AN INCREASING FOCUS ON FINANCIAL REGULATION OF ENERGY MARKETS

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The liberalisation of energy markets has given rise to a raft of new regulatory challenges, with policymakers and regulators devising increasingly elaborate responses. Traditional measures of market power have been refined to recognise the power to set prices in time frames which may be only minutes in duration. Dominance is being addressed through measures including regulated contracts, virtual independent power auctions and regulated bidding. Third-party access rights are being structurally reinforced by network unbundling.

More recently, in Europe, we are seeing financial regulatory tools increasingly being used to ensure transparency in energy markets and the integrity of price information. Traditionally, energy trading has been the subject of fairly light-touch regulation in Europe, save for commodity derivatives which are regulated under the Markets in Financial Instruments Directives (Directive 2004/39/EC) (MiFID I) but are subject to exemptions that are helpful to energy companies. By contrast, investment firms have been regulated at an EU level and availing of passport rights since 1993 following the introduction of the Investment Services Directive (Directive 93/22/EEC).

In more recent years the increased spotlight on commodities markets and derivatives at a European level is most obviously demonstrated by the introduction of the Regulation on Wholesale Energy Market Integrity and Transparency (Regulation (EU) No 1227/2011) (REMIT). REMIT draws on financial regulatory principles from the Market Abuse Directive (Directive 2003/6/EC) (MAD I) but, in addition, the scope of financial regulatory rules themselves has changed to bring the energy market participants within their focus more directly.

REMIT – PHYSICAL AND DERIVATIVE TRADING

REMIT introduces a bespoke regime designed to prohibit market manipulation and trading on inside information on wholesale energy markets. REMIT also obliges market participants to: register with their competent national authority; report wholesale energy market transactions, including orders to trade; and publish inside information. The definitions in REMIT are largely based on the definitions in MAD I, but tailored to gas and electricity markets. REMIT designates the Agency for the Cooperation of Energy Regulators (ACER) as the recipient of the wholesale market data and the watchdog for cases of market abuse at first instance.

REMIT obligations are applicable to "market participants", being any person, including transmission system operators, who enters into transactions, including the placing of orders to trade, in one or more wholesale energy markets. Wholesale energy markets include regulated markets, multilateral trading facilities (MTF) and over-the-counter (OTC) and bilateral contracts, directly or through brokers. Wholesale energy products include contracts for the supply of electricity or natural gas where delivery is in the EU; contracts relating to the transportation of electricity of natural gas in the EU; and derivatives relating to electricity or natural gas produced, traded or delivered in the EU or related to the transportation of electricity or natural gas in the EU. Contracts for supply to final customers are generally not wholesale energy products, unless the final customer's consumption is greater than 600 GWh per year.

Commission Implementing Regulation (EU) No 1384/2014 provides that, where persons have reported details of transactions in accordance with certain requirements under MiFIR and the European Market Infrastructure Regulation (EMIR), their obligations in relation to reporting under REMIT shall be considered as fulfilled. This is an important clarification in terms of derivatives.

The requirement to publicly disclose inside information in an effective and timely manner under REMIT is arguably its most intriguing feature. This includes information relevant to the capacity and use of facilities for production, storage, consumption or transmission of electricity or natural gas or related to the capacity and use of LNG facilities, including planned or unplanned unavailability of these facilities. ACER provides a list of central platforms for disclosure.

The most recent edition of REMIT Quarterly published by ACER indicates that it is reviewing 47 potential REMIT cases and notes that the first economic sanctions have been applied by the Spanish and Estonian national regulatory authorities for REMIT breach. The cases illustrate not only the perils of both engaging in market abuse, but also the consequences of failing to adhere to disclosure requirements. Specifically, the Spanish energy group, Iberdrola, was fined €25 million for manipulating prices over three weeks from two hydroelectric power plants which account for around half of the country's total hydroelectric capacity. In Estonia, the transmission system operator was fined €10,000 for failure to inform the market in sufficient time of maintenance work on a 650MW subsea electricity cable linking Estonia with Finland.

MARKET ABUSE DIRECTIVE

MAD I prohibits market manipulation in respect of financial and derivative markets and not to the related (non-financial) spot markets. In the commodities space this could create the unwelcome scenario of strict rules applying to derivative but not the underlying markets. To address this, prohibitions on insider trading and market manipulation under Regulation 596/2014 on market abuse (MAR) (which replaces MAD I from 3 July 2016) will apply to spot commodity contracts, which are not wholesale energy products under REMIT, where the transaction, order or behaviour has or is likely or intended to have an effect on the price or value of a financial instrument traded on a regulated market, MTF, organised trading facility (OFT) or financial instruments whose value or price depends on or has an effect on those instruments.

MIFID – DERIVATIVES

An energy market participant's activity will be within the scope for the requirement for authorisation as an investment firm under MiFID I where it deals on own account in commodity derivatives. Spot commodity transactions are not caught by MiFID I as such contracts are not classified as financial instruments. However, derivative contracts relating to commodities are within this scope. It is important to note, however, that physically settled contracts may still be within the scope if they can be cash-settled at the option of one of the parties, traded on a regulated market or on an MTF, or if they are not for commercial purposes.

A number of exemptions are typically availed of by non-financial participants to bring them outside of the requirement for authorisation. There is an exemption for persons dealing on their own account provided it is ancillary to their main business and a further exemption for persons whose main business consists of dealing on own account in commodities and/or commodities derivatives.

The introduction of Directive 2014/65/EU on markets in financial instruments (MiFID II) and Regulation (EU) No 600/2014 on markets in financial instruments (MiFIR) is rapidly approaching (albeit that the European Commission has recently signalled its intention to extend the application date for MiFID II by one year to 3 January 2018). These rules will expand the definition of financial instruments set out in MiFID I and also remove or narrow exemptions typically relied on by commodities firms. The upshot is that unregulated energy market participants will need to carefully re-examine their trading operations to determine whether they are caught by this new regime.

In summary, changes to the exemptions for commodity derivative traders under MiFID II include removal of the exemption for firms whose main business is dealing on their own account in commodities and/or commodity derivatives. It now applies to financial instruments other than commodity derivatives and is subject to additional requirements. Entities will likely look to rely on a narrower exemption available for persons dealing on own account (except dealing on their own account when executing client orders). This exemption only applies where individually and on an aggregate basis these activities are ancillary to their main business considered on a group basis and that main business is not the provision of investment services or banking activities or acting as a market maker in commodity derivatives. The person must also notify its national competent authority on an annual basis that it is applying the exemption. Transmission system operators are exempt when carrying out their functions under European Directives and Regulations.

If a firm cannot rely on an exemption it will need to become regulated as an investment firm under MiFID II. This means adherence to conduct of business rules and heightened requirements under other financial services legislation, including capital requirements under the Capital Requirements Directive and classification under EMIR.

MiFID II also introduces commodity derivative position limits and reporting requirements, with the intention of preventing market abuse and supporting orderly pricing and settlement conditions. National authorities are required to establish and apply limits on the net position a person can hold for commodity derivatives traded on trading venues and economically equivalent OTC contracts. An investment firm or market operator operating a trading venue which trades commodity derivatives must also apply position management controls and have certain powers, including to monitor open interests, assess information in relation to the size and purpose of a position or exposure, requiring a person to terminate or reduce a position and requiring a person to provide liquidity back into a market at an agreed price and volume on a temporary basis with the intent of mitigating the effect of a large or dominant position. While position limits are to apply regardless of whether a firm is an authorised investment firm or not, the limits will not apply to non-financial entities' positions where they are objectively measurable as reducing risks directly related to the commercial activity of that entity.

An investment firm or market operator operating a trading venue which trades commodity derivatives will be required to fulfil position reporting obligations. Trading venues will make public a weekly report of aggregated positions held by categories of position holders for the contracts traded on that venue. Trading venues must also report on a daily basis to national regulatory authorities with a breakdown of positions and position holders right down to members, participants and their clients. Investment firms trading outside a trading venue will also be required to fulfil certain position reporting obligations. As set out below, derivatives transactions are also reportable under EMIR – meaning there is a duplication of effort for commodities derivatives.

EMIR

EMIR provides for reporting of all derivative contracts (exchange-traded and OTC) to Trade Repositories; clearing of certain OTC derivatives in central counterparties; and risk mitigation techniques for non-centrally cleared derivatives, including timely confirmation of terms, dispute resolution processes, portfolio reconciliation, marking to market, margin requirements for non-cleared derivatives for certain clients, capital requirements and portfolio compression. Derivative contracts under EMIR include commodity derivatives. OTC derivatives for the purposes of EMIR are any derivative contracts which are not executed on a regulated market.

EMIR divides parties into financial counterparties (such as credit institutions, insurance companies, MiFID investment firms, certain funds and alternative investment fund managers) (FCs) and non-financial counterparties (such as energy companies) below the clearing threshold of €3 billion in gross notional value (NFC-) and those above threshold (NFC+). A higher burden is placed on FCs and NFC+s, including the requirement to clear derivative contracts between FCs/NFC+s where the contract has been declared subject to the clearing obligation and margin requirements for non-cleared derivatives.

For energy market participants, avoiding triggering an authorisation requirement under MiFID II is crucial to avoid the most onerous obligations under EMIR. However, EMIR has a significant impact on NFCs and the systems required to ensure derivatives are monitored, reported and dealt with in line with the requirements of EMIR.

CONCLUSION

The trend towards increasing reliance on financial regulatory instruments to ensure transparency in energy markets and the integrity of price information gives rise to a raft of new challenges for utilities, system operators, traders and operators of trading platforms, all of whom face much greater regulatory, compliance and reporting burdens than those to which they have been historically subject. This trend appears to be one that is likely to continue for the foreseeable future, and will create significant challenges for advisers in keeping pace with the volume of regulatory change, reconciling obligations in different regulatory instruments and ensuring that contractual terms secure compliance where necessary and ensure that entities do not inadvertently fall outside relevant exemptions.