MiFID II Level 2 and energy trading:

How to further specify the ancillary activity exemption in Article 2?

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1. Introduction

The undersigned associations believe that open, robust, liquid, competitive and transparent energy markets are key to ensuring secure, sustainable and competitive energy supplies for final customers, together with adequate infrastructure and a supportive regulatory framework. With this core and shared objective in mind, and while fully supporting the overall principles of the revised Markets in Financial Instruments Directive 2014/65/EU (MiFID II), we are nevertheless very concerned by some of the provisions which are currently being discussed in Level 2.

The low ancillary activity thresholds proposed in the Regulatory Technical Standards (RTS), which ESMA is due to send to the European Commission by the 3rd July 2015 for adoption, would require many energy trading firms to become MiFID-authorised, despite the fact that these firms are not comparable to 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.

Given the direct linkage of MiFID II to the applicability of CRD IV[1], a large majority of real economy physical companies, including small and medium-sized utilities, would have to meet considerably higher capital requirements than today (e.g. in relation to the tier-one capital, liquidity and large exposure regimes of CRR/CRD IV). The same applies to the mandatory clearing obligation under EMIR[2]. Once those firms are required to obtain a MiFID-license, they will not be able to qualify anymore for the specific provisions for non-financial counterparties (NFCs). As a result, many non-financial companies would not be able to cope

[1] Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms
[2] Regulation 2012/648/EU on OTC derivatives, central counterparties and trade repositories

with the cost increase and may either largely reduce their trading activity or move it to non-financial markets and/or venues outside the European Union.

Exchanges pool liquidity through providing non-discriminatory access to a central trading environment and an order book, which is subject to mandatory pre- and post-trade transparency. A withdrawal of non-financials from trading risks triggering a vicious circle of declining liquidity and a further fragmentation of the energy markets, which could undermine the MiFID II/MiFIR and EMIR frameworks alike. Lower wholesale market liquidity would result in significantly higher trading costs. It would undermine competition and increase market entry barriers as potential entrants would be deterred by the high costs and/or the inability to hedge. This would, in turn, 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.

Rising energy prices are also in stark contrast to the outlined policy of the European Commission for an EU Energy Union which is based on the following five pillars: (i) energy security, solidarity and trust; (ii) a fully-integrated European internal energy market; (iii) energy efficiency contributing to the moderation of demand; (iv) decarbonising the economy; and (v) research, innovation and competitiveness. In its recent communication, the European Commission estimates that "*the transition towards a more secure and sustainable energy system will require major investments in generation, networks and energy efficiency, estimated at some € 200 billion annually in the next decade*"[3].

In this context, the Agency for the Cooperation of Energy Regulators (ACER) considers a churn rate of at least 8 as necessary to obtain a sufficiently liquid market. ACER thereby recognises that energy traded more than once is not an expression of "speculative trading", but simply a way for the energy sector to optimise and hedge their (physical) positions.

Most recently, in its response[4] to the latest ESMA MiFID II/MiFIR Level 2 consultation, the Council of European Energy Regulators (CEER) expresses concerns that there is a "need to recognise that energy markets are different and that financial regulation should not undermine the years of work building the Internal Energy Market (IEM) - which is a high-level political goal of the European Union." In addition, CEER points out that "[d]espite the approach suggested by ESMA in the Discussion Paper of May 2014, in particular with respect to the threshold level set for the ancillary activity test (at 50% of the group's main business), [CEER is] afraid that extremely low thresholds, as suggested for both the ancillary activity test and the trading activity test, would deprive the exemption of application more than envisaged by the legislator; whose intention is mainly to capture non-financial firms dealing in financial instruments in a disproportionate manner (see also Recital 20 of MiFID II). […] Therefore [CEER] suggest[s] that the setting of thresholds should take into account the features of commodity asset classes, for example by linking their levels to the systemic threat of non-financial firms' trading activities".

[3] Energy Union Package – A Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy – 25 February 2015 – http://ec.europa.eu/priorities/energy-union/docs/energyunion_en.pdf
[4] http://www.esma.europa.eu/system/files/esma_mifid2_cp_ceer_replyform.docx

2. <u>Recalibrating the ancillary activity thresholds</u>

We deem it important to clearly specify in the RTS that both tests must be failed in order for an entity to be required to obtain a MiFID license. We understand that this is in line with the Level 1 text and the mandate given to ESMA by the European Commission. The mandate explicitly asks ESMA to develop a methodology where both the ancillary nature and the trading size of the activity are taken into account in order to determine whether a firm should be captured by the scope of MiFID II or not.

2.1 First test - "Capital employed"

We consider the proposed threshold of 5% as inappropriate, especially when it comes to gas, power and emission allowances markets. A cautious threshold of at least 25% should be set initially to avoid forcing small entities to exit the market, thereby preventing an immediate, irreversible drop in liquidity. This threshold could be reviewed at a later stage, based on an in-depth economic analysis and lessons learnt from the application of MiFID II. The recalibration of the threshold(s) could e.g. coincide with the report required by Recital 160 of MiFID II in 2018 that will provide an assessment of "the potential impact on energy prices and the functioning of the energy market of the expiry of the transitional period provided for the application of the clearing obligation and the margining requirements set out in Regulation (EU) No 648/2012".

2.2 Second test - "Market share"

As far as commodity markets are concerned (gas, power and emission allowances in particular), we consider the threshold to be too low and very difficult to assess, due to the unavailability of data. ESMA's latest proposals would see the vast majority of energy trading and other real economy firms being regulated as if they were banks, subject to detailed oversight by financial regulators and forced to comply with onerous and costly rules on licensing requirements, capital and liquidity adequacy, etc. These obligations would trigger a cascade of materially adverse and unintended consequences for energy markets, energy consumers and the real economy. This damage to wholesale energy markets would also directly undermine the policy objectives of the 3rd Energy Package and the Single Energy Market. Illiquid wholesale markets reduce competition and market efficiency with direct effects on the production and retail markets. Energy prices for consumers and industry would increase as a result.

In line with the first test, a cautious threshold of at least 15% should be set initially to avoid forcing a large number of firms to exit the market and more generally to prevent an irreversible drop in liquidity. Against this backdrop, we call upon ESMA to take immediate steps to make publically available the 2014 market size data for each commodity asset class. Persons seeking to use the exemption should be enabled to make the required calculation through the data provided in order to anticipate potential effects of MiFID II on their businesses and to make arrangements as they deem necessary.

2.3 Applying a weight-adjusted approach to volumes on regulated markets

The risk-reducing effect of central clearing by central counterparties (CCPs) should be reflected in the determination of the two ancillary activity tests for capital employed and market share**.** Contracts traded on regulated markets are by definition centrally cleared and thus, have a different risk profile compared to non-cleared contracts traded outside regulated markets. This is also reflected in EMIR where exchange-traded and centrally cleared derivatives (ETDs) do not count towards the clearing threshold. We suggest that the capital employed for carrying out the ancillary activity at the group level should be measured according to the initial margin for RM-traded contracts. The same should be applied to the calculation of the market size. Indeed, the risk to cover an open position of a trading participant in the event of a default corresponds to the initial margin. In energy commodities, this initial margin does not exceed 15%. Thereby, an exchange-traded contract would be weighted with 15% compared to an uncleared derivative with similar characteristics. This would not only better reflect the actual capital employed by the market participants but also the risk structure of the cleared contracts.

The RTS should also take into account that regulated markets already impose high standards on their members, irrespective of whether they are financial or non-financial firms. This includes mandatory clearing for every traded contract, full pre- and post-trade transparency, the control of algorithmic trading and capital requirements for clearing purposes. Additionally, there are organisational requirements for trading companies, strict "Know Your Customer" (KYC) procedures and membership requirements, as well as an active surveillance of all trading activity on the exchanges.

Applying these weight-adjusted methods would incentivise non-financial firms to trade in cleared products (under the scope of EMIR) on exchanges (under the scope of MiFID II). Counterparty risk and systemic risk in European wholesale commodity markets would thereby be reduced. Such an approach would also be fully in line with the G-20 Pittsburgh commitment to promote more transparent, non-discriminatory and systemically safer markets.

2.4 Emission allowances

Finally, MiFID II seems to underestimate the fact that energy groups normally manage their commercial commodity risks centrally, including the compliance obligations of the EU ETS. Whereas Art. 2(1)(e) of MiFID II exclusively exempts operators of installations that need to comply with the EU ETS, group entities buying emission allowances on behalf of the group remain in the scope of financial regulation.

Therefore, there is a danger that such central risk management entities can only make use of the ancillary activity exemption of Art. 2(1)(j) of MiFID II and that emission allowances traded for compliance reasons would fully count towards the thresholds of the ancillary activity exemption as proposed by ESMA. We strongly disagree with this approach and suggest that the RTS clearly specify that emission allowances can be considered as hedging / "risk reducing" transactions. Consequently, it should be allowed to exclude them from the calculation of the ancillary activity thresholds, independently of whether they are entered into by the operator of the EU ETS compliance installation or by a central risk management entity within the same group. Otherwise central risk management group entities would find themselves caught in an EU ETS compliance trap, i.e. exposed to MiFID II licensing, because they will be very likely to breach the very low threshold proposed by ESMA.

This issue is crucial for the functioning of the EU ETS. The European Union has put a considerable amount of effort into repairing the European emissions trading market, which remains the primary instrument for achieving the decarbonisation of the European economy and for fighting climate change. Damages to the liquidity of the emissions market would be contrary to a wide range of EU climate and energy policy goals.

BDEW
The German Association of Energy and Water Industries (Bundesverband der Energie- und Wasserwirtschaft - BDEW), Berlin, represents the interests of approximately 1,800 companies. The spectrum of its members ranges from local and municipal to regional and international companies. They represent about 90 percent of electricity sales, more than 60 percent of local and district heat supply, 90 percent of natural gas sales as well as 80 percent of drinking water abstraction and about one third of wastewater disposal in Germany.

EFET
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.

ENERGY UK
Energy UK is the trade association for the British energy industry. We represent over 80 members made up of generators and gas and electricity suppliers of all kinds and sizes as well as other businesses operating in the energy industry. Together our members generate more than 90 per cent of the UK's total electricity output, supplying more than 26 million homes and investing in 2013 more than £13 billion in the British economy.

EURELECTRIC
The Union of the Electricity Industry - EURELECTRIC is the sector association which represents the common interests of the electricity industry at pan-European level, plus its affiliates and associates on several other continents. We currently have over 30 full members which represent the electricity industry in 32 European countries.

EUROGAS
Eurogas is an association representing 43 companies and associations engaged in the wholesale, retail and distribution of gas in Europe. Eurogas provides data and information relevant to EU decision makers and opinion formers in making the right policy choice.

EUROPEX
EUROPEX is a not-for-profit Association of European Energy Exchanges, currently with 21 members, representing the interests of exchange-based wholesale electricity, gas and environmental markets with regards to developments of the European Regulatory Framework for wholesale energy trading, while providing a discussion platform at European level.