EFET European Federation of Energy Traders

EFET Commentary

On the IDW draft paper on the interpretation of EMIR provisions applicable to non-financial counterparties

27 June 2014

The European Federation of Energy Traders (EFET) welcomes the draft position paper of the IDW on the interpretation of EMIR provisions applicable to non-financial counterparties. The draft paper addresses key elements in the implementation of EMIR, from the scope of the Regulation to the various obligations falling on non-financial counterparties. We welcome the useful clarification and harmonisation efforts of the IDW, which are certainly appreciated to forge a common understanding of EMIR provisions.

However, we would like to draw the IDW's attention to a number of points, namely:

- we would first caution the IDW against a purely German reading of the Regulation, since the interpretations contained in this paper are likely to be applied by non-financial counterparties far outside the borders of Germany;
- secondly, the interpretations of the IDW needs to take into consideration the reality of commodity markets and the real economy, and notably the physical reality of energy markets;
- thirdly, it is important to consider that OTC derivatives are defined in EMIR by reference to MiFID. This particular definition cannot be understood in a strict accounting perspective or even compared to derivatives as per IFRS rules;
- finally, certain individual assumptions of the draft paper, listed in the table below, are not compliant with the text of EMIR.

You will find hereunder a table developing these arguments and providing further details. EFET would kindly advise the IDW to address these concerns before the publication of the final position paper.

For further comments we would be happy to get in touch with you. Please refer to Karl Peter Horstman (Chair of the EFET Market Supervision Committee, karl-peter.horstmann@rwe.com), Cemil Altin (Vice-Chair of the EFET Market Supervision Committee, cemil.altin@edftrading.com), or Anya Bissessur (Chair of the EFET EMIR working group, Anya.Bissessur@statkraft.com).

Kind regards,

On behalf of the European Federation of Energy Traders,

Jan van Aken,
Secretary General

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Section	Page	Comments	Priority
2.1 (scope)	7	The group definition is linked to the presence of a parent company in a EU Member State. Although this interpretation does not per se contradict EMIR, it could in practice have detrimental effects certain European groups particularly active in the EU energy markets (for example those with parent companies located in the EEA or Switzerland), who would have to fulfil the third country requirements under EMIR. EFET would appreciate if this concern could be in any possible way taken into consideration to alleviate the negative effects such an interpretation would have on liquidity of European energy markets.	Medium

2.2.1 - 2.2.2 (scope/ definiti on of derivati ve)	8-12	IDW sets out its own understanding of what is an OTC Derivative under EMIR/MiFID I. This can lead potentially to disputes during EMIR compliance audits in respect of certain contracts, such as Take-or-Pay Contracts, respectively, Embedded "Derivatives". In the end this means that firms have to assess the concerned contracts on a case-by-case basis. Therefore, we propose to improve these sections: These contracts where the primary obligation (in the legal sense) of the parties is physical delivery and offtake are out of scope of EMIR / MiFID I. This assessment does not change where this primary obligation is replaced by a secondary obligation to compensate (financially) for the non-execution of the primary obligation. The IDW should therefore recognize the legal fundamentals underlying in these contracts and thus shorten these sections as far as possible and restrict its explanations to the legal provisions in MiFID I, respectively, the German law provisions (in this respect see next comment). It should be noted and taken into account that the underlying understanding of the legal definition of Derivatives under MiFID I will be anyway further defined by ESMA guidelines later this year (and expected to be consulted over the summer period) and that BAFin will over the summer also issue its understanding of the classification of Take-or-Pay Contracts.	Medium

2.2.1 (scope)	8	IDW is of the opinion that all derivatives traded outside of a RM are OTC Derivatives, even if they are cleared or margined. This is correct with the exception of ***OTC Derivatives which are voluntarily given up to a RM*** *(such contracts being commonly known an "voluntarily cleared OTC derivatives" in the energy markets)* provided they fulfil the conditions required by ESMA in its Q&As (immediate give up for clearing + contract subject to and executed in compliance with the rules of a RM) (see also comment hereunder to IDW P 12, Section 2.2.3 which is clearly in contradiction with ESMAs position). ESMA clearly recognizes that such "voluntarily cleared transactions" are not OTC Derivatives but derivatives which as such are only subject to reporting under EMIR. In general and concerning IDW's statement EFET would like to urge IDW to specify in relation to those contracts that remain OTC	High

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		Derivatives despite clearing how the risk mitigation obligations in EMIR should be fulfilled and how the reports to the TR are to be completed – regarding all fields. In some cases – ex: EFS or EFP – the party entering into the contract (party A) does so via screen trading, without knowing the identity of its counterparty. The only counterparty known is the CCP. Is party A thus expected to exchange confirmations with the CCP, and reconcile its portfolios with the CCP? This does not seem a practical and realistic solution.	

2.2.2 (scope/ definiti on of derivati ve)	9	As regards the definition of "derivatives", the IDW states that where MiFID Annex 1 Section C contradicts with the ***national implementation laws*** of the Member State, the definition of the Member State should apply. This contradicts the text of EMIR, which refers expressly to MiFID I definitions (and not to the national implementation laws). Such an interpretation would also contradict the purpose of the regulation to create a uniform regime for OTC Derivatives, as there could potentially be 27 different definitions of Derivatives that would apply. EFET could consider the use of national laws for interpretation purposes only, in cases where the EMIR text is not clear. This is however not the case for the definition of derivatives, where the reference to MiFID I in the EMIR text provides a clear guidance and does not give way to interpretation. At any rate, ESMA should remain the reference body in case of conflicting interpretation by different national regulators.	Medium

2.2.2 (scope/ definiti on of derivati ve)		The definition of commodity derivatives with physical settlement traded outside of regulated markets and MTFs equally raises concerns. In accordance with EMIR, the speculative nature of an OTC derivative contract only indicates whether it should be counted towards the EMIR clearing threshold, not whether the contract is a derivative or not. From a conceptual point of view, one should remember that (1) MiFID I, Annex I section C 7 and article 38.1 of Implementing Regulation 1287/2006 give a **joint definition** of the two concepts "not being for commercial purpose" and "having the characteristics of other derivative financial instruments" and that (2) it is practically and theoretically difficulty to classify a contract as a financial instrument or not based on a not easily demonstrable feature such as being speculative or not.	

2.2.2 (scope/ definiti on of derivati ve)		Long-term supply contracts for energy commodities such as gas or power which may contain delivery flexibilities – even with certain secondary obligations to pay financial compensation – are not to be regarded as derivative as defined under MiFID I and are, hence not subject to requirements under EMIR, as suggested in the IDW paper (section 2.2.2). These types of long-term supply contracts are settled physically. They provide buyers generally with off-take flexibilities and at prices which do not aim at taking advantage of market price volatility but at prices	

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		which aim at reflecting market prices at the time of physical delivery. Off-take flexibilities enable the buyer to react to physical market demand changes. Min-Take and ToP (Take or Pay) provisions in such contracts provide certainty about minimum revenues to the supplier in cases where the buyer (temporarily) takes less than the agreed minimum take within agreed delivery flexibilities. Such certainty about minimum revenues are required to underpin the significant investments required to produce gas or power; thereby they enable secure energy supplies. ToP payments for volumes not taken within a certain period principally provide the right to the buyer - within contract flexibility and duration - to still request physical delivery at a later point in time. To the seller such payments are a compensation for the management of the excess commodity in accordance with the rules of the network operators. Hence, ToP payments are no cash settlements. EFET would like to remind that these contracts are considered under German civil law, as setting out a primary obligation to deliver and accept, replaced upon non execution of the primary obligation by a secondary obligation to pay compensation. These contracts are thus not financial instruments under MiFID I (C4 to C10) and not derivatives under EMIR.	

2.2.3 (definition of OTC Derivative)	12-13	The status of voluntary cleared OTC Derivatives, ie, OTC Derivative transactions registered via EU Exchanges (or recognised 3rd Country Exchanges) which are subsequently cleared via an EMIR regulated clearing house, is not explicitly mentioned. IDW needs to clarify that these OTC derivatives voluntarily given up to a RM are not anymore OTC Derivatives and, therefore, do not count against the clearing threshold under EMIR. Therefore, a reference to the according section of the ESMA Q+As on EMIR and the according to rules of the Regulated Market should be made.	High

2.2.4 (Definition of Regulated Market and MTF)	13-14	A reference in the IDW Paper also to the ESMA lists of Regulated Markets and Multilateral Trading Facilities (MTFs) would be helpful because - according to BAFin - Market Participants can rely on these list to identify Regulated Markets and MTFs. See ESMA lists under: http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=22&language=0&pageName=MTF_Display and http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=23&language=0&pageName=REGULATED_MARKETS_Display. In addition to the above-mentioned list, market participants will also rely on information directly received from a trading venue about its status as a MTF, non-MTF or RM. The IDW standard should also take account of the British regulator FCA requirements and relevant rulings that allow UK broker platforms holding an MTF licence to propose certain workflows for trading of energy commodity outside of their MTF licence. Any transaction arranged via such non MTF services is not a derivative and thus falls outside of the scope of EMIR.	Medium

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3.2 (risk reducing intragroup transactions)	17	Regarding intragroup transactions and the calculation of the GNV, it is correct but not complete to consider only transactions between a FC and an NFC. Also intragroup transactions which are entered into for risk reducing purposes by one entity in the group (NFC-), passed on to another entity (NFC-, who is the "trading" entity of the group) and finally carried "outside" via an external transaction, should all be considered as risk reducing (chain of contracts, as per ESMA Q&A).	

3.2 (Clearing Obligation for NFCs)	18	We do not share the view that OTC Derivatives which are so-called "Over-Hedges" are per se non-hedging transactions which count against the clearing threshold under EMIR. This statement ignores (1) the characteristics of a macro-portfolio hedge approach (as this would force NFCs to identify for each single OTC Derivative contract an isolated, specific underlying commercial risk) and (2) the nature of energy markets and the assets therein. Seen from an isolated perspective, a new transaction could theoretically tip the position within a portfolio in the other direction (from long to short, or short to long). Such commodity transactions are in the normal course of business not done for speculative purposes, but with the intention to reduce the risk in a portfolio. However, due to the nature of commodity derivatives - which have scarce liquidity and product variations in certain markets/positions - a transaction can tip the aggregate position in a portfolio in the other direction because the commodity trader is not able to find a suitable liquid market for the type of derivatives that can cover/match the underlying position on exact same assets and/or on timing (duration). Also, we are not aware of an official BAFin/ESMA position in this regard. Therefore, we ask IDW to delete or soften that statement by proposing for example boundaries (per commodity and market) that are acceptable and appropriate for the market. We also disagree with the findings of the IDW according to which "For derivative contracts that do not have risk-reducing effects and which are traded in foreign currency, the hedging of the currency exposure through OTC derivative contracts do not possess any risk-reducing effect. For example, an OTC FC derivative contract to a speculative OTC oil derivative contract in foreign currency is not considered as risk-reducing". This interpretation is not based on EMIR or any guidance from ESMA. In addition, this would contradict the approach under IFRS which allows that FX trades can be classified as hedges.	High

3.3 (Risk Reducing OTC Derivatives)	22	In our opinion macro-portfolio hedging also means hedging with time incongruent products and, therefore, hedging across years must be possible. Therefore, the contrary statement that "A period per portfolio has to be set, e.g. calendar year for power or gas year" should be deleted or at least softened.	Medium

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3.3 (risk reducing OTCD)	22	The IDW states correctly on page 20 that the risk which is reduced needs to stem from the ***normal course of the business or the treasury activity of a company***. This is in line with the RTS 149/2013. But on P22 IDW mentions that "the main activity in the portfolios (i.e. the risk reducing portfolios) needs to come from the operative activity of the entity and can't in general be any derivative contracts. This interpretation is overly restrictive and is contradicted by the reality of energy trading. In mature markets financial transactions are not a rarity. OTC derivatives are often entered into to permit one of the counterparties to hedge risks, which it can't hedge on a regulated market (for instance because the transactions are outside of the traded curve or because the transaction is tailor made for a particular risk). The counterparty to such contracts is often a utility who trades with its own customers and which is expected by the market to offer such "hedging" products, to ensure the proper functioning and the liquidity of the market. This utility can't be prohibited from reducing its own risks stemming from such derivatives. While we understand that purely speculative derivatives are entered into by a counterparty at its own risks (and can't thus be risk reduced) the situation needs to be differentiated for utilities intervening in the real economy to offer needed derivatives to customers. Both counterparties to such derivatives would fulfil the criteria set out by the IDW for differentiating speculative from real economy contracts (See P 10, last sentence): the derivative contract does not per se offer the parties a possibility to speculate with the purpose of achieving a profit. It should be underlined that the "normal course of the business" of a utility can validly be trading in derivatives (besides production and operation of energy generating facilities). This is in line with article of association and allowed by legal frameworks (including MiFID I and II, allowing own account trading in financial instruments without a licence).	High

3.3 (Risk Reducing OTCDs)	23	We disagree with the concept that a trade that actually hedges a company's commodity price risk, can only be considered a hedge if it was intended as a hedge and allocated as such already at trade inception. This requirement is not explicitly imposed by EMIR, the EMIR Technical Standards or the ESMA Q&As. This is also inconsistent with the possible ex post classification of hedges under IFRS and, as stated in the EMIR Technical Standards, IFRS hedges are accepted under EMIR. This statement should be deleted and it should be mentioned that a clear (ex-post) allocation to "Hedging" and "Non-Hedging" portfolios is sufficient under the macro-portfolio approach.	High

5.1 (Risk Mitigation Techniques)	29-31	The risk mitigation techniques mentioned in EMIR are conclusive, i.e., there is the obligation to comply exclusively with those mentioned in the EMIR and EMIR technical standards. Hence, a "gold-plating" approach, e.g. the introduction of additional formal procedural and documentation requirements, as suggested in the IDW paper is not mandatory (even if they represent a "best practice" for risk management). Therefore, the paper should mention more clearly that such "gold-plating" is not required by EMIR.	Medium

5.3.1 (confirmation)	31	Confirmation may be performed electronically according to EMIR. This is in no case an obligation or a default case scenario.	Medium