eurelectric
powering people

ESMA Consultation on Discussion paper on the review of the clearing thresholds under EMIR

A Eurelectric response paper

January 2022

Eurelectric represents the interests of the electricity industry in Europe. Our work covers all major issues affecting our sector. Our members represent the electricity industry in over 30 European countries.

We cover the entire industry from electricity generation and markets to distribution networks and customer issues. We also have affiliates active on several other continents and business associates from a wide variety of sectors with a direct interest in the electricity industry.

We stand for

The vision of the European power sector is to enable and sustain:
- A vibrant competitive European economy, reliably powered by clean, carbon-neutral energy
- A smart, energy efficient and truly sustainable society for all citizens of Europe

We are committed to lead a cost-effective energy transition by:

investing in clean power generation and transition-enabling solutions, to reduce emissions and actively pursue efforts to become carbon-neutral well before mid-century, taking into account different starting points and commercial availability of key transition technologies;

transforming the energy system to make it more responsive, resilient and efficient. This includes increased use of renewable energy, digitalisation, demand side response and reinforcement of grids so they can function as platforms and enablers for customers, cities and communities;

accelerating the energy transition in other economic sectors by offering competitive electricity as a transformation tool for transport, heating and industry;

embedding sustainability in all parts of our value chain and take measures to support the transformation of existing assets towards a zero carbon society;

innovating to discover the cutting-edge business models and develop the breakthrough technologies that are indispensable to allow our industry to lead this transition.

Dépôt légal: D/2022/12.105/2

WG Financial Regulation & Market Integrity

Contact:
Stella BENFATTO, Advisor – Wholesale Markets - Investment Lead
sbenfatto@eurelectric.org

General information about respondent

Name of the company / organisation	Eurelectric
Activity	Non-financial counterparty
Are you representing an association?	☒
Country/Region	Belgium

Introduction

Please make your introductory comments below, if any:

1. In spite of the significant price increase in power, gas and CO2 allowance prices in 2021, we have not seen any defaults of major counterparties. Moreover, there has been no "domino effect" as experienced in the 2008 financial crisis, which resulted in the Pittsburgh agreement and, consequently, in the introduction of EMIR. This real "stress test" has proven that the utility industry manages the risk appropriately and does not impose significant systemic risk on the financial system.

2. Prices of energy commodities have overall quadrupled since the definition of the EMIR clearing threshold for commodities ("EMIR CCT"). As the open notional of OTC derivatives are measured, the available volume in terms of MWh or tons are reduced by the same ratio for market participants. As the relevant position is calculated by the open notional of the previous twelve months, this becomes already effective for the calculation of the 2022 NFC-/NFC+ threshold compliance.

3. The restriction of available volumes for OTC derivatives is limiting firms to engage in new evolving business to facilitate the energy transition. Investors in e.g. wind farms and solar power seek protection from price and volume risk independent from the physical delivery of the power production. This can be offered – by a counterparty of the utilities – using structured financial contracts, which for these counterparties are in scope of EMIR and, hence, contribute to the clearing threshold usage of the offering utility firms. Although, the particular products contain physical characteristics according to the power produced in reality and are therefore not suitable for any margining or clearing.

4. EMIR is very restrictive in terms of thresholds and scope in comparison to other jurisdictions (we refer to EFET's Benchmark Study of 4 October 2021 "Commodity derivative clearing under EMIR – A cross jurisdictional analysis"), putting European firms into a disadvantageous position compared to third-country competitors.

Therefore, we urge ESMA to review and increase the EMIR CCT significantly to a really systemic relevant level, not only compensating the effect of increasing price levels.

As amendments to the Level 2 text of EMIR (Article 11 of Regulation (EU) No 149/2013) can be applied quickly, the increase should be already effective for the threshold calculation of 2022.

Q1. Please explain if you see a need for further clarification on how to identify OTC contracts for the purpose of the calculation of the positions to be compared to the clearing thresholds.

Eurelectric does not require further clarifications on how to identify OTC contracts.

Q2. Please explain if you see a need for further clarification to identify OTC contracts that can be considered as reducing risks directly relating to commercial activity or treasury financing activity. And please mention any additional aspects to be further considered with regards to the hedging exemption.

Eurelectric acknowledges that EMIR also includes portfolio- and macro hedging, which should be main-tained independently of any future review of the EMIR CCT.
However, in the Level 2 text of Article 10(1) of Commission Delegated Regulation (EU) No 149/2013 ("CDR 149/2013"), the definition of a trade that is "objectively measurable as reducing risks directly relat-ing to the commercial activity or treasury financing activity of that group" is interpreted narrow.

Currently, the underlying commercial business ("commercial activity") in Art. 10 (3) of EMIR REFIT is considered as covering physical transactions only, which can be hedged by financial instruments.

In the latest Q&A on EMIR (ESMA70-1861941480-52) ESMA indicates in its answer to question 10 (d) that offering financial contracts by a NFC can be part of the commercial activity. We interpret the answer by ESMA as saying that the provision in Article 10(3) can in fact include financial contracts as part of the core business and in consequence the hedges thereof can be classified as a hedge under EMIR.

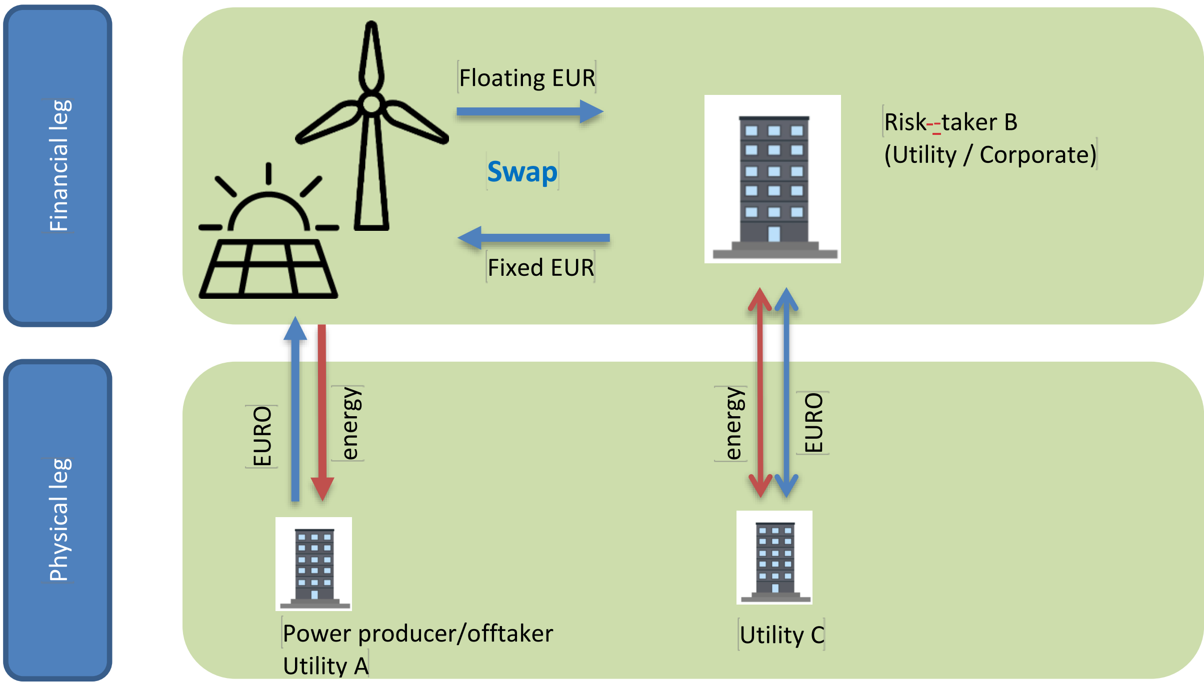
However, the Q&A text is not fully clear. Thus, it should be clarified or extended to hedging of OTC finan-cial contracts which are offered to counter-parties as part of the commercial activity of the group (e.g. being counterparty to financial power purchase agreements offered by another NFC wanting to hedge its exposure related to e.g. wind farms and solar power plants). Such clarification/extension should either be included in the Level 2 text or by clear guidance in the ESMA Q&A.

Q3. Please provide information and examples on how counterparties count fungible ETDs and OTC derivatives for the purpose of the calculation of the clearing thresholds?

From the perspective of e.g. wind and solar based producers, OTC trading markets are a key hedging option because the exchanges generally do not offer long-term structured contracts needed to match the long-term risks of the sustainable energy assets. For utilities, financial PPAs give the opportunity to onboard production capacity into their portfolios without the requirement for full investment in production assets.

The particular risks and frequent volatility in renewable energy markets often require hedging solutions that are non-standard (i.e. provided via the OTC market) and which can only be offered and managed by experienced energy industrials, whereas investors in projects may often come from outside the energy industry.

Example: A producer of wind and solar power is exposed to market and volume risk as it is selling the power at spot price to Utility A (physical producer/offtaker). To hedge market and volume risk the producer could request a physical PPA with the offtaker (Utility A) or hedge the floating leg by a financial contract (e.g. fixed floating swap, financial PPA) with a third party (Risk taker B).



The advantage of a financial PPA is that the risk-taker and the offtaker of the physical power delivery can be separate, hence putting the producer into the advantage of having the choice from competing for offers to select the most cost-effective risk-taker independent from technical restrictions of physical power offtake contracts.

However, with a narrow interpretation of the definition of commercial activity the Risk-taker B cannot include the client facing financial transaction (MiFID II instrument) in a risk-reducing portfolio even in the case it is fully hedged back-to-back with physical contracts towards a third party (Utility C) or using own production / consumption in a portfolio hedging approach.
Even worse, if risk-taker B often has no direct market access but is hedging towards an internal trading entity, then the corresponding internal and external contracts should not be considered as hedging contracts resulting in a tripled notional amount (as pointed out in ESMA Q+A, ESMA70-1861941480-52, OTC Answer 3 (e)).

Given the above-described situation, the volume of financial PPAs offered in the market is limited by the capacity of risk-takers to use the EMIR clearing thresholds for such contracts.

From the perspective of e.g. wind and solar producers OTC trading markets are the key hedging option because the exchanges generally do not offer structured long-term contracts needed to match the long-term risks of the sustainable energy assets.

Eurelectric calls for clarifying what should be understood under the term ‘commercial activity’. This unclarity shall also be seen in connection with the German auditing standard on EMIR states that “the underlying transactions in the portfolios must originate from the operational business of the company and may not be derivative contracts within the meaning of MiFID II” (Entwurf einer

Neufassung des IDW Prüfungsstandards: Prüfung von Systemen nach § 32 WpHG bei nichtfinanziellen Gegenparteien (IDW EPS 920 n.F. (12.2021)). Based on this standard, only financial instruments hedging exposure from physical trades can be risk-reducing and financial contracts are not considered being part of the “operational business”.

Following the recent ESMA Q&A, we consider this interpretation too restrictive. EMIR defines any trade that is “objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of that group” as risk-reducing. In fact, entering into financial contracts is often part of the core business of the power industry. Renewable producers and consumers are asking for risk management solutions to reduce their commercial risks, which can include derivatives according to the MiFID II definition (e.g. swaps). On the other hand, utilities being counterparties to such hedges can hedge such financial contracts either back-to-back (physical and financial) or by using the flexibility of own production assets.

We ask ESMA for a clarification on the level 2 text that the “commercial activity” can include offering financial contracts. This is already indicated in the latest ESMA Q+A on EMIR, but to trigger amendments in the above-mentioned auditing standards requires in our view a change of the technical standard or a clear clarification in the guidance given (level 3).

Q4. Please provide data and arguments to illustrate the potential impact of the lack of an equivalence decision under Article 2a of EMIR and what could be done to alleviate your concerns (besides an equivalence decision)? Please specify the kind of transactions and activities that would be affected and the purpose of those, and whether there are alternatives.

Energy and industrial firms are exposed to market risk which is mainly driven by global market developments (Crude Oil, Fuels, LNG, fright, UK gas, metals). As a result of Brexit and the absence of an equivalence decision in respect of ICE Futures Europe (“IFEU”) or other UK based exchanges, trades executed on these venues will constitute economically equivalent over-the-counter (OTC) trades for the purposes of EMIR.

In the absence of a recognition decision by the EU Commission, the result of the above is a considerable (further) increase of the level of trades counted under the threshold for several industry groups in the EU.
It is noticeable that this specific increased number of trades that counts in under the threshold would be determined in practice by centrally cleared derivatives - that is, by a type of trading activity that is devoid of the typical counterparty risk characterizing non-cleared OTC derivatives. Moreover, one should keep in mind that a potential breach of the EMIR clearing threshold would have well-known widespread effects for many legal entities and asset classes in industrial groups currently classified as NFC-. For this reason, NFC-s are in these months adopting mitigating actions, such as a reduction of the trading activity on UK venues and/or the switch to other exchanges - where feasible.
As addressed above and in Q3, all trades not in the scope of the hedging definition contribute to the CCT usage, limiting the offering of market access to the real economy for tailor-made risk management products. Consequently, market participants have restricted their trading activities on UK exchanges to avoid breaching the EMIR CCT due to the lack of alternative venues for trading in EU27, resulting into a considerable loss of business opportunities.

Q5. Please describe the scenarios when transactions do not qualify as hedging transactions.

Please refer to answer to Q3 as an example.

Q6. Please describe your views on how the EMIR framework works (also compared to other regimes) for the purpose of the clearing thresholds and the requirements triggered by those? Please provide examples and supporting data.

1. **EMIR does not mitigate but shift risk in a negative way**

Real economy firms avoid by any means (e.g. by restricting the activity in OTC derivatives) breaching the CCT as the resulting consequences are dramatic in terms of liquidity allocation and operational efforts. With the qualification as NFC+ and the forced collateralization and margining, the counterparty risk is shifted to liquidity risk.

With the rapidly increasing commodity prices and the increased volatility level, the margin requirements for exchange-traded contracts and voluntarily collateralized transactions (CSAs) have, in many cases, already reached a challenging level. Following the introduction of EMIR and MiFID II, energy firms active in the EU markets have shifted long term hedging of their natural asset positions to regulated markets.

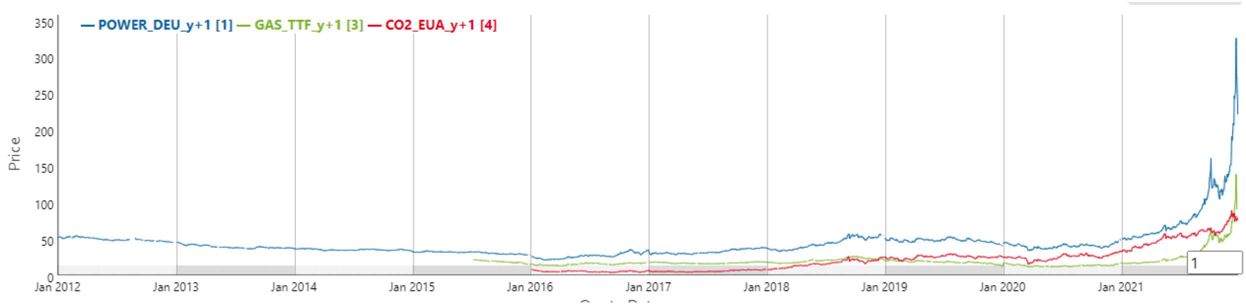
With a hedging horizon of typically three to five years ahead, these firms currently hold significant exchange-traded derivative positions in power, gas, oil, coal and EU emission allowances. The margin requirements have been multiplied (factor 6+) in 2021 while holding the same volume position (MWh, tons). An exchange of positions from cleared to uncleared OTC derivatives would mitigate liquidity risk but seems not feasible as no counterparties are willing to take the positions and jeopardizing its EMIR status as NFC-, as a qualification as NFC+ would result in burdensome additional requirements of cash plus even higher exposure to liquidity risk from daily margining of OTC positions.

In this respect, EMIR is simply shifting market and credit risk towards liquidity risk for the real economy when collateralization is enforced with the qualification as NFC+.

Liquidity imposes by far the most critical risk as market risk and counterparty risks are managed and limited as part of the daily business anyway. Hence, with regards to NFC+ status, in consequence, EMIR falls short of its original purpose as it is not really addressing systemic risk here but is imposing liquidity risk to utilities and industry firms they cannot mitigate.

2. **Static Clearing Thresholds do not account for shifts in price levels**

When the EMIR CCT was defined in 2012 at a low fixed level of a gross notional value of 3bn. And compared to the prices in 2012, in 2021 the prices for gas, power and EUAs have nearly quadrupled by end of 2021.



One year ahead rolling prices in EUR for power (German calendar baseload future (blue), TTF gas (green), and EUA (red)

When the price levels stay at a considerable higher level than 2012, any new contract will eat up more and more of the available headroom for the CCT. As a result, the trading activity will be reduced to avoid breaches of the CCT with adverse effect on market liquidity.

Q7. Considering the current coverage provided by the clearing thresholds in relation to credit derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

Q8. Considering the current coverage provided by the clearing thresholds in relation to interest rate derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

Q9. Considering the current coverage provided by the clearing thresholds in relation to commodity derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

Because of the lack of information about the assumptions and boundary conditions (e.g. notional of the full market), we cannot provide useful data to address the shortcomings of the study. Furthermore, the considerations do not really address the original intention of EMIR, which is to mitigate systemic risk on the financial system. EMIR never intended to capture a minimum portion of the market participants with a CCT (NFC+ status).

Q10. Considering the current coverage provided by the clearing thresholds in relation to equity derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

TYPE YOUR TEXT HERE

Q11. Considering the current coverage provided by the clearing thresholds in relation to currency derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

TYPE YOUR TEXT HERE

Q12. Beyond the different treatments between FCs and NFCs in the calculation, are there differences between the different types of counterparties that might justify a different calibration of the actual clearing thresholds? In addition, please consider if a different calibration of the current clearing thresholds by type of counterparty should apply in the same manner to all asset classes. Please provide any supporting data that might help illustrate your response.

As stated above, NFCs in commodity trading impose no significant systemic risk for the wider financial markets even when the CCT would be increased by a wide margin meeting the thresholds of other jurisdictions (e.g. Singapore) or narrowing the scope of the attributable contract volume.

Q13. Looking at the simulations presented in the paper and at the impact they would have, do you have any views on the sensitivities of the thresholds?

The main shortcomings of these simulations are the negligence (vulnerability) of the dramatic price shifts in the commodity markets.

Eurelectric struggles to see any relevance for the current situation. The assumed variations of the clearing threshold fall short to just compensate the upward price trend as the survey is hindsight and does not consider any resulting shifts in the market segments (Cleared / not cleared) induced by too low EMIR thresholds (see also Q6 for explanation of the shifts)

Because of the lack of information about the assumptions and boundary conditions, we cannot provide useful data. Furthermore, the indicated shifts do not really address the original intention of EMIR, which is to mitigate systemic risk on the financial system.

Eurelectric pursues in all its activities the application of the following sustainable development values:

Economic Development

- Growth, added-value, efficiency

Environmental Leadership

- Commitment, innovation, pro-activeness

Social Responsibility

- Transparency, ethics, accountability

Union of the Electricity Industry - Eurelectric aisbl
Boulevard de l'Impératrice, 66 – bte 2 - 1000 Brussels, Belgium
Tel: + 32 2 515 10 00 - VAT: BE 0462 679 112 • www.eurelectric.org
EU Transparency Register number: 4271427696-87