As such, the approaches taken to assess risk-reducing activities are solidly anchored with the principles and objectives of EMIR. Article 10 of Commission delegated Regulation 149/2013 was introduced to allow non-financial firms to continue to hedge the risk associated with their business and assets without having to incur significant additional margining costs associated with central clearing for all OTC derivative transactions they enter into; central clearing is however among the risk management practices used to reduce counterparty risks. Firms that are genuine asset based traders and are taking appropriate and proportionate steps to hedge and trade against their commercial and asset based risks in the (derivative) markets should not necessarily find themselves in a position above the clearing threshold. This will ensure that financial means are not being diverted and constrained to margining but remain available for continued asset investment and development. A practical approach to assessing hedging activity will also help to ensure that non-financial firms do not unnecessarily switch away from derivative markets (thereby damaging liquidity) in order to reduce the costs associated to their hedging strategy.

5. Conclusion

We hope that this document provides satisfactory evidence of how energy firms mitigate their business or asset risks through the use of standalone or combined OTC derivative contracts. Our member companies remain at your disposal to present their approach in more detail on an individual basis, such presentations containing some sensitive information that go beyond the knowledge and mandate of EFET.

Best regards,



Jan van Aken
Secretary General