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RECOMMENDATION OF THE AGENCY FOR THE COOPERATION OF
ENERGY REGULATORS No 01/2015

of 17 March 2015

ON THE REGIME APPLYING TO THE DERIVATIVE CONTRACTS
REFERRED TO IN SECTION C.6 OF ANNEX I OF MIFID II WHICH
HAVE THE CHARACTERISTICS OF WHOLESALE ENERGY
PRODUCTS THAT MUST BE PHYSICALLY SETTLED
ACCORDING TO ARTICLE 4(1)(2), SECOND SUBPARAGRAPH,
AND ARTICLE 89 OF MIFID II

THE AGENCY FOR THE COOPERATION OF ENERGY REGULATORS,

HAVING REGARD to Regulation (EC) No 713/2009 of the European Parliament and
of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy
Regulators\(^1\), and, in particular, Articles 5, 11 and 17(3) thereof,

HAVING REGARD to Directive 2009/72/EC of the European Parliament and of the
Council of 13 July 2009 concerning common rules for the internal market in electricity
and repealing Directive 2003/54/EC\(^2\), and, in particular, Article 1 thereof,

HAVING REGARD to Directive 2009/73/EC of the European Parliament and of the
Council of 13 July 2009 concerning common rules for the internal market in natural
gas and repealing Directive 2003/55/EC\(^3\), and, in particular, Article 1 thereof,

HAVING REGARD to Regulation (EU) No 1227/2011 of the European Parliament
and of the Council of 25 October 2011 on wholesale energy market integrity and
transparency\(^4\) and, in particular, Articles 1, 7 and 8 thereof,

HAVING REGARD to the favourable opinion of the Agency’s Board of Regulators of
16 March 2015, delivered pursuant to Article 15(1) of Regulation (EC) No 713/2009,

WHEREAS:

\(^{3}\) OJ L211, 14.8.2009, p.94.
(1) The Third Energy Package aims at the creation of an internal market for electricity and gas with real choice for all consumers of the European Union, be they citizens or businesses, new business opportunities and more cross-border trade, so as to achieve efficiency gains, competitive prices, and higher standards of service, and to contribute to security of supply and sustainability.

(2) According to Article 5 of Regulation (EC) No 713/2009, the Agency may provide, on its own initiative, a recommendation to the European Parliament, the Council and the Commission on any issue relating to the purpose for which the Agency has been established.

(3) Pursuant to Article 1 of Directive 2009/72/EC and of Directive 2009/73/EC, these Directives establish common rules for the generation, transmission, distribution and supply of electricity, together with consumer protection provisions, with a view to improving and integrating competitive electricity markets in the Union and common rules for the transmission, distribution, supply and storage of natural gas.

(4) Regulation (EU) No 1227/2011, according to its Article 1, establishes rules prohibiting abusive practices affecting wholesale energy markets which are coherent with the rules applicable in financial markets and with the proper functioning of those wholesale energy markets, whilst taking into account their specific characteristics, and provides for the monitoring of wholesale energy markets by the Agency to detect and prevent trading based on inside information and market manipulation.


(6) The scope of the definition of financial instruments, according to Article 4(1)(15) of MiFID II, covers all instruments specified in Section C of Annex I of MiFID II. According to Section C.6 of Annex I of MiFID II, this includes options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled.

Recital 9 of MiFID II states that the scope of the definition of financial instruments will include physically settled energy contracts traded on an OTF, except for those already regulated under Regulation (EU) No 1227/2011. Recital 10 of MiFID II adds that the restriction of the scope of such a definition concerning commodity derivatives traded on an OTF and physically settled should be limited to avoid a loophole that may lead to regulatory arbitrage.

Recital 10 of MiFID II therefore calls for a delegated act to further specify the meaning of the expression “must be physically settled”, taking into account at least the creation of an enforceable and binding obligation to physically deliver, which cannot be unwound and with no right to cash settle or offset transactions, except in the case of force majeure, default or other bona fide inability to perform. The Commission is currently preparing such delegated acts, based on technical advice from the European Security and Market Authority (ESMA).

ESMA provided its Technical Advice to the Commission on MiFID II and MiFIR on 19 December 2014 (hereinafter referred to as “ESMA’s Technical Advice”), covering Section C.6, 7 and 10 of Annex I of MiFID II in its “Section 7 on Commodity derivatives and in particular on the Financial instruments definition - specifying Section C 6, 7 and 10 of Annex I of MiFID II”.

In particular, in paragraph 26 of ESMA’s Technical Advice, ESMA considers that a “C.6 wholesale energy product contract can only be categorised as ‘must be physically settled’ when the parties entering into the contract are actually capable of delivery or receipt of the agreed amount of gas, power, oil or coal. Therefore the terms of a C.6 wholesale energy product contract or the rules of the OTF on which it is traded must require that both buyer and seller should have proportionate arrangements in place to make or receive delivery of the underlying commodity upon the expiry of the contract. The principle of proportionality should, in this case, be understood as requiring that the parties to the contract have arrangements in place which are adequate considering, for example, the size of their commercial activities or their production, storage or consumption capabilities.”.

In paragraph 27 of ESMA’s Technical Advice, ESMA flags out that “it did not consult on the concept described in paragraph 26 since it had only been developed late in the ESMA deliberations. ESMA did, however, receive initial feedback in respect of this concept from energy regulators who were concerned that it may be detrimental to liquidity in energy markets and therefore may go against the goals of the Third Energy Package. ESMA however agreed to include it in ESMA’s Technical Advice, in order to frame the C.6 exemption in line with the principles described in Recital 10 of MiFID II. In fact, such contracts, which according to MiFID should carry an enforceable and binding obligation to physically deliver, could in theory be sized in a manner that would render delivery or receipt physically impossible in comparison with the storage, consumption or production capabilities of the counterparties. They would, in ESMA’s view, run contrary to the line expressed in Recital 10 of MiFID II.”.
(12) In general, the Agency agrees with ESMA’s views laid down in its Technical Advice.

(13) However, the Agency is concerned that the explanatory text in paragraphs 26 and 27 could lead to a misinterpretation of ESMA’s Technical Advice if it were to require that only counterparties with production, consumption or storage capabilities may enter into “must be physically settled” contracts. Such misinterpretation could have several adverse impacts and undermine the concept of intermediation at the basis of liberalisation of energy markets. The Agency therefore supports ESMA’s Technical Advice with the following clarifications.

(14) The Agency clarifies that in both gas and electricity markets, several market participants (for example, the retail gas and electricity suppliers and gas shippers) may not have any storage, consumption or production capabilities. These operators bring together producers and consumers contributing to the foundation of a competitive energy market: the single European energy market that is the Third Energy Package aims to establish.

(15) Wholesale energy market participants may move energy from one part of the network to another without producing and/or consuming it. Without the presence of these market participants it would not be possible to have well-functioning, liquid wholesale energy market. Consuming or producing the energy commodity should not be considered a prerequisite for defining what is physically delivered. In fact the “provisions which ensure that parties to the contract have proportionate arrangements in place to be able to make or take delivery of the underlying commodity” or “another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods”, as indicated in ESMA’s Technical Advice, suffice to guarantee the physical delivery of the commodity. Most likely, the energy commodity which is ultimately delivered in the network has passed hands several times before it is consumed by the final user.

(16) The Agency also believes that derivatives that “must be physically settled” should be understood as contracts that cannot be settled in cash or financially. Since only two types of settlement exist for derivatives, if a contract cannot be settled in cash, it must be physically settled. There is no other alternative.

(17) With regard to commodity derivatives and physically settled contracts, the Agency believes that there is still some uncertainty around their meaning. In particular the Agency believes that the wording “must be physically settled” does not refer only to the commodity, but to the derivative contract that must be physically settled.

(18) The Agency believes that wholesale energy products falling under the scope of REMIT and which must be physically settled include futures, option on futures,
option on swaps and any other type of derivative that must be physically settled. This means that an option that must be settled with the physical delivery of a future or swap shall be considered as a "must be physically settled" derivative.

(19) Furthermore, the Agency believes that sometimes the distinction between forward contracts that can be settled in cash or with physical delivery (which are derivatives) and forward contract that must be settled with physical delivery (which are not derivatives) is not yet spelled out properly. The lack of guidance creates confusion among market players and sometimes contracts that have to be settled with physical delivery are understood to be derivatives when they are not. The Commission’s delegated acts should aim at clarifying this issue,

HEREBY RECOMMENDS THAT:

The Commission’s delegated acts clarify that the “provisions which ensure that parties to the contract have proportionate arrangements in place to be able to make or take delivery of the underlying commodity” or “another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods”, as indicated by ESMA’s Technical Advice, suffice to guarantee the physical delivery of the commodity.

The Commission’s delegated acts clarify that if a wholesale energy derivative contract traded on an OTF cannot be settled in cash, it must be physically settled and therefore this is falling outside the scope of Annex I C.6 of MiFID II.

The Commission’s delegated acts clarify that forward contracts that must be settled with physical delivery (which are not derivatives) do not fall under the scope Annex I C.6 of MiFID II.

This Recommendation is addressed to the European Commission.

Done at Ljubljana on 17 March 2015.

For the Agency:

Alberto Pototschnig
Director
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