17 April 2015

Subject:
The second level legislation of MiFID II and the risk of stalling European wholesale commodity markets

We, the undersigned National and European associations, are writing to you with respect to the ongoing Level 2 legislation drafting process of the revised Markets in Financial Instruments Directive 2014/65/EU (MiFID II).

We believe that open, robust, liquid, competitive and transparent energy markets are key to ensure a secure, sustainable and competitive energy supply to end customers. We would like to bring to your attention our concerns that ill-calibrated Level 2 provisions in MIFID II may jeopardise the political aims of the Third Energy Package and the attained successes of the internal European energy market to the detriment of energy consumers and the real economy. These concerns are shared by ACER and EU Energy regulators in recent communications and relate to the ancillary activity exemption and definition of commodity derivatives.[1]

MIFID II includes an exemption for commodity trading activity that is "ancillary" to a company's main corporate business. The express purpose of this exemption is to ensure that non-financial companies dealing in financial instruments in a proportionate manner compared with the level of

[1] *ACER Recommendation 01-2015 on physical forwards, CEER Letter C15-MIT-60-03 dated 19 March 2015 and the CEER Response to the ESMA Consultation Paper on MiFID II*

investment in the main business are not covered by the scope of the Directive. It is the task of the Level 2 legislation to develop the technical criteria for determining when an activity is ancillary to such a main business.

In defining ancillary activity ESMA proposes that commodity trading activity will only be exempt if the capital employed in this activity stays below 5% of a company's total capital employed and if a company's market share in individual European commodity markets stays below 0.5%.[2] These thresholds are so low that they distort the intent of the legislator and in fact make the exemption worthless. We believe that these proposals will trigger a cascade of materially adverse and unintended impacts on energy markets, energy consumers and the real economy, which we further explain here below. In this way, ESMA is exceeding its mandate derived from the Level 1 text and is extending the perimeter of financial regulation deep into the real economy against the original intent of the legislator.

Based on the above, we urge a more cautious approach towards the calibration of the capital employed and market share thresholds. ESMA should set these thresholds at a substantially higher level to properly reflect the original intent of the legislation and avoid unintended adverse consequences. Such thresholds could eventually be reviewed at a later point in time, based on an in-depth economic analysis and lessons learned from the application of MiFID II to commodity markets.

Furthermore, we are concerned that ESMA's proposals with regard to the definition of commodity derivatives[3] will drive commercial commodity contracts into the scope of MiFID II, although they are used by the real economy companies to source commodities for their commercial activities and to mitigate their commercial commodity risks. Please find attached to this letter a paper supported by some representative energy associations[4] which very clearly demonstrates through examples how the structure of the markets, including producers, intermediaries and consumers would be damaged by an ill-suited definition of commodity derivatives.

All these proposals together would see the majority of commodity trading companies and even some industrial companies being regulated as if they were banks, subject to detailed oversight by financial regulators and required to comply with onerous and costly rules, such as licensing requirements, clearing and margining, and potentially capital and liquidity adequacy. These obligations will trigger a cascade of materially adverse and unintended impacts on commodity markets, consumers and the real economy for the following reasons, which have also been acknowledged by ACER and EU Energy regulators in their recent communications:

- Small and medium sized commodity (trading) companies and the industrial companies concerned may be forced to exit the market due to prohibitive compliance and conservative capital and liquidity requirements. In addition, larger companies will have an incentive to curtail or close their EU trading activity in the light of increased compliance and capital costs.
- Where possible, trading activity may be routed via other international markets to avoid disproportionate licensing and capital costs. Trades may also migrate to purely bilateral, physical markets and products.
- Affected companies will have to reallocate capital within their businesses to meet the capital and liquidity ratios for their trading unit. This will "trap" liquidity in the

[2] ***See RTS 28 in Chapter 7 of the Consultation Paper, Annex B***
[3] ***ESMA's Technical Advice to the Commission on MIFID II and MIFIR dated 19 December 2014***
[4] BDEW, EFET, Energy UK, Eurelectric, Eurogas

trading unit or force consolidation of asset (generation) businesses with trading businesses in order to utilise the liquidity.

- Despite the need for increased liquidity in many European commodity markets, liquidity may dry out, particularly in less mature markets. The fall in liquidity will significantly increase the costs of risk management for commodity companies and massively reduce opportunities for commodity risk management by industrial customers. For some products, it may be impossible to hedge the embedded risks.
- The damage to wholesale energy markets also directly undermines the political aims such as the completion of the internal European energy market. Illiquid wholesale markets will reduce market competition and efficiency in the production and retail markets and prices for consumers and industry can be expected to increase as a result. Higher risk, constrained investment capital and poor market price signals will significantly undermine investment, production and consumption decisions and reduce security of supply.
- The trigger factor for the energy group to be captured by the MiFID II regime may be obligatory trading in emission allowances, as such trading will probably not be considered as 'hedging'. This will have an impact on the liquidity of the emissions market and investments for the decarbonisation of the European economy will be affected. Considering the features of many sectors covered by the EU ETS (long investment cycles, high capital intensity, long payback periods, etc.), long-term visibility is critical for any investment decision. Accordingly, lower liquidity destroys the long-term visibility needed for taking investment decisions. We believe that in order to meet the EU's decarbonisation ambitions and targets, a fully liquid and well-functioning EU ETS market is necessary.

These increased costs and risks come without additional improvement of the risk profile or integrity of the financial markets. Commodity markets are already effectively regulated, transparent and subject to the same high standards of conduct and integrity. In particular, energy markets are already subject to a sector specific market abuse regime (REMIT), which should be recognised.

Moreover, these requirements do not achieve a "level playing field" between financial and non-financial counterparties as claimed. Trading commodities on own account between professionals poses no threat to savers and there is no requirement to protect investors. Commodity traders do not have access to central bank liquidity to meet liquidity requirements and do not take deposits from private clients. Imposing the same obligations on fundamentally different businesses causes an unfair and unnecessary burden.

For all of the above-mentioned reasons, we would highly appreciate your intervention in the current process and the upcoming discussions in the comitology procedure in order to get the MiFID II package back on track in a more balanced and appropriate manner.

Yours faithfully,

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5 *Nordenergi is the collaboration between national associations for electricity producers, distributors and sales companies in the Nordic countries*

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