EFET European Federation of Energy Traders

Position paper on the application of the

proposal for a
Directive on Investment Services and Regulated Markets
(Brussels, 19 November 2002, COM (2002) 625 final)

to companies dealing with Energy Commodity Derivatives

Version 1, March 10th, 2003

The European Federation of Energy Traders (”EFET“) represents more than sixty energy trading companies from 14 European countries. EFET was established in 1999 to stimulate and promote energy trading throughout Europe. Our members include the leading energy market participants that buy and sell energy commodities and derivatives over-the-counter and through exchanges: producers, suppliers, multi-utilities, large energy users, commodity houses and financial institutions.

The approach of any particular EFET member to energy trading varies with respect to its size, range and scope of products, the firm's know-how, resources and commercial requirements. While most of our members engage in physically settled gas and power transactions on the continent, an increasing number also trade financially settled commodity derivatives.

EFET's views of the proposal

EFET supports the justification and objectives of the proposal for a Directive. In particular, the members of EFET share the view that "*the absence of single market framework for this business is anachronistic, particularly when one considers parallel steps taken to liberalise underlying commodity and energy markets*" (Explanatory Memorandum, IV.3).

In EFET's view, it is fundamental that "*the extension of the ISD to commodity derivatives business must take account of certain features specific to trading in these instruments, as well as the predominantly "wholesale/professional" nature of the market participants*". EFET agrees with the recognition of "*the widespread presence of experienced traders active in the market for hedging/commercial reasons or acting exclusively on behalf of their parent companies or affiliated subsidiaries*" that "*should not be required to hold an ISD licence to deal on own account*" since "*such entities are not investment firms*" (all quotes are from section IV.3 of the Explanatory Memorandum).

However, while supporting the proposed scope of the ISD and the system of exemptions that is provided, EFET is concerned with the following main aspects of the text:

A. **The wording of the proposed exemptions**. Although the intention of the exemptions is shared by EFET, their applicability to a significant segment of participants of the energy markets is unclear. EFET considers that some minor changes would contribute to make these exemptions clearly useful and relevant to the reality of the European energy markets.

B. **The treatment of physically settled commodity derivatives**. Any excessive regulatory requirements imposed on the companies dealing with these products could have a devastating impact on the on-going process of liberalisation of the European energy markets, by imposing significant costs and obligations that would lead to a reduction on the number of market players and, thus, liquidity and competition, and would eventually produce increases in prices.

C. **The application of the Directive to entities that do not provide services to third parties.** The majority of EFET members, and energy traders in general, deal with energy and energy derivatives on their own account and do not provide services to third parties. This is consistent with the aims of the proposed Directive. However, the experience with some domestic regulatory regimes shows that some clarification to the proposed wording is required in this respect to clearly limit the scope of applicability to entities that actually provide services to third parties.

D. **The future applicability of capital adequacy requirements to entities dealing with energy commodities**. The current capital adequacy schemes have been designed for financial institutions, and must be carefully reviewed before being applied to entities whose main business is dealing with commodities or commodity derivatives.

E. **The duration of the review period after which the regulatory treatment of energy commodity derivatives could be modified**. The proposed text establishes this duration to be two years, and this could lead to 2005 or 2006. On the other hand, taking into account the expected schedule for the liberalisation of the European gas and electricity markets, this deadline can be too close to allow for a thorough review of the requirements and problems of these markets. Therefore, it is proposed to extend this review period to 5 years.

A. The wording of the proposed exemptions

The relevant exemptions for EFET members are 2.1(i) and 2.1(h).

2.1(i) ***"undertakings whose main business, when considered on a consolidated basis, consists of dealing on own account in commodity derivatives"*****;**

It is quite uncertain whether energy trading companies could benefit from 2.1(i) as currently drafted. This would depend on the treatment of physically settled energy commodity derivatives and on the interpretation of the words *"on a consolidated basis"* included in the exemption.

- The vast majority of the energy and energy commodities activity in the European energy markets consists of physically settled forward and options. This is specially the case in markets such as Germany, France and The Netherlands, who are the core of the wholesale power and gas markets in continental Europe. Therefore, for most energy trading companies, it can be argued that its main business is not energy commodity derivatives, but physical energy transactions (apparently not considered to be commodity derivatives by the draft directive proposal). Therefore, it would appear that most energy trading companies would be unable to apply exemption 2.1(i).
- Many of the energy trading companies active in Europe are the trading arms of integrated energy companies, electricity generators or suppliers, gas distributors and the like. When considered "on a consolidated basis" (i.e., when considering the activities of the rest of the consolidated group to which the trading company belongs) these trading companies will likely be unable to argue that their main activity is dealing in commodity derivatives (since, on a consolidated basis, this main activity is electricity generation or supply, gas distribution, etc.) and therefore will be unable to use this exemption.

If exemption 2.1(i) is to apply then it should be amended, deleting the mention *"when considered on a consolidated basis"* and ensuring that, instead of referring to *"commodities derivatives"* it refers to *"commodities and commodities derivatives"*.

2.1(h) ***"persons dealing on own account in financial instruments as an <u>ancillary activity to their main business</u>, where that main business is not the provision of investment services within the meaning of the ISD or banking services under Directive 2000/12/EC"*;**

It is unclear whether most energy trading companies would be able to make use of exemption 2.1(h). The key is whether the energy commodity activities carried out are ancillary to their main business: the test of *"ancillary activity"* is not carried out *"on a consolidated basis"*.

- In some cases, when an integrated energy company, electricity generator, gas distributor, or the like, deal with energy commodities without the use of an energy trading subsidiary, the applicability of this exemption would be straightforward.
- However, energy companies frequently set up trading subsidiaries for this type of business, for reasons that can range from accounting to tax or credit risk management, or simply because of internal control. For these trading arms, it could be argued that energy commodity derivatives are not ancillary, but constitute their main business, making 2.1(h) inapplicable.

Exemption 2.1(h) could be clarified by ensuring that the determination of whether dealing on energy commodity derivatives is an ancillary activity is carried out "*on a consolidated basis*".

In fact, the use of the term "on a consolidated basis" in exemption 2.1(i) and its absence in exemption 2.1(h) could lead to many energy trading companies (specially those which are owned by integrated energy companies, utilities, generators, gas distributors and the like) not qualifying under either exemption.

B. The treatment of physically settled commodity derivatives

Section IV.3 of the Explanatory Memorandum states that "*The definition does not include physically-settled spot or forward exchange or commodities*". However, this apparent exclusion of physical transactions has certain, somehow unclear, limits.

There are significant factors weighing against the inclusion of physically-settled energy commodity derivatives in the scope of the Directive:

- The consideration of physically-settled commodity derivatives as financial instruments subject to the Directive could mean that most of the activities of energy companies could be subject to financial regulation, and would then have to comply with capital adequacy requirements that, as currently drafted, have not been designed for energy companies, but rather have been designed for financial institutions. Such a burden on physically settled commodity derivatives would be a significant obstacle in the development of the European energy market, by reducing the number of market participants and imposing additional costs in the remaining market players. This would reduce the level of liquidity and competition in wholesale activities and would impact on clients.

- In particular, the exemption 2.1(i) applicable to specialised commodity traders, that should be used by a most energy trading companies dealing in those physical transactions included in the Directive is, in principle, limited to two years. Depending on the final regime adopted after the two year revision, this could mean that physical energy commodities carried out by companies applying this exemption would no longer be exempt from the Directive in the mid term.
- For those trading companies not exempted from the Directive, the basis for the calculation of capital adequacy requirements would include physical plus financial commodity derivatives and therefore would be potentially higher than if a company were to calculate such exposure only on the basis of financially settled derivatives.

A clarification on the treatment of physically settled ECD is thus necessary. This requires:

- To add an exemption 2.1(m) with the following text: "*physically-settable option, future and forward contracts in respect of commodities*".
- To amend Article 60.2(a) to specify that the reporting duty does not cover physically settable business.

There would be a way of including physically settled transactions in the Directive, as part of the so-called "*ancillary services*" (listed in Annex I, Section B). This would not impose authorisation or capital adequacy requirements in companies dealing with physical energy commodity derivatives only, but would allow firms dealing with both physically and financially settled commodity derivatives to apply their passports to physical commodity derivatives as well.

C. Effect on entities that do not provide services to third parties

The proposed Directive is intended to cover entities whose business is the provision of investment services to third parties. The majority of members of EFET in particular and energy traders in general deal with energy and energy derivatives on their own account and do not provide services to third parties. However, the management of their positions obviously requires dealing with third parties (i.e., they do not deal **for** third parties, but **with** third parties).

However, the experience with some domestic regulatory regimes shows that some clarification to the proposed wording is required in this respect to clearly limit the scope of applicability to entities that actually provide services to third parties. This would also help to clarify the concept of "*dealing on own account*", used in exemptions 2.1(h) and (i).

Thus, the proposed text for Article 3.1(1) would be as follows: "*Investment firm means any legal person whose regular occupation or business is the provision of investment services on a professional basis to third parties*".

D. The future applicability of capital adequacy requirements to entities dealing in energy commodities

The current capital adequacy schemes have been designed for financial institutions, without having in mind the reality of commodity derivatives business. Therefore, any potentially applicable regime must be carefully designed, especially considering the possibility of a modification of exemption 2.1(i). This design should take into account issues that can be specific of energy commodities and could impact the capital requirements of energy commodity traders, such as long term contracts, generation, production or distribution assets, tolling contracts, etc.

Therefore, it is proposed to add a new paragraph (c) to Article 60.2 as follows: "*(c) modifications to the rules laid down in Directive 93/6/EEC for those investment firms that deal in commodities or the derivatives referred to in point (i) of Article 2.1 to ensure that those rules are proportionate having regard to the nature of that business.*"

E. The duration of the review period after which the regulatory treatment of energy commodity derivatives could be modified

The proposed text establishes this duration to be two years, and this could lead to 2005 or 2006. On the other hand, the total liberalisation of the retail electricity and gas markets is expected to take place by July 2007, although it could be delayed under certain circumstances. Therefore, the deadline for revision of the Investment Services Directive can be too close to allow for a thorough review of the requirements and problems of these markets. Therefore, it is proposed to extend this review period to 5 years.

Therefore, it is proposed to modify Article 60.2 to establish that the reporting obligation of the Commission will have effect "*No later than 5 years after the entry in force of this Directive*".