

EFET calls for action to prevent unintended consequences of financial market regulation for the European energy market in developing MiFID II Level 2 measures

The European Federation of Energy Traders (EFET)¹ warns against the irreparable harm to European energy markets that would result from failing to make a clear distinction between the physical and the financial world. Extending the MIFID licensing regime too far would impose an undue regulatory burden on commodity firms. We call for a balanced approach to prevent an immediate and irreversible drop in liquidity once MiFID II applies. This includes:

- **Re-calibrating the ancillary activity thresholds:** Cautious thresholds of at least 25% for the ‘capital employed’ test and 15% for the ‘market size’ test should be set initially to avoid deterring market entry or forcing commodity firms to exit the market. It is also essential to specify that both tests must be failed for an entity to be required to obtain a MiFID license.
- **Giving full effect to the exclusion of *must be physically settled gas and electricity contracts traded on OTFs* (‘forward gas/ power contracts’ traded on broker platforms) introduced in MiFID II Level 1 [Section C6 of Annex II to MiFID II]:** It should be sufficient for counterparties to these contracts to have adequate contractual arrangements to make or take delivery of the underlying. No quantitative criteria should be introduced.
- **Ensuring that bilateral commercial contracts for delivery of commodities are not defined as commodity derivatives [Section C7 of Annex I to MiFID II]:** To avoid classifying as financial instruments contracts that are not financial instruments, the characteristics of bilateral physical contracts that can become *equivalent* to contracts traded on regulated platforms need to be specified further. This would ensure that end consumers are not inadvertently drawn into financial regulation. More importantly, the ‘commercial purpose’ test should be widened with further examples. A balance needs to be found when determining these elements.

We understand that Regulators are concerned about legislative loopholes in the commodity markets. However, the recent introduction of stricter market abuse rules, new transparency requirements and position limits are already sufficient to address concerns about transparency and conduct in the commodity markets. Moreover, breaches come with very strict sanctions.

Against these developments, extending the MIFID financial licensing to commodity intermediaries comes with no additional benefits to regulatory oversight, while imposing huge additional costs on market participants and ultimately, on consumers. The proposed rules will inadvertently damage the structure and liquidity of Europe’s energy markets and

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 28 European countries. For more information, visit our website at www.efet.org.



effectively render futile two decades of efforts to create the Internal Energy Market. This will have serious consequence for the prices paid by end consumers, for the investment necessary for the decarbonisation of the European economy, and for the security of our future energy supplies.

For further information, please contact:
Maria Popova, *Manager for Market Supervision*
E-mail: M.Popova@efet.org

APPENDIX

Ancillary activity thresholds

Unlike purely financial entities, energy trading firms pose no threats to deposits, raise no issue of investor protection and have no access to central bank liquidity. However, the low ancillary activity thresholds recently proposed by the European Securities and Markets Authority (ESMA) would require many energy trading firms to become MiFID-authorized entities. This means that they will also become subject to considerably higher capital requirements² and mandatory clearing obligations³. A number of non-financial companies would not be able to cope with this cost increase and may either largely reduce their trading activities, or move to non-financial markets.

Lower wholesale market liquidity would lead to significantly higher trading costs. It would undermine competition and increase barriers to market entry, as potential entrants would be deterred by the high costs and/or the inability to hedge. In turn, this would have a direct effect on energy prices and ultimately, on final energy consumers. The overall impact on the EU economy would be a significant increase in energy prices at the expense of competitiveness and economic growth.

To avoid this, we call for a re-calibration of the ancillary activity thresholds. Cautious thresholds of at least 25% for the 'capital employed' test and 15% for the 'market size' test should be set initially to avoid forcing commodity firms to exit the market. It is also essential to specify that both tests must be failed for an entity to be required to obtain a MiFID license. This would help to prevent an immediate and irreversible drop in liquidity.

Section C6 of Annex I to MiFID II

Furthermore, the exclusion of *must be physically settled* gas and electricity contracts traded on OTFs ("forward gas / power contract") introduced in MiFID II Level 1 was designed to avoid unintended consequences for European energy market liquidity and ultimately, for energy prices paid by consumers. However, its effectiveness is jeopardised by the interpretation proposed by ESMA that market participants may be required to have physical storage/delivery/production capacities in order to be able to enter into contracts that 'must be physically settled'.

This interpretation would go far beyond the content of the contracts and it is not in line with the Level 1 decision, because neither the legal text, nor the Recitals of MiFID II suggest quantitative limits. If additional clarity is deemed necessary in the text of the Delegated Acts to specify such 'proportionate arrangements', it should be based on the qualitative/contractual ability of market participants to deliver or receive the agreed amount of gas or electricity.

A quantitative approach, in contrast, would undermine the concept of intermediation, which is at the heart of the liberalisation of energy markets. It would artificially split the market into two segments - consumers/producers on one hand and financial entities/intermediaries on the other - because consumer/ producers will have to avoid dealing with financial entities to be able to take advantage of the C.6 Exemption. The subsequent substantial reduction of liquidity in physical markets would hinder the effective management of volume and price

² Required by Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms

³ Required by Regulation 2012/648/EU on OTC derivatives, central counterparties and trade repositories

risks by the real economy. The impact on the ability to manage risks, in turn, would have a negative effect on energy prices and consumers.

Section C7 of Annex I to MiFID II

Last but not least, the changes introduced by ESMA in the Technical Advice on the text proposed for the Delegated Acts regarding C7 are so wide that in the future they could inadvertently lead to defining bilateral commercial contracts for delivery of commodities as commodity derivatives. This is clearly not the intention of the Level 1 text, as such commercial commodity delivery contracts display no characteristics of traditional financial instruments and are entered into for commercial purposes.

A balance should be sought to avoid such unintended consequence. This can be done by specifying further the characteristics of bilateral contracts that need to be equivalent to those contracts traded on regulated platforms. More importantly, the commercial purpose test should be widened with other examples. A starting point could be referring to the commercial business of the counterparties and to the intention of the seller/buyer to deliver/take delivery of the underlying commodity.