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**CESR/CEBS joint consultation paper on commodities**

28.07.2008

Dear Sir or Madam,

Enclosed please find the position paper submitted by the VKU in response to the questions you posed as part of the public consultation regarding CESR's/CEBS' technical advice to the European Commission on the review of commodities business (Ref.CP 3L3 08 02/CESR/08-370).

Should you have any questions or comments please do not hesitate to contact us. Our expert, Mr Raiko Zwilling (tel. 030/58 58 0 186, [zwilling@vku.de](mailto:zwilling@vku.de)), will be pleased to assist at any time.

Yours faithfully,

Hans-Joachim Reck  
Managing Director

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**Position paper of the Association of Local Utilities (VKU)**

**in response to the public consultation held by CESR and  
CEBS on the regulation in the energy trading sector**

Consultation paper on CESR's/CEBS' technical advice to the European  
Commission on the review of commodities business (Ref.CP 3L3 08  
02/CESR/08-370)

Berlin, 28 July 2008

## I. Preliminary remarks

The VKU (German Association of Local Utilities), together with the "VKS im VKU", represents the interests of Germany's local public utilities in the fields of energy and water supply as well as sewage and waste management. Nearly 1,400 member companies are organised within the VKU, accounting for a turnover of around €71 billion and employing some 233,000 people in total.

The VKU represents approximately 600 electricity and 570 gas utilities. The local public utilities in Germany, which are predominantly small and medium-sized enterprises, constitute an important locational factor in terms of regional economic development and local employment. With an overall installed capacity of almost 10,000 MW (more than 80 % from combined heat-and-power generation), they make a substantial contribution to Germany's energy security on the basis of environmentally sound and decentralised supply.

A large number of our member companies make use of the opportunities offered by liberalised energy markets and engage actively in energy trading. These include not only the large municipal utilities with their own trading departments and specialised energy trading companies but also smaller-scale municipal energy utilities that have collaborated to form joint procurement companies.

A change in the legal framework in which these firms operate would have some major impacts on their activities and thus on the structure of the energy market as a whole. This is why the VKU is keen to take this opportunity to respond to some of the points raised in the current consultation process.

## II. The VKU's responses to the consultation paper

**10. Do the risks generated by energy-only investment firms differ materially from those posed by investment firms engaging in other commodity derivative activities/services? If so, how do they differ?**

**14. Do you have any evidence that regulation according to the main business of the group may cause competitive distortions?**

The risks associated with the activities of specialist commodity derivative traders are significantly lower than those generated by the activities of banks. The reason lies first of all in the nature of the businesses they run. The activities of local public utilities are primarily aimed at meeting the existing energy needs. As

a rule, they operate in the underlying physical market and aim at achieving the price security needed in their market environment. Secondly, the market participants are not private clients but firms who tend to be sophisticated market operators. Moreover, the trading firms under consideration here operate with the backing of mainly solid companies with a high proportion of assets, for instance power plants or supply infrastructures. So their structure is clearly very different from that of banks. This distinction should therefore be upheld in the interest of energy market liquidity.

**13. Do you have any evidence on potential problems, and if so, on the scale of these problems, that are posed by current client categorisation rules?**

Categorisation is needed to take account of the differences in experience and knowledge of clients. Annex II of the current Directive contains a definitive list of types of clients who are to be regarded as professional for the purpose of the Directive. However, some of the smaller municipal utilities and other energy sector companies that might well engage in energy trading do not meet the criteria as stated. Yet they are experienced businesses that are familiar with the energy trading risks and opportunities. It would therefore make sense to broaden the concept of the professional client, for example by making it easier for a client to choose to categorise himself as professional. This would raise the number of market participants and thus enhance the liquidity of the markets.

**15. Do you agree that full application of CRD capital requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their systemic impact?**

**16. Do you believe that full application of CRD large exposure requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their business and their systemic impact?**

If the capital requirements were raised, many firms would find it significantly more difficult to participate in trading or even be barred completely. This would have a negative impact on liquidity in energy markets. Furthermore, since the risks faced by these firms are in any case low, the advantages arising from an application of the aforementioned requirements would tend to be minor.

**18. Do you believe that the application of the *MiFID* organisational requirements support the intended aims of market regulation when applied to *specialist commodity derivative firms*, or *commodity derivatives business*? If not, what aspects of the organisational requirements do you believe do not support the aims of market regulation when applied to such firms and why?**

In order to ensure the security, stability and integrity of the financial system it is necessary to impose certain rules, including organisational requirements. However, in relation to specialist commodity derivative firms in the energy sector it should be noted that these firms are usually relatively small. Applying the organisational requirements here might therefore represent a particularly heavy burden. Particularly problematic in this context are the requirements on managers under Article 9 of the MiFID and the organisational separation of operational functions. We are therefore opposed a blanket application of the organisational requirements on specialist commodity derivative firms.

**24. If the capital treatment of *specialist commodity derivatives firms* is resolved, do you think there is still a case for retaining both of the exemptions in Articles 2(1)(i) and (k)? If not, how do you think the exemptions should be modified or eliminated? If the exemptions in articles 2(1)(i) and (k) were eliminated, what effect do you think this would have on *commodity derivatives markets*?**

The VKU represents numerous firms that are engaged in energy trading. They include large municipal utilities or their subsidiaries dedicated to organising energy procurement on their behalf. But many small municipal utilities also participate in the market through jointly run procurement companies. All these firms are dependent on the exemptions provided under Article 2(1)(i) and (k). They participate in commodity markets in order to extend their opportunities for energy procurement. Whereas such firms used to be heavily dependent on their upstream supplier with whom they entered into exclusive supply agreements, participation in energy trading now gives them new opportunities. In particular, these firms have much more room for manoeuvre thanks to their ability to purchase energy on the basis of futures traded on commodity exchanges or their scope for achieving price security on these exchanges. Having to comply with the conditions for authorisation set by the MiFID would create obstacles that many firms would find very difficult to overcome. Without the exemptions, the smaller companies in particular would probably refrain from applying. In any

case, the removal of exemptions would reduce the liquidity on markets for energy derivatives because market participants would withdraw and potential participants would be prevented from entering the market. A large number of firms would no longer be in a position to reap the demand-side benefits of energy market liberalisation and might even have to return to exclusive supply agreements. Such a trend would only bolster the market power of the major energy utility groups. So, for these reasons, the exemptions in Articles 2(1)(i) and (k) should not be eliminated or modified.