and is no longer subject to review by ESMA or the competent authorities. However, the practicalities of the process could have a significant impact on commodities markets today.

'VENUE TRADING IN EUROPE WILL ALSO BE IMPACTED BY THE PROVISIONS ON POSITION REPORTING.'

Under the proposed rules, a venue – including brokers – would be in possession of the complete position breakdown of every single participant on any given day. This raises serious questions around data confidentiality, especially in markets where trading is fragmented across platforms. This issue becomes even more relevant for third-country firms; the obligation to report positions rests with the venue, but the likelihood of getting accurate information from firms that are outside the scope of MiFID II is likely to be remote.

Similar questions arise in the context of transaction reporting where the venues are required to report on behalf of non-MiFID firms but where the data is unavailable to the venue itself (fields currently include a short selling flag, decision- and trader identification, etc. …).

If venues and brokers find themselves in a position where they are not able to get the position and transaction reporting information, the question of consequences will undoubtedly have to be answered. Taking a hard line and expelling participants from the venue will only result in reduced and potentially fragmented liquidity, ultimately harming end-users.

A more successful approach would be to require participants to self-report positions and, in the case of third-country participants, to find a mutual approach for cross-border recognition of trading firms, ensuring pooled liquidity can continue delivering best value for end-users.

Trading venues of the future

The future for inter-dealer brokers and other intermediaries in the commodities markets has been written – the path towards reorganizing as a trading venue is set. However, big question marks will have to be answered before the commodities' space is ready for MiFID II.

Key is the setting of transparency thresholds and the liquidity calibration – it will determine to what extent intermediation, in today's sense of the word, can continue. If full pre-trade disclosure were to be required, many markets may well be starved of liquidity, and trading would migrate to dark pools in related assets, or move into third-country markets with lesser transparency requirements.

As highlighted, the organizational form of the venue itself will be dependent on the asset traded. In the case of wholesale energy products, some OTC-intermediated business may migrate to OTFs to make full use of the non-financial product definition.

Beyond those key points, much of what used to be determined by exchanges will now be set by regulatory authorities. And therein lies a risk – whereas a wrongly calibrated size threshold at one exchange might have encouraged traders to block their trades elsewhere, this is no longer possible. Now a wrongly calibrated size threshold which has to be applied across venues will result in the disappearance of liquidity.

Whatever happens next, and wherever these thresholds ultimately come out, the face of the commodities markets is set to change significantly.

Regulatory change: impact on major energy companies and challenges they face

Jonathan Hill

Introduction

The international policy response to the financial crisis in the 2000s has presented an extremely challenging agenda for the energy sector. On the whole, this challenge should be cautiously welcomed. Through these policy initiatives, society is demanding more of the financial services sector in order to rebuild trust and to encourage improved market functioning in years to come. However, the energy sector should rightly look for, and assertively present, unintended consequences where it foresees them, as a means of constructive response. These concerns are: the result of commodity markets (including physical commodity markets) being made subject to the same regulations as other financial markets, and the distinction between group funding activities for investment in exploration and production, from physical commodity trading.

Not systemic

The primary objective of the reforms, led by the G20 group of countries, has

been to reduce systemic risk to the financial system. Our sector's key response to this, which has largely fallen on deaf ears to date, is so fundamental that it must still be made and continually remade. Oil and gas producers and their physical commodity markets aren't big enough, nor do they have sufficient leverage, to pose systemic risk to the financial system.

Appropriate mitigation?

The reforms are well documented and are covered by at least one other contributor to this edition of the *Forum*, giving a good overview of the provisions. Let me not restate them. Rather, let's get straight to the reality of dealing with the new requirements.

The point on systemic risk remains fundamental. Notwithstanding this, where there are risks which impact market confidence, they should be appropriately mitigated.

Challenge of implementation

The pace of reform and introduction of new directives is unlike anything previously experienced in the financial services sector. Political imperatives, in support of real financial concerns arising from the 2008 crisis, have driven the timetables for the current reform round. This has been good, because it has required timely response and change from participants and regulators alike, to start addressing the need to rebuild public confidence.

'THE PACE OF REFORM AND INTRODUCTION OF NEW DIRECTIVES IS UNLIKE ANYTHING PREVIOUSLY EXPERIENCED IN THE FINANCIAL SERVICES SECTOR.'

On the other hand, grappling with the need to respond has been extremely challenging, and has created much inefficiency. It seems that each time more light is shed (for example, when a new Regulatory Technical Standard is published) it gets darker in key localities as new questions emerge. In turn, even with the best of intentions, subsequent guidance in the form of 'Questions & Answers' documents leads to more questions, and so it goes on. The Q&As have no legal status, yet it would be a brave company which decided not to heed them.

Uncertainty is therefore the only certainty. A company inevitably reaches a point when it must either press ahead with implementation, or not. In late 2013 the energy industry continued a close dialogue with regulators and some were convinced that reporting of exchange-traded derivatives under EMIR (European Market Infrastructure Regulation) would be delayed, owing to clear technical difficulties. It was not, however, and a subsequent scramble to implement the rules ensued.

Another example falls on those companies, due to a breach of the commodity threshold under EMIR, that are designated NFC+ (non-Financial counterparty above a dealing threshold). These companies are to benefit from a delay to central clearing [until late 2018] on treasury hedges, whereas those same companies will have to source personnel, set up new systems and processes, and incur regret spend throughout 2016 in order to comply with bilateral collateralization requirements in early 2017 and then repeat the process in respect of central clearing too. Only those OTC (over-the-counter) hedges not capable of central clearing will be subject to bilateral collateralization after 2018, meaning that much of the 2016 work will then be redundant. Again, the timing and a lack of appreciation of the impact on the oil and gas industry leads to frustrating and expensive consequences.

As MiFID II implementation approaches, the key Ancillary Activity test will be impossible to calculate until July 2016 (when ESMA – the European Securities and Markets Authority – is scheduled to publish the market size denominator) and yet MiFID II comes in to force just six months later. Prudence dictates that companies who are in any doubt as to whether they will be in scope should ready a MiFID II licence application, but they may well not be needed and this will lead to regret spend. The calls for delay are starting, including one could infer from some regulators, but will they be listened to?

The platform can be a moving one. The interaction of MiFID (Markets in Financial Instruments Directive) and MAR (Market Abuse Regulation) presents a further example. MAR comes into force in June 2016, referencing the list of financial instruments in MiFID I. Six months later MiFID I is superseded by MiFID II with a much wider list of financial instruments and hence the scope of MAR will be broadened significantly.

Compliance challenge

No one said it should be easy. It certainly isn't. There is considerable cost and the benefits are not always clear.

'ON THE FACE OF IT, HOW DIFFICULT CAN IT BE TO REPORT, ON A DAILY BASIS, DETAILS OF THE TRANSACTIONS A COMPANY ENTERS INTO?'

On the face of it, how difficult can it be to report, on a daily basis, details of the transactions a company enters into? It has, though, proven very difficult across the reporting chain (submitter–repository–regulator) and both policy and operational issues continue to emerge. Participants are working on ESMA's level II validation for EMIR reporting 18 months on, which means the value of the data at present held in the repositories must be limited.

However, is it the right data? Participants are certainly submitting the data as requested, with considerable effort. The original mandate from the G20 was to monitor for emerging systemic risk, and the initial response from the regulators was to take position data from companies. The EMIR OTC reporting requirements, however, are for a log of trade reports, which indicates a different purpose. It is interesting that an industry-negotiated compromise with the regulators over the requirements has led to position reporting being implemented for exchange-traded derivatives in place of the trade reports. Can the original purpose be fulfilled? Arguably, the MiFID position reporting, which will be implemented for commodity derivatives markets from January 2018, looks more as if it could address this, although given that commodities are not systemic, its restricted scope would prevent this.

As indicated above, this is a step change in the amount of regulation on the energy sector. The political imperative has mandated that there shall be position limits on *every* commodity derivatives contract, meaning that there will be thousands. Everyone knows the application is too wide, and that it would be far more impactful to focus on the key contracts.

Something as apparently basic as tracking position limit requirements will be a very significant compliance challenge. In practice, ESMA sets the framework, but the 28 National Competent Authorities (NCAs) set the limits. Will their approaches align? Will they coordinate when the limits change? This is also an example of how companies will have to work with far more regulators in more jurisdictions; it is potentially a departure from the passporting concept of reliance on the home state regulator, which was a key deliverable of MiFID I.

Dealing with more regulators is a particular issue for companies active in the wholesale power and gas markets, who are likely now to be regulated by both the Agency for the Cooperation of Energy Regulators (ACER) member in their country of domicile for REMIT (Regulation on Energy Market Integrity and Transparency) for physical business, and by NCAs for financial business (under MAR, MiFID, and others). The two constituencies' jurisdictions should not overlap and cooperation between them must be hoped for. Operationally though, it is a reality of the markets that there will be considerable overlap and firms will have to be very precise in their dealings on the boundary.

Working capital impacts

The complexity of compliance and uncertainties of implementation are very significant, but there are highly material commercial impacts as well.

Energy market participants who exceed an EMIR clearing threshold will be required to post margin in clearing houses and to exchange collateral on remaining OTC transactions. This outcome may occur even where a corporate's market activity is overwhelmingly in hedging (which may be discounted from the calculation) due to uncertainty of how to classify hedging in a compliant way. These costs may be very appreciable.

This is, moreover, required in all asset classes, not just the one which breaches the threshold. For corporates, as mentioned, this has the highly significant impact of bringing into scope corporate treasury hedging activity, since hedges have no exemption. This then makes the treasury business of impacted corporates uncompetitive, since they incur costs which peers who do not have oil and gas trading businesses will not have. In contrast the US regime allows an end-user exemption to mandatory clearing.

The projected costs of the margining and clearing are very high, and these are in addition to the very high costs generated by the prospect of posting regulatory capital. Currently, there is an exemption in the EU Capital Requirement Directive for commodity trading firms but it expires at the end of 2017. But looking at a commodity derivatives trading operation, if margin is posted or collateralization made, what are the risks remaining which regulatory capital could appropriately mitigate?

The existing regime was designed for banks, and commodity firms were given exemption for various reasons, including their risk profile and the unsuitability of the regime to their businesses. It is hoped the exemption will be extended to 2020 and beyond, but the political mood seems clear that capital rules will be applied to our sector. The key point, however, is that commodity firms should not be subject to the same capital rules as banks, as they neither pose the same systemic risk nor are they eligible for the same public funding in times of strain. This does not mean that good risk management practice should not apply, just that it should be appropriate, and capital requirements are disproportionate.

Certain corporates active in the energy sector are on record as forecasting the cumulative impact of all of these charges as being from several to 'many' (a figure exceeding ten) billions of dollars. It is certainly true that application of the banking capital rules to a major corporate's oil and gas business generates a completely disproportionate outcome to the market risk they take.

These corporations are large, yet the possible calls upon their capital are material even to them. Their key mission is delivering energy and

that requires working capital for the associated infrastructure. To illustrate, an oil and gas producer might allocate an annual capital investment in its North Sea programme of a few billion dollars. However, going forward, the regulatory charges for its supply and corporate treasury operations which seek to hedge the associated risks of supply, distribution, and funding, would be likely to significantly exceed this.

Operational impacts

Keeping on the theme of consequences which, when looking at the original legislation and when thinking about the purpose and functioning of our markets, must surely have been unintended, brings me back to MiFID position limits. Hedging of physical activity should be covered by a hedge exemption to the position limits. This was the working assumption of the industry during the negotiations. This has been the practice since position limits were first brought in.

'HEDGING OF PHYSICAL ACTIVITY SHOULD BE COVERED BY A HEDGE EXEMPTION TO THE POSITION LIMITS.'

However, wholesale changes to the MiFID ancillary exemption test look like bringing far more firms in to scope of the Directive than envisaged. In scope MiFID firms may not apply for a hedge exemption. The position limits will be set in a range of 5–35 per cent, which is pretty broad for planning purposes. Remember that the limits apply to *every* platform traded commodity derivative in Europe. Liquidity varies greatly between these contracts as do numbers of participants. Also, many of them reference pricing at key infrastructure points whereby positions much larger than 35 per cent at delivery are inevitable.

The operational consequences of this for individual firms and for key infrastructure cannot have been fully scoped, but it will certainly create operational problems. Some markets cannot work within these numbers.

In addition, if you can get a hedge exemption it must be applied for in advance (up to 21 days). Inevitably there will be times when this impacts orderly operations.

Impact on markets

The matters discussed above are just a small subset of the changes to regulation of our firms and markets that are forthcoming in the next few years. But what is the cumulative impact of all these changes? Certainly that is something impossible to predict.

First there is the prospect of participants relocating, which may in turn lead to markets relocating. Clearly this would negatively impact Europe's competitiveness as a region. Some participants are already indicating their intention to move jurisdiction to take advantage of differences. However, the sense of doing business where clients are based, and particularly where key infrastructure is located, remains. Can you sensibly trade European power from Singapore? Although in contrast, it may be possible to relocate capital market activities to other regions to eliminate the regulatory cost burden on corporate funding for NFC+ groups.

So, for participants who stay put, what they do know is that costs are highly material, even to the largest amongst them. There have been withdrawals from the markets, most notably bank proprietary trading activity which has been attributed to many factors, not least of which is the reported impact of capital rules on the activity which made it commercially unviable.

It could be argued, however, that banks trading proprietarily were voluntary market participants and, whilst their presence was to be welcomed as valuable liquidity provision, it was not essential. These vastly increased costs are now spreading to more participant types. It is highly likely that there will be further withdrawals. In general, markets thrive on liquidity – which will be impacted to the detriment of the market.

Many point to small- and medium-sized physical participants for whom the compliance burden alone will necessitate a rethink. Certain big utility corporates have also stated that they will not tolerate the compliance costs.

These participant types are not optional; they are the participants without whom markets cannot exist. Certain policymakers have in the past said they would welcome the disappearance of the energy trading sector. Do they hold the same sentiment for the EU oil and gas production industry? Alternative suggestions, however, on how commodity pricing could be better achieved have not been forthcoming. Inefficient and ineffective pricing will ultimately only lead to negative outcomes for producers and consumers alike.

What should happen next?

Inevitably, the preceding sections have focused largely on problems identified – the unintended negative consequences. However, it remains the case that the overall reform package and its intent is to be welcomed. Improved transparency, appropriately calibrated, is a positive development from which all can potentially benefit. Enhanced supervisory powers for regulators so they can achieve the

'IMPROVED TRANSPARENCY, APPROPRIATELY CALIBRATED, IS A POSITIVE DEVELOPMENT FROM WHICH ALL CAN POTENTIALLY BENEFIT.'

tough objectives they now have are also positive.

However, the number and extent of the changes is unprecedented. Given all of the uncertainty they engender, time is needed to assess impacts. We need to make the changes which have been put in to effect work. For example, it is reported that the quality of the data set from the EMIR reporting remains unsatisfactory and yet it is supposed to be the basis of so much which is of key importance. Also, I recall that the data was intended to be used to provide market, as well as regulatory, transparency. This should be achieved before new reforms are advanced.

Further, where negative unintended consequences emerge, the community should respond quickly and make changes to correct them.

Conclusion

The financial services sector must accept the need to repair public confidence and accept the utility of many of the reforms. Every participant, including those in the commodity sector, should embrace constructive compliance. Energy markets do, however, fulfil a vital role and it is right that where we see negative consequences, we must highlight them and work hard to seek understanding. We need to do this to ensure they are put right, in order to safeguard investment in the EU and to encourage energy businesses worldwide to continue to view the EU as an attractive region in which to do business. This is for the good of our economies, our consumers, and our quality of life.

This article is written in the author's personal capacity and should not be taken as reflecting BP's views.

A new regulatory paradigm for EU commodity markets

Jonathan Farrimond and Paul Wightman

From 3 January 2017, Europe's financial commodity markets will march to a different regulatory beat. The recast MiFID II (Markets in Financial Instruments Directive) and its sister regulation MiFIR (Markets in Financial Instruments Regulation) have, remarkably, been over five years in the making. But upon implementation, they are set to introduce sweeping changes to the structure and workings of EU financial commodity markets – or rather, the entire European Economic Area (EEA), as the legislation has 'EEA relevance' – impacting participants, trading venues, and regulators alike.

'THE POLITICAL INTENT IS CLEAR: TO BRING MORE COMMODITY FIRMS DIRECTLY INTO FINANCIAL REGULATION.'

Many commodity firms with physical operations that are currently engaged in derivative trading but exempt from financial regulation face the spectre of being authorized, and therefore directly regulated, for the first time. This is because MiFID II will sweep away the 'commodity dealer exemption' available under MiFID I whilst at the same time significantly narrowing the current 'ancillary activities' exemption. The political intent is clear: to bring more commodity firms directly into financial regulation.

There are notable implications for a commodities firm becoming MiFID-authorized. In addition to the new organizational requirements and certain direct obligations to comply with, there would be consequential effects under a raft of other EU financial regulations. For example, under EMIR (European Markets Infrastructure Regulation) authorized firms cannot qualify for 'non-financial counterparty' status, regardless of whether they are active in physical commodity markets or not, and thereby lose significant relief from potentially onerous EMIR requirements such as mandatory clearing of over-the-counter (OTC) derivative contracts and wide-ranging risk mitigation techniques.

But it is capital requirements that have commodity firms most worried. CRD IV/CRR (Capital Requirements Directive IV / Capital Requirements Regulation) is legislation designed to ensure that banks and other financial firms hold financial resources sufficient to protect against losses relevant to the business risks they face. Whilst most specialist commodity firms authorized under MiFID II would benefit from certain exemptions from CRD IV/CRR, related to 'large exposures' and regulatory capital treatment, these exemptions are due to expire at the end of 2017, and in any event these are not blanket exemptions; liquidity rules and 'Pillar 3' requirements (including remuneration code requirements) would still apply, as well as potentially other capital requirements in a firm's home jurisdiction.

The cost implications for individually affected firms could be huge. Whilst the exact impact can't yet be quantified, warning bells are beginning to sound from certain quarters. EFET (the European Federation of Energy Traders) suggested in a press release dated 16 April 2015 ('EFET calls for