Sector specific regulation for energy trading

The regulators' view

Johannes Kindler,
Vice-President Federal Network Agency Germany
Vice-President ERGEG

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Energy trading is of crucial importance

- **Trading volumes** in gas and electricity have constantly **increased** over the last years and are expected to continue growing even faster.

- **Trading…**
  - provides **hedging opportunities** in markets of **growing volatility**;
  - will play an important role for the **gradual integration of renewable energy sources** and **save on subsidies**;
  - is a key driver for **achieving** the **EU internal market**.

Why do we need better rules?

On the basis of a joint mandate of the European Commission, Energy and Financial Market Regulators (ERGEG/CESR) concluded:

Current financial regulation is not adequate to guarantee integrity in the energy markets

- **Only a small part** of energy trading falls under the current **Market Abuse Directive** (MAD) which covers **Insider Trading** and **Market Manipulation**
- There is a **lack of transparency,** a **lack of regulatory tools** and a **lack of effective supervision** (i.e. no sanctions)
- **Thus: The door is wide open for market abuse!**

What are the remedies?

Regulators suggest:

- A **tailor-made** and **sector-specific regime** of
  - **Transparency** and
  - **Effective supervision**
- Including both **physical** and **financial** products
- Developments of **other** markets (e.g. oil, coal or **CO_2 allowances**) and interdependencies with those have to be considered.
- Prices on these markets have a direct and indirect impact on electricity and gas prices.
- However, because of their **global** dimension the inclusion of markets for **oil** and **coal** in a European regulatory framework would require **international agreements**.

What do the traders need?

TRANSPARENCY

The **“EMART Poll”** (18 November 2009) confirms:

- Traders need **better European-wide harmonised** information that can be processed easily

- **Different types** of transparency:
  - **Pre-Trading.** Publication of harmonized **fundamental data** which provides information about **available electricity and gas supply** (e.g. available generation and net capacity, planned outages).
  - **Post-Trading.** Anonymous publication of **transactions** close to real-time. Publication of **aggregate market data** at the end of each day.

Effective supervision needs effective reporting!

TWO ALTERNATIVES:

- **RECORD KEEPING = “soft” reporting?**
  - **Transparent description** of all transaction details (e.g. buyer/seller, volume, price). In the case of **suspected market abuse**, regulatory authorities could request these records.

- **TRANSACTION REPORTING = “effective” reporting?**
  - **Whether** market participants should be obliged to **report every transaction automatically to the supervisory authorities** is still under consideration. Transaction reporting was **not** part of the **mandate**. Nevertheless, **ERGEG** tends to **recommend** this explicitly.
  - In the meantime, the **Commission** (DG TREN **and** DG MARKT) seems to be shifting towards **Transaction Reporting**.

What kind of supervision do we need?

A new supervisory structure is a highly political issue and up to the European Commission and the Member States.

ENERGY REGULATORS' DREAM:

- **One single Supervisory Authority** for **Energy** and **Emissions trading** at **national** level, cooperating closely and on the basis of the same standards with other authorities of the relevant Member States.
- Under a coordinating **European roof?**

  (Repository? Supervisory Authority?)

What kind of supervision do we need?

- The possibly **realistic** scenario will consider:
  - the **Almunia** proposal on the future organisation of financial markets supervision (Sept. 2009)
    → **ESMA** (European Securities and Markets Authority);
  - the **specificities** of certain **commodity markets** (e.g. **electricity, gas and CO_2**) which are particular in their underlying physical market structure;
  - the supervisory situation in the **U.S.** (e.g. FERC, CFTC).

- **In any case**: **energy regulators**, because of their expertise, should assume a **prominent role** in this context.

The G20/Commission proposals: New challenges for energy trading?

- **On the basis** of the decisions taken at the **G20 Summit in Pittsburgh** (24 September 2009), the **Commission** (DG MARKT) **is currently preparing a strategy with the objective to reduce the negative impact** of **derivatives markets on financial stability.** Markets should be *“ultimately enabled to price risks properly”*.

The Commission proposal

Key elements:

- **Most extensive standardisation of OTC derivatives and mandatory central clearing** of such contracts on **exchanges** (e.g. EEX) and **”other organised trading venues“** .
- OTC derivatives contracts that are **not** suitable for **central clearing** (because too „customized“) have to provide <u>substantially</u> **higher collaterals**
- **Position limits for “speculative” positions** (to be decided by the **regulator)**
- Harmonised **pre- and post- trading requirements** also for the **OTC sector**
- **Transaction reporting** to „**trade repositories**“
- **Exemptions/facilitation** for **non-financial** („commercial“) investors **may** be granted.

Energy regulators' reaction: Don't throw the baby out with the bath water

Strongly enhanced risk management in derivatives trading
as a consequence of the financial crisis **is absolutely necessary**, **but**

- markets for **electricity**, **gas** and **CO_2 allowances** are mainly **regional markets**. The risks in regional markets are generally **easier to assess**;
- the trading of electricity and gas **has <u>not</u> contributed** to the emergence of the **financial crisis** (see CESR-CEBS advice);
- **a one-fits-all approach would endanger further energy market development**. This would be the case if the **standardisation of OTC derivatives** would be promoted **exclusively** under **risk limitation** aspects **without** taking account of the various **needs of the market** which frequently require **customized solutions.**

Energy regulators' reaction: Don't throw the baby out with the bath water

Furthermore:

Unilaterally risk-oriented and expensive regulation would make hedging more difficult, especially for SMEs.

Therefore we **welcome** the **ECOFIN Council** statement (2 December 2009) pleading *"to take into account differences […] of **specific market participants**, including non-financial firms, and **commodity markets**, e.g. for **gas and electricity**. Any future policy option should ensure that non-financial institutions can continue to manage their risks without incurring disproportionate costs…"*

Energy regulators' proposal: Together we could do better. Merger of the best ideas!

- We propose that the **strategic** elements of the **ERGEG/CESR model** be integrated with the **concept of DG MARKT.** This is possible and would be optimal under energy and trading aspects.

- **A realistic view of the market** (supply and demand) **provided by ERGEG/CESR's sector specific transparency regime is a systemic protection against the building up of dangerous positions**! The compliance and financial burden of the whole risk management would be lower.

- This would create a **win-win** situation both for the **market** and the **financial stability**.

Thank you for your attention!