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Amsterdam, 25 September 2002

Re: Planned Commission Proposal for a revised EU Investment Services Directive

Dear Mr. Jones,

Could financial regulation of energy trading impair liquidity and transparency in physical electricity and gas markets and hence jeopardize completion of the internal market in energy?

EFET's answer to this question is: "Yes: applying the revised Investment Services Directive (ISD) indiscriminately to power and gas derivative transactions will undermine the continued liberalization of the European energy sector." A disproportionate application of, in particular, the regulatory regime and capital adequacy provisions of the draft revised ISD to energy commodities will thus hinder the realization of parts of the Conclusions of the Presidency at the European Council held in Barcelona last March.

In the remainder of this letter we explain the dependence of the successful completion of EU power and gas end-user market opening on a sensitive EU financial regulatory regime for wholesale energy transactions. In particular:

- Sections 1 and 2 below discuss the dependence of market opening and network management and investment on an efficient and liquid wholesale market;
- Section 3 highlights the costs imposed by ISD and the resultant impact on entry to the sector and the efficiency of the wholesale market;
- Section 4 draws some conclusions on the impact of the ISD on market opening; and
- Section 5 outlines EFET's preferred approach to the financial regulation of energy commodities.

1. Liquidity, transparency and competition in national and cross border wholesale commodity markets are essential for consumers to enjoy the full benefit of market opening

An increasing number of European consumers enjoy the freedom to choose their supplier (at least in theory). However, the benefits of this increased choice will not be realized without a competitive, efficient and fully integrated wholesale market for power and gas. New entry into retail and generation markets can only take place if market participants have access to a competitive wholesale market to source their electricity and to manage their output and price risk. Effective wholesale competition also drives efficient decisions on when to produce or consume, when to undertake maintenance and when to invest which brings major savings to electricity consumers. The success of wholesale power markets is therefore the cornerstone of effective competition and the ultimate success of market opening. Any but the very largest energy consumers are most unlikely to reap the full rewards of liberalisation of the electricity and gas sectors, without the creation and maintenance by policymakers and regulators of legislative regimes, which allow wholesale competition to flourish. An extract from Barcelona seems apposite: "*Real, effective competition in markets is a cornerstone of the economic reform process. Competition provides the discipline and the incentive to secure greater economic efficiency and*

strengthen the competitiveness of the European Union". (para. 28, part III, Economic and Financial Affairs Council section).

Moreover, effective wholesale market competition leads to a multiplicity of market participants (producers, wholesale merchants and suppliers) competing to buy and sell electricity and gas. This leads both to the reliable discovery of the market clearing price and the creation of market "liquidity", ie, the ability to source all of one's requirements at those market prices. Another extract from the Barcelona Conclusions seems apposite: "*Priority should be given to reaching agreement on the basis of the proposals relating to the opening and further development of energy markets, taking into account the requirement to satisfy user needs and the need for transparency in the market through appropriate regulatory instruments with a view to implementing the objective of market-opening in these sectors.*" (para.17, part III, Internal Market, Consumer Affairs and Tourism Council section).

2. Traders also contribute to efficient network management and investment

The ongoing transformation of the EU energy sector relies very much on the efficient management and investment of the networks. The Barcelona Conclusions clearly state, "*...powerful and integrated energy and transport networks are the backbone of the European internal market. Further market opening, appropriate regulation, improved use of existing networks and completion of missing links will increase efficiency and competition, and ensure an adequate level of quality, as well as reduced congestion and thus enhanced sustainability*" (para 36, part I).

Wholesale market competition can also make a major contribution to the difficult job of unbundled grid operators. Again, the secret lies in the enhancement of transparency and liquidity. Because the delivery of electricity or gas is bound to the physical operation of a transmission network, third party access is indispensable for the functioning of that marketplace. Both eligible consumers and wholesale marketers should be able to rely on access to transmission grids on objective, transparent and non-discriminatory terms. In turn, in the new competitive environment, they can help optimise utilization of grid capacity and thus contribute to the elimination of inefficiency in grid operation.

The full development of a traded market signals the future locational value of electricity to system operators earlier and more clearly. The future value of the commodity in each control area will become apparent, helping system operators to identify emerging imbalances between regional demand and supply. In turn this allows system operators to optimise plant dispatch, efficiently allocate entry and interconnection capacity and, over the longer term, identify network investment requirements. Traded markets therefore promote the efficient usage and provision of delivery infrastructure, which in turn promotes short-term and long-term security of supply.

3. The ISD affects all wholesale energy market participants, increasing costs and reducing wholesale market competition

The proposed ISD would affect all wholesale energy market participants and not just those participants engaging in "pure trading" activities. Energy trading is not the exclusive domain of independent energy trading companies or finance houses. All physical market participants in liberalised energy markets also participate in the wholesale energy markets. Both generators and suppliers need access to the wholesale market to manage their exposure to variable outputs and prices.

They are increasingly being joined by companies who specialize in providing wholesale merchant risk-management services, including specialist energy traders and financial institutions. However, there is no "bright line" distinction between specialist energy traders and physical market participants. Many energy traders take contracts to physical delivery and some of largest specialist energy trading companies are also significant physical players.

The financial regulation of energy commodity transactions, especially the imposition of regulatory capital requirements, erects a further barrier to entry to the fragile continental European power and gas wholesale

markets. In these markets, inadequate third-party access, a lack of sufficient competition and counterparties and credit difficulties, are already undermining liquidity. The fear of having to post collateral in the light of poorly

perceived creditworthiness is already driving some newcomers out of the physical markets, especially on a cross-border basis. If the potential providers of such services are put off not only by difficulties in the physical market, but also by their own assessment of the reduced return they may receive from entering a wholesale market where investment protection regulation has been imposed, then a vicious circle could be created.

More specifically, the regulatory regime suggested in the draft revised ISD is not appropriate to the electricity market, given that it has been designed to capture the risks of the financial, retail market (predominantly securities). The capital regime as envisaged fails to recognise and appropriately manage all the risks inherent in a physical commodity market (the definition of operational risk is not broad enough, whilst the measures used to gauge credit risk focus purely on balance sheet measures and make no consideration of physical ability to service a transaction). The regime also makes no allowance for the illiquid nature of many physical assets such as power stations that commodity companies commonly hold. This could even force companies to sell or close power stations in an attempt to realise liquid capital and reduce position sizes. Additionally, the capital requirements will be under the control of the Basel Committee, an entity focused on financial markets and without any involvement in the development of the internal energy market.

The additional requirements imposed by the ISD could therefore lead directly to a significant increase in the costs and operational difficulties of producers and suppliers alike. Moreover, the requirements will lead to a significant reduction in the number and the scope of activity of specialist trading companies leading to a reduction in market liquidity, transparency and, hence, an impaired ability to manage energy market risks efficiently and cheaply. Both effects will lead to less competitive energy markets and higher prices for end consumers.

4. Conclusion: The link between effective energy market opening, the depth and competition of energy trading and light touch financial regulation.

The Barcelona Conclusions set up a very specific deadline, to adopt “*full freedom of choice of supplier for all European non-household consumers as of 2004 for electricity and for gas*” (para 37). This legally mandated opening will amount to at least 60% of total EU demand, so the overall market must be ready to provide sufficient choice to consumers to enable them to reap its potential benefits.

The existence of a wholesale market in electricity is an integral element of a properly liberalized electricity sector. Free access to efficient wholesale market prices underwrites competition between retailers and guarantees competitive prices for energy consumers. Trading plays a crucial role in enhancing efficient price discovery by providing liquidity and corresponding risk management services. The imposition of disproportionately rigorous ISD requirements in respect of energy commodity transactions is likely to reduce the trading activity of both traditional players and new entrants and their ability to operate efficiently. Any further shrinkage in continental European trading activity (beyond that already evident so far in 2002), due to an injudicious application of the ISD to energy commodities, will certainly worsen liquidity and price discovery. The achievement of the Barcelona market-opening targets would consequently be jeopardised.

5. The EFET proposal: not exclusion, but reasonable and precise exemptions

EFET is not seeking the complete exclusion of commodity trading from the scope of the ISD. Indeed, the extension of the ISD to commodities brings many important advantages, including the ability to use the European Passport to energy trading activities, the harmonization of currently diverse domestic regulatory regimes and generally improved standards of conduct and security in the business.

EFET advocates a tailored approach to energy trading in the ISD that reflects established market practice. In particular, the ISD must take account of the professional nature of energy market participants and existing sector-specific regulation aimed at customer protection. Moreover, the ISD should be sufficiently flexible to account for the role currently played by assets and customer portfolios in providing credit support for energy trading activities rather than imposing inappropriate and unnecessary bank-style capital requirements across the board.

EFET considers that energy trading activities could be included in the ISD as non-core services or, alternatively, a minimum set of exemptions should be included, to ensure that companies that trade on their own account or



exclusively provide services to group companies are excluded from the ISD requirements. It is important to make the definition of these exemptions clear and accurate. In our opinion, exemptions based on the "speculative" nature of trading activities would be impossible to apply, since the definition of what can be considered speculative is by no means clear. Exemptions based on "trading on an ancillary or incidental basis" are also impractical, since for many energy producers and suppliers who are managing complex portfolios of assets and clients it can be difficult to argue that they carry out trading activity on such basis.

Yours Sincerely,
On behalf EFET

Jan van Aken
General Secretary

