The development of the European electricity market in a juridical no man's land

Pront-van Bommel, S.

DOI
10.1007/978-3-642-19709-3_10

Publication date
2011

Document Version
Final published version

Published in
Financial aspects in energy: a European perspective

Chapter 10
The Development of the European Electricity Market in a Juridical No Man's Land

Simone Pront-van Bommel

Abstract Energy trade, including trade in energy derivatives, may entail various potential risks. Conceivably, these risks could jeopardize European Union objectives, such as consumer protection. Under the European Third Energy Package, which recently entered into force, Member States are required to confer new competencies upon national energy regulators to regulate this type of trade.

This chapter elaborates on the sector-specific regulation of the financial aspects of energy trade, with reference to several types of energy contracts. It also deals with the overlaps and differences between this particular type of regulation and financial regulation in general. Furthermore, the article explores whether the current regulation of trade in energy derivatives is sufficient.

Keywords Agency for the Cooperation of Energy Regulators · Energy derivative trading · Energy market manipulation · Energy trading · Supervision

10.1 Introduction

Financial and energy markets are becoming more and more intertwined. This development is especially illustrated by the strong growth in energy derivatives trading by energy companies and financial institutions. Derivatives' trading is associated with financial risk management[1] and its default is regarded as one of the main causes of the onset of the Financial Crisis[2] of 2008, which continues years

[1]Pilipovic (2007).

[2]Report of the De Larosière Group, 25 February 2009; Communication from the Commission, Ensuring efficient, safe and sound derivatives markets, COM (2009) 332 final, Brussels, 03.07.2009, p. 2.

S. Pront-van Bommel (✉)
The author is Director of the Amsterdam Centre for Energy within the Faculty of Law, University of Amsterdam
e-mail: S.Pront-vanBommel@uva.nl

A. Dorsman et al. (eds.), *Financial Aspects in Energy*,
DOI 10.1007/978-3-642-19709-3_10,

after. This implies also a system risk by undermining the trust required for the stability of the banking sector and the financial services industry. Its consequences were severe for the economies involved and left lasting impact on budget regimes of many governments all over the world. Billions of dollars of government support were required urgently to prevent a total collapse of the financial sector.

Risk features involved in energy derivatives trading may be regarded as similar to those of financial derivatives. It could be claimed that the general interest involved is comparable because of the utility function of large international energy companies. Moreover some very large energy companies dominate the wholesale market. Those companies as well as the large financial institutions and system banks are strongly interdependent.

The likelihood of financial risks resulting from derivatives trading can be illustrated by the number of companies that have suffered significant losses in derivatives markets.[3] Enron's collapse for instance revealed the problems of credit risk and default risk involved in the use of electricity derivatives. Halfway through the year 2000, however, California's electricity market virtually collapsed, causing a major utility provider to file for bankruptcy and another to accept huge financial losses,[4] among others also because of Enron's market manipulation and fraud. Another relevant case involves manipulation of the final, or rather "settlement" price of the NYMEX Natural Gas Future Contracts on February 24, March 29 and April 26, 2006, by selling an extraordinary amount of these contracts during the last 30 min of trading within validity of futures contracts expired, with the effect of driving down the settlement price.[5] Such market manipulations and potential risks ask for government supervisions and remedies.[6]

Because of these potential risks[7] it is relevant to answer the question whether or not supervision of the energy sector is sufficient bearing in mind increasing significance of the financial aspects involved in energy trade. This article aims to answer this question, thereby focusing on both the electricity and gas sector. European Union (EU) legislation that came into force recently aims to expand the supervision on energy derivatives and other energy contracts. This article will be limited to the EU legislation and will be oriented around the position of energy companies. Reason therefore is the recent enforcement of new European legislation, as a part of the European Third Energy Package,[8] which aims amongst other

[3]E.g. Connecticut's investigation of the State trash authority's loss of $220 million in a failed deal with Enron: Zielbauer 2002).

[4]U.S. Energy Information Administration (2002). "Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries", SR/SMG/2002-01, pp. 29–31.

[5]Federal Energy Regulatory Commission (2007).

[6]U.S. Energy Information Administration (2002), p. 31: "In March and October 2001, for example, the FERC ordered California power wholesalers to refund tens of millions of dollars in overcharges."

[7]U.S. Senate (2007).

[8]The Third Energy Package is a set of adjustments and new legislation for the directive of the European Parliament and of the Council amending Directive 2003/54/EC of the European

remedies to strengthen government supervision in regard to market manipulation by energy derivatives trading.

The urgency of this matter evolves from the magnitude of the trading positions of large energy companies, which is many times larger than their original core activity being the supply of energy.[9] Also the dominance of the market by only a few large energy companies makes this issue a matter of public interest.[10]

In this article the following issues will be explored: the variety of energy contracts and energy markets, the substance of relevant EU rules and legislation and their ratio to the general European financial legislation. Overlaps and gaps in governmental supervision on energy trading will be defined. For example, a remarkable gap is the lack of adequate legal objective criteria to access energy (derivatives) trading. The description will be made from the perspective of a proper functioning of the internal EU market and the European legal requirement of a reasonable price for energy for small consumers (households and small and medium sized business). This is one of the central objectives of the Third Electricity Directive and Third Gas Directives (Third Energy Directives).[11] Governmental supervision on energy trading will be expanded in accordance with these recent directives.[12] This is a sector-specific supervision.

The new legislation for energy is complementary to the Markets in Financial Instruments Directive[13] (MiFID) in which *general* rules for supervision on the

Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity; for a directive of the European Parliament and of the Council amending directive amending Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas; for regulation of the European Parliament and of the Council amending Directive establishing an Agency for the Cooperation of Energy Regulators; for a regulation of the European Parliament and of the Council amending Directive amending Regulation (EC) No 1228/2003 and for a regulation of the European Parliament and of the Council amending Directive amending Regulation (EC) No 1775/2005, adopted on 3 September 2009.

[9]It is pointed out by Jessayan (2009) that companies are being confronted with multibillion risks due to speculation. This author illustrates that the size of the trading activities in the energy business is many times larger than the size of the original core activities. Moreover it is argued that adequate supervision on the risks involved is largely absent. Energy companies only rely on their own internal risk management systems.

[10]Communication from the Commission to the Council and the European Parliament, Report on progress in creating the internal gas and electricity market, COM (2010) 84 final, Brussels, 11.3.2010, p. 5 and 8.

[11]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, OJ C 211, 14.8.2009, recitals 1–6, 37, 42, 45, 50; Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in gas and repealing Directive 2003/55/EC, OJ C 211, 14.8.2009, recitals 1–4, 43, 47.

[12]The new directives of the Third Energy Package have to be transposed correctly by 3 March 2011.

[13]Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004, on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and

financial and banking sector are defined. This article will depart from this set of rules as well as the interrelation of both kinds of European directives.

This chapter also takes into account private mechanisms, especially the master agreements issued by leading European or international umbrella organizations such as European Federation of Energy Traders (EFET).

10.2 Various Types of Energy Trading Contracts

10.2.1 General

The reach of governmental supervision on energy trading is dependent on the type of contract being traded, the parties involved and the location of execution of the transaction. In order to address its supervision in more detail a general overview of the various sorts of energy trading, especially derivatives, is required.

10.2.2 Day-Ahead Market

First of all there are the short-term energy contracts with a short and limited time span. This contract is the one that will be cleared and settled within 24 h. The short-term contracts are considered to be part of the day-ahead market or spot market (spot contracts). Moreover, short-term contracts have a less far-reaching regime of supervision than the long term contracts to be dealt with later in this chapter. This market falls beyond the scope of the MiFID, which will be explained in the next paragraphs. It should be emphasized that a short-term contract is to be considered short-term when the trade is being cleared and settled within two trading days.[14]

Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145 30.4.2004 (MiFID).

[14]Art. 38(2) Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive, OJ L 241 1, 30.4.2004 (MiFID Implementing Regulation). It stipulates that a contract is not a spot contract if, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the period mentioned in the first subparagraph. Art. 38(2)b stipulates further: "A spot contract for the purposes of paragraph 1 means a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the period generally accepted in the market for that commodity, asset or right as the standard delivery period".

10.2.3 Long-Term Energy Contracts

The other category of energy contracts is being defined as long-term energy contracts. The so called model contracts of the European Federation of Energy Traders are exemplary and are often used in the wholesale market.

10.2.4 Commodity Contracts and Energy Derivatives

According to ‘real’ commodity contracts, the buyer is under contractual obligation to take the stipulated volume of energy agreed upon at the contractually fixed price.

Energy contracts often provide a clause in which the opportunity is being offered for a financial settlement without the actual delivery of energy. The buyer pays the seller a price related to the volume of the energy not physically taken up. Moreover parties could agree on exclusive cash settlement contracts, which is a way of settling contract by cash instead of by a physical transaction. In these long-term contracts it will generally depend on the actual market price for energy at any given moment which party will have which payment obligation and which party will receive the actual payment.[15] These contracts are described as derivatives according to the EU Financial legislation.

Derivatives are contracts in which the value is derived from underlying assets such as electric power and gas.[16] Derivatives trading can serve several purposes between hedging financial risks to making an investment to sheer speculation.[17] Derivatives are perceived as crucial risk management instruments in an open market environment.[18] The various types of derivatives need to be described in detail in order to determine which law applies.

On the other hand, electricity futures contracts are such financial instruments. These contracts differ from forward contracts insomuch that a highly standardized fixed price is established for the delivery or purchase of a certain quantity of electric power at some time in the future usually, during peak hours for a period of a month. Another key feature of futures contracts is that these are traded exclusively on regulated exchanges, reason why the MiFID applies.

[15]EFET (2007b). General Agreement, Concerning the Delivery and Acceptance of Electricity, Version 2.1(a)/ 21 September, par 8; EFET (2007a). General Agreement Concerning The Delivery And Acceptance Of Natural Gas, Version 2.0 (a)/11 May.

[16]Hull (2009) and Marthinsen (2009), COM (2010) 84 final, p. 8.

[17]Hull (2009); Communication from the Commission, Ensuring efficient, safe and sound derivatives markets, COM (2009) 332 final, Brussels, 03.07.2009, pp. 3–5.

[18]Deng and Oren (2006); COM (2009) 332 final, pp. 3–5.

Electricity swap contracts, a different kind of energy contracts for a specified quantity of electric power, are based on the variable spot price at either the generator's or consumer's location. Basis swaps are also commonly used to lock in a fixed price at a location other than the delivery point of the futures contract. Specifically, the holder of an electricity basis swap has agreed to either pay or receive the difference between the specified contract price and the local spot price at the time of the transaction. These contracts can be traded 'over the counter'.

The derivative option, also common in the OTC market, typically holds flexible consumption terms. An option gives the buyer the right but no obligation to purchase additional electric power at a fixed price. Instead of energy delivery, the purchaser can decide on a cash settlement. *Spark spreads* are cross-commodity options designed to minimize differences between the price of electricity sold by generators and the price of the fuels used to generate it.[19]

10.2.5 Greenhouse Gas Emission Allowance Trading

Another energy trading aspect is greenhouse gas emission allowance trading. The legal base for this CO_2-trading system is Directive 2003/87/EC adapted by Directive 2004/101/EC.[20] In this directive a system for awarding CO_2-allowances is set up for the period after January 1 2013.[21] This type of trading will strongly affect the price setting of energy including the price for electricity for consumers. However for reasons of practicality CO_2-trading falls outside the scope of this article since CO_2-trading is not covered by the previously mentioned EU directives. However it is worthwhile to stress that there is a substantial growth in the CO_2-trade with all the risks associated for the ultimate price of electric power.

[19]U.S. Energy Information Administration (2002), p. 31.

[20]Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003, establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, OJ L 275, 25.10.2003. Amended by: Directive 2004/101/EC of 27 October 2004 L 338 18 13.11.2004, Directive 2008/101/EC of 19 November 2008 L 8 3 13.1.2009, Regulation (EC) No 219/2009 of 11 March 2009 L 87 109 31.3.2009, Directive 2009/29/EC of 23 April 2009, L 140 63, 5.6.2009.

In line with Article 32, Directive 2003/87/EC, this directive entered into force on the day of its publication in the Official Journal of the European Union, 25 October 2003.

[21]See Art. 2 Directive 2009/29/EC of the European Parliament and of the Council of 23 April 2009 amending Directive 2003/87/EC to improve and extend the greenhouse gas emission allowance trading scheme of the Community, OJ L 140, 5.6.2009. See also: COM (2008) 16 Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community, COM (2008) 16 final, Brussels, 23.1.2008.

10.3 Supervision on Financial Conditions in Energy Contracts in Accordance with the Third Energy Directives

10.3.1 General

Recently included definitions in the Third Energy Directives expand the supervision of energy trading.[22] Article 40, Third Electricity Directive, and Article 44, Third Gas Directive, force EU Member States to include in their national energy legislation the obligation of extended administrative and information obligations related to energy contracts. This kind of regulation is new[23] and was therefore not included in the Second Power and Gas Directives.[24]

Based on the new provisions, Member States are obliged to enforce energy companies to keep, for a period of at least 5 years, records of all the relevant transaction data concerning their energy trading activities with large end-users and transport system operators and to supply these data to national regulatory authorities including the competition agencies and the European Commission to enable them the execution of their tasks. These data comprise particulars like the specifics of the transactions involved such as the duration, delivery and payment arrangements, volumes, expiry dates and timing, transaction prices and means to identify the large end-user involved. Moreover specific other relevant details are required about all open delivery contracts and energy derivatives. Based on Article 40 of the Third Power Directive and Article 44 of the Third Gas Directive, all Member States are obliged to give their national "energy regulator" the authority to publish (a part of) the data required as described above.[25]

By setting these administrative and information terms the European Commission aims to enhance existing supervision on suppliers by obligating them to file trading

[22]Directive 2009/72/EC, recitals 4 and 39; Directive 2009/73/EC, recitals 4 and 36.

[23]Directive 2009/72/EC, recitals 4 and 39; Directive 2009/73/EC, recitals 4 and 36.

[24]Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/54/EC concerning common rules for the internal market in electricity, COM (2007) 528 final, Brussels, 19.9.2007, p. 8–9; Commission Staff Working Document, Accompanying the legislative package on the internal market for electricity and gas, Impact Assessment, SEC (2007) 1170, Brussels 19.9.2007, pp. 45–46.

[25]CESR and ERGEG advice to the European Commission in the context of the Third Energy Package, record-keeping, transparency, exchange of information, CESR/08-998, December 2008, p. 43 a.f.: "The regulatory authority may decide to make available to market participants elements of this information provided that commercially sensitive information on individual market players or individual transactions is not released. This paragraph shall not apply to information about financial instruments, which fall within the scope of Directive 2004/39/EC. [. . .] The three different options for publication presented for consultation were: mandatory' publication by the energy regulator (M3), dissemination by energy regulators based on the assessment of the sufficiency of existing information (M2) and keeping the status quo (M1)."

data and keep their records available for audits by the national Energy Authority (or Energy Supervisor). These obligations are meant to enlarge the transparency of the energy trading and to counteract market abuse. The national Energy Authorities are in charge of the execution of this system of surveillance.[26]

These new rules apply to both short-term day-ahead contracts and long-term energy contracts alike. They also apply to the so called “real” commodity contracts. The new rules can also be applied to energy derivatives.[27]

Because of the nature of this kind of legislation, the conditions of the directives do not impose direct obligations to market parties. Based on Article 288 of the Treaty on the functioning of the EU (TFEU) directives can only impose obligations on Member States,[28] which can fulfill these obligations by implementing the regulations of the directives in their own national legal order.[29] In most cases this is done by way of national legislation. In this specific situation it will most likely be national energy legislation.

Implemented in existing national legislation, energy companies in general will already have the obligation to supply company and operational data at the request of the supervisory authority. Relevant for this article is that the new Directives provide an obligation for the energy suppliers to archive certain contract details and authorize the national Energy Authorities to publish their findings and make market information available.

10.3.2 Background and Objectives

By making these new supervisory rules in the Third Energy Directives, the European Council and Parliament, the communitarian legislator, followed the mutual advices of the Committee of European Securities Regulators (CESR), the European Regulators Group for Electricity and Gas (ERGEG) and other advisory committees

[26]Directive 2009/72/EC, recitals 33, 34 and 39; Directive 2009/73/EC, recitals 29, 30 and 36; COM (2007) 528 final, pp. 8–9.

[27]Art. 40 Directive 2009/72/EC and Art. 50 Directive 2009/73/EC.

[28]“To exercise the Union’s competences, the institutions shall adopt regulations, directives, decisions, recommendations and opinions. A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States. A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods. A decision shall be binding in its entirety. A decision that specifies those to whom it is addressed shall be binding only on them. Recommendations and opinions shall have no binding force.”

[29]Hartley (2006) and Horspool and Humphreys (2006).

and organizations.[30] CESR and ERGEG are authorized to advise the European Commission.[31]

The starting point for the recommendations of both CESR and ERGEG is a well-functioning energy market. It was assumed that such a well-functioning market does not yet exist.[32]

Factors to determine the well functioning are price setting without manipulation and market abuse, liquidity, efficiency and a complete market. Put simply, a market is liquid when there are many buyers and sellers with easy access to one another. Information on market prices must be made available to market participants. Transparency of the market is a precondition as is the requirement of a well functioning market. The intended extension of the supervision in the Third Energy Directives is meant to increase transparency and prevent market abuse, as well as to enhance market trust, liquidity of the market and the number of market participants.[33]

Both advisory committees and the European Commission had serious indications to suspect market abuse.[34] "Market abuse" is assumed present when there is foreknowledge in trading with energy derivatives, "insider trading" and price manipulation by obtaining certain market positions[35] for example on imbalance markets and on energy exchanges. These suspicions were amongst others reason to advise the expansion of the supervision.

---

[30]CESR and ERGEG advice to the European Commission in the context of the Third Energy Package, record-keeping, transparency, exchange of information, CESR/08-998, December 2008; CESR and ERGEG advice to the European Commission in the context of the Third Energy Package, market abuse, CESR/08-739, October 2008. These advices are given in the context of the Third Energy Package, a set of proposals for new directives amending Directive 2003/54/EC and Directive 2003/55/EC.

[31]CESR is an independent Committee of European Securities Regulators, which was established under the terms of the European Commission Decision of 23 January 2009 (2009/77/EC). One of the tasks of CESR is to improve co-ordination among securities regulators; act as an advisory group to assist the EU commission relating to the field of securities; work to ensure more consistent and timely implementation of community legislation in the Member States. CESR has several working groups consisting of national experts.

ERGEG is the European Regulators' Group for Electricity and Gas, which was set up by the European Commission by the Decision of 11 November 2003, 2003/769/EC, as its advisory body on internal energy market issues. It is made up of the national energy regulatory authorities of the EU Member States. Its purpose is to facilitate a consistent application of regulations in the field of electricity and gas."

[32]CESR and ERGEG advice on market abuse, pp. 30–31; CESR and ERGEG advice on record-keeping, pp. 80–81.

[33]CESR en ERGEG advice on record-keeping, par. 151: "It should be noted that platform operators can also be located outside Member States and offer services for delivery of electricity or gas in Member States. This might result in a gap which cannot be sufficiently addressed with this proposal and may need further considerations in case it becomes relevant." COM (2007) 528 final, pp. 2–4 and 8; Recital 39 Third Electricity Directive 2009/72/EC.

[34]COM (2007) 528 final, Brussels, 19.9.2007, p. 8; CESR and ERGEG advice on market abuse, p. 15.

[35]Compare Art. 1 Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L 96/16, 12.4.2003.

10.3.3 Limited Scope

For the time being the rules set in the new directives have limited meaning when it comes to supervision. Member States are only obliged to implement these administrative and information obligations as soon as the European Commission has established the relevant guidelines to execute the new rules of the directives. In these rules of conduct, the parameters need to be set for the relevant data to be given by energy suppliers and submitted to the national energy supervisors.

The authority to set these rules of conduct has been allocated to the European Commission by Article 40 of the Third Power Directive and Article 44 of the Third Gas Directive and will be binding.[36] The binding character is derived from procedure for regulation the Commission must follow.

The European Commission is however not obliged to set these rules of conduct. This means contingency whether or not the new rules of supervision as described in the Third Energy Directives will ever lead to obligations for the Member States. At present there are no proposals by the Commission to define the rules of conduct.[37]

The scope of the new rules of supervision is also limited as these rules only apply the administration and information obligations to energy supply companies and not to other enterprises and market participants in the energy sector. Supply is defined as (re) selling power to customers.[38] This means that the new rules for supervision do not account for trading in energy derivatives by financial institutions and most probably neither for trading subsidiaries of energy conglomerates that are registered as separate legal entities.

Yet another part of the energy trade falls beyond the range of the new rules. So called "pure" cash settled energy contracts, i.e. energy derivatives with financial settlement only, are not included in the range of rules laid down in the Third Energy Directives and it does not make a difference whether or not an energy company is involved. The same goes for trading in greenhouse emission allowances, as these are not perceived as energy trading. These omissions exist due to the limited mandate of the European Commission in relation to energy legislation.[39]

[36]SEC (2007) 1170, p. 26: "In the current framework, transparency is only partially addressed. ERGEG has therefore already proposed guidelines on transparency and advised the Commission that these should be made legally binding. The Commission intends therefore to introduce binding guidelines for transparency either through new legislation or by modifying the existing electricity Regulation (EC) No 1228/2003. It also intends to improve the transparency requirements for gas using Regulation (EC) No 1775/2005. While the current regulatory framework has limited scope as far as transparency is concerned, the business as usual is also considered in this report."

In general European directives are not binding directly, see Steiner and Woods (2003).

[37]November 2010.

[38]Art. 1(19) 2009/72/EC.

[39]Art. 47(2), 55 and 95 TFEU.

10.3.4 ACER

By nature energy and energy derivatives trading are cross-border. The former municipally and provincially owned Dutch utility Essent, acquired in 2009 by German energy company RWE, established a large trading operation in Geneva[40] and through their trading activities ended up owning a sizeable derivatives position. This portfolio caused RWE not to offer a specific acquisition price or a broad price range. RWE wanted to avoid any depreciation on the acquisition price of Essent in case of expected losses on the Essent market positions.[41] National supervision is not sufficient for these kinds of cross-border activities and their consequences. Cross-border trading requires cooperation between national supervisors or possibly a supranational or European supervisor. The recent establishment of the Agency for the Cooperation of Energy Regulators (ACER) might provide in this as far as the Third Energy Directives are involved.

As of March 3, 2011, ACER will begin its work.[42] The general task of ACER is to advise the European Council, Commission and Parliament and provide a platform for cooperation between the national Energy Authorities of all Member States and for mutual decision making. Other tasks of ACER are related to the cooperation of Transmission System Operators aimed at the accomplishment of a European internal market and setting up non-binding guidelines for the codes relating to cross-border trading activities on behalf of the European Commission. ACER has the legal authority to make binding rulings with regard to technical issues in individual cases as far as international trade is concerned and as long as these technical issues are required by the Third Energy Directives and Ordinances. Its competence to make binding decisions is limited. Further-reaching competences to make politically as well as (generally) binding decisions would be incompatible with European institutional law (Meroni doctrine).[43]

Furthermore ACER has been assigned to advise the Commission in regard to decisions of national Energy Authorities and verify whether or not these decisions are in accordance with the rules of conduct as laid down in the Third Energy Directives by the Commission. This authority might encompass energy derivatives trading.

ACER has a broad working area, which coincides with the Third Energy Directives. The supervision by ACER might affect consumer protection as far as power and gas prices are concerned. As will be illustrated in Sect. 10.5 derivatives trading could influence energy prices and the protection of consumers could be at risk.

---

[40] Former Essent Trading International SA.

[41] Jessayan (2009).

[42] Art. 35(2) of Regulation 713/2009/EC of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators, OJ L 211 14.8.2009.

[43] Case 9/56, Meroni & Co Industrie Metallurgiche ApA v High Authority of the European Coal and Steel Community, (1958) ECR 11. Cf. Hancher, L., Hauteclocque, A. de (2010). "Manufacturing the EU Energy Markets: the Current Dynamics of Regulatory Practice", *European University Institute Working Paper*, RSCAS 2010/01.

This public interest could suffer from abuse of market power according to the Third Energy Directives, whereas the extension of supervision on energy trade is specifically meant to prevent this kind of market abuse.

The competences of ACER are discretionary by nature. Practice will show the intensity of ACER's involvement and how much bearing this will have on the "policy agenda" of the national Energy Authorities.[44] The latter will also depend on the extent to which the European Commission will adopt ACER advices. ACER will most likely become for the national Energy Authorities a growing power to be reckoned with. They have to cooperate within the context of ACER, when it comes to decision making by the EU. Mutual decision making will take place within the frames of the institutionalized forum ACER offers. The principle of subsidiarity implies that it is to be expected that ACER will only deal with those cases where national supervision seems inadequate. However this principle allows room for manoeuvring into various explanations, possibly also in favour of a more activist approach of ACER by calling upon the authorities assigned to ACER,[45] which could very well be the case when energy derivatives trading comes into focus.

10.4 General Financial Supervision on Energy Contracts According to MiFID

10.4.1 Sector-Specific Supervision in Addition to General Financial Supervision

Articles 40 of the Third Power Directive and 44 of the Third Gas Directive provide a sector-specific supervision solely for the energy sector. This system of supervision is meant as a supplement to the general financial supervision based on MiFID. Taking into account the history of the European lawmaking overlaps are to be avoided.[46] However, MiFID could be applied for energy trading. This will be examined specifically as to whether or not applicable financial legislation will fill the gaps as mentioned before. Also gaps or overlaps between the Third Power and Gas Directives and the MiFID will be subject to evaluation. Again, the MiFID offers only direct obligations for Member States to comply with their national financial legislation. The time frame for implementation is long overdue.[47]

[44] COM (2010) 84 final, p. 12.

[45] Haverbeke et al. (2010).

[46] COM (2007) 528 final, pp. 8–9; CESR and ERGEG advice on record keeping.

[47] Art. 53(1) and (2) MiFID.

10.4.2 Financial Instruments

Supervision based on MiFID is limited to financial instruments as defined in the Directive. Financial instruments are described in this directive as securities and other explicitly mentioned financial products, such as commodity derivatives including energy derivatives.[48]

Trading of short-term energy contracts, even those with cash settlement only, is out of reach of the MiFID.[49] Reason for this is applicability to financial instruments only, the definition of which is included in MiFID. MiFID is only applicable to energy derivatives and CO_2-derivatives and not relevant for short-term energy contracts. The result is a considerable narrowness of the supervision based upon the MiFID.

10.4.3 The Market Place

Financial supervision based on MiFID depends on the type of market place where derivatives are traded. MiFID applies solely for trading on a “regulated market”,[50] which is often described as an exchange, and the “multilateral trading facility” (MTF).[51] Europe has a number of energy exchanges where energy derivatives are being traded, such as APX-Endex,[52] EEX, Powernext and Nasdag OMX. These are regulated exchanges as defined by MiFID.

A regulated market has the following characteristics. Financial instruments are being traded as described in title II of the MiFID. There is a set of rules in relation to membership, the admission to trade financial instruments, trading between members, references to transactions and transaction obligations and so forth. These general conditions are meant to offer a far-reaching level of standardization

[48] Art. 4(17) juncto Annex I part C, MiFID.

[49] Art. 38(2) MiFID Implementing Regulation.

[50] See Art. 4(2) 14 MiFID: “Regulated market’ means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III.”

[51] See Art. 4(2) 15 MiFID: “‘Multilateral trading facility (MTF)’ means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II.”

[52] On 24 October 2004, Endex was designated as an exchange by the Minister of Finance of the Netherlands.

of transactions on this market.[53] Multilateral trading facilities have these characteristics.[54]

The difference between these regulated markets and a MTF is the quality of control for the admission of financial instruments. Only regulated markets have this quality.[55] The quality control is conducted by the (private) operator of the market. If the operator is not living up to this obligation he can be confronted with governmental upholding measures.[56]

Based on the general contractual terms and conditions used by the private operator of the specific market place an assessment can be made by the national Financial Authority whether or not there are relevant quality requirements towards the market participants.[57] The quality demands are meant to offer guarantees for the trade on the regulated market. Member States are under obligation to establish a system of allowances and permissions for the regulated market that covers these requirements.[58]

10.4.4 The Nature of the Trading Activity

The applicability of MiFID depends on the nature of the trading activity or service involved. This is defined by offering investment services or executing investment activities. A company involved in these services or activities is not allowed to operate on the financial markets without an *entrance* permission.[59] Furthermore, business transactions are subjected to behavioral and prudency rules as included in MiFID. Investment companies trading energy derivatives outside a regulated market or MTF can fall under the scope of MiFID.

[53]See recital 6 and Art. 4(4) MiFID; Proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, COM (2002) 625 final, Brussels, 19.11.2002, pp. 15–18.

[54]Catá Backer (2008).

[55]Cf. Art. 37(1) MiFID Implementing Regulation. This rule has direct effect in the national legal order and should therefore not be implemented in national legislation.

[56]Recital 4 MiFID.

[57]See ENDEX Rules (Version 12.0), February 2010. See also for quality requirements for these products e.g. Par. 1–19 ‘Eligible Products’ and Appendix C. See also Art. 40(4) en 43(1) and (2) MiFID; Art. 37 MiFID Implementing Regulation.

[58]Recital 49 MiFID; Art. 36 MiFID.

[59]Art. 5 MiFID.

10.4.5 Exceptions

Despite the above, there are various exceptions to MiFID supervision to be seen in this field. Investments services and investment activities are excluded when these services or activities are executed by investment companies, whose core activity is trading for their own account in instruments derived from commodities and when those companies are not part of a group whose core activity is investment services. Furthermore those are excluded when they are not part of the execution of investment activities or the execution of banking services; or when trading for their own account of offering investment services on a group level that is to be considered a non core activity of the main company and the main company of the group is not primarily engaged in trading investment services, execution of investment activities or the execution of operating a bank.[60]

These companies are excluded when their trading remains within the group of companies.[61] Energy companies with a package of energy derivatives involved with investments services or activities as part of their trading portfolios will be able to apply for one or more of these exceptions,[62] if and when the trading in energy derivatives is meant for risk management purposes only and for spreading risks and not intended primarily for speculative purposes, thus avoiding acting in conflict with client interests which is one of the key objectives of MiFID. It will therefore be difficult for companies to hold a large package of energy derivatives. The margins between risk control and the structural efforts to make financial returns by using these derivatives are hard to set.

It is obvious that financial institutions that operate business wisely in setting their targets for making profits on commodity transactions or security trading derived from commodities are not in a position to fall under the exemption.

10.4.6 Purpose of Supervision Based on MiFID

The purpose of MiFID diverts considerably from the aims as described before in regard with the Articles 40 and 44 of the Third Power Directive and the Third Gas Directive respectively. The purpose of MiFID is primarily the protection of

[60]Art. 2(1) i and k, MiFID.

[61]European Commission, Internal Market and Services DG, Background document for the public hearing on commodity derivatives, Brussels, September 2008, p. 2: "It is important to note that the existing exemptions in the CAD were meant to be non-permanent. They are scheduled to expire in 2010, but the Commission services would prefer to extend them to 2012 in order to buy time for a more thorough review. Clearly, this extension is by no means intended to prejudge the fate of these exemptions after 2012."

[62]Art. 2(1) b MiFID. See recital 22 MiFID Implementing Regulation; CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, CESR/05-290b, April 2005.

consumers, the guarantee of the stability of the financial system (system supervision) and the guarantee of the financial solvency of financial institutions and in doing so in securing the general trust in the financial sector. The guarantee of the stability of the financial system can be seen as the main objective of the European governments' intention to expand their supervision on the financial system after the recent credit crisis. MiFID is primarily focused on client protection. This could explain why trading in energy derivatives by energy companies falls outside the scope of the financial supervision because of risk management purposes. Consumer protection is hardly the issue here.

A client could be a consumer, being defined as a person not involved in the execution of a job or function within a company. A client protected by legislation could be an entrepreneur or a company without the required skills. There are three categories of clients to be distinguished: the relevant counter party, the professional investor and the non-professional investor. This splitting up of clients into categories is relevant for the degree of protection of the investor and for answering the question which set of rules of conduct is applicable for an investment company. A client in the category of relevant counterparty has the lowest level of protection. The non-professional investor is the best-protected category.

The new supervision on energy trading based on the Third Electricity and Gas Directives serves a specific purpose. It is aimed primarily and mainly at promoting the well functioning of the market. Consumer protection is not considered a primary goal.

Furthermore, it is important to note that the stability of the energy sector is not an aim in itself for the expansion of the supervision on energy contracts to the European legislation.

10.4.7 Gaps and Overlaps

After the implementation of the Articles 40 of the Third Electricity Directive and 44 of the Third Gas Directive energy derivatives traded on a regulated market or MFT could fall under two distinct sets of supervision regimes: i.e. MiFID and sector specific supervision based on the two energy directives. Both models of supervision are different when it comes to substance and tendency.

The larger part of energy trading, including trading in energy derivatives, falls outside the scope of MiFID, also because of exemptions obtained from MiFID for investment activities and services as mentioned before. This trade will be partly subjected to the extended supervision of the new Third Power and Gas Directives after its implementation by the Member States and after the realization of the above-mentioned European Commission guidelines. However, the latter has a more limited scope than the financial supervision based on MiFID as explained earlier in this chapter.

Other parts of the energy trade, such as cash settlement contracts traded outside a regulated market or MFT, will also remain outside the domain covered by both forms of supervision.

10.4.8 Possible Adjustments

Articles 40 Third Electricity Directive and 44 Third Gas Directive were intended as complementary to Financial regulation based upon the MiFID and other European directives such as the Market Abuse Directive (MAD).[63]

Important developments in the field of financial regulation, which are to be expected within the near future, will lead to further expansion of the power of the national Energy Authority. In the first place, when proposals by the European Commission in regard to the amendment of the MiFID and its related derivatives, such as the MAD, become effective. The goal of the mentioned proposals is to ensure efficient, safe and sound derivatives markets. In that regard it is expected that a relevant part of the energy derivatives trade shall mandatory take place in reglemented exchange markets. Besides, in the event that a more restrictive interpretation of the statutory exceptions for investment services and – activities as currently practiced occurs, the supervision of the national Financial Authority will be extended. These exceptions have been elaborated in the previous paragraphs.[64]

As a result of the financial crisis the Commission recently presented proposals for strengthening guarantees concerning derivatives trade. These proposals could also affect the energy derivatives trade and could for instance include new provisions for mandatory trade in reglemented markets, resulting into the required transition from predominantly bilateral trade to more centralized trading on regulated markets. The Commission has stated that financial regulation and supervision of government on the energy sector are urgent.[65] If these proposals will lead to European legislation they could have far-reaching consequences for both the national Energy Authority and the national Financial Authority. The subdivision of competences will need to be reviewed by the Member States and agreed on between both supervisors.

---

[63]Market Abuse Directive, 2003/6/EC. An adaptation of this law is currently being prepared, see i.a. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committe of the Regions and The European Central Bank. Ensuring efficient, safe and sound derivatives markets: Future policy actions, COM (2009) 563 final, Brussels 20.10.2009, p. 10.

[64]Art. 4(1) 2 MiFID.

[65]COM (2009) 563 final, i.a. p. 2. Further proposals for European financial legislation, adapting the existing, can be expected shortly. A consultation of stakeholders and national governments is completed. Consultation document available at http://ec.europa.eu/internal_market/consultations/2010/derivatives_en.htm

10.4.9 Self-Regulation

Before drawing conclusions about the adequacy of supervision, the scope of existing private regulation, also called self-regulation, has to be considered. Self-regulation is provided, among similar other organisations, by the European Federation of Energy Traders (EFET).[66] Its members are energy traders from all over Europe. This organisation aims to promote and facilitate European energy trading in open, transparent, sustainable and liquid wholesale markets and to enhance the performance of traders and as well as to support the well functioning of those markets. This is done by providing standard solutions to the repetitive aspects of wholesale energy transactions, advocating relevant policies and regulatory measures and encouraging probity, good risk management practices, responsible corporative governance and proper accounting among energy traders. The contract models intend to offer standard solutions to the recurring aspects of wholesale energy transactions.

EFET aspires to adopt within its member companies values such as integrity of action, i.e. not to engage in any activities which could lead to market abuse, market manipulation or fraud, nor relay information known or strongly suspected to be false or misleading, deal with customers fairly and with integrity and manage appropriately any conflicts of interest that may arise. So far, these principles have no contractual binding and the only sanction on violating them could be the exclusion of the concerned party.[67]

The self regulation and private supervision of the EFET are therefore very limited. In the first place, parties are allowed to make alternative arrangements. Moreover its measures to control the conduct of participants are limited, voluntary and of a contractual nature.

10.5 A Proper Market Functioning and Consumer Protection as a Reference

10.5.1 General

Whether or not governmental supervision on the financial aspects of energy contracts is sufficient will primarily be judged in this article from the perspective of a proper market functioning. The promotion of a proper market functioning was, as described before, one of the main considerations for the extension of the rules and regulation for supervision.

[66] EFET (2007a, b).

[67] EFET (2009).

Governmental supervision will also be judged from the perspective of the utility function of the supply of energy to consumers, also one of the foundations of European energy law. Supervision should enable energy suppliers to deal with the risks that could undermine the utility function of energy. The relevant risks will be described and associated with the objectives and fundamental principles of the regulation of energy.

10.5.2 Risks and Uncertainties Relating to Price Setting

A party forced to buy or sell energy at a short notice can be confronted with large financial losses because of unfavorable market prices. This is a particular risk for power markets since power cannot be stored at economically viable terms. There are only limited opportunities for companies to save power for emergencies.

This risk is real in view of the standard long-term energy contracts and their various clauses plus the fact that it is rather difficult to master the art or science of forecasting the actual consumption of electricity. Electricity markets are regarded as highly volatile making power prices swing strongly in prices north- and south-bound (Deng and Oren 2006; Liu and Wu 2007) This risk becomes even stronger in a market with a limited number of participants where there is a strong suggestion of market manipulation, often characterized by lack of transparency. The extension of supervision based on the Third Electricity and Gas Directive aims to specifically improve transparency.

Entering into energy contracts often requires substantial financial amounts for collaterals in order to secure the compliance of a contractual arrangement. These are called "financial securities" or "collaterals". It is often the case that because of price fluctuations extra collateral is required. This could cause cash drain for companies within a very short period of time and cause serious capital problems.

The size of financial securities depends on the rating of the parties involved, attributed by rating agencies to those parties. If one of those parties is unexpectedly forced to buy (extra) energy at unforeseen high prices, to sell a power surplus at unforeseen low prices or to revalue a substantial package of derivatives because of strong fluctuations of the prices, ratings can be adjusted downwards.[68] The trading and financial parties involved are in most of the existing (standard) energy contracts entitled to unilaterally demand additional collateral. This also leads to extra costs

[68]On 5 December 2008, the Norwegian company Eco Energi announced to have suffered considerable losses resulting from "unauthorized" trading transactions. The total size of the losses was not made public by the company. The CEO resigned and the trader was suspended. The company announced to have made all necessary steps to avoid further damage. Cf. the "packaging industry" of financial instruments by using securitisations by Gazprom in the Netherlands: Meeus (2008). Several companies, i.a. E.ON, were confronted with large losses in the third quarter of 2008 because of energy derivatives: Kakebeeke (2008).

and could generate substantial losses for any energy company involved. These circumstances could cause bankruptcies.

The bankruptcy of a large energy company could push prices upwards in a market where a small number of large players dominate with substantial market positions. The default of such a large energy company could also jeopardize financial institutions and other energy companies when they have entered into an extensive package of deals with the defaulting energy company. If this risk materializes, one could expect to see a system risk comparable to those witnessed in the financial sector since 2007. It could happen that large energy suppliers need to give governmental financial support to large groups of end users, in order to safeguard more or less the aforementioned utility service. This risk cannot be ignored, small as it may be. At this moment in time there is no insight if such risks are bound to happen. To be able to judge this risk there is the need of material insight in energy trading and the energy contracts entered into by the energy companies. There should be a set of clear guidelines based on which these risks can be assessed. However, there is no such a set within the European energy policy nor is there legislation.

The previously mentioned risks associated with contracts are even greater in the case of the easier tradable energy derivatives. It is important to stress that the value of such contracts is, in most of the cases, related to the energy price. Strong fluctuations of the energy price could lead to the substantial downwards revaluation of a package of energy derivatives. This is a real risk given the fact that large (traditional) energy companies own considerable packages of energy derivatives. Recently these positions needed to be devalued with hundreds of millions of Euros.

10.6 New Energy Trading Supervision: Sufficient or Not?

10.6.1 General

The forced sale and purchases of power at unfavorable prices, price fluctuations and possible market abuse are primarily related to the pricing mechanism on the wholesale market but ultimately influence the interest of the (small) end user. High prices at the wholesale market are strongly correlated with the price increases of consumers need to pay for their power, given the fact that a small group of energy companies enjoys a dominant market position within the EU.

It is relevant to pose the question whether or not an Energy Authority should supervise the pricing mechanism and the price fluctuations. Governmental supervision would be justified if one of the main objectives and principles of the energy legislation were at stake.

This includes not only a well-functioning market, but also the guarantees of power supply to small end users at “fair” prices. This is considered a utility provision. Supervision of energy contracts and in particular the trade in energy derivatives by energy companies should (also) serve to protect these objectives and principles.

In addition both supervision of energy trading and pricing mechanism should serve to protect the stability of the energy sector, based on the idea that the supply of electricity and gas at fair prices is essential not only to guarantee the universal service obligation to small end users but also for assuring the survival of entire economies.

10.6.2 Consumer Protection: Reasonable Price for Energy

A last issue of importance that needs to be dealt with, concerns the fair price. The fair price is not specified in the Third Energy Packages. This is an important consideration for the recent European legislation with regard to the expansion of the supervision of energy contracts.

A reasonable price and the stability of the energy sector are essential components of the 'universal service obligation'. The universal service obligation refers to services considered to be of fundamental interest from a societal perspective, such as power. These are referred to as 'services of general economic interest'.[69] This universal service obligation consists of a defined minimum package of services of a certain quality available to all users, notwithstanding their geographical location, at a fair price, taking into consideration specific national circumstances.[70] This results in the availability of utility services for everyone, and consumers in particular, under reasonable conditions, such as more or less affordable prices. In relation to the energy sector more specifically, the entitlement to the universal service obligation is based on Article 3 clause 3 Third Power Directive and Article 3 clause 2 Third Gas Directive. The Gas Directive is less far-reaching than the Power Directive. Based on these rules, end users are entitled to a guaranteed supply of energy at reasonable prices.

To be able to establish potential gaps in the supervision of energy trading and related financial risks, the universal service obligation was taken as a starting point in this article. Supervision of energy trading is justified when financial risks are at stake with potentially far-reaching consequences for the energy price to be paid by consumers, or risks that could lead to a system risk comparable to those as manifested in the financial and banking sector since 2007.[71]

[69]Green Paper on Services of General Interest, COM (2003) 270 final, Brussels, 21.5.2003, pp. 16–19.

[70]Damme et al. (1998) and Devroe (2000).

[71]What defines a 'reasonable' price is not elaborated on in this chapter given that further discussion on this issue may require a separate publication.

10.6.3 Gaps

From this perspective the supervision of energy trading has several gaps. A practical but essential gap is that the new articles on supervision as defined in the Third Power and Gas Directives are not applicable for the time being.

A far more important gap is potentially the following issue. Remarkably, the necessity to expand supervision on energy contracts and energy derivatives in particular was dictated neither by the fear of potential big risks as experienced by energy companies and its consequences for the utility service provided by energy companies nor by the fear of putting the stability of the energy sector at stake as a whole. These considerations are mostly lacking in the legislative history of the Third Energy Package Expansion, which makes it evident that supervision was not primarily meant to neither protect consumers nor guarantee the stability of the energy sector. The plan for the expansion of supervision was fundamentally aimed at supporting the real liberalization of the European energy sector. Apparently transparency is regarded as an intrinsic value; the new communitarian obligations for administration and information are primarily meant to guarantee a well functioning market and to prevent market abuse. As a consequence there are serious limitations to the intended expansion of supervision on energy trading. Existing European financial legislation is hardly adequate to fill this gap.

A crucial aspect is the limited scope of the new Articles 40 Third Electricity Directive and 44 Third Gas Directive which are strictly applicable for "supply companies". Therefore trading companies that are incorporated in energy holdings fall beyond the reach of those articles. Taking into account the aims of the Third Energy Directives to prevent market abuse and as well as guarantee the utility service obligation to the full, a broad interpretation of those articles should be considered where vertically integrated energy companies are involved.

However, it should not be too difficult to close this gap. National supervisory authorities could apply the new information competences also for other European interests such as guarantee for the universal service obligation and the protection of consumers. Appropriate intensified governmental supervision and potentially far-reaching other governmental steps towards large energy companies engaged in utility services may be required. The Third Electricity Directive warrants the discretion of the Member States and content and scope of national energy legislation ultimately determines this.

Those information and investigation competences give national supervisors access to information that would allow them to gain insight in the balance positions of energy companies and the potential risks associated with energy contracts they have entered into. Whether or not it will be possible to obtain this insight will partly be defined by the content of the code of conduct to be set by the European Commission. It is imperative that national supervisors must have in-depth knowledge of energy trading and its financial risks involved. This is an important issue to be addressed.

A second gap refers to the absence of a quality assessment grid to formulate objective evaluation criteria for the determination and control of collateral risk. Clear and identifiable material measures to judge risks are currently not available. Raising questions such as how do energy companies manage portfolio risk or rather according to which standards could a collateral portfolio cause the trading position of any given energy company to jeopardize its universal service obligation? Without the proper evaluation tools governmental supervision seems insufficient. Subsequently it is strongly recommended that a set of adequate and generally accepted objective criteria for the assessment of risks associated with derivatives trading is developed. It shall not be easy to outline such standards, partly for the unmanageable side effects incurred in derivates trading, which makes it hard to characterise the underlying risk features.

Another relevant issue concerns each national government's democratic legitimation to intervene in order to supervise and prevent potentially unacceptable financial risks. Nothing about their role and the authority to do this is mentioned in the Third Energy Directives, although national legislation could be detrimental to the outcome. It is more likely however that national politics and legislation will not be adequate and that differences in ruling between Member States may affect EU policy.

As a result of MiFID's limited scope in the energy sector these sector specific gaps in supervision stemming from the Third Electricity Directive and their general financial supervisory role is only marginal, as a result of which a considerable part of the energy derivatives trading is not covered by MiFID regulation.

10.7 Concluding Remarks

Market abuse and financial risk occurring in the wholesale energy market may affect the energy price for consumers as well. From this perspective financial and energy markets are strongly interrelated. The goals of the new EU regulation on energy trading are at this stage mainly directed at the prevention of market abuse and not primarily at the security of the utilities service obligation in the interest of its consumers. Moreover, a latent problem could be the supervisory powers of the national Energy Authorities, which may be ample to intervene in the consumer market, but lacks adequate remedies to counteract in the wholesale market. This may be seen as another gap in the supervision on energy trading. With regard to these gaps the following development could be of great importance.

The ongoing financial crisis compelled the European Commission to put forward proposals for a European Regulation that should lead to more security in derivatives trading, also in energy derivatives trading. Those were approved on 15th September 2010.[72] One of the proposals concerns the switch from mainly bilateral trading to

[72]COM (2009) 563 final.

a multilateral trading system with central clearing and settlement facilities.[73] Urgent reason for the mentioned proposals was the fact that derivatives trading contributed largely to the outbreak of the financial crisis by interweaving market interests and causing an increased debt to capital ratio. This entwinement of market players was left unnoticed due to the lack of transparency caused by the diffuse market structure of derivatives trading. A major contributor to this lack of transparency is the 'over the counter' derivatives trading transactions that are traditionally settled within 1 or 2 days and therefore remain 'out of sight'.

The implementation of proposed standards for more security will most probably lead to a shift in derivatives trading towards more regulated markets, ultimately resulting in a far-reaching standardization of the derivatives trading business. Yet, for the development of a proper set of standards their relevance needs to be clearly stated, i.e. for each individual case it is important to assess if the transaction is solely intended for reasons of risk management, it is purely speculative, or it is made as an investment. In any case it will not be easy to propose a clear and simple quality grid to define the assessment criteria. The warranty of the intended measures should also be extended to the energy derivatives trade. Large industrial end users in particular fear that the enforcement of rules with respect to collateral requirements will lead to high barriers of entry into these markets.[74]

However, energy derivates trading by energy companies will mostly not fall under the scope of this proposed regulation, because: "As regards non-financial (corporate) counterparties, they will in principle not be subject to the rules of this Regulation, unless their OTC derivatives positions reach a threshold and are considered to be systemically important. Given that their derivatives activities are generally assumed to cover those derivatives that are directly linked to their commercial activity rather than speculation, those derivatives positions will not be covered by this regulation. In concrete terms, this means that the clearing obligation will only apply to those OTC contracts of non-financial counterparties that are particularly active in the OTC derivatives market and if this is not a direct consequence of their commercial activity. For example, this may be the case for *energy suppliers that sell future production*, agricultural firms fixing the price at which they are going to sell their crops, airlines fixing the price of their future fuel purchases or any commercial companies that must legitimately hedge the risk arising from their specific activity.[75]

---

[73]Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, Regulating Financial Services for Sustainable Growth, COM(2010) 301 final, Brussels, 2.6.2010.

[74]Many objections have been put forward, and not only by large industrial end users and energy companies. See European Commission, Internal Market and Services DG, Summary of the consultation on: Possible initiatives to enhance the resilience of OTC Derivatives Markets, Brussels 16.10.2009, p. 13.

[75]Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, Brussels, COM (2010) 484 final, p. 7.

The proposed exclusion will not be exhaustive, when there are large financial positions and speculation involved: "There are, however, reasons for not granting non-financial counterparties a full exemption from the scope of this regulation. First, non-financial counterparties are active participants in the OTC derivatives market and often transact with financial counterparties. Excluding them entirely would diminish the effectiveness of the clearing obligation. Second, some non-financial counterparties may take systemically important positions in OTC derivatives. Leaving systemically relevant non-financial counterparties whose failure may have a significant negative effect on the market completely outside the scope of regulatory attention would not be an acceptable course of action.

The Regulation sets out a process that helps to identify the non-financial institutions with systemically important positions in OTC derivatives and subjects them to certain obligations specified under the Regulation. The process is based on the definition of two thresholds:

(a) An information threshold
(b) A *clearing* threshold[76]

These thresholds will be specified by the European Commission on the basis of draft regulatory standards proposed by the European securities and markets authority (ESMA), in consultation with the European Systemic Risk Board (ESRB) and other relevant authorities. For example, in case of energy markets, the ESMA would have to consult the Agency for the Cooperation of Energy Regulators established by Regulation (EC) No 713/2009 in order to ensure that the particularities of the energy sector would be fully taken into account."

For instance, it implies that financial counterparties and non-financial counterparties above the clearing threshold must report the details of any derivative contract they have entered into and any modification thereof (including innovation and termination) to a registered trade repository. Greater transparency of the OTC market is critical for regulators, policymakers, and the marketplace.

Probably large energy companies, with trading positions that are many times larger than their original core activity being the supply of energy, will fall under the scope of these proposals for new additional European financial legislation, because their OTC derivatives positions reach a threshold and are considered to be systemically important.

So the proposed new Financial Regulation will bridge the mentioned gaps in financial supervision on the energy derivates trading to some extent, including diverse new measures, also in regard to clearing and settlement, data storage and providing information, but how far and with which exact aims is not (yet) clear. Partly, it depends on more detailed proposals for standardization to be developed by the new European Financial Authority. Furthermore the distribution of competences between the ESMA and the ACER needs further elaboration. A new

[76]See Art. 7 (3).

period will start with the new financial, general and for the energy sector specific, European regulation coming into force.

Acknowledgement Thanks to Anne van Toor, research assistant, for her excellent assistance.

Bibliography

Catá Backer L (2008) Monitor and manage: MiFID and power in the regulation of EU financial markets. Yearb Eur Law 27:349–386

CESR and ERGEG advice to the European Commission in the context of the Third Energy Package, market abuse, CESR/08-739, October 2008

CESR and ERGEG advice to the European Commission in the context of the Third Energy Package, record-keeping, transparency, exchange of information, CESR/08-998, December 2008

CESR's technical advice on possible implementing measures of the Directive 2004/39/EC on markets in financial instruments, CESR/05-290b, April 2005

Damme E, van Jansen J, Potter J, ten Raa T, Verouden V (1998) Universele dienstverlening. Marktwerking ten bate van iedereen. Research report for the Ministry of Economic Affairs, The Hauge, March 1998

Deng SJ, Oren SS (2006) Electricity derivatives and risk management. Energy 31:941–943, 949–952

Devroe W (2000) 'Universele dienstverlening', als nieuwe manier van denken. Soc Econ Weekbl 3:82–95

EFET (2007a) General agreement concerning the delivery and acceptance of natural gas, version 2.0 (a)/11 May

EFET (2007b) General agreement, concerning the delivery and acceptance of electricity, version 2.1(a)/21 September

EFET (2009) Principles of good conduct for energy trading – the "10 pillars" of good conduct. A single European Energy Market? Traders' hopes and fears at ten years. Highlights, p 4. http://www.efet.org/Main/Energy_Background_4849.aspx?urlID2r=1

ENDEX Rules (Version 12.0), February 2010

Federal Energy Regulatory Commission (2007) Commission takes preliminary action in two major market manipulation cases. News Release, 26 July, IN07-26-000 and IN06-3-002

Hancher L, de Hauteclocque A (2010) Manufacturing the EU energy markets: the current dynamics of regulatory practice. European University Institute Working Paper, RSCAS 2010/01

Hartley TC, 6 (2006) The foundations of European Community Law, 6th edn. Oxford University Press, Oxford, pp 102–104, 201–206

Haverbeke D, Naesens B, Vandorpe W (2010) Strengthening European regulatory powers. Eur Energy Rev, 25 January 2010

Horspool M, Humphreys M (2006) European Union Law, 4th edn. Oxford University Press, Oxford, pp 77–78

Hull JC (2009) Options, futures, and other derivatives. Pearson Prentice Hall, Upper Saddle River, pp 9–16, 581

Jessayan H (2009) Toezicht op handel van energiebedrijven is een 'blinde vlek'. Het Financieele Dagblad, 9 January 2009

Kakebeeke P (2008) Risico's bij energie. Het Financieele Dagblad, 1 December, p 16

Liu M, Wu F (2007) Risk management in a competitive electricity market. Elect Power Energy Syst 29:690–697

Marthinsen J (2009) Risk takers, uses and abuses of financial derivatives, 2nd edn. Pearson Prentice Hall, Boston, p 3

Meeus J (2008) Een markt van 8000 miljard. NRC 14 November, pp 13–14

Pilipovic D (2007) Energy risk. Valuing and managing energy derivatives, 2nd edn. McGraw-Hill, New York

Steiner J, Woods L (2003) Textbook on EC Law, 8th edn. Oxford University Press, Oxford, p 56

U.S. Energy Information Administration (2002) Derivatives and risk management in the petroleum, natural gas, and electricity industries. SR/SMG/2002-01

US Senate (2007) Excessive speculation in the natural gas market. Report of the Permanent Subcommittee on Investigations, S. Hrg. pp 110–235. http://frwebgate.access.gpo.gov/cgibin/getdoc.cgi?dbname=110_senate_hearings&docid=f:36616.pdf

Zielbauer P (2002) Trash agency investigators seize on Enron revelations. New York Times, 8 August, p B5