ISDA®
International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AO
Tel: 44 (0) 20 3088 3550
Fax: 44 (0) 20 3088 3555
Email: isdaeurope@isda.org
Website: www.isda.org

FOA
2nd Floor
36-38 Botolph Lane
London EC3R 8DE
Tel +44 020 7929 0081
Fax +44 020 7621 0223

EFET European Federation of Energy Traders
European Federation of Energy Traders
Amstelveenseweg 998
1081 JS Amsterdam
Tel: +31 (0)20 5207970
Email: secretariat@efet.org

Mario Nava,
Head of Unit, Financial Market Infrastructure G2,
DG Internal Market,
The European Commission
200 Rue de la Loi
Brussels 1049

29 May 2009

Dear Mr Nava,

<u>Central Clearing of Commodity Derivatives – views of Commodity Derivatives Working Group</u>

We are writing to you regarding your ongoing considerations on counterparty and operational risk issues around OTC derivatives – in particular pertaining to the more widespread use of central clearing for OTC commodity derivatives.

The Commodity Derivatives Working Group represents the views of the commodity firm members of the European Federation of Energy Traders (EFET), the Futures and Options Associations (FOA), and the International Swaps and Derivatives Association (ISDA). This working group was originally set up to discuss the prudential treatment of commodity firms in the EU in the context of the review required under MIFID and the CRD of exemptions for commodity firms, but has evolved to provide an industry platform to discuss and engage with policymakers on the wider regulatory landscape for wholesale commodity trading, as it affects commodity firms.

A number of the firms involved in the CDWG were present at the meeting you held with wholesale commodity market participants in Brussels on 29 April. Firms present at that meeting noted the belief held by your colleagues in the Financial Market Infrastructure unit that central clearing is an extremely useful tool in reducing risk in wholesale markets, including in OTC derivatives markets, and that central clearing has proven its value in the current crisis. The CDWG shares this positive view of the many benefits accruing from central clearing of commodity derivative. However, the CDWG is of the opinion that there are a number of characteristics specific to wholesale commodity markets, and indeed to the commodity firms active in these markets, that negate the need for the Commission to mandate central clearing, or to incentivize it through alteration of capital rules applying to contracts that are not suitable for central clearing. We offer the following points which we believe warrant further consideration by the European Commission in addressing central clearing for commodity derivatives.

1. ***Central clearing is already commonly used in OTC commodity derivative markets), and is likely to become increasingly prevalent in the coming years as a result of market-led initiatives***

There is growing evidence of strong competition between exchanges, alternative trading platforms and clearing houses to launch products to suit the evolving needs of market participants to manage and limit counterparty credit risk. This has been identified and seized upon as a business opportunity by clearing houses. Specific examples include:

- the recent announcement by ICE Clear Europe that it has launched over 100 new OTC energy products since its establishment 6 months ago;

- clearing by the European Commodity Clearing AG (ECC) of contracts traded on the European Energy Exchange (EEX), the European Energy Derivatives Exchange N.V. (ENDEX) and the Powernext SA, as well as for over-the-counter (OTC) trades registered via these exchanges/platforms;

- the FOA initiative, working with counterparties and brokers to deliver central clearing services for the trading of UK power by NASDAQ OMX Commodities and Nord Pool Spot;

- the initiative by EFET to increase operational efficiency and facilitate clearing through EFETnetvia electronic confirmation matching (eCM), electronic Position Matching (ePM) and electronic Settlement Matching (eSM) and its work with clearing houses, brokers, exchange, GCMs and traders to automate the flow of trades into clearing by removing proprietary procedures and IT interfaces and levelling the 'playing field' for all clearing service providers.

In the short term, we expect that the benefits of initiatives such as these will only be able to apply to contracts where there is sufficient standardization and liquidity to facilitate central clearing. There are a significant number of OTC commodity derivatives which are not suitable for central clearing because they are either not sufficiently standardized, are not sufficiently liquid to be economically viable for central clearing or they do not trade frequently enough to develop the kind of robust forward curves and readily calculable margin calls required by clearing houses. In addition, many of the commercial firms active in the energy markets who have a commercial need to hedge positions would not be able to meet the collateral requirements associated with clearing and would find it harder to access the markets.

The market is therefore already delivering a central clearing solution to those contracts that are suitable for central counterparty clearing. Arguably, regulation mandating or incentivizing central clearing may actually stifle the innovation and competition apparent between clearing providers that is clearly in evidence in solutions such as these. We believe that regulators should facilitate the continuance of OTC commodity derivatives which are not suitable for central clearing in order to sustain the high level of product diversity and market flexibility necessary to meet all the underlying and often complex risk management needs of market participants.

2. ***No 'financial' systemic risk requiring a regulatory push of OTC commodity derivative contracts (to which commodity firms are counterparties) on to clearing houses is apparent for commodity firms.***

European Commission officials will be aware of the review the European Commission has been required to undertake on exemptions in the MIFID and Capital Requirements Directive for specialised commodity firms. This review has been under way since 2006, but is not yet complete. The Committee of European Banking Supervisors and the Committee of European Securities Regulators, in joint technical advice to the European Commission, have (in October 2008) noted that, though *'activities of specialist commodity firms can give rise to systemic risk through externalities... systemic risks generated by these firms appear in general to be lower than the systemic risks and externalities generated by credit institutions and ISD investment firms.'*[1]

This statement is borne out by recent evidence, i.e. that commodity firms have not contributed to the causation of the current crisis and have performed robustly through it without bearing the kind of losses suffered by financial institutions – at a time when sharp falls in commodity prices have been driven by a significant decline in global demand.

While it is clear that financial regulators believe that the current financial turmoil provides the justification for closer regulation of OTC financial markets, including mandating, incentivizing or seeking voluntary commitments for central clearing of OTC derivatives, the CDWG does not believe that any such justification has yet been made for similar measures being required of commodity firms or for commodity derivative markets. In fact, the evidence is that such a step would be unnecessary - commodity firms have an existing and long-established capability to manage risks by existing risk management tools (e.g. internal counterparty and credit risk analysis, collateral, netting).

3. ***What is right for credit default swap (CDS) markets may not be right for commodity derivative markets***

It is clear that there were a number of factors pertaining to credit default swap markets which led regulators to conclude that central clearing of credit default swaps was necessary and appropriate. These include

- Prior to the initiatives launched in recent months (against a background of regulator-industry discussions), credit default swaps were not being centrally cleared;
- The credit default swaps market is a market where financial institutions make up a large part of the market, acting as dealers.
- Credit default swaps are very standardised at the more liquid end of the market (e.g. index trades), and thus central clearing is operationally more feasible;

[1] See http://www.c-ebs.org/getdoc/ee9b85fa-4d64-48dc-9f45-a7350881ddac/2008-15-10-CESR-CEBS-advice-on-Commodities.aspx

Addressing each of these points in turn, we would observe that

- As previously highlighted, there are already a number of existing market-led initiatives to clear OTC commodity derivatives
- The OTC commodity derivatives market is comprised of a wide variety of actors, ranging from large oil companies to local municipalities, corporates, specialist energy traders and financial institutions and investment firms and is not dominated by dealers and financial institutions in the same way as the CDS market.
- The OTC commodity derivative market is not homogenous – it is rather comprised of many different underlyings and local markets, with further diversity apparent through different types of documentation and methods of settlement.

The CDWG would like to underline that the characteristics specific to the commodity derivatives markets should be taken into consideration when considering how and if central clearing should be incentivised or mandated for OTC commodity derivatives trading. While it is clear that the European Commission is taking a rigorous and thoughtful approach in its analysis of 'other' OTC derivatives markets, we feel it is worth stressing that a 'one size fits all' approach would not benefit financial stability or the development of deeper, more liquid commodity derivative markets.

4. Mandating or incentivising central clearing would introduce a new layer of intermediation into commodity derivative markets

Commodity firms, while currently direct participants in commodity derivative markets, are not, typically, clearing members at central counterparties (with the occasional exception). Thus, a regulatory push towards central clearing of commodity derivatives would either (a) require commodity firms to pay considerable amounts in initial and ongoing margin to be members of central counterparties or (b), more likely, require commodity firms to pay financial institutions for clearing services at central counterparties.

The CDWG believes that this would impose an unnecessary extra expense, which would only serve to increase the cost of managing the various risks faced by commodity firms.

5. Regulatory-driven standardisation and mandating or incentivisation of central clearing would, far from reducing risk in commodity markets, actually increase it, and would undermine the development of commodity markets in general

Commodity derivative markets developed out of a wish by commercial producers and users of commodities to manage price risk.This pure 'risk management' function offered by the OTC commodity derivative markets has led to the kind of diversity that is now available to producers and users and the emergence of bespoke, structured and illiquid contracts to manage the risk of increasingly more complex underlying needs.

The CDWG understands the interest in promotion of standardisation of contracts, with a view to facilitation of central clearing efforts. However, commodity firms caution that a risk-focused drive to further standardise contracts, for the purpose of central clearing or any other purposes, would be counter-productive, i.e. it would:

- actually increase risk, as commodity market participants seeking to mitigate specific risks would find it harder to enter into the kind of tailor-made OTC transactions capable of mitigating their specific transactional and commercial risks;

- incentivise dealers not to offer those kind of contracts and/or increase their cost where available;

- undermine the post-crisis regulatory priority of enhancing the capability of financial institutions and their counterparties to increase their risk management capabilities;

- provoke a risk-enhancing unhealthy trade-off between reducing credit risk in certain standardized contracts and increasing basis risk by encouraging the use of those standardized contracts to cover underlying risks, on a mismatched basis;

- require commodity firms to allocate increased amounts of money and margin at clearing houses and so increase the cost of managing risk.

We would add that we do not believe that commodity derivative markets are well-served by regulation mandating central clearing or incentivizing central clearing via capital requirements, for either financial institutions participating in commodity derivative markets, or commodity firms. In both cases, the outcome would be to make participation in these markets prohibitively expensive, reducing levels of participation and consequently liquidity. We believe that this would represent excessive regulatory intervention in markets where no significant failure has been apparent.

The members of the CDWG who have met with you or your colleagues in the Financial Market Infrastructure unit to date have commented on the mutually beneficial nature of these meetings, as well as your interest in exploring the market structure, risks and other characteristics apparent to commodity derivative markets. We believe that that the views expressed in this letter should be read in this context.

We look forward to working further with you on these and related subjects and are at your disposal if you would like raise any questions in relation to this letter, or any other matter.

Yours etc

Emma Culley

Emma Culley,
Chair of the Commodity Derivatives Working Group
Manager, Compliance, EAME and Asia
ConocoPhillips

Cc
Martin Power, Head of Cabinet Commissioner McCreevy
Nathalie de Basaldua, Deputy Head of Cabinet Commissioner McCreevy
David Wright, Deputy Director-General, DG Internal Market, European Commission
Maria Velentza, Head of Securities unit, DG Internal Market, European Commission
Patrick Pearson, Head of Banking unit, DG Internal Market, European Commission