

**Public Consultation by the Directorate General for Energy on
measures to ensure transparency and integrity of wholesale
markets in electricity and gas**

**A response paper by the Commodity Derivatives Working Group (CDWG)
of ISDA, FOA and EFET**

JULY 2010

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1. Introduction

- 1.1. The Commodity Derivatives Working Group (CDWG) is a joint association working group comprising commodity market participant members of ISDA, the FOA and EFET. This working group was established to represent the views of both specialist commodity firms and financial participants in a range of commodity markets including energy, oil, gas and base metals. The individual members of the working group are predominantly risk officers, compliance officers and lawyers for firms active in the EU.
- 1.2. ISDA represents participants in the privately negotiated derivatives industry and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.
- 1.3. The FOA is the industry association for more than 160 firms and institutions which engage in derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.
- 1.4. The purpose of this paper is to outline the position of the CDWG as regards the DG Energy consultation on transparency and integrity of wholesale electricity and gas markets. Comments made in this paper represent the views of the CDWG as a whole. Where no consensus opinion could be reached the differing views of participating firms have been outlined.

2. General comments

- 2.1. The CDWG believes that there are fundamental differences between commodity derivative markets, including the energy markets covered by this consultation, and financial derivative markets. Any approach to regulation of commodity derivatives markets must take these differences into account to ensure that regulation appropriate to financial derivative markets does not have a distorting effect on commodity derivatives trading and, indirectly, on the underlying physical markets.
- 2.2. Commodity derivatives are distinct from financial derivatives in that they are linked to physical underlying asset. In practice this helps protect the price of commodity derivatives against price movements based purely on market confidence and results in market stability even in the face of the failure of significant market participants, as was evidenced during the collapse of Enron in the context of energy markets. For this reason, the CDWG has consistently argued that commodity derivative markets are not subject to the same systemic pressures as purely financial markets.

- 2.3. While the CDWG agrees with the need to ensure the orderly operation of markets, it is crucial that regulators continue to avoid altering market behaviour to meet political rather than regulatory objectives.

3. Specific questions

Q1: Are there particular developments in relation to oversight of energy markets at a national, European or global level that we have not properly considered?

- 3.1. The CDWG notes the issues outlined under general comments above. Any consultation on the regulatory development of energy markets must be made with an awareness of features specific to these markets.
- 3.2. The CDWG highlights the importance of effective coordination across the various interrelated European regulatory initiatives in order to fully understand the impact of proposed policy measures and to ensure there is no unnecessary overlap or duplication of regulation.
- 3.3. The above notwithstanding, the CDWG supports the move towards the introduction of effective pan-European energy market regulation and urges DG Energy to ensure, above all, that any regulatory proposals are implemented consistently throughout the EU so as to avoid opportunities for regulatory arbitrage.

Q2: Do you agree that the current Regulatory Framework should be updated to include clear rules governing energy market oversight? Please justify your reply.

- 3.4. Yes. Energy market regulation is currently fragmented, resulting in regulatory gaps and overlaps, which foster legal uncertainty, barriers to entry and the commensurate increase in costs for market participants. Adoption of clear rules would reduce the cost of market participation and facilitate further development of these essential markets.

Q3: Do you agree that this update should ensure integrated/coordinated oversight between financial and commodity markets and across borders?

- 3.5. Yes. The interrelation between physical and derivative markets requires a regulatory approach which is closely coordinated between the regulators of physical and financial markets. A lack of adequate cooperation in this respect increases the risk of market arbitrage, which may in turn lead to manipulation.
- 3.6. As part of this enhanced cooperation, it is crucial that the primary responsibility for regulatory monitoring of products and markets is clearly defined.
- 3.7. Cross border coordination is essential for building a cohesive European market in electricity and gas. The current fragmentation of energy markets results in increased cost for market participants with resulting implications for end users.
- 3.8. The CDWG strongly believes that a single integrated regulator for both physical and financial energy markets would be a sub-optimal solution as no one regulatory authority currently has the degree of understanding to effectively monitor both markets.

Q4: Do you agree that the overlap of physical and financial (derivatives) markets, and the cross border nature of the market currently leads to sub-optimal oversight of energy markets?

- 3.9. Yes. As noted above, the lack of a cohesive regulatory framework within Europe has necessarily hindered the development of wholesale energy markets. Moreover, the current patchwork of regulation has failed to keep pace with changes in market practice leading to disconnects between energy market operation and national regulation in some jurisdictions.
- 3.10. This is not to say that the solution should require the introduction of pan-European bodies with direct regulatory oversight over different national markets. Efforts to ensure greater harmonisation of regulation between national regulators are likely to be both more effective for firms and regulators alike than the transfer of market monitoring responsibilities to new bodies without the relevant expertise. Pan-European bodies could nevertheless ensure EU-wide harmonisation and coordination to create a level playing field and avoid regulatory arbitrage.

Q5: Do you agree that definitions of market misconduct for gas and electricity markets should be consistent across the EU? If not, why not?

- 3.11. Yes. The CDWG agrees with the need for consistent definition of market misconduct across Europe.
- 3.12. The specific features of physical markets and interconnectivity between physical and financial energy markets gives rise to some concerns. Many participants in financial commodity markets are also active in physical markets as producers and/or suppliers of the underlying physical commodity. Definitions of market misconduct should not restrict the legitimate business of these firms (for example, hedging) or place them at a disadvantage relative to other market participants.

Q6: Do you agree that market misconduct should follow the MAD definitions? If not, why not?

- 3.13. Views of firms within the CDWG on the appropriate definition of market abuse and inside information for physical and derivative markets vary, but the following points are widely agreed.
- 3.14. MAD is drafted specifically to address financial market concerns, and does not adequately reflect the interplay between physical and derivatives markets. At the very least, the definition of insider trading and the extent to which this conflicts with legitimate trading activities of physical market participants would require consideration. For this reason, the direct application of financial MAD definitions to power and gas markets is problematic.
- 3.15. However, there are benefits in having a common reference point for market abuse in financial markets, including commodity derivative markets, and the MAD would seem the appropriate place to deal with this definition. A supplementary annex to the MAD addressing the specifics of abuse within gas and electricity derivatives markets,

including specific examples, would be an acceptable solution, and could be considered in conjunction with the current MAD review.

- 3.16. The CDWG does not believe that financial regulation drafted without reference to physical commodity markets can address the peculiarities of physical wholesale energy markets, and recommends that physical markets be subject to a bespoke physical market regime independent of MAD.

Q7: Do you agree that specific account of the specificities of the physical energy markets should be taken of energy markets through guidance rather than legislation? If not, why not?

- 3.17. The CDWG believes that legislation is preferable to guidance in this area, although the careful combination of the two is more preferable still. Guidance alone is insufficient to establish the necessary consistency of application across the EU, and a lack of legal certainty and enforceability undermines the effectiveness of regulation.
- 3.18. Guidance should be used in conjunction with legislation to ensure that legislation is enacted in a manner consistent with the original intentions by providing greater clarity on those issues which might otherwise be open to interpretation. If necessary, such guidance could be made binding by the EC through comitology proceedings.
- 3.19. Legislation should not be introduced in a manner which would restrict regional variations in legitimate market practices which do not increase the likelihood of misconduct nor impinge on the integrity of the market. In cases where regional variations in market practice are known to exist, guidance should be used to illustrate how these practices align with the legislation.

Q8: Do you agree that regular market monitoring is an essential function to detect market misconduct?

- 3.20. Yes, but it is important to ensure that monitoring is meaningfully directed to identify market misconduct effectively, and the necessary regulatory and disciplinary framework must exist for misconduct to have the appropriate and visible consequences.

Q9: If yes, given the characteristics of wholesale energy markets, do you agree that market monitoring is best organised on EU level?

- 3.21. The CDWG supports organisation and coordination of monitoring at an EU level, but believes that monitoring at a practical level may need to call on the input and expertise of national regulators with a focus on, and experience of, regional markets and the participants therein. National regulators are best placed both to maintain the necessary working relationships with market participants and to instigate rapid investigation of suspected misconduct.
- 3.22. This approach is consistent with the operating model under MiFID (currently under routine review), whereby national regulators operate a consistent regime. The CDWG does not support a move to create differing hierarchical structures for different markets, in particular in cases such as physical commodity and commodity derivative

markets, where the parallels with financial markets could inadvertently lead to greater regulatory confusion rather than enhanced oversight.

Q10: If yes, do you believe that ACER should be given the role of an EU level monitoring body for wholesale energy markets?

- 3.23. The CDWG does not support giving a single body monitoring responsibility for markets throughout Europe, but does appreciate the value of having a designated body to harmonize and coordinate the market monitoring activities of the relevant national regulators, and assist in areas where cross border concerns require the oversight of a single authority. This could be reached by binding guidelines under a future physical market regime of DG Energy.

Q11: Do you agree that the EU level monitoring body for energy markets should have a coordinating role to ensure effective application of EU level rules for energy markets? If not, why not?

- 3.24. Yes. As per Q10 above, the CDWG supports the appointment of an EU level coordinator to ensure the consistent application and enforcement of rules by, and coordination between, national regulators.

Q12: In your view, would enforcement of market misconduct rules be best organised on a national level or EU level? a) If on a national level, would national energy regulators or national financial regulators be better placed to enforce compliance? b) If on a European level, which institution would be best placed to enforce compliance?

- 3.25. The CDWG believes that enforcement and sanctioning should be the responsibility of national regulators.

- 3.26. Granting responsibility for market misconduct enforcement to either energy or financial regulators presupposes that one regulator has the necessary expertise to oversee activity in the other market. The CDWG instead believes that the two regulators should work together under a regime which enables greater cooperation but does not leave either party facing the burden of responsibility for activity falling outside their area of expertise. The EU heads of both regulatory networks, ACER and ESMA, should also coordinate their actions and rule-setting.

Q13: Do you agree that the market monitoring body for energy markets should also be able to monitor EUA transactions?

- 3.27. Yes, as electricity and gas markets are closely interrelated with EUA transactions.

Q14: Would monitoring of traded carbon markets be best organised on national or EU level?

- 3.28. The CDWG believes that the legislation underpinning market monitoring should be determined at an EU level to ensure consistency of application, but the practical monitoring of carbon trading should fall within the remit of national regulators for monitoring to be both practical and efficient.

Q15: If on EU level, do you believe that ACER could be an appropriate monitoring body?

3.29. N/A

Q16: Do you agree that it is not appropriate, at least at present, to consider coal, oil and other commodities alongside wholesale gas and electricity markets? If not, why not?

3.30. The specificities of commodity markets vary depending on a wide variety of factors including, but not limited to, methods of production, transport, storage and utilisation of the commodity in question. In consequence, the regime for wholesale electricity and gas should already differentiate between those two commodities, and the CDWG sees no value in extending this consultation to cover additional markets at this time.

Q17: Do you agree that it is appropriate to apply exemptions and de minimis levels? If not, why not?

3.31. The CDWG agrees with the principle of minimising the cost of regulatory compliance, in particular for small and medium sized firms where the costs of compliance could constitute a barrier to entry. However, any exemptions and *de minimis* levels should not prejudice the core aim of ensuring adequate market transparency and integrity. If reduced reporting requirements are introduced for different categories of firm there must be clarity around the thresholds for falling into each category.

3.32. It is important to ensure that sufficient transaction data is captured to provide regulators and other users of proposed trade data repositories with a complete picture of market activity. In determining exemptions for SMEs, care should be taken to ensure that essential trade data can still be captured through other means. In particular, reporting requirements for SMEs should remain sufficient to enable regulators to identify and successfully pursue market misconduct

Q18: Do you agree that market data relating to energy market transactions should be reported centrally? If not, why not?

3.33. The CDWG has previously supported the formation of centralised trade repositories and continues to do so. However, the CDWG believes that the number of repositories and the reporting burdens placed on firms should be kept to a minimum through coordination and optimisation of reports made, therefore any proposal for central reporting requirements arising from this consultation should take into account similar proposals arising from consultations specific to financial markets to avoid duplication of efforts and requirements for firms.

3.34. Primary responsibility for reporting transaction data to a trade repository should reside with the market operator (i.e. regulated exchange, broker, MTF etc) where the trade was concluded. As suggested in the consultation paper, transactions in standard products concluded on a purely bilateral basis (and not cleared) should be reported in a proportionate and cost effective way (i.e. monthly/quarterly/yearly). Information fed into a repository must only be mandated by electronic means and based on standardized formats and electronic data exchange standards could be adopted to

facilitate peer to peer or centralised communication of data. This approach would reduce the burden of providing transactional data, because there will be one set of data, one format, one reporting delay and frequency across the EU instead of potentially 27 different reporting regimes.¹

Q19: Do you agree the body with an oversight role requires full access to fundamental data relating to carbon?

- 3.35. Yes. The carbon market is integral to power and gas and therefore access relating to carbon can directly impact the power and gas markets, and should be available to any such body.

¹ Please see for possible formats etc. CESR-ERGEG Advice on Transparency, ref. 69 et seq.