



Will MiFID II hurt industrial players in Europe?

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Much of the criticism of Europe's regulation of trading has focused on its potential impact on large companies with substantial physical and derivatives market exposures. There has been much less focus on the potential fallout from the new regulations on industrial players for whom energy trading is a sideshow. But stakeholders in the European power and gas industry have highlighted the risk that the EU's revised Markets in Financial Instruments Directive (MiFID II) could seriously damage industrial players and consequently hurt liquidity in European power and gas markets.

Concern over extension of regulation to non-financial companies

An open letter – published on 15 October – called for caution. It was signed by the energy trade groups Eurogas (an association representing the European gas wholesale, retail, and distribution sectors) and Eurelectric (an association representing European electricity producers, suppliers, traders, and distributors), as well as the European Federation of Energy Traders (EFET), and a number of energy-intensive industries.

The letter said in part: 'We note with concern that the European Securities and Markets Authority's (ESMA's) final proposal for level 2 measures is designed in such a way that many non-financial companies trading in commodity derivatives on an ancillary basis to their main commercial group business would risk capture in the scope of MiFID II, facing as a consequence disproportionate capital, prudential and liquidity requirements normally applicable only to investment banks.'

Whereas energy and energy-intensive companies were largely exempted from the obligations under MiFID I, the revised directive cast the net much wider. Brussels wants deep, liquid, and transparent derivatives markets and to achieve this it believes investor protection and counterparty risk are key challenges that need to be addressed, also in energy markets.

However, the question arises as to whether Brussels is burdening non-financial companies with a directive that is too stringent relative to their market share and the financial risk they pose.

One key issue is that companies that do not secure exemptions from MiFID licensing would be subject to capital requirements under the EU's Capital Requirement Regulation (CRR). That means energy companies and energy-intensive industries would have to prove they have enough cash to cover trading losses, depending on their risk profile and financial structure. Energy producers will basically be treated like investment firms and will be subject to capital requirements under the CRR.

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Energy companies and industrial players have argued vigorously that they do not pose systemic risk and should therefore not be regulated as banks. Another argument is that industrial players are rich in assets – not in cash – hence it is unreasonable that regulators expose them to stringent capital requirements. Additionally, they lack the staff and experience to deal with financial regulation of this scope.

But these arguments – however valid – seem to fall on deaf ears in Brussels. Few seem to believe that industrial players will now secure last-minute exemptions to the capital requirements under MiFID II. If the battle is lost on MiFID II exemptions, lobbying for amendments to the CRR, and designing a capital regime which is appropriate for firms with substantial physical assets, may be a better idea. Although amending the CRR may be difficult to achieve in practice, Brussels will listen to the industry's concerns if the arguments come across as sufficiently compelling.

Potential adverse effects from MiFID II

The open letter said that the new rules could force industrial players out of European energy markets, and that the direct cost to energy markets would amount to at least EUR 15–20 billion per year. Although it is hard to put a precise figure on the cost of market participants leaving or reducing their activity in European gas and power markets, there is no doubt that reduced liquidity will eventually harm consumers in terms of higher energy prices. After all, energy-intensive industries such as aluminium, steel, and chemical production are key players in wholesale energy markets. The energy bill for some aluminium producers is around 40 per cent of production costs. Hence the need to hedge their exposure to energy price volatility is self-evident.

It appears reasonable to argue that the proposed rules drawn up by ESMA do not go far enough in exempting non-financial companies from trading commodities derivatives on an ancillary basis. For instance, ESMA's methodology, for use by non-financial

companies when applying for an exemption from MiFID licensing, takes no account of the company's asset base and primary commercial business.

Instead, ESMA has set out thresholds based on the total trading activity for non-financial firms. That means a non-financial firm may be exempted from MiFID II if its trading in gas derivatives constitutes less than 3 per cent of its total trading activity. For power derivatives, the proposed benchmark is 6 per cent.

It would make sense to include a 'capital employed test' to be added as an additional option for non-financial firms. This is also what many stakeholders seem to want. A capital employment test was proposed by ESMA in December last year, but has since been abandoned. Such a test would allow comparison of the capital invested in commodity derivative transactions with the capital employed in assets and commercial activities at group level.

In addition to capital requirements, MiFID II will also impose position limits on energy trading. The position limits will range from 10 per cent to 40 per cent of deliverable supply. Again, the main concern is that players will leave markets or reduce trading activity substantially, due to perceived over-regulation. Players leaving could also affect security of supply.

Industrial players should be treated differently

Brussels is of course right to revise its market rules in the wake of the 2008

financial and banking crisis. Taking the necessary steps to strengthen investor protection and minimize counterparty risk is key to achieving trust and stability in derivatives markets. It is also understandable that the EU does not want to give outright exemptions to companies trading energy derivatives. Reducing counterparty and default risk should ultimately benefit these markets in the longer term.

Let's not forget that many European energy markets are still seeing low levels of liquidity and competition. In wholesale gas, the trading hubs TTF (the Dutch Title Transfer Facility) and NBP (Britain's National Balancing Point) are the only gas hubs in Europe with more than 100 registered participants each and churn ratios above 10, according to a market monitoring report released by the Agency for the Cooperation of Energy Regulators (ACER). A liquid market typically has multiple buyers and sellers, allowing trades to move quickly in and out of positions.

Several banks and other financial institutions have left or downscaled energy trading in order to focus on their core markets such as equities and fixed income instead. Whether a tighter regulatory regime for energy derivatives will actually make banks return to these markets remains to be seen. Banks have vast experience in dealing with financial regulation; it is not unthinkable that they will see a tighter regulatory framework as at least one of several reasons to return to energy trading in the longer term.

All things considered, it is not hard to sympathize with industrial players

who do not want to be regulated on an equal footing with investment banks. A legitimate concern is that binding capital requirements under the CRR could force these firms to sell off assets to downsize or, alternatively, try to attract more equity capital from owners.

MiFID II is one of several legislative instruments drawn up by Brussels in response to the financial crisis. The Market Abuse Regulation/ Directive and the Regulation on Energy Market Integrity and Transparency – as well as the European Market Infrastructure Regulation – are also in the process of being implemented. Moreover, the obligation to report trades under the Regulation on Wholesale Energy Markets Integrity and Transparency (REMIT) came into force on 7 October.

The European Commission has until the end of December to decide whether to adopt the technical standards proposed by ESMA. The directive is expected to enter into force in January 2017.

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Although a tighter regulatory framework on energy trading will likely deliver long-term gains, the industry's call for more flexibility should be taken seriously. A longer phase-in period for non-financial firms is one option. A grace period of, say, three years would give industrial players breathing space to adapt to the new requirements under MiFID II.

