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London, 17 July 2001

Teresa Poy
Investment Firms Division
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Ms. Poy,

RE: CP96 : Energy Market Participants and Oil Market Participants: a consultation on the interim regulatory regime for Energy Market Participants.

The International Swaps and Derivatives Association Inc. (ISDA) is an international organisation whose membership comprises over 500 of the world's largest commercial, merchant and investment banks and other corporations and institutions that conduct significant activities in swaps and other privately negotiated derivatives transactions. Additional information about ISDA can be obtained from our website, www.isda.org

ISDA welcomes the opportunity to comment on the FSA Consultation Paper 96, " Regulatory regime for Energy Market Participants" (CP96).

Our views may be summarised as follows:

- Further consultation on the proposals, in the light of the comments received as part of the current round of consultation, will be important.
- The proposed interim regime is complex and, in some ways, confusing.
- The scope of the proposed regulation, and in particular the "capital adequacy carve-out test", raises competitive issues.
- The longer term regime should be clarified and assessed against the current review of the ISD at European level.

Consultation process

We welcome the FSA's willingness to seek the views of market participants and other interested parties. A broad and inclusive consultation process is vital to ensure that the views from all sections of the industry are taken into account in developing the rules. In order to achieve a transparent consultation process, we particularly welcome the commitment made by the FSA to publish, in general, responses to the current consultation.

However, we note that the consultation paper was issued on 6 June 2001 and the deadline for comments was set for 17 July 2001. We believe that this timeframe is too short for a thorough consultation to be carried out.

We therefore urge the FSA to commit to holding at least an open forum session with industry participants regarding the proposed interim regime, once it has considered the responses to the current consultation, and to use that forum session to explain the reasoning for accepting or rejecting comments received.

With respect to the longer term regime, we also recommend that the FSA implements a thorough consultation process with industry participants as soon as possible.

Complexity

The proposed regime is complex and lacks clear guidance for Energy Market Participants as to whether they need to seek FSA authorisation.

For example, CP96 does not address whether bilateral trades under the New Electricity Trading Arrangements (NETA) qualify as investments and, if so, why. It is not clear that transactions under the Grid Trade Master Agreement (GTMA) are investments. Hence, it is not clearly stated whether NETA business constitutes regulated activity; it would be helpful if the FSA and OFGEM addressed the question in a co-ordinated fashion.

It should also be clarified that an energy investment retains its nature if it includes an ancillary currency or interest rate element.

The guidance given to permitted persons in paragraph 3.20 of the consultative paper is very limited. It seems important that the question of what investment business constitutes energy activity be properly addressed, in order to help the current permitted persons to reach a decision as to whether or not to seek authorisation. Their familiarity with regulation varies and the concepts developed in the Consultation Paper may, hence, be new to them.

Capital adequacy carve out

ISDA notes that CP96 provides for the dis-application of the Capital Adequacy Directive (CAD) regulatory capital rules. In order to qualify for relief, the firm must demonstrate that (paragraph 3.8):

- it does not carry on any regulated activity other than activities in relation to energy;
- its main business is the generation, production, storage, distribution and/or transmission of energy and;
- it does not engage in oil market activity as a member of an exchange, under the rules of which it is entitled to trade with other members.

CP96 clearly stipulates that the criteria above will be assessed at legal entity level.

CP96 recognises as the rationale for disapplying CAD regulatory capital requirements that the energy market is a wholesale market, with participants sophisticated enough to safeguard their assets and make their own credit assessments, ISDA does not believe that the degree of systemic risk in these markets should give rise to CAD-type requirements. Nowhere else in Europe or the United States does a regime equivalent to that envisaged by the FSA apply. All firms should, therefore, in our view be treated under the proposed carve-out.

In addition, the criteria proposed in this carve-out for differentiating between high-risk and low-risk business do not appear to be based on any precise analysis of risk inherent in energy-related activities. These rules will merely encourage market participants to locate or relocate their trading activities under the umbrella of entities involved in the generation, production, storage, distribution and/or transmission of energy in order to avoid the capital requirements.

In this respect, ISDA is concerned that the "main business test" may create competitive disadvantages for some firms or sectors. For example, a number of major players, particularly in the oil and gas markets, have structured their business so that regulated activities are conducted through a separate subsidiary that then interfaces with the rest of the group. These players will be placed in the unenviable situation of having to choose between complying with heavy capital adequacy rules or reorganising their business. ISDA believes that, if the "main business test" has to be included, which as stated above we do not advocate, it would make more sense to apply it at group level.

Furthermore, we do not understand the rationale for the differentiation in the capital adequacy test between the Oil Market Participants regime and the Energy Market Participants regime. In our opinion, the two approaches could easily have been aligned for the purposes of an interim regime.

We are also concerned that the "main business test" cannot be applied to all entities within the scope of the Energy Market Participants regime. For example, entities trading in weather derivatives or tradable renewable energy credit cannot be expected to have a main business in the generation, production, storage, distribution and/or transmission of energy. The regulatory burden on these entities will also increase.

We urge the FSA to re-consider the relevance of the "main business test", in view of its stated objective that "the same activity carried out in the same way for the same reasons should, in principle bear the same regulatory burden" (see paragraph 4.2.).

European context

The proposed regime for Energy Market Participants is an interim regime and the FSA has said that it will be reviewed no earlier than one year after implementation. However, it is also stated in paragraph 4.5 that the introduction of a longer-term regime may be allied to the introduction of the Prudential Sourcebook in January 2004. In the proposals it is stated that the FSA is "unable to give a clear indication of the substance or timing of a longer term regime".

ISDA is concerned that this approach creates uncertainty for the industry and hence recommends starting the longer-term regime review once regulation has been considered on a European level.

ISDA believes that, in a single European market, a regulatory regime for Energy Market Participants can only be effective if the framework is designed at European level. The potential inclusion of commodities

in the scope of the Investment Services Directive is one of the issues currently being discussed by the European Commission to which the potential regulation of energy activity might be related.

In our opinion, a global EU passport and related regulatory regime should be considered for the protection of market participants and market confidence. Any regime must, however, be suited to the nature of the market, so that it does not impose overly cumbersome regulation, including capital requirements, on market players. ISDA urges the FSA to wait for the completion of the review of the Investment Services Directive before considering the longer-term regime.

ISDA appreciates the opportunity to comment on the draft rules. We would reiterate that we believe an open discussion with industry participants should be held in the light of comments received. In the meantime, please do not hesitate to contact us, should you wish to discuss any of these comments further.

Yours sincerely,

Katia d'Hulster
Policy Director
International Swaps and Derivatives Association
European Office