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BW

Mr Andrea Enria  
Secretary General  
Committee of European Banking Supervisors  
Tower 42 - 18 th Floor  
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**Second Part of CEBS' technical advice to the European  
Commission on the review of commodities business under Article  
48 of Directive 2006/49/EC**

**Assessment of the prudential risks that arise from the conduct of  
commodities business and the activities of firms carrying out  
commodities business**

Dear Mr. Enria

The German Electricity Association (VDEW) appreciates the opportunity to comment on the Second Part of CEBS' technical advice to the European Commission on the review of commodities business under Article 48 of Directive 2006/49/EC.

As the central trade association in Germany, VDEW represents more than 750 utilities including most energy trading companies covering all levels of the value added chain. In total, VDEW's members comprise more than 90 percent of power generation and supply in the German electricity market.

In general, VDEW supports CEBS' method to thoroughly analyse the impact of possible regulating regimes on the financial markets and its respective participants before recommending a future structure for the existing regulatory framework. VDEW especially welcomes CEBS' fact finding activities to generate a complete picture of the complex commodities trading markets, enabling a thorough assessment of the prudential risks that arise from the conduct of commodities business.

In the following, we would like to comment on specific topics of the report.

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## General remarks

VDEW welcomes CEBS' conclusion that the systemic risk represented by activities of (specialised) commodity firms seems to be „significantly smaller relative to the systemic risk posed by banks and ISD financial investment firms“. We also appreciate the conclusion that „there appears to be negligible direct contact between retail consumers and commodity firms, and market mechanisms seem to address any externalities that may arise“ (see page 2, *para. 12 & 13 of the second Part of CEBS technical advice*).

Generally, we would like to point out that activities in energy trading do not imply the same financial systemic risk as activities in the traditional financial markets. The functioning of the energy-related capital market is therefore much less affected by trading related risks. 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 differ fundamentally from those triggered by banks, financial institutions or investment companies in the classical financial sector. The energy trading market is a purely professional market with only professional participants being active. Moreover, the majority of energy related contracts are concluded in order to physically deliver energy – the prime business purpose of energy companies.

The main focus of financial market regulation is to limit the systemic financial risks stemming from the activity of financial institutions, investment companies and banks in the “traditional” 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. Thus, the insolvency of the energy trader Enron did not lead to a major disturbance in the capital / financial markets. The asset structure of the market participants together with 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. The comment made in this context in *paragraph 75* should not serve as a “justification” for expanding the financial regulatory regime to the energy sector. The rise of electricity market prices can be explained through a whole set of determinants (e.g. rising fuel and freight prices, rising demand, significance of intermittent generation) and have not been solely triggered by the exit of Enron.

In this context we would like to elaborate on the specific characteristics of energy trading markets and the issue of systemic risk in relation to financial markets:

#### *Specific characteristics of Energy Trading Markets*

Financial market regulation predominantly addresses market and credit risks as well as the operational risks of the traditional financial services market, thereby not considering the conditions immanent to the commodity trading business and especially the energy wholesale markets: In financial markets the flow of capital is predominant, whereas the main objective in European energy markets is the generation and supply of energy. Due to the wholesale nature of commodity and commodity derivative markets and the customers they serve, the relevant regulatory risks caused by such markets (issue of security of supply and offering robust prices for end-customers) are significantly different from those present in financial markets (financial systemic risk and investor protection). Furthermore, electricity markets feature lower systemic risk, as “typical” energy companies are more or less invested in generation and transmission assets. Rather than having to provide additional own capital, these assets can be used in order to cover possible remaining risks. Asset ownership of electricity companies should therefore be taken into account when considering the systemic risk of the electricity business. Another feature specific to the energy market is that trading by “typical” energy companies is predominantly done on own account for risk management and hedging purposes. While generation companies are interested to sell their output to the market, supply companies without generation facilities need to purchase electricity to fulfil the supply obligations with their customers; accordingly, energy companies holding generation as well as supply entities, pursue a mix of both objectives. To mitigate the arising price and volume risks, trading of electricity on own account on wholesale markets is, most commonly, used as a risk management and hedging tool. This does per se not lead to any risks for third parties. Moreover exchange and platform based trading is usually cleared through a central counterparty and bilateral trading is mostly done based on master agreements which have clear-cut rules for reducing credit risks. Therefore, the MiFID-exemption of “own account trading”, which is not under review, should not be touched by any future legislation.

#### *Diverging structures in energy supply and trading market*

Credit risks 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 is characterised by significant differences. Typically, the structure in the energy

(trading) market is completely different to that of the financial market with respect to the individual company structure, the client structure and the product structure. One major difference is based on the fact that in energy markets the products are either physically delivered or serve the purpose of optimising products for physical delivery. In power and gas markets a (constant) load is transferred through a period of time. Energy trading companies vary significantly from companies in the financial sector with regard to capital structure, organisation and core business. Counterparties of energy trading companies comprise mostly other energy trading entities, distributors, municipalities, large industrial companies and to a lower extent members of the classical financial sector. The transactions conducted on the energy market mostly more or less directly serve to supply end customers or distributors; i.e. the products are physically delivered. 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.

Many energy companies have set up specific trading units or separate entities. Their main aim is to market the electricity of their generation unit and to procure the electricity for their retail unit; this includes the procurement of both the primary fuels needed for generation and the CO<sub>2</sub> emissions rights to satisfy the respective legal obligations.

## **Part B. Risks arising from commodities markets**

CEBS states in *paragraph 40*, that “subdividing the forward markets into a market for financially settled and a market for physically settled forward transactions does not seem to be appropriate” (see page 13). This should not imply the possible extension of the scope of financial regulation to both market segments.

VDEW would like to point out again that the physical spot market is explicitly not covered by the MiFID and this should remain the case. Also, we would like to state that the underlying electricity and gas markets are already subject to a sector specific regulation regime ensuring the functionality of the energy market; any additional regulation of the physical markets arising from financial regulations would be detrimental for the development of the Internal Energy Market. In this context, *paragraph 91* of the report refers to the scope of Physical Commodity Regulator’s (PCR) scope of supervision, thereby stating that national gas and power markets are (regularly) within the scope of PCR’s

regulation, whereas coal, fuel and oil markets normally remain out of this regulatory framework (see page 24). Gas and electricity are commodities, which are grid-bound. Therefore, the grid-owners do have a so called natural monopoly, which is - according to EU-regulations - to be supervised by energy regulators.

In particular, Directive 2003/54/EC and Regulation 1228/2003 for electricity and Directive 2003/55/EC and Regulation 1775/2005 for gas set the legal framework for the internal energy market (certainly the legal provisions for the Greenhouse Gas Emissions Trading Scheme have additional significant impact on the energy market). With reference to these regulations a harmonised implementation and supervision approach is necessary to avoid distortions for cross-border energy wholesale trading. Thus, the power and gas markets shall predominantly be governed by this set of energy regulations (and the respective energy regulators) and not by financial market regulation.

Consequently, probably the most important challenge of the current EU legislative framework is to define the appropriate borderline between financial market regulation and the regulation of the physical (energy) commodity markets and - if there is an interface – to develop appropriate measures to address this matter.

CEBS conclude in *paragraph 98*: “Overall, there seems to be negligible direct contact between private clients and commodity firms.” VDEW fully supports this statement.

As mentioned before, the energy trading market is a purely professional market where only professional trading companies (i.e. energy traders, financial institutions and traders from energy-intensive industries) participate in. The counterparties structure of energy trading companies includes basically distributors, municipalities, large industrial companies and to a lower extent members of the classical financial sector. The transactions conducted on the energy market mainly serve to supply end customers or distributors. Due to this structure, “private” investors do not participate in energy trading, hence there is no comparable specific need for customer protection as it is appropriate in the financial market.

#### **Part D. Assessment of the possible implications of regulatory changes**

VDEW welcomes the definition in *paragraph 162*, clarifying, that Category D firms (firms generally subject to the Capital Requirement Directives but exempted from the capital regime under Art. 28 (1) of the CAD) are a subset of category B firms (firms that become subject to EU legislation for the first time as a consequence of the extension of the MiFID to include commodity business and that cannot make use of any exemptions within MiFID).

We fully support the observation stated in *paragraphs 172-174* that some firms may not be able to operate in the energy market any longer due to potentially rising costs caused by regulatory requirements. This is particularly true for smaller and medium-sized firms that do not have the resources (finance, structure, personnel) to address these additional requirements. However, these market exits that are due a too rigid regulatory system would impede the idea of a competitive deregulated internal energy market.

Hence we appreciate the statement in *paragraph 197* that for firms belonging to category B, C and D "... any change to the current regulatory framework would potentially cause higher costs, additional administrative burden and the like. The imposition of these stricter rules would only be justified, if the need for financial regulation was evident."

In this context, we would like to suggest that further commentary is provided on the issue of specific factors which would show if there is actually a need for financial regulation of the mentioned companies; this should be done against the background of the main objectives of financial regulation being the protection of the capital market as well as consumer protection.

### **Concluding Remarks**

Generally, VDEW supports CEBS' work to thoroughly analyse the situation of the respective market participants in relation to the review of the commodities business under Article 48 of the CAD. As stated before, there are significant differences between the traditional financial markets and the energy markets addressed in this assessment.

Considering the future scope of financial regulation, VDEW likes to point out that due to the delayed implementation of the new financial legislative framework in all Member States, we see difficulties in providing a proper evaluation as there has been no or only very limited time for both the commodity industry and the legislator to gain sufficient experiences. This is particularly true for the requirements arising from the relevant provisions in the CAD.

Against this background we could envision the following future procedure:

- a) In a first step the relevant exemptions under Article 2(1)(i) and 2(1)(k) of MiFID should be fully maintained. Additionally, the "expiry date" of the exemption of Article 45 in conjunction with Article 48 CAD should be made permanent or at least be extended beyond the current deadline of 31 December 2010.

- b) Only after the full implementation of all relevant financial market regulations (mainly MiFID, MiFID-regulation and CAD) and in the light of sufficient experience gained with these regulations it can fully and comprehensively be assessed whether the relevant exemptions are appropriate or not. In either case we would then favour (again after a proper assessment procedure) the creation of a special risk-adjusted commodity derivatives regime for the energy wholesale market as a subsequent second step.

We hope that our comments are helpful for the work of CEBS on this important issue. If needed, VDEW and its member companies are happy to provide further input.

Sincerely yours,

A handwritten signature in blue ink that reads "Bernhard Walter". The signature is written in a cursive style with a large initial 'B'.

Dr. Bernhard Walter