

# **EUROPEAN COMMISSION**

## **Draft discussion paper by DG TREN on transparency and integrity of traded wholesale markets in electricity and gas**

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## **1. THE POLICY CASE FOR A REGULATORY INITIATIVE**

The emergence of liquid European traded wholesale markets for electricity is a positive and beneficial outcome of over a decade of successive European energy liberalization packages. Liquidity in traded gas markets is still lagging behind but catching up steadily. Beyond generators and suppliers, wholesale energy markets now attract a wide range of actors including utilities, pure traders, financial institutions and other trade facilitators. As a result many marketplaces have emerged both on a bilateral "over the counter" basis and in organised – sometimes mandatory – markets. Important derivative markets have arisen around markets in the underlying energy products. As a result energy wholesale markets have become increasingly hybrid physical and financial ones. From an EU policy perspective it is important to note that prices established at the level of traded wholesale markets do not only affect market participants, but do also serve as benchmark for retail prices for household consumers and industrial users. Equally importantly, these markets send important price signals for future investments in energy infrastructure.

Along with these developments there have however been claims that price increases observed on these markets are not only and always the result of the interplay of supply and demand fundamentals, but also of unfair trading practices. Such allegations undermine the public trust in the integrity of the market and trigger an overall discussion about the need for regulatory improvements.

The changes in the energy sector combined with increasing market integration pose challenges for current oversight practice which has traditionally been both country and sector specific. Depending on the overall market framework and regulatory situation, this may result in trading activities being subject to multiple jurisdictions with oversight by several different authorities, possibly located in different countries (with a lack of clarity as to who has ultimate responsibility) or even to a situation where there is no oversight at all.

In this regard the input which European securities (CESR) and energy (ERGEG) regulators jointly delivered has provided a good basis for the ongoing work on the design of an effective and consistent EU regulatory framework for traded electricity and gas markets which could eventually include the carbon market. The integrity of traded energy markets can be best ensured if a) wholesale transactions are subject to an effective and comprehensive regulatory surveillance and b) data which influence market fundamentals are made transparent to a sufficient extent taking into account legitimate competition concerns (e.g. collusive behaviour) in the highly concentrated energy sector. Such an ambition would ultimately lead to a regulatory framework in which the regulator(s) has/have a responsibility and capability to comprehend price formation on those markets, to identify malpractices such as insider dealing and market manipulation with the objective to sanction such practices. At the same time such framework needs to be balanced enough to foster further market development. This suggests a carefully crafted and sufficiently integrated (financial and physical) regulatory framework with an effective European institutional set-up.

The coincidence of the ongoing financial market regulatory reform debate, and preparations for the implementation of the 3<sup>rd</sup> IEM Package and revised EU ETS provide a good window of opportunity for the Commission to come forward with a legislative initiative covering traded wholesale markets for electricity and gas with the option to also include the EU ETS

carbon market. To this end, the Commission is currently exploring possible design options for a tailor made market transparency & integrity regime which should improve confidence in traded energy markets by closing the existing regulatory gaps and leading to higher levels of liquidity and further integration of European energy markets.

It should be noted that in parallel, following recommendations of a high-level group of experts chaired by J. de Larosi re that the framework of EU financial supervision needed to be strengthened to reduce the risk and severity of future financial crises, legislation is being debated on the creation of three European Supervisory Authorities and a European Systemic Risk Council. One of the authorities, the European Securities and Markets Authority (ESMA) should act with a view to improving the functioning of the internal market, including in particular by ensuring a high, effective and consistent level of regulation and supervision, to protect investors, to ensure the integrity, efficiency and orderly functioning of financial markets, to safeguard the stability of the financial system, and to strengthen international supervisory coordination. The integrity and oversight of commodity derivative markets will thus be strengthened, in line with recommendations from the G20 and IOSCO (International Organisation of Securities Commissions). An agreement on the creation of ESMA, which will be responsible for overseeing derivatives markets, was reached in Council on 2 December 2009.

## 2. ANALYSIS OF THE CURRENT LEGAL SITUATION

Potential gaps and inconsistencies in the regulatory oversight framework of electricity and gas wholesale markets were recognised by the Commission during the preparatory phase of the 3<sup>rd</sup> Package. On 21 December 2007 DG TREN/MARKT issued a joint mandate to the Committee of European Securities Regulators (CESR) and the European Regulators' Group for Electricity and Gas (ERGEG), seeking advice on issues concerning record keeping and transparency of transactions in electricity and gas supply contracts and derivatives. The Advice also focused on the relevance of the Market Abuse Directive (MAD). This joint CESR/ERGEG work proved to be a very useful basis for the ongoing preparations for a regulatory initiative to increase transparency and integrity of traded energy wholesale markets such as electricity and gas.

In terms of current regulatory framework the following areas of EU legislation are of key relevance:

- The **3<sup>rd</sup> IEM Package** is addressing traded markets to a limited extent only. The gas and electricity Directives codify a record keeping obligation for supply undertaking on all trading transactions for 5 years to be accessed by competent authorities (MiFID-regulated entities are exempted from such obligation). Beyond that there exists a rather weak wholesale market monitoring duty for NRAs (*"monitoring the level of transparency, including of wholesale prices, and ensuring compliance of electricity undertakings with transparency obligations"*, Art 37, 1 (i) of electricity Directive). Also in the Regulation for ACER appears a general obligation to monitor the internal market for electricity and gas. There is also a broad range of already applicable disclosure obligations for fundamental data codified in the Package which could be expanded through comitology.

- The **Market Abuse Directive (MAD)** provides a common EU framework for the disclosure of information to the market and aims at the prevention, detection, investigation and sanctioning of insider trading and market manipulation. MAD is designed for financial markets. It applies almost exclusively to financial instruments admitted to trading on a regulated market. Physical products (e.g. spot market products) are not covered and derivatives markets products are covered only if they are admitted to trading on a regulated market. Thus, the present scope of market abuse regulations (insider trading, market manipulation) generally does not apply to standard OTC (spot and forward) transactions that make up the bulk of traded electricity and gas markets.. It should be noted however that the ongoing MAD review is addressing, inter alia, specific shortcomings in relation to its treatment of commodity derivatives. This concerns for example, the commodity derivative specific definition of insider information in MAD which may be difficult for securities regulators to apply, in the absence of a clear definition of the information that users of commodity markets can expect to receive in accordance with accepted market practices on those markets.
- The **Markets in Financial Instruments Directive (MiFID)** is of particular relevance. One of its key objectives is free competition and a level playing field between trading venues. Equally importantly the Directive provides for requirements to ensure fair and orderly trading and appropriate transparency of trading venues for shares admitted for trading on a regulated market. However these pre- and post-trade transparency obligations do not apply to commodity derivatives. Hence there are only relatively high level transparency obligations with regard to exchanges listing commodity derivatives as part of their basic organizational requirements to ensure fair and orderly trading. Overall the definition of financial instruments in the Directive does not cover the spot market and physically settled OTC transactions which are non-standardized. Its basic objective of ensuring “financial stability and investor protection” seems less relevant for energy since energy derivatives are typically not investment products but are primarily used as hedging instruments for mitigating price risks of professional market participants (e.g. some utilities).<sup>1</sup> A potential breakdown of such markets, it is argued, would not pose a systemic risk to financial stability or to the interests of investors. Specialist commodity derivative market participants can currently avail themselves of two exemptions from MiFID (and a further exemption from the Capital Requirements Directive) in specific cases. These exemptions will be addressed as part of the review of MiFID in 2010.

### 3. OPTIONS FOR AN EU REGULATORY INITIATIVE

Since traded energy markets have a number of dimensions (spot vs. forward, financial vs. physical, OTC vs. exchanges, standardised vs. non-standardised, brokered vs. non-brokered) it needs to be carefully assessed as to "what" should be monitored, by "whom" and "how". As the underlying rationale of a consistent and effective EU regulatory framework it would seem that all types of transactions for which market misconduct leads to a comparable economic outcome would need to be subject to the same standard of market oversight.

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<sup>1</sup> See e.g. advice by the European Securities Markets Expert Group on commodity derivatives business, p.59ff [http://ec.europa.eu/internal\\_market/securities/docs/esme/commodity\\_derivatives\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf)

### ***3.1. Definition of insider dealing and market manipulation***

An important first step in the design of the regulatory initiative is a clear definition of insider dealing and market manipulation for traded wholesale markets in electricity and gas (and beyond, e.g. for the carbon market) in cases where MAD does not apply. The applied definitions will be as much as possible analogous to the ones applied in MAD. Wherever appropriate these definitions will be extended taking into account the specificities of the underlying commodity market. The principal objective is to achieve legal certainty for all market participants including those that pursue a predominantly asset-backed trading strategy. Since the later constitutes the prevalent form of trading this necessitates that monitoring and supervision captures both the physical position of such undertakings and their related wholesale transactions. Only a regulator which has sufficient data to assess trading behaviour of such undertakings will be able to judge compliance with "accepted market practices" which would still need to be defined.

### ***3.2. Commodity scope***

The appropriate commodity coverage of a market integrity initiative needs to be assessed. It remains to be seen whether it is at this stage desirable to go beyond electricity and gas. Limiting the scope to these two would facilitate the legal and institutional design of the market integrity initiative. At the same time the strong cross-commodity inter-linkages would suggest that at least carbon markets needed to be captured. As regional markets, electricity, gas and carbon would clearly be within EU jurisdictional reach. However the legal and institutional design of the new initiative would become more complex. Also new entities such as emitting industrials might need to be covered, at least as regards basic requirements such as record-keeping based e.g. on the advice of CESR and ERGEG, derived from requirements under MiFID. The cross-commodity interconnectedness would even suggest the broadening of the regime towards globally traded commodities such as coal and oil. Such level of ambition would however require a strategy for international regulatory cooperation in order to address the risk of regulatory arbitrage. Moreover it would seem obvious that the broader the commodity scope of the initiative is designed the heavier the transactional reporting burden would become for the undertakings concerned.

### ***3.3. Transactional data***

As a first step it will need to be determined whether the record keeping obligations codified under the 3<sup>rd</sup> Package would provide a solid enough basis for the market integrity initiative. It could be argued that regulator(s) will have the power to access the transactional data kept by the undertakings and that no regular reporting of transactions would be needed. At the same time it is likely that overall prudence of traded markets can be more effectively achieved if undertakings are obliged to actively report their transactions to a regulator(s) which has a distinct mission for constant monitoring. In such a scenario a comprehensive and holistic monitoring concept would need to cover, first and foremost, all standard wholesale transactions - be they spot or futures/forwards entered into by energy companies not falling under financial supervision. In a secondary instance, it could monitor all other energy trading independently of whether such energy-related transactions fall under financial supervision, by way of cooperation with financial regulators. As far as transactions are already reported under

MiFID and/or MAD, such transaction reports would need to be made available to the market monitor whatever its new institutional set-up will be. A "multi-channel" monitoring framework could be envisaged under which transactions subject to financial regulation continue to go to national securities regulators. Transactions that are going to be made subject to tailor made market conduct rules could in future go to national and / or an EU level energy regulatory body(ies). The more streamlined the reporting scenario the better.

Given the European nature of the EU ETS carbon market, there are no national regulators of the European carbon market who would be natural recipients of data on carbon market transactions. If the option of national level reporting is chosen - and assuming that the EU ETS carbon market is covered by any legislative initiative in this field - the competencies of the national energy regulators would have to be extended.

### ***3.4. Fundamental data***

With regard to fundamental data due account needs to be given to the legal possibilities offered under the 3<sup>rd</sup> Package to codify disclosure obligations for fundamental data through comitology. It seems preferable to fully exploit the potential of the 3<sup>rd</sup> Package in this area and to only leave the codification of fundamental data disclosure obligations to the new legal instrument in areas where this cannot be done through the 3<sup>rd</sup> Package. This would be clearly the case if the regulatory initiative on market integrity were to capture commodities beyond electricity and gas. Another issue which needs to be thoroughly examined is the need or not for differentiation of the disclosure regime between electricity and gas. On the one hand it may be desirable to go as much as possible for harmonization between the two commodities. On the other hand, there may be a need to recognise different physical characteristics of the two commodities suggesting different operational conditions and related price sensitivities related to the availability of physical status data to the market. As for the carbon market, the fact that the majority of industrial companies covered by the EU ETS are competing with companies in other parts of the world poses different questions again in relation to data disclosure.

### ***3.5. Monitoring models***

There are two basic design options for monitoring of the market which need to be examined thoroughly. One is an oversight framework which is built on the competence of Member States' regulatory authorities (energy and securities regulators) limiting new legislation to the improvement of their cooperation across sectors and borders. This would be a sort of subsidiarity-based model leading in particular to the upgrading of competences of energy regulators developing in parallel monitoring and sanctioning competences and capacities for covering also traded energy and carbon markets. This would clearly involve a multiplication of jurisdictions with an inherent risk of regulatory or operational (i.e. data formats) divergence. The inter-agency cooperation would need to be regulated through a rather sophisticated set of rules ensuring operational efficiency and effectiveness across many competent bodies. There would remain a certain risk of regulatory arbitrage among national oversight practices which would need to be carefully considered.

In contrast to such a subsidiarity-based design option a more centralised and integrated oversight framework at the European level could be envisaged. One option would be the

creation of a new European body which monitors, either directly or indirectly as explained above, all standard wholesale European transactions in spot and derivative products on all European trading venues. Such an integrated European level monitoring body would require a targeted and collective institution building effort *ex novo* or adaptations to the development of the Agency for the Cooperation of Energy Regulators ACER. For asset-backed trading in spot and forwards, not covered by MiFID and MAD, carried out by non-MiFID energy companies – its key concern – and any associated misconduct as defined in future tailor-made rules, it could exercise direct monitoring and oversight functions. For other energy trading falling under MiFID and MAD, e.g. carried out through brokers, or by MiFID-firms, appropriate cooperation agreements between this monitoring body and national securities regulators, notably as regards the sending of transactional data on derivatives from the latter to the former, will have to be put in place in order to be able to fulfil its monitoring function. For trades captured by MAD, but carried out by non-MiFID energy firms, energy and securities regulators would have to cooperate in an appropriate manner depending notably on whether the case mainly concerns financial instruments or not.

It is to be recognized however that the choice of the monitoring model and its necessary institutional arrangements can only be explored in a meaningful manner once the work on design options 3.1 to 3.4 will have been concluded.