

# **EU Commodity Markets and Trading: An Introductory Workshop**

Brussels, 28-29 September 2006

## ***Foreword by Chairman (Day 1) – Peter Styles***

### **Purpose and format of the Workshop**

EFET, ISDA and FOA, with the kind cooperation of DG Market of the European Commission and of the Legal and Public Affairs Departments of RWE Trading, are pleased to offer this two-day schedule of presentations and discussions on the use of derivative instruments in commodity markets. The schedule gives us the opportunity to explain the functioning of different commodity markets, especially those, which are energy-related, including the relevant policy and regulatory context. Our intended audience are interested Commission officials and representatives of financial regulatory authorities. We hope to explore the implications for regulation of commodity derivatives at a more fundamental level of detail, and in a more comprehensive way, than would be possible in the course of regular Brussels encounters.

We dedicate the first day to presentation of the overall function of wholesale tier commodity trading, of individual commodity markets (starting with physical contracting) and of risk management approaches. During the second day we explore the practical effects of the recent liberalization of the European electricity and gas sectors, as well as the regulation of commodity markets; this will include discussion of the pertinent aspects of *financial market* regulation, as it relates to derivative instruments, but only in the wider context of an evaluation of the risks inherent in, and the overall regulatory supervision of, the wholesale tier of commodity markets.

### **Energy liberalization and the development of physical wholesale trading**

An increasing number of European consumers enjoy the freedom to choose their supplier (at least in theory) thanks to the first and second packages of EU electricity and gas internal market legislation. However, the benefits of this increased choice will not be realized without liquid, efficient and integrated wholesale markets for power and gas, based on free competition. New entry into retail, import and generation markets will only take place on a significant scale if potential market participants gain confidence in a liquid and transparent wholesale, traded tier. To become successful entrants they require a reasonably deep wholesale market, in which to source their electricity or gas and manage their output, basis, and price risks.

The success of wholesale energy markets will provide a cornerstone for effective competition also in production and retail supply and lead ultimately to the success of market opening. Effective competition in turn drives efficient decisions on when to produce or consume, when to undertake maintenance and when to invest. Energy consumers are most unlikely to reap the full rewards of liberalisation of the electricity and gas sectors, without the creation and maintenance by policymakers and regulators of legislative regimes, which allow wholesale trading to flourish.

### **Limited depth and liquidity in power and gas markets despite liberalization measures**

In the past two years tangible progress towards real market opening has been rather modest, pending full implementation of the second liberalization legislation package. In particular, the gas market in Germany, which is key for the whole of Europe in terms of volume, transit and price setting, has exhibited no real development of competition and remains opaque. The electricity sectors of many of the accession countries are not yet subject to competition in any realistic way either, whilst Switzerland has yet to begin the legislative process of market opening. Some other existing EU countries' markets, in the case of either electricity or gas or both, are still dominated by incumbents in reality.

There is continuing debate in both the electricity and gas sectors about lack of cross border co-operation between transmission system operators (TSOs), their methods of congestion management and the isolated organisation of national intra-day and balancing markets. These important aspects of market integration have not yet been resolved on a pan European scale in any recognisably harmonised manner. On the gas side, whilst policymakers and regulators increasingly emphasise the need for fully transparent, simple and cost-reflective third party access regimes, there remain formidable barriers to entry. These impediments rest partly on foundations of artificial complexity and opacity, which continue to deter new entrants.

Thus, in this still fragile stage of liberalization, many players fear the financial regulation of commodity derivative transactions, especially the imposition of regulatory capital requirements, may erect a further barrier to entry to the fragile continental European power and gas wholesale markets.

### **From physical to financial trading in commodities**

Companies, who specialize in providing merchant risk-management services, including specialist commodity traders and financial institutions, are joining the established physical players, though in relatively small numbers. In even smaller numbers in Europe so far, some hedge funds and even diversified investment vehicles are starting to build commodities and commodity futures into their portfolios. There is no "bright line" distinction between specialist

energy or other commodity traders and physical market participants. Many “pure” or “financial” energy traders and some of the largest banks take contracts to physical delivery; and some specialist trading companies are subsidiaries or affiliates of significant physical players.

### **Which risks are commodity traders predominantly exposed to?**

Let us take the electricity sector as an example. It can provide lucrative opportunities for trading, even when markets are not transparent and harmonised. But – as in all other markets – participants expect to be adequately rewarded for the risks that they take.

Academic consultants at the London Business School carried out analysis for one particular trading house last year into a range of risk premiums in some of the most mature and liquid markets of Europe. They examined electricity term and cross-border trading in Germany, the Netherlands and the UK. They found average monthly forward premiums of some 30%, and weekly premiums of 17%, for national transactions in the winter. They also found substantial option premiums paid for access to transmission capacity across national boundaries. (It is to be noted that TSOs still do not offer commercially and contractually “firm” transmission capacity rights across intra-EU borders, despite their obligations set out in the EU Regulation on cross-border power transmission access.)

Counter-party risk premiums even in non-exchange based power trading appeared, however, to be much lower in the three mature markets studied than the premiums attributable to forward delivery and basis risks. When the analysis was extended to OTC deals in Slovenia, the premiums attributable to counter-party risks turned out just around 1% higher when compared to Germany. Only when the academics examined countries to the east and south of the EU did counter-party premiums rise steeply, to 5% for Serbia and Montenegro, for example, and around 19% for Bosnia and Herzegovina. ]

### **What prudential regime for commodity firms ?**

Existing EU capitalization rules as applied to banks stipulate the minimum amounts of *financial* resources that lenders and investment specialists must retain, in order to cover the risks to which they are exposed. The capital adequacy schemes contained in the Capital Adequacy Directive (CAD) were designed primarily for financial institutions. But since commodity derivatives were included within the basic scope of the Markets in Financial Instruments Directive (MiFID, previously ISD), even commodity trading companies not engaged in other financial business potentially fall under capital adequacy rules (subject to provisional derogations).

The capital review envisaged in article 48(2) of the CAD is not understood by market participants to aim to capitalise the whole balance sheet and physical activities of commodity firms. Indeed, the banking regulatory framework is ill equipped to deal with physical assets and security of supply issues, which fall more squarely within the remit of the commodity markets regulators.

If, as the industry believes, the capital review seeks to ensure the adequate prudential supervision of firms' commodity derivatives trading activities, then a first step towards structuring this approach must be to define its precise scope. Here, a fundamental link exists between the capital review and the MiFID exemptions review: currently, the exemptions available at Articles 2.1(i) and 2.1 (k) of MiFID, together with the definition of commodity derivatives under the Directive, are broad enough to exclude from the scope of licensing most if not all trading activities of commodity firms. By implication, the CAD does not apply to these firms. If and when the range of exemptions is reduced under MiFID, then the CAD potentially becomes applicable. Unfortunately, the MiFID exemptions review has not yet begun. The Commission should launch it without delay, as failing to do so would risk putting the cart before the horse: designing a capital regime applicable to a null set.

Assuming that some transactions fall within the scope of a prudential regime, the second step will be to design this regime. The industry has given some thought to the shape of a future harmonised prudential framework for commodity firms. In a nutshell, there is doubt as to whether imposing minimum capital requirements on commodity firms makes much sense, considering that only a small portion of the firm would be capitalised for regulatory purposes.

Subjecting commodity firms to strict risk management principles and a disclosure discipline may carry greater benefits both for the firms, in terms of improved measurement and hedging of financial risks, and the regulators. More detail will be provided on this approach on Friday.