The Ancillary Activity Exemption of MiFID II is key to ensure security of supply

Brussels, 09 February 2023

Key messages

- Open, robust, liquid and transparent EU energy markets are key to ensuring a secure, sustainable, affordable and competitive energy supply to end consumers.

- Financial market regulation should support the energy market participants to achieve these aims and help them to manage the challenges of the current energy crisis, whilst safeguarding transparent and safe financial markets.

- The ancillary activity exemption under MiFID II – as confirmed by the recent MiFID Quick Fix legislation – is amongst other measures appropriate to deliver these outcomes.

- The scope of the ancillary activity exemption is appropriately calibrated and should be kept in place to avoid adverse and unintended consequences for energy market participants, the real economy and end consumers.

- A change to the scope of this exemption and a consequential imposition of a MiFID II investment firm regime on energy firms would not solve the causes of the energy crisis. On the contrary, this would pose an additional compliance and regulatory burden which would exacerbate the liquidity challenges of energy market participants when they are already facing many challenges including continued energy market volatility.

Executive Summary

JEAG (Joint Energy Associations Group) considers that open, robust, liquid and transparent EU energy markets are key to ensuring a secure, sustainable, affordable and competitive energy supply to end consumers. These aims are to be delivered by the energy market participants such as power and gas producers, suppliers and trading firms. Currently these energy market participants face numerous challenges caused by the energy crisis in the EU. These include unprecedented continuing energy market volatility and energy price increases, fundamental shortage in gas and power supplies, poor market liquidity in energy markets as well as increased collateral and margin requirements and consequential liquidity stress for energy firms.

Financial market regulation should support the energy market participants to achieve the above-mentioned aims of the EU internal energy market and help them to manage the challenges of the current energy crisis, whilst safeguarding transparent and safe financial markets. The ancillary activity exemption under MiFID II – as confirmed by the recent MiFID Quick Fix legislation – is amongst other measures appropriate to deliver these outcomes.

Any narrowing of the ancillary activity exemption and the consequential imposition of a MiFID II licensing requirement on energy market participants would cause unintended, detrimental consequences for energy market participants, real economy and end consumers:

- A wider scope of a MiFID II licensing requirement with regard to energy market participants will trigger prudential requirements under the Investment Firm Regulation and additional EMIR requirements such as mandatory central clearing and collateralisation. This will aggravate the (cash) liquidity problems of energy market and its participants. According to a conservative estimate the overall amount of (cash) liquidity needed to meet those obligations could amount to at least €5-10 billion for larger energy firms.

- The consequences of these and other consequential regulatory requirements might be higher (market price) risks, higher hedging costs, constrained investment capital and poor market price signals which will significantly undermine investment, production and consumption decisions and, ultimately, reduce the security of supply and increase energy prices for consumers at a time when the market needs support.

- Finally, the application of those additional requirements would negate the positive impact of the MiFID Quick Fix in a market situation where energy market participants face even greater challenges as those that were addressed by the previous MiFID Quick Fix (Covid 19 pandemic-related).

Furthermore, the narrowing of the ancillary activity exemption does not appear necessary:

- Firstly, energy firms have employed efficient risk and liquidity management in cleared exchange and OTC energy markets and they have been able to overcome the challenges of the energy crisis. These firms have continued to operate and secure the gas and power supply to end consumers despite the challenges of the energy crisis and no market failure caused by increased margin requirements has been observed.

- Secondly, the current regulatory framework guarantees that the physical and financial energy markets and their participants are sufficiently and effectively regulated and supervised so that an extension of MiFID II investment firm status is not needed from a regulatory point of view.

Therefore, it would be more helpful if the EU would adopt targeted and proportionate measures to mitigate the adverse impacts of the energy crisis on energy markets and their participants, in particular with regard to the liquidity stress of energy firms. For example, the EU Commission's proposal for a "EMIR 3.0" is a step in the right direction.

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1. Energy market participants employ efficient risk and liquidity management in cleared exchange and OTC energy markets

Energy market participants, in particular energy trading firms, employ efficient risk and liquidity management in cleared exchange and OTC energy markets. These firms have continued to be able to operate and secure the gas and power supply despite the challenges of the energy crisis and, consequently, no market failure caused by increased margin requirements has been observed.[1] From this perspective, a MiFID licensing requirement for these firms is not needed as it would add no further improvements to the firms' risk and liquidity management to manage the current challenges. This is already adequately managed, and the imposition of a MiFID II investment firm regime would result in disproportionate and burdensome requirements for these firms.

In detail

Market participants are predominately active in the energy markets to cover their supply and demand and to execute transactions to mitigate the market risk of their commercial activities (hedging). For example, the operator of a gas fired power plant must hedge its commercial risk (market risk) which consists of the constant change in value of the gas procurement and of the produced power. Furthermore, these firms provide liquidity in particular to exchange markets which facilitates the aforementioned hedging activities of energy market participants and the wider real economy. For these purposes, energy firms

[1] See EBA response to Commission request on energy derivatives markets, 29 September 2022, nr. 19 (link)

trade on wholesale energy markets via bilateral transactions (undertaken over the counter, "OTC") and/or via centrally cleared, regulated markets.

The energy market participants face manifold challenges caused by the energy crisis in Europe. These include a continued fundamental shortage in gas and power supplies, unprecedented energy market volatility and energy price increases and poor market liquidity in cleared exchange markets and OTC markets, which impacts their ability to hedge. The increased volatility and prices have led to substantially increased margin calls and bilateral collateral requirements for firms active in both the cleared markets and OTC market. Both the margin and collateral posted with clearing members and OTC counterparties are predominantly cash. This has created a significant liquidity management challenge for energy market participants.[2] For example, energy sellers, i.e., the power and gas producing firms, have had to post large and frequent initial and variation margins for their centrally cleared, exchange traded positions they have entered into to hedge the commercial risks of their energy production.

Energy market participants have employed comprehensive and sophisticated risk and liquidity management practices to effectively mitigate these above-mentioned risks. Therefore, no market failures triggered by increased margin requirements have been observed to date as these firms were able to match the margin and collateral calls.[3]

- The energy firms apply a centralised and consistent approach to risk management in line with best practices (e.g., MaRisk in Germany[4]) and legal requirements (e.g., mandatory EMIR Risk Mitigation techniques). Their professional risk management enables them to mitigate the various involved risks, which are market (price) risks, credit risks (counterparty risks) and liquidity risks (cash liquidity).

- Energy firms have further enhanced their liquidity risk management practices over the past 12 - 18 months to enhance their robustness in face of the volatile market conditions. For this purpose, energy market participants have managed their liquidity needs by using a combination of several mitigation measures to optimize their exposure to market, credit and liquidity risks.[5] These include credit lines and loans by banks, structured financing with banks, issuing capital market bonds, generally higher liquidity buffers and more stringent liquidity management and

[2] See European Central Bank (ECB), Financial stability risks from energy derivatives markets, section 3 (link)
[3] See EBA response to Commission request on energy derivatives markets, 29 September 2022, nr. 19 (link): "The EBA has, however, not been aware of any cases of missed margin calls, even during the peaks of energy prices, suggesting that banks and their clients have handled the situation, despite the challenges."
[4] Minimum Requirements for Risk Management (MaRisk) in the version of 16.08.2021 (link)
[5] See also ECB, Financial stability risks from energy derivatives markets, section 3 (link): "In addition to using existing cash buffers, counterparties managed their liquidity needs by using a combination of credit lines and loans extended by banks, partially shifting to OTC transactions and strengthening margin optimisation strategies for centrally cleared ETD portfolios."

supervision and shift in market activity from the centrally cleared exchange markets to OTC markets.

- Firms have also used margin optimization techniques for centrally cleared exchanges portfolios, including inter alia optimisation via transfer of positions between clearing members and exchanges, in order to generate offsetting benefits.[6]

A more detailed description of this risk and liquidity management can be found in the Annex 1.[7]
In this context it is important to note, that large banks play a key supportive role for energy firms, both as clearing members for their energy firms clients and more broadly through the provision of credit and funding.[8] However, the banks' risk appetite to provide further substantial support to energy firms, in particular in the form of cash liquidity through inter alia credit lines and loans, was constrained during the peaks of the energy crisis.[9] Therefore, some EU governments have adopted national measures to provide additional liquidity support to energy firms to help them to meet their margin requirements.[10] It is our understanding that currently only very few energy firms have applied for and drawn the credit lines for cash liquidity under such governmental liquidity programs.

2. Extension of MiFID II investment firm status is not needed from a regulatory point of view

The current regulatory framework guarantees that the physical and financial energy markets and their participants are sufficiently regulated and supervised.

The existing EU regulations cover all relevant regulatory issues, in particular with regard to transparency, market integrity, mitigation of credit risk and conduct of business. The current set of rules enable energy market and financial market authorities to conduct effective supervision of spot and energy derivatives markets, to effectively enforce the applicable regulations vis-à-vis energy market participants and to cooperate with each other. It is crucial to note that this existing regulatory, supervision and enforcement

[6] See also ECB, Financial stability risks from energy derivatives markets, section 3 (link)
[7] See Annex 1 "Efficient risk and liquidity management by energy market participants"
[8] See EBA response to Commission request on energy derivatives markets, 29 September 2022, nr. 10 et seq. (link)
[9] See EBA response to Commission request on energy derivatives markets, 29 September 2022, nr. 23, 24. (link)
[10] For example, Germany (link, in German), UK (link), Denmark (link), Sweden (link, in Swedish), Finland (link).

framework applies independently of the regulatory status of energy market participants as it applies equally to non-financial or financial firms. Therefore, currently there does not exist any material regulatory and supervisory gap. If any need for further regulation is identified in the future, then the EU should propose more targeted and proportionate rules addressing the identified specific issues.

Consequently, we do not see the benefit of narrowing the ancillary activities exemption and to extend a MiFID II licensing requirement to energy market participants and further consequential financial market regulations, such as prudential regulation under the Investment Firm Regulation (IFR). **Furthermore, such imposition of an investment firm regime on energy firms would not solve the causes of the energy crisis. On the contrary, this would pose an additional compliance and regulatory burden which would exacerbate the liquidity crisis of energy market participants when they are already facing many challenges including continued energy market volatility.**

In detail

Regulations – Physical and financial gas and power markets are already effectively and sufficiently regulated under applicable EU regulations.

Physical and financial energy markets are regulated under the Market in Financial Instruments Directive (MiFID II), the European Market Infrastructure Regulation (EMIR), the Market Abuse Regulation (MAR) and the Market Abuse Directive (MAD) and the sector specific Regulation on Wholesale Energy Market Integrity and Transparency (REMIT). These EU energy and financial market regulations create a comprehensive and efficient framework for energy markets and its participants to ensure high standards of market transparency, conduct and integrity as well as to mitigate potential systemic credit risks for the wider financial system.

In particular, MiFID II contains already appropriate and proportionate provisions to address specific regulatory issues on the energy and commodity derivatives markets. The MiFID II provisions cover in particular the issues of position limits, position management (accountability levels) and position reporting as well as of algorithmic trading. It should be noted that these MiFID II provisions and the aforementioned regulations of EMIR, MAR/D and REMIT apply both to non-financial energy firms and financial energy firms (investment firms).

The scope of the current ancillary activity exemption under MIFID II is appropriately calibrated as confirmed by the recent MiFID Quick Fix legislation. It ensures that non-financial energy firms whose activities of dealing in energy derivatives are secondary to

the real economy business of their group are not included in the scope of the other, additional onerous and costly MiFID II obligations, including the requirement to be licenced as a MiFID II investment firm, and consequential financial regulation, such as obligations under IFR and EMIR. In particular, the prudential regulation under IFR and mandatory collateralization and margining obligations under EMIR would cause disproportionate compliance burdens and costs, which would aggravate the liquidity stress of energy firms in the current energy crisis. [11]

Finally, it should be noted that there are no regulatory gaps with regard to physical gas and power markets. These physical energy markets are subject to sectoral energy market regulations governed by energy regulators with adequate powers and the capability to oversee these markets. The physical energy market is in particular subject to specific, robust and tailor-made energy market regulations under REMIT, as this EU Regulation provides for comprehensive and efficient market transparency and integrity framework for physically settled gas and power products.

Supervision - This regulatory framework allows the energy and financial market authorities to conduct effective market supervision and enforcement

This regulatory framework provides the energy and financial market authorities with the tools to conduct effective market monitoring, supervision and enforcement. The authorities recently used these powers to conduct a review of the market functioning and this oversight did not reveal material concerns about the energy market functioning. This is confirmed by ACER's (Agency for the Cooperation of Energy Regulators) preliminary assessment of Europe's high energy prices (link) and in its final assessment of the EU wholesale electricity market design (link). ACER's conclusion is that the energy crisis is caused by the fundamental shortage in gas and electricity supply and not by the current market design and rules or market manipulation. With regard to the EU carbon market, which is an integral part of the EU energy markets, ESMA stated in its final report (link) that it has not unearthed any major abnormality or fundamental issue in the functioning of the EU carbon market from a financial supervisory perspective and that the market is functioning as expected.

Cooperation and Data Exchange – The current regulatory framework allows for the necessary cooperation and data exchange between financial market and energy market regulators

This cooperation takes place in practice and includes – inter alia – exchange of data about the physical and financial energy markets between the authorities which they require for

[11] See section 3 below.

the seamless monitoring and supervision of these markets. For this purpose, ACER and the ESMA (European Securities and Markets Authority) announced a new joint task force to monitor and detect possible market manipulation and abuse in Europe's spot and derivative energy markets.

MiFID II scope extension – The extension of additional MiFID/R requirements to non-financial energy firms is not justified and will not create material benefits

In light of the above, the extension of the application of any other, additional MiFID/R requirements to energy market participants – by way of a MiFID II licensing requirement – to energy market participants seem not to be required and will not create any additional benefits.

This finding is supported by the fact that the underlying aims of a MiFID II licensing requirement and the resulting prudential regulation, inter alia to protect savers and investors and the stability of the financial system, does not require such an extension:

- Energy firms trade on their own account on energy wholesale markets between professionals to mitigate their own commercial risks stemming from their power and gas production and supply activities.
- Energy wholesale market are dominated by professional market players and there are practically no private investors directly active on these markets. Energy trading firms do not hold client money or assets and hence pose no threat to savers and, consequently, there is no requirement to protect investors.
- We believe that energy firms do not tend to be of systemic importance for the financial system. A failure of a non-financial energy trading firm would not trigger a “broader contagion” of the financial sector, for example, triggering the failure of a systemically important financial institution.
- This is because relevant credit risk with regard to the cleared energy markets (exchanges) and OTC markets is effectively mitigated through current EMIR rules for FCs and NFCs+ on central clearing, margining for cleared markets and collateralization for OTC markets.[12] The banks’ exposure towards the energy firms, in particular through clearing services, loans and credit lines, is mitigated by the prudential regulation for credit institutions, such as the large exposure framework, and banks’ internal risk management.[13]

[12] See section 3.2 below. The ECB report, “Financial stability risks from energy derivatives markets”, states in section 2 (link) that “Some of the inherent risks in the market are mitigated by the dominance of centrally cleared transactions and the margining practices associated with them”

[13] See EBA response to Commission request on energy derivatives markets, 29 September 2022, nr. 23 and nr. 27 (link)

- Also in practice, the central clearing of energy derivatives has proven to be resilient and energy market participants have orderly managed the market and liquidity stress in cleared and OTC markets, so that no market failures have been observed.[14] In particular, the energy market participants have been able to manage their liquidity stress and met their margin and collateral calls.

Therefore, the application of additional MiFID/R obligations, such as investor protection rules, conduct of business obligations, internal organisational and governance requirements and increased transparency and reporting obligations would cause onerous and costly compliance efforts without creating material benefits for energy and financial markets and their participants.

Detrimental Impacts – The imposition of a MiFID II licensing requirement would be rather detrimental

MiFID II licensing requirements would be harmful for multiple reasons:

- One of the reasons is that the preparatory work for the authorisation proceedings, the authorisation proceedings themselves and subsequent implementation work of the rules applicable to investment firms are burdensome and costly for the concerned energy firms.
- This implementation is also a lengthy process as it is estimated that it will take at least 2-3 years and, hence, any such regulatory change cannot be introduced on short notice.
- Most importantly, it will lead to additional capital and liquidity requirements which would further increase the liquidity stress of energy market participants, in particular because of the requirements under the Investment Firm Regulation and EMIR.[15] These requirements are estimated to amount to at least €5-10 billion for concerned larger energy market participant.
- This could lead to a negative impact on energy markets and consumers, in particular it will reduce market liquidity, negatively impact the competitiveness of EU energy markets and firms, create higher cost for hedging and less efficient hedging and ultimately higher energy costs for consumers.[16]

[14] For details about the risk management see section 1 above.
[15] See section 3 below.
[16] See section 4 below.

3. Application of additional capital and liquidity requirements under IFR and EMIR will aggravate the energy and liquidity crisis

Energy market participants, which would not be exempted under any future version of the Ancillary Activity Exemption, will have to be licensed as investment firms under MiFID II. As investment firms, they must comply with all obligations under the so-called new Investment Firm Regulation and Directive ("*IFR*" and "*IFD*") and with all obligations for financial counterparties ("FCs") under EMIR.

Consequently, the imposition of a MiFID II licensing requirement on energy market participants would impose on energy firms not only authorisation proceedings and, but also, lengthy, onerous and costly preparatory and implementation work.[17] More importantly, affected energy firms would be subject to own funds and liquidity requirements under IFR as well as mandatory clearing and margining requirements under EMIR for the first time. ***For larger energy market participants these capital and liquidity requirements have mostly been estimated to two-digit billion euro for additional required (cash) liquidity to meet these obligations. According to a conservative estimate the overall amount of the (cash) liquidity needed for meet those obligation could amount to at least €5-10 billion for larger energy firms.*** It is obvious that this would substantially increase the liquidity stress of the concerned firms.

The following two sections describe in more detail the impact of capital and liquidity requirements under IFR and EMIR on energy market participants:

IFR prudential rules lead to prohibitively high capital and liquidity rules

Energy market participants, which will have to be licensed as so-called investment firms under MiFID II have to comply with a wide set of new, additional obligations under financial market regulations such as IFR/D, MiFID II/MiFIR and EMIR. In particular, the concerned energy market participants will have to implement for the first time the new prudential regime of the IFR and IFD, i.e., the regime for capital and liquidity requirements ("Pillar 1"), supervisory review and evaluation ("Pillar 2"), supervisory reporting and public disclosure, as well as corporate governance and remuneration rules ("Pillar 3").

Licensed energy market participants will usually qualify as so-called "commodity and emission allowance dealers" under IFR ("CEADs"). These investment firms must fulfil specific capital requirements, the so-called K-Factor requirements for market, credit and

[17] See section 2 above.

concentration risks, and liquidity requirements as set out in the IFR.[18] This prudential regime is not tailored to the specific business and risks of energy and commodity market participants and, therefore, it will lead to prohibitive high amounts of capital and liquidity requirements for these participants.[19] The EU legislators recognised that the previously applicable Capital Requirement Regulation (CRR)[20] rules were inappropriate for commodity firms through an exemption for licensed commodity firms from the own funds requirements (Article 498 CRR) and large exposure requirements (Article 493 CRR). These provisions required the EU Commission to prepare a report on an appropriate regime for the prudential supervision of commodity trading firms. When the new regime for investment firms under IFR/D was proposed and adopted, this kind of commodity related prudential review never took place. Consequently, the current prudential IRFF/D regime is still not appropriate as it broadly represents a simplified application of the former CRR prudential rules, whereas the latter were predominately designed for credit institutions.[21]

The attached example shows that the consequential capital and liquidity requirements of IFR are prohibitively high for an energy utility if regulated as an investment firm.[22] According to a conservative estimate the overall amount of the (cash) liquidity needed to meet the prudential obligations could amount to at least €5-10billion per larger energy firm. Consequently, the own fund and liquidity requirements of the IFR would exuberate the current liquidity stress of energy firms.

EMIR clearing and margin obligations for OTC hedging further constrain cash liquidity

The vast majority of energy market participants are not financial counterparties and are not classified as non-financial firms above the EMIR Clearing Threshold (so-called NFCs+).[23] As MiFID II investment firms they will become so-called financial counterparties (FCs). FCs are – like NFCs+ - subject to additional, more stringent EMIR obligations. This means that the imposition of a MiFID II investment firm licensing requirement on energy

[18] Until 2026, there is a transition period, in which CEADS may apply lower own fund requirements and are exempted from liquidity requirements. This paper, however, is based on the ultimately applicable IFR regime, because of the mid-term perspective of the review.

[19] This was recognized by the repeated extension of the duration of the specific exemption of the former Art. 493 and 498 CRR; see Regulation (EU) 2016/1014 of 8 June 2016 amending Regulation (EU) No 575/2013 as regards exemptions for commodity dealers (link)

[20] Regulation (EU) No 575/2013 of 23 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (link)

[21] This is also the reason why the IFR provides in Art. 60(1)(g) that the EU Commission shall submit a report by 26 June 2024 on the application of capital requirement under IFR on CEADs and CEADs can take advantage until 2026 of a transitional regime under Art. 57 IFR.

[22] See Annex 2 "Example of prudential requirements for a power producing utility under IFR".

[23] Nevertheless, as non-financial firms (NFCs) they have currently to comply with a set of defined reporting and risk management requirements under EMIR.

market participants would force the concerned NFCs to implement additional mandatory EMIR requirements for the first time. [24]

The most burdensome and costly additional EMIR obligations for FC/NFC+ counterparties are the following:

- All future derivatives in a class of derivatives[25] declared eligible for clearing and concluded with either another NFC+ or a FC have to be cleared with a central counterparty (CCP); and
- Counterparties have to exchange two types of collateral, i.e., variation margin and initial margin, when facing FC/NFC+ counterparties and this will apply to all derivative classes

A recent study of Frontier Economics[26] explains that these (and other additional) EMIR obligations require significant implementation costs and resources, even for large and sophisticated energy players. [27]

The Frontier Study finds that beyond the initial implementation efforts these obligations cause further significant ongoing costs and liquidity risks for the concerned firms operating under an NFC+ status. The additional liquidity needed to post cash as collateral (initial and variation margin) is estimated for larger energy market participants to cost at least €1-2 billion. In the context of the current energy crisis these mandatory margin requirements present a significant challenge for energy market participants, in particular in the current market environment with high and volatile prices.[28]

4. Imposition of MiFID II licensing requirement would cause material adverse consequences for energy markets and consumers

Subjecting energy market participants to a MiFID II licensing requirement could trigger adverse and unintended impacts on energy markets, consumers and the real economy. The adverse consequences might be higher (market price) risks, higher hedging costs, constrained investment capital and poor market price signals which will significantly

[24] See description of the additional EMIR obligations in Annex 3 "Additional EMIR requirements for FCs and NFCs+ ".
[25] For FCs, i.e., MiFID II investment firms, there exist no "ring-fencing" of the clearing obligation, i.e., FCs need to centrally clear all derivatives classes. NFC+ needs to clear only such derivatives classes, in which the breach of the EMIR clearing threshold occurred.
[26] Frontier Economics, Review of the EMIR clearing threshold for commodities (CCT), Report for EFET, 31 May 2022 ("Frontier Study"), see under link.
[27] For a detailed description based on the Frontier Study see Annex 4 "Implementation efforts and costs of becoming an FC / NFC+ under EMIR"
[28] See Annex 5 "OTC margining requirements further constrain cash liquidity for FCs / NFCs+".

undermine investment, production and consumption decisions and ultimately reduce the security of supply and increase energy prices for consumers at a time when the market needs support.

These adverse impacts are explained in detail below:

- The energy market participants are already negatively impacted by the energy crisis as they face continuing energy market volatility and energy price increases and, therefore, experience increased collateral and margin requirements and consequential liquidity stress.

- These problems will be aggravated by the adverse consequences of a MiFID licensing requirement and consequential prudential regulation under the IFR and margining/collateralisation requirements under EMIR.[29] According to a conservative estimate the overall amount of the (cash) liquidity needed for meeting those obligations could amount to at least €5-10 billion for larger energy firms. This seems especially concerning in light of the already high margining and collateral costs of energy firms as it would further increase the liquidity stress for energy market participants.

- Energy market participants who are licensed as investment firms under MiFID II will have to reallocate capital within their businesses to meet the capital and liquidity requirements under IFR and the margining/collateralisation requirements under EMIR. This will "lock" liquidity that cannot be used for other purposes, such as investments in renewable assets or maintenance of existing production assets. This will hinder a timely energy transition as foreseen under the EU's Green Deal.

- The above-mentioned prohibitively high prudential requirements and margining/collateralisation requirements might incentivise non-financial firms to reduce their activities on energy derivatives markets, which will most likely lead to a further substantial reduction of the liquidity in already stressed EU energy markets:

    - Small and medium sized energy firms and industrial companies may be forced to exit the European energy derivatives market due to prohibitive compliance and conservative capital and liquidity requirements.
    - In addition, for the same reasons the larger energy trading firms or larger industrial companies may withdraw from EU energy derivatives markets or cease to trade certain derivative products in the EU.
    - Where possible, derivatives trading activity may be relocated or routed via other international markets.

[29] See sections 3.1 and 3.2 above.

- Energy firms may be forced to migrate to purely bilateral, physical markets and products.
- Hence, it may further reduce the already thin liquidity on the EU future/forwards markets on EU energy exchanges.

- A further substantial drop in liquidity will trigger manifold adverse impacts for the real economy, the security of supply and ultimately for consumers:

    - This exacerbates the current liquidity crunch, further boosting the reinforcing loop of increasing volatility and price levels.
    - The fall in market liquidity combined with higher volatility may mean no or less efficient hedging and/or more costs of hedging: Either this means that energy and real economy companies will have to stop or reduce their hedging activities because of the capital and liquidity costs; or that they can hedge only at higher costs as a result of wider bid ask spreads at future markets; or can hedge less efficiently; or not hedge at all as a result of missing liquidity in certain markets and products. For some products, the reduced liquidity might mean that it can be impossible to hedge the embedded risks, and this will then expose firms to substantial market risks.
    - The reduced ability to manage merchant risks will significantly increase the costs of risk management not only for energy companies, but also reduce opportunities for commodity risk management by industrial consumers.
    - Illiquid energy wholesale markets will reduce market competition and efficiency in the wholesale, production and retail markets likely causing price increases for consumers and industry as a result, in an already high price environment.
    - Illiquid energy wholesale markets will reduce the robustness and reliability of the price formation and consequently the quality of the price signals, whereas those are needed to steer energy consumption and production as well as investments in energy infrastructures.

Conclusions - Keep the current scope of the Ancillary Activity Exemption in place

The scope of the current ancillary activity exemption under MiFID II is appropriately calibrated as confirmed by the recent MiFID Quick Fix legislation and should be kept in

place to avoid adverse and unintended consequences for energy market participants, the real economy and end consumers.

Therefore, it would be more helpful if the EU would adopt more targeted and proportionate measures to mitigate the adverse impacts of the energy crisis on energy markets and their participants, in particular with regard to the liquidity stress of energy firms. The adoption of two delegated regulations to ease the increased liquidity pressure on energy firms is a step in the right direction.[30] Also, the EC's legislative proposal for a more fundamental review of the EMIR rules, is a step in the right direction to further improve the regulatory framework appropriately to help energy firms with the various challenges, including the EMIR clearing threshold and margining practices.[31]

With regard to the orderly functioning of the EU energy (gas, power, carbon) markets the EU could better adopt more targeted and proportionate measures to address the energy crisis instead of a blanket MiFID II licensing requirement. There are specific legislative measures proposed by the EU Commission[32] to address inter alia specifically the price volatility in power and gas markets, such as an intraday price volatility management mechanism, and specifically the price formation in gas markets, such as a new EU LNG price benchmark.[33] A blanket MiFID II licensing requirement would not address these issues. Furthermore, ESMA recommended in its final report (link) policy measures that can contribute to ensuring that the carbon market continues to facilitate price discovery and hedging while remaining free from manipulation and abusive practices.

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Annexes

Annex 1 "Efficient risk and liquidity management by energy market participants"

[30] A delegated regulation increasing the clearing threshold for positions held in OTC commodity derivative contracts and other OTC derivative contracts to EUR 4 billion and a delegated regulation regarding temporary emergency measures on collateral requirements.
[31] For example, ESMA recommended and the EC proposed structural changes in the way the EMIR clearing threshold is calculated, i.e., distinguishing between cleared vs. non-cleared transactions rather than between exchange traded derivatives and OTC derivatives.
[32] See EU Commission proposal for a Council Regulation on "Enhancing solidarity through better coordination of gas purchases, exchanges of gas across borders and reliable price benchmarks".
[33] However, EFET disagreed with the introduction of a "gas market correction mechanism" ; see (link)

Energy market participants, in particular energy trading firms, employ an efficient risk and liquidity management, which allowed them to overcome the various challenges of the energy crisis.

Energy trading firms employ efficient risk management

Holistic, sophisticated risk management practices are embedded into the energy sector

Energy trading firms apply a centralised and consistent approach to risk management in line with best practices (e.g., under MaRisk in Germany) and legal requirements (e.g. EMIR Risk Mitigation techniques). These approaches are timely, documented and additionally as NFC entities, in certain countries EMIR governance processes (Risk Mitigation techniques) are audited on an annual basis.

Energy trading firms adhere to fundamental risk management principles, specifically:

- **Risk Ownership**: Clear designation of responsibilities to specific risk owners, who have a defined mandate
- **Independent Risk Governance**: Independent risk controlling tasks, separated from risk owners
- **Performance Management:** The occurrence of risks is directly reflected in their performance assessments of risk owners
- **Transparency**: All risks are consistently monitored, measured and reported on

For both hedging and non-hedging trading, firms maintain consistent risk management governance based upon measurement and control procedures, in line with the level of complexity inherent in each transaction. Conservative risk management safeguards financial solvency in line with tailored FX/IR hedging, while sophisticated risk management is in place for both hedging and non-hedging commodities trading activity.

There is a functional separation between risk management and commercial operation throughout firm hierarchies (up to ‘C-suite’).

Market risk management:
Daily mark-to-market and monitoring of e.g., VaR and delta limits is common embedded practice in the energy industry amongst major firms. This includes daily reporting of P&L to limit occurred losses, and frequent stress testing (where extreme market conditions are assumed against the existing portfolio) in order to identify vulnerabilities. Some energy trading firms also monitor specific “tail risk limits”, in order to limit the P&L impact of extreme market scenarios.

Credit risk management:

It is common practice to have credit management frameworks in place, including internal credit policies, guidelines and procedures. Daily monitoring of credit risk limits and continuous counterparty assessments (using external rating agencies' and/or internal credit rating standards) are applied throughout the market and include exposure limits. Daily OTC Collateral Management is practiced through credit support arrangements covering bilateral margining agreements (typically in relation to Variation Margin) and risk transfer through credit insurance, bank guarantees, letters of credit and parental guarantees.

Liquidity risk management:
Energy trading firms have dedicated teams in place responsible for managing and optimising the liquidity position of a company, the objective being to safeguard financial solvency. Firms steer the liquidity risk of commodity positions using a liquidity buffer system, where liquidity risk bearing contracts (exchange and CSAs) are stressed with a "VaR model". The liquidity risk of Initial Margins is also often reflected therein.

Energy firms have further enhanced their liquidity risk management practices to make them even more robust in face of the volatile market conditions

This includes:

a) **Liquidity planning cycles**: Carried out with increased frequency, with additional tools and inputs used to improve planning quality. Firms are including OPEX & CAPEX costs, expected roll-off of exchange and CSA positions and assumptions on future deals in planning cycles. In addition, some firms have introduced a **pricing system,** adding financing options to the price of commodity contracts in order to steer investment decisions from a liquidity perspective. In extreme situations, firms have temporarily stopped hedging activities.

b) **Increased financing measure lead-times:** Via a **"traffic light system"** giving Treasury departments increased lead time. Firms apply a liquidity buffer with a risk premium to their liquidity planning, in order to compare with financing instruments.

c) **Real-time reporting:** Allows a live forecast of expected Variation Margin and collateral margin on a short-term basis. In addition, firms are applying **stress test scenarios** to liquidity planning, allowing evaluation of the liquidity impact following a defined price shock scenario. The use of such tools therefore allows liquidity planning to play a fundamental role in future investment decisions.

d) **Cash secured through bank loans and capital market bonds:** Firms secured cash to cover additional liquidity requirements by negotiating bilateral and syndicated loans with banks, and by issuing bonds to the money markets and the

capital markets. Proactive discussions were also held with rating agencies, in order to provide confidence and reassurance on how firms were coping with the volatile market conditions.

e) **Central steering:** Firms have introduced a **central steering desk** to steer the liquidity risk position of commodity contracts. The central steering desk manages **liquidity optimisation** via commodity financing transactions with banks and other institutional investors, as well as entering into triangulation arrangements in order to reduce credit exposure.

f) **Optimization of Initial Margin payments:** Exchange-traded position optimisation via transfer of positions between clearing members and exchanges, in order to generate offsetting benefits. Firms have further developed frameworks to calculate and assess the impact of Initial Margin, before entering into transactions. This has extended to taking Gas and Power positions off exchange, replacing them with physical transactions (in order to avoid Initial Margin).

g) **Increased headcount:** Facilitating additional focus and long-term efforts to ensure better liquidity risk management.

Annex 2 "Example of prudential requirements for a power producing utility under IFR"

This annex contains an example of prudential requirements for a power producing utility which is regulated as a MiFID II investment firm under the Investment Firm Regulation (IFR). To understand the own funds requirement of such an IFR-regulated utility, we assumed:

- such utility owns and operates CCGT (combined cycle gas turbine) gas power plants; hence, this example assumes that the IFR-regulated entity is also the asset owner.
- it hedges its power sales for simplicity with base load futures contracts and procures fuels (gas & CO2), both sold or purchased via an exchange only.
- its hedge profile is as followed: 100% hedged for the front year, 70% for the second front year, and 30% for the third front year; for simplicity we ignore any hedge position of the current year.

Assuming that K-NPR (Market Risk) is calculated according to the Capital Requirements Regulation standardised approach (to which the IFR refers) we obtain the following own funds requirements for commodity related Market Risks, based on the exemplary asset portfolio:

Assets parameters	
Installed CCGT capacity [MW]	3,000
Average runtime p.a. [hours]	3,000
Effective hedge horizon (100/70/30) [years]	2
Power production hedged [MWh]	18,000,000
Gas efficiency of assets [%]	50
Gas needed for hedged power production [MWh]	36,000,000
EUA efficiency of assets [%]	40
EUAs needed for hedged power production [tCO2e]	7,200,000
Notional values of hedge positions as of 22 Aug 2022	
Market price of power position (DE baseload) [EUR/MWh]	496
Notional/ market value of power position [EUR]	-8,931,600,000
Market price of gas position (TTF) [EUR/MWh]	207
Notional/ market value of gas position [EUR]	7,439,400,000
Market price of EUA position [EUR/tCO2e]	99
Notional/ market value of EUA position [EUR]	709,560,000
Total net notional value [EUR]	-782,640,000
Own funds requirements (Market Risk/commodity risk only acc. to Art 360 CRR = 18% of a directional single product position)	
Power [EUR]	1,607,688,000
Gas [EUR]	1,339,092,000
EUA [EUR]	127,720,800
Total [EUR]	3,074,500,800

In this context it is also worth mentioning that in particular the following prudential rules for IFR-regulated utilities will lead to disproportionate capital and liquidity requirements:

1. The standardised approach for the calculation of own funds requirements for commodity related market risk ignores correlations across commodities.

2. A credit quality-independent risk factor for the calculation of own funds requirements for Credit Risk in the IFR standard approach.

3. The Potential Future Exposure (PFE) calculation according to the IFR standard approach do not consider the remaining maturity of commodity transactions. I.e. the PFE is the same for a short-term transaction and a long-term transaction, except maturity all else the same. Compared to the PFE calculation according to the standardised approach for measuring counterparty credit risk exposures (SA-CCR), where remaining maturity is explicitly considered, IFR'S PFE can be up to five times larger than SA-CCR's PFE.

Issues 2 and 3 above are also applicable to K-CON.

Annex 3 "Additional EMIR requirements for FCs and NFCs+"

FC and NFC+ requirements

Obligation	Description
Clearing obligation	▪ **All future derivatives in a class of derivatives declared eligible for clearing and concluded with either another NFC+ or a FC have to be cleared**[34] with a central counterparty (CCP) (Article 4 and Article 10(1)b, EMIR). Currently, the clearing obligation is restricted to certain interest rate swaps, forward rate agreements and credit default swaps, but this obligation may be extended to further derivative classes in future. ▪ FCs and NFC+s are restricted to only conclude **future derivatives transactions (which are subject to a clearing obligation) with FCs or other NFC+s on Regulated Markets**[35], organised trading facilities, multilateral trading facilities or third country trading venues (subject to EC decision on

[34] This clearing obligation does not apply if an NFC+ trades with an NFC-, see Article 4 (1) of EMIR.
[35] As defined in Art 4 (1) no.21 MiFID II.

Obligation	Description
	equivalence and reciprocity) (so-called **Trading Obligation**, Article 28, MiFIR).
Risk-mitigation procedures	▪ **Counterparties have to exchange two types of collateral when facing FC/NFC+ counterparties,** independently of the derivative class that reflects the volume and risk of the derivative contract:[36] "**Variation margin**", which is calculated daily and reflects the current market values and the corresponding risks of the derivative contract; "**Initial margin**", which is additional collateral that should cover sudden adverse movements in the value of the risk exposure of the contract or the variation margin that might occur before the next update of the variation margin. ▪ **A mark-to-market valuation of all outstanding derivative contracts on a daily basis**. This does not only apply to the derivatives transactions, but also to the exchanged collateral. Where market conditions prevent marking-to-market, reliable and prudent marking-to-model must be used. (Article 11(2), EMIR) ▪ FCs and NFC+ are subject to the stricter requirements regarding timely deal confirmation and portfolio reconciliation, to the same extent as already applicable to FCs.
Reporting	▪ **Daily reporting of market-to-market and collateral.**

Source: Frontier Economics

Note: Being qualified as NFC+ has further consequences, for example: The deadline for the confirmation[37] of derivative trades between FCs and NFC+s is shortened from two to one days following the date of execution (see Article 12, Commission Delegated Regulation (EU) No 149/2013). NFC+s also have to perform portfolio reconciliations[38] with their trading counterparties more frequently than NFC-s. If two NFC+s have 100 OTC

[36] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 by the Joint Committee of the European Supervisory Authorities (ESAs). The detailed requirements for the collateral have been set out in a Regulatory Technical Standard (RTS) by the European supervisory authorities (ESAs).

[37] Derivatives trades are typically executed between traders by telephone or electronic messages and later confirmed with a written document.

[38] Portfolio reconciliation means that the trading counterparties bilaterally verify the existence of all outstanding trades and compare their principal economic terms, including a valuation of the contract.

contracts outstanding between them, they have to reconcile their portfolios once a week rather than once per year), see Article 13, Commission Delegated Regulation (EU) No 149/2013.

Annex 4 "Implementation efforts and costs of becoming an FC / NFC+ under EMIR"

Becoming an FC / NFC+ under EMIR is not a trivial undertaking for energy companies. It requires significant implementation efforts and resources, even for large and sophisticated energy players, and the process triggers significant costs:

- **Initial set-up costs** for new IT systems, enhanced regulatory reporting and the renegotiation and managing of credit support annexes (CSA) with all FC and NFC+ counterparties, with the result of significantly increased operational effort to manage portfolios. Moreover, the posting of IM is likely given the current low thresholds for IM to apply, and the calculation methodology set out in the EMIR margining RTS[39]. In this case, an entire new operational set-up with custodian banks (Clearstream, Euroclear etc.) has to be implemented which is fundamentally different to exchanging collateral bilaterally.

- **Ongoing annual costs**, which relate mainly to the costs of cash liquidity, administrative costs for regulatory reporting as well as ongoing operations (annual costs).

The table below provides further detail on these cost categories:

Table 1 Types of initial setup and ongoing annual costs when becoming NFC+

Initial set-up costs, including	Ongoing annual costs including
Intragroup Exemptions & Reporting	Additional Interest cost through engaging with a wider set of lenders
CSA renegotiations & system upgrades	Cost of capital for additional capital requirement
Variation Margin management systems	Liquidity management
Initial Margin management systems	Ongoing administrative effort and costs for additional staff to meet the requirements

Source: Frontier Economics based on large European energy player.

[39] Commission Delegated Regulation 2016/2251.

Note: CSA = Credit Support Annexes. A detailed explanation of those costs can be found in the Frontier Study for EFET.

The case study for a large European energy company below shows that these costs can be material, with estimated implementation costs of €10m and ongoing costs of €25m p.a.

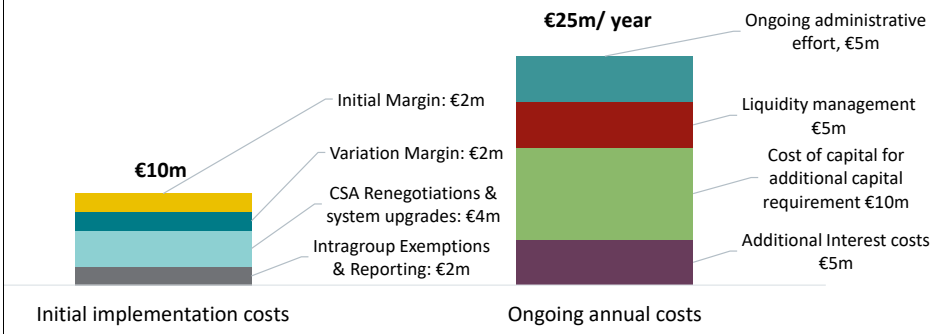
Case study: NFC+ COST ESTIMATES FROM AN INTERNAL IMPLEMENTATION PROJECT BY A LARGE EUROPEAN ENERGY COMPANY

Figure 1 provides cost estimates from an internal NFC+ implementation project[40] conducted by a large European energy company that has been evaluating a move to NFC+ status if the current €3bn CCT were to remain broadly unchanged:

- The implementation processes would take more than 18 months and would cost at least €10m for the set-up. This includes hiring of at least 10 additional staff members, the use of external consultants and legal counsels and require close and ongoing Board attention.

- Significant ongoing annual costs of around €25m which consist of additional interest costs for project financing of new assets, cost of capital for maintaining initial margin for uncleared derivatives, liquidity management costs through additional liquidity reserved for collateral and ongoing administrative costs.

Figure 1 NFC+ initial implementation and ongoing annual costs



Source: Frontier Economics based on estimates provided by a large European energy company, see the Frontier Study for EFET for details.

The **burden is not only financial** and not all processes may be outsourced to external providers. The enhancement of processes requires significant administrative efforts and attention from key managerial staff **across all entities in a group**. The company, on which the case study is based, expects that attention to other core business activities would be to some extent limited during implementation but also to keep on adhering to reporting obligations.

[40] The strategic feasibility project lasted for several months and involved numerous staff members from different departments, including the commercial teams, Risk, Legal, Trading, Back Office, IT and Treasury. The project outcome was presented to Senior Management at the highest level of the company.

FCs and NFC+ costs can vary across companies, depending on size and trading activity:

Initial setup costs depend on the available internal expertise and resources as well as the organisational set-up prior to becoming FC and NFC+. Large and sophisticated energy players have rather lower setup costs as they already have sophisticated organisational conditions in place (see case study below). Setup costs might be significantly higher for smaller energy players.[41] In particular if there is a large number of small subsidiaries and joint ventures, and if trading activities are spread more widely than in the specific case here.

Ongoing costs typically depend on the size and type of the company and its trading activities. While ongoing annual costs are larger for companies with extensive trading activities, those costs may be lower for smaller energy companies that implement FC or NFC+ requirements.

Annex 5 "OTC margining requirements further constrain cash liquidity for FCs / NFCs+"

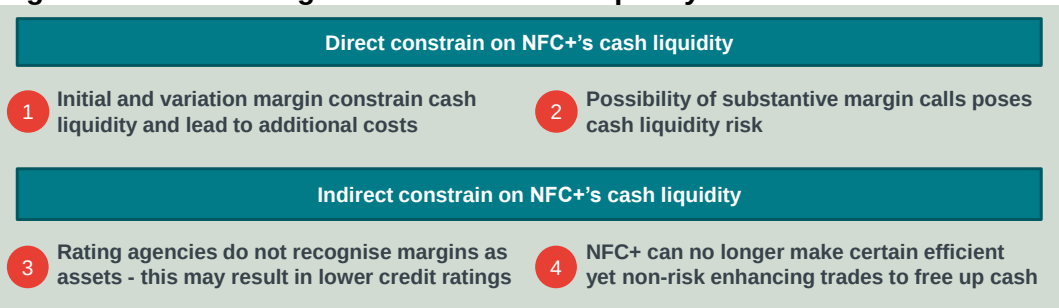
In addition to significant implementation efforts and costs, gaining FC or NFC+ status materially increases the need for liquidity to continue their OTC hedging activities. Margins of non-cleared trades serve as collateral that cover (parts of) the credit risk of the counterparty. NFC+ and FC counterparties are required to post margins for OTC derivatives[42] when the other counterparty is an NFC+ or FC.[43]

Margin requirements may present a significant challenge for companies, in particular in the current market environment with high and volatile prices. A lack of liquidity may even lead to limitations in FC and NFC+s' commercial activities since cash liquidity is costly and may be limited in the short run.

In the following we highlight the **four challenges** for cash liquidity through margin requirements.

[41] It is worth keeping in mind that the purpose of utilities is primarily the production of electricity. The group structures typically reflect this.
[42] The requirement to post initial margin is supposed to kick-in in a phased approach according to Art. 36 CDR 2016/2251, however, in light of the applicable aggregate average notional amount (AANA) of non-centrally cleared derivatives, it is safe to assume that an NFC- which passes the Clearing Threshold will likewise pass the threshold to become eligible for submitting initial margin.
[43] For completeness, note that NFC-, NFC+ and FC are all required to post margins when trading derivatives on exchanges.

Figure 2 Four challenges for NFC+'s cash liquidity



Source: Frontier Economics

1. *OTC initial and variation margin requirements further constrain cash liquidity and lead to additional costs for NFC+*

Margin requirements (from non-cleared OTC trades) directly draw upon cash liquidity through two channels:

- **Initial margin (IM)**: IM is a form of collateral that covers potential future portfolio losses originating from the default of the counterparty. The IM is exchanged once when entering a contract.[44] IM remains subject to further adaptations driven by market volatility (margin parameters). The size of the IM is typically proportional to the transaction volume. By way of approximation, an IM tends to be in the magnitude of 15% of the gross notional value of the trade at the time of conclusion.
- **Variation margin (VM):** VM is a payment to settle the mark-to-market moves on open positions. As such VM reflects the price moves of the market and the commercial situation of the counterparties. VM is updated daily responding to so-called 'margin calls'. Margin calls can result in both an increase and a decrease of the posted margin. The materiality of margin calls varies.

Cash and other liquid assets are scarce and costly[45] resources for a firm. Margin requirements can either pose a liquidity constraint on companies (with adverse impacts on business operations) or come at additional costs, which would be passed on in competitive markets.

2. *OTC margin requirements further increase the liquidity challenge posed by margin calls*

Margin calls could have major implications for the liquidity management of counterparties and exposes them to cash liquidity risk. While also NFC-s are to some extent exposed to this risk through exchange trading, OTC margin requirements further increase the exposure of FC or NFC+s.

Margin calls present a cash liquidity risk because of the **combination of two factors**:

[44] And only after the counterparty threshold of €50m is exceeded.

[45] For example, in the case study above, the costs of capital for cash liquidity are assumed to be 1% p.a.

- **Materiality of margin calls.** High levels of market volatility, just as one has observed following the outbreak of the Corona crisis, may result in a significant increase in margin calls from derivative positions; and
- **Extremely short response windows.** When margins are called, NFCs need to respond to such margin calls usually intra-day due to EMIR requirements.

Under normal market circumstances with moderate price volatility, a hedged FC or NFC entity, i.e., an entity with low-risk exposure[46], should be able to find sufficient working capital to meet margin calls. There is however a practical issue to access the liquidity needed to meet excessive margin calls within very short time windows of few days.

Liquidity buffers and revolving credit facilities may help to some extent but are costly and are usually not designed to meet the requirements of rare (but possible) excessive margin calls. The inability to meet margin calls may lead to forced liquidation of other open positions, or the exclusion from the trading platform.

3. *High volumes of posted cash collateral may result in lower credit ratings and higher financing costs*

There is also an important indirect effect from higher liquidity requirements on the credit rating (and thus finance costs) of NFC+s. When an NFC+ uses debt to provide collateral, the debt ratio would increase as a consequence. Rating agencies classify the substantial collateral posted for margins as a receivable which is at risk. And, under the international accounting standard IFRS, NFC+ should not include IM or VM in the balance sheet.[47] This can lead to a lowering of the credit rating, which increases the costs of financing for an NFC+ entity.

For completeness, NFC-s would also be affected due to their activity on exchanges, but the OTC margin requirements add to the challenge for NFC+s.
Lower credit ratings can have detrimental consequences for the energy transition since it is more difficult for NFC+s to finance renewable projects and makes renewable investments more costly. For balance sheet financed projects, the costs will be higher and/or fewer projects will be executed.

4. *FCs and NFC+s can no longer make certain efficient yet non-risk increasing trades to free up cash*

FCs and NFC+s cannot engage in certain efficient and non-risk increasing trading activities, compared to NFC-s. For example, NFC-s can release cash liquidity by converting an exchange commodity position (subject to clearing/margining) into an equivalent OTC position (without IM margining with cash).

[46] In particular, utility companies with generation assets who may benefit from increasing energy prices and whose credit rating should improve as a consequence.
[47] EBA response to question on Treatment of Cash collateral, 16 January 2015, link