Stellvertretender Hauptgeschäftsführer

Leiter der Vertretung bei der EU

Commission of European Banking
Supervisors
25 Old Broad Street
London EC2N 1HQ
United Kingdom

Submission via Email: le@c-ebs.org

Verband der Elektrizitätswirtschaft e.V.

VDEW-Vertretung bei der EU
148, Avenue de Tervuren bte. 17
1150 BRUXELLES
BELGIQUE
Telefon +32 2 7719642
Telefax +32 2 7630817
info@vdew.net
www.strom.de

Dr. Michael Wunnerlich
michael_wunnerlich@vdew.net

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MW/BW

Consultation on Large Exposures – Input to the credit risk mitigation workstream

Dear Sir or Madam,

we welcome the opportunity to provide further input to the consultation process on the review of the Large Exposure rules, particularly regarding further input to the credit risk mitigation workstream. The current consultation process by the Committee of European Banking Supervisors (CEBS) is part of the call for technical advice (No.5) by the European Commission regarding Large Exposures following the required review of the rules on Large Exposures of Article 119 Capital Requirements Directive (CRD).

The German Electricity Association (VDEW, Verband der Elektrizitätswirtschaft), represents more than 750 utilities (including most of the German energy trading companies) covering more than 90 per cent of the German electricity market.

With the introduction of commodities into the Directive for Markets in Financial Instruments (MiFID), regulated commodity firms (including energy trading companies) will also have to meet the requirements according to the CRD and the Banking Directive. The main thrust of these Directives, however, is aimed towards financial institutions such as banks. One such issue is the potential impact of the provisions of the Large Exposure Directive. According to the CRD, all companies being active in "MiFID-licensed" trading also have to comply with the capital requirements due to Large Exposures; whereby all commercial operations, including off-balance positions are taken into account. This includes all "normal day-to-day" business activities conducted in the course of end- customer supply. Hence, specific technical necessities (i.e. metering) as well as established

Sitz Berlin
Robert-Koch-Platz 4
10115 Berlin
Telefon +49 30 7261 47- 0
Telefax +49 30 726147-140

VDEW-Büro Bonn
Friedrich-Wilhelm-Straße 1
53113 Bonn
Telefon +49 228 231031
Telefax +49 228 236760

practices, such as delivery and payment arrangements will also be affected.

Since the start of the liberalisation process in 1998 the liberalised European power market has evolved at a rapid pace; as a parallel development, market places for trading in energy products have become a major cornerstone for the purchasing and selling strategies of energy companies. Under the provisions of the MiFID, the number of commodity firms that have to comply with the regulatory regime may increase. In turn, these companies also need to comply with the respective capital adequacy rules, including the requirement of the Large Exposures Directive. An unadjusted implementation of the existing capital framework may severely damage this evolving market and thus hamper the European Commissions' objective to develop liberalised and functioning energy markets.

Importance of energy trading for an effective internal energy market

The liberalisation of the European electricity and gas markets as envisioned in the "Barcelona-process" shall promote the European economy by means of competitive pricing and the focus on customer needs. Hereby, the establishment of the business area energy trading is an important step. Vital for a functioning trading market is the creation of reliable price-references, particularly via the price formation on energy exchanges. These prices serve as benchmark for more sophisticated financial products that are vital for risk management activities (position hedging). Without the possibility to implement risk management, companies that are active in the energy markets would be extremely exposed to unpredictable changes (like unplanned generation outages or unpredictable changes of weather conditions) and hence would have to put their economical basis continuously at considerable risk. A functioning energy trading market supports the security of supply on a national and Europe-wide level. Moreover, it promotes competition as market liquidity will increase and in turn will create strong incentives for other market participants - also from other business areas - to participate in energy trading markets.

No comparable systemic risk between the financial and the energy market

We like to point out that activities in energy trading do not imply the same systemic risk as activities in the classic financial markets. The functioning of the energy-related capital market is therefore much less affected by trading-related risks, which justifies lower capital requirements. Due to differences in the internal organisation as well as market and customer structures, the market price risks and counter-party risks as well as the

operational risks caused by energy trading companies, vary fundamentally from those triggered by banks, financial institutes or investment companies in the classical financial sector. The energy trading market is a purely professional market where only professionals participate in. Moreover, the majority of energy related contracts are concluded in order to physically deliver energy. Due to the technical complexity of this process (i.e. adjustment control, measuring etc.), there are significant differences in the billing and settlement of these products compared to the financial markets .

The main focus of Basel II and the CRD is to limit the systemic risks stemming from the activity of financial institutions, investment companies and banks in the financial market. In comparison to the failure of a participant in the financial market, the insolvency of a market player in the energy market cannot lead to a disturbance of the capital market itself. A prime example is the insolvency of the energy trader ENRON that did not lead to a major disturbance in the capital / financial markets. The methods of risk and credit management used in energy trading have proved that they are adequate to guarantee the functionality of the (energy) capital market. Thus, the energy market holds a lower level of systemic risk than in the financial market; and notably, insolvency will not affect generation capacity as these capacities will most likely not disappear from the market, but rather continue to be used, possibly under new ownership.

Generally, we support an appropriate body of rules and regulations to harmonise the European financial and commodities markets. A common body of rules encourages the entry of new market participants, increases investor security and promotes market confidence throughout the European Union. But we also like to stress that the application of undifferentiated capital requirements will fundamentally affect "MiFID-authorised" energy derivatives trading, which in the long run may put the liberalisation process of the EU internal markets for electricity and gas in jeopardy.

In the following we like to provide our comments specifically regarding the review process of the Large Exposure Directive.

Diverging structures in energy supply and trading market

Credit risks due to Large Exposures are undoubtedly relevant for traditional financial institutions. They are, however, not relevant for the energy commodity industry in the same manner as the operative business model in the energy industry has significant differences. Typically, the structure in the energy (trading) market differs from the financial market as to the individual company structure, the client structure and the product structure.

We like to point out that the financial markets are structured completely different from the commodities market. A major difference is based on the

fact that in commodities markets the products are physically delivered. In power and gas markets a (constant) load is transferred through a period of time.

The structure of companies, customers and the energy trading market itself differs considerably from those in the financial sector. In matters of capital structure, organisation and core business, energy trading companies vary significantly from companies in the financial sector. Customers of energy trading companies comprise mostly distributors, municipalities, large industrial companies and to a lesser extent members of the classical financial sector. The transactions conducted on the energy market mostly serve to supply end-customers or distributors. Moreover, energy trading is a vital means for an effective management of the generation capacities and provides the important measures for risk management activities of energy suppliers, energy producers and energy consumers. Essentially, energy trading is based upon the physical exchange of power, gas and coal with the purpose of ensuring security of supply and the hedging of risks. In contrast, the majority of the classical financial sector comprises bank and investment-related activities, such as traditional banking and investment services.

The „traditional“ day-to-day business of energy companies is to provide energy products to their customers. Due to e.g. specific regulations such as unbundling obligations, the value chain in the electricity industry may be longer than in other industries including the units generation, trading and sales, distribution (e.g. via regional distribution companies), co-operation of public utilities for joint procurement purposes, end customers/users and grid operators.

Many energy companies have set up specific trading units that serve as a platform to purchase and sell electricity. Their aim is to market the produced electricity of their generation unit and to procure the electricity for their retail unit. In other words, they have structured their business to create a single trading entity that presents one face to the market and centralises risk management expertise. Naturally, this entity will enter into a large number of transactions with group companies, which under the Large Exposure Directive could either give rise to additional capital requirements, or at worst reduce the potential for intra-group trading, thereby destroying the risk management benefits that go with it.

Without specific rules on the issue of Large Exposures that take the peculiarities of the energy markets into account, the risk exposure will be overstated resulting in too restrictive capital adequacy requirements for energy companies.

Unsettled Transactions

Furthermore, we like to stress the issue of additional requirements according to the large Exposure directive in relation to so-called unsettled transactions energy market. Currently, additional funds for credit exposure would be necessary in cases when a transaction is unsettled while this extra capital would be required to be set aside from trade date, not payment due date, in lieu of a potential credit risk that has yet to crystalise.

It is common practice that electricity is supplied throughout the entire month with the metering of the actual usage and the issuing of the bill at the end of the month. Further, the supply company then usually allows for a deferred payment (i.e. a specific time after issuing the bill). In Germany, for example, the established practice of delivery and payment modalities are one month plus 20 days post delivery. This is mainly due to the fact that the energy supplier will only at the end of the month know the actual delivered quantity and commonly grants a term of payment of 20 days.

This could lead to the fact that the upper limits for Large Exposures are quickly reached and exceeded. As a consequence, the capital requirements to cover Large Exposures would also have to be met. In other words, if an energy supplier is also active in "MiFID-licensed" trading, the usual commercial operations like supply of electricity, gas or heat would cause an inappropriate additional need for capital adequacy due to the capital requirements for Large Exposures. However, the commercial customs and established procedures can only be changed with major efforts and cost, while alternatively additional equity will be difficult or almost impossible to obtain. Thus, the undifferentiated application of the CAD requirements for Large Exposures to energy companies will be prohibitive for future "MiFID-licensed" energy derivatives trading, i.e. energy suppliers will either not consider to apply for a licence in the first place, or they will not be able to utilise their trading licence and will in turn be forced to terminate their licensed trading activities. This surely would be an enormous obstruction for the development of liquid energy trading markets in the EU.

As a consequence, firms would be required to set aside significant amounts of “unnecessary” capital, which could give rise to a liquidity constraint in the markets. We therefore suggest to include an exemption which allows investment companies to exclude accounts receivable from physically settled energy trading contracts (especially electricity) which have a payment target of up to a specific time period from the calculation of Large Exposures.

Long term contracts

Also, in energy trading longer term supply contracts are commonly used as “normal” trading products. However, for MiFID-licensed energy companies, these positive market values of these contracts would also be classified as credits with the result that the limits of the Large Exposure Directive would be quickly reached and exceeded. Again, this would lead to a significant increase in regulatory capital (for credit risk purposes) for energy markets where the contracts are typically long dated (many years) and payment can occur several days post delivery reflecting the payment terms used in the underlying physical market.

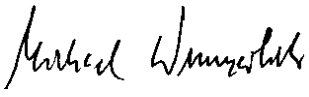
Acceptation of collateral

The CRD includes the possibility to reduce the need for capital adequacy due to counter-party risk by providing collateral like mortgages or lien on material assets (gold, cash, securities). These items are commonly available in the financial sector but rather unusual in the energy sector (besides from cash). In energy/commodity trading, inventory (stock of products), debt guarantees or guarantees by holding companies (letter of comfort) are widely used as collateral. Moreover, these assets can only be utilised to reduce the capital requirements if the "Internal Rating Based Approach (IRB)" will be applied to calculate the respective capital requirements. As the IRB-Method puts high demands on the internal organisation of analytic schedule and risk monitoring, most energy/commodity traders would be impeded from the usage of collateral to reduce the need for capital adequacy for counter-party risks. We therefore recommend that investment companies, who are solely active in energy derivatives related businesses, can utilise guarantees and letters of comfort with the "Standard Approach" to calculate their counter-party risk.

We would very much appreciate if CEBS takes our comments into consideration when developing its advice to the European Commission.

In case of any queries, please do not hesitate to contact Dr. Bernhard Walter (bernhard_walter@vdew.net; phone ++49/ 30 72 61 47 - 470) or me.

Yours sincerely



Dr. Michael Wunnerlich