Increased financial regulation in the European Union for energy firms extensively active in energy derivatives markets?

Increased financial regulation for energy firms extensively active in energy derivatives markets?

Randy Priem*

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Abstract:

Because of the excessive prices and volatility in the energy derivatives markets over the period 2021-2023 margin calls increased considerably leading to major European energy companies experiencing liquidity stress in meeting their margin calls. As a consequence, several local governments needed to provide guarantees to them to avoid their default. This article puts forward several legislative proposals to assure that energy firms being extensively active in the energy derivatives markets are prudentially safer and that there exist a level playing field with financial actors active in the same market segment. Specifically, this article proposed to a) decrease the clearing threshold for commodity derivatives under the European Market Infrastructure Regulation (EMIR), b) to narrow down the definition of hedging relevant to the calculation of the clearing threshold, c) to remove the intragroup exemption possibility under the reporting requirement of EMIR, and d) to make sure that energy firms can be categorized more easily as investment firms by making the ancillary service exemption under MiFID II more stringent.

Keywords: commodity derivatives, energy futures, energy firms, central counterparties, financial regulation

* Corresponding author: Randy Priem, UBI Business School, Naamsestraat 48, 1000 Brussels (Belgium); Antwerp Management School, Boogkeers 5, 2000 Antwerpen; Katholieke Universiteit Leuven, Naamsestraat 69, 3000 Leuven (Belgium); Financial Services and Markets Authority, Congresstraat 12-14, 1000 Brussels (Belgium). E-mail address: randy.priem@ubi.edu Tel: +32 494 40 36 01. The information contained in this article is the personal view of the author solely and not of the FSMA. This article also does not bind the FSMA in any way. The author is responsible for any errors or omissions. This research did not receive any specific grant from funding agencies in the public, commercial, or not-for-profit sectors. Declaration of conflicts of interest: none.

1. Introduction

Despite Russia's demand for Ukraine not being a member of the NATO, Ukrainian President Volodymyr Zelenskyy approved on 14 September 2021 Ukraine's national security strategy including a partnership with the NATO. On 10 November 2021, the US observed that Russian troops were moving towards the borders of Ukraine with US President Joe Biden warning the Russian President Vladimir Putin of strong economic sanctions if Russia would attack Ukraine. On 17 January 2022, Russian troops arrived in Russia's ally Belarus, but it was sold to the public that this would be for military exercises only. Three days before the invasion, Vladimir Putin announced that Russia recognized the independence of two pro-Russian regions in eastern Ukraine (i.e. the Donetsk People's Republic and the Luhansk People's Republic). On 24 February 2022, Russia invaded Ukraine.

As a consequence of the invasion, financial markets reacted in a substantial negative manner: the S&P 500 dropped more than 10%, the Euro Stoxx 600 index closed at its lowest level in almost a year, while also the MSCI All-Country World Index dropped with around 6%[1]. The Russia-Ukraine war also made the VIX index rise considerably together with major benchmarks being more volatile.[2] In addition to the negative impact on financial markets, the invasion negatively impacted Europe's real economy. According to the ECB's chairman Christine Lagarde, "The Russian-Ukraine war will have a material impact on economic activity and inflation through higher energy and commodity prices, the disruption of international commerce, and weaker confidence".[3] Indeed, corporations are facing challenges from rising

[1] See <https://time.com/nextadvisor/investing/stock-market-rattled-by-russia-ukraine/> accessed 10 May 2023 and <https://www.ft.com/content/4c4c4c04-151c-467c-b011-136d56546da9> accessed 10 May 2023.
[2] See <https://lplresearch.com/2022/02/25/what-is-the-vix-index-and-how-has-it-responded-to-russia-ukraine-conflict/> accessed 10 May 2023 and see <https://time.com/nextadvisor/investing/stock-market-rattled-by-russia-ukraine/> accessed 10 May 2023
[3] See <https://www.ecb.europa.eu/press/pressconf/2022/html/ecb.is220310~1bc8c1b1ca.en.html > accessed 10 May 2023.

input prices, which translates into higher prices of end products (i.e. the Euro area's annual inflation rate went up to 9.2%).[4]

Regarding gas prices, these were 300% higher in August 2022 higher compared to February 2022 (i.e. a record of EUR 236 per megawatt, being the equivalent of $410 per barrel of oil) and 1000% higher than the average prices seen before in the European Union, combined with high volatility. The changing gas prices led to stress in gas futures markets as well as electricity markets (i.e. prices were 10 times higher than in 2021) given that both are highly correlated through the marginal pricing in the electricity market.[5] The higher futures prices were also due to many parallel uncertainties, such as the shortfall of nuclear energy in certain countries[6], the scarcity of European hydropower generation, and draught-inducing low river flows thereby affecting coal transport. Market manipulation, however, seemed to be a less prevalent reason to explain the higher futures prices.[7]

In case the payoffs of futures positions on energy derivatives are negative, the energy companies need to post additional margins directly, or indirectly via their clearing members, to central counterparties (CCPs) in case of central clearing.[8] Because of the high volatility in the

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[4] See <https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Inflation_in_the_euro_area#:~:text=Euro%20area%20annual%20inflation%20was,from%2010.1%20%25%20in%20November%202022.&text=The%20%EF%AC%81gures%20presented%20in%20this,of%20Consumer%20Prices%20(HICP)> accessed 10 May 2023.

[5] European gas and power markets are integrated as gas is used to generate electricity and therefore, these markets display high correlation around 0.60 (see <https://acer.europa.eu/sites/default/files/documents/Publications/ACER_FinalReport_MCM.pdf> accessed 10 May 2023). See also Carlo Fezzi and Derek W. Bunn, 'Structural interactions of European carbon trading and energy prices' (2009) 2(4) The Journal of Energy Markets 53.

[6] Regarding the electricity market, nuclear power plants in France as alternative sources of power suffered from maintenance problems thereby reducing their capacity when they were needed the most. At the end of August 2022, more than half of France's nuclear generation capacity was offline.

7 According to the Dutch market regulator AFM, the Dutch trading venue for gas derivatives performed well but there were more suspicious transactions and order reports (STOR) and so the AFM examined whether market abuse impacted the market. There was no real indication for this. See <https://fd.nl/politiek/1459788/prijsplafond-voor-gas-kan-de-zaken-nog-wel-eens-erger-maken https://www.standaard.be/cnt/dmf20221104_95298746 > accessed 10 May 2023

[8] See Randy Priem, 'A relaxation of commodity derivatives clearing legislation as a consequence of the 2021-2023 energy crisis'. (2003) SSRN Working Paper. < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4448470> accessed 10 May 2023

energy market, margin calls increased considerably to 1.5 trillion EUR.[9] In several countries, such as Germany, Finland, Austria, and Sweden, energy companies experienced liquidity stress in meeting their margin calls, which typically need to be posted within less than a day. If a firm does not succeed in doing so, the central counterparty can consider the firm as defaulting. This would be problematic, given that many energy firms can be considered "too big to fail" as their failure would have severe negative consequences for electricity production and distribution.[10] Therefore, many energy firms needed to ask their local governments for help because it became too expensive and difficult to obtain further credit from banks to be used as collateral.[11] The European Central Bank was asked whether liquidity could be provided to energy companies but rejected this request given that the European Central Bank serves as a liquidity provider for financial institutions, but not for energy companies.[12] Although opponents see state support as an inducer of higher levels of moral hazard and excessive risk taking, the Commission's state aid temporary crisis framework, adopted in March 2022 and amended in July 2022, enabled Member States to provide loans and guarantees to cover liquidity needs also derived from energy activities.[13]

This article is the first to discuss the question of whether energy firms extensively active in the energy derivatives markets should be subject to more stringent financial regulation to

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[9] See <https://www.esma.europa.eu/sites/default/files/library/esma50-165-2229_trv_2-22.pdf> accessed 10 May 2023.

[10] See Erik R. Larsen, Ann van Ackere and Sebastien Osorio, 'Can electricity companies too big to fail?' (2018) 9 Energy Policy 96

[11] Germany set aside 7 billion euros in loans to be made available to companies facing liquidity issues. German energy firm Uniper SE sought an extra 4 billion euros after fully using a 9-billion-euro existing facility. Austria extended a 2 billion-euro credit to cover the trading positions of Vienna's municipal power utility, Wien Energy. Finland and Sweden announced a $33 billion emergency liquidity facility to backstop utilities through loans and credit guarantees. The Danish government also announced that it will offer up to 100 billion Danish crowns in credit guarantees to energy firms affected by collateral demands. Also outside the European Union, similar measures are being taken. In the United Kingdom, the Bank of England raised a fund of 40 billion pound in order to help energy companies being in liquidity need. In Switzerland, the government granted a line of credit of 4 billion Swiss Franc to Axpro; a producer of renewable energy.

[12] See <https://www.bloomberg.com/news/articles/2022-09-09/lagarde-says-ecb-can-offer-liquidity-to-banks-not-energy-firms> accessed 10 May 2023 and see <https://markets.businessinsider.com/news/commodities/ecb-lagarde-europe-energy-crisis-margin-call-liquidity-bank-risks-2022-9 > accessed 10 May 2023

[13] See <https://ec.europa.eu/commission/presscorner/detail/en/ip_23_1563> accessed 10 May 2023

avoid potential government interventions. If governmental support would indeed be needed, it means that tax money would have to be used. Several legislative proposals are put forward in this article, also to ensure that there exists a level playing field between financial actors active in the commodity derivatives markets compared to energy firms currently being subject to lighter financial requirements. Indeed, Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties, and trade repositories (EMIR)[14] is more stringent regarding the clearing obligation for financial counterparties compared to non-financial ones and also imposes more severe risk-mitigation requirements on financial entities for OTC derivative contracts that are not cleared by a CCP (see infra for a detailed discussion). Knowing that energy firms are key users in the energy derivatives markets; much more compared to e.g. smaller investment firms being subject to severe legal requirements,[15] one can argue that a level-playing-field issue is perhaps at stake. Indeed, energy firms (utilities or independent commodity trading firms) act more as ultimate investors in the energy derivative market. 70% of all positions are held by non-financial counterparties (utilities and commodity trading firms), followed by financial institutions (banks) at around 22% and investment firms.[16] The investment type thus least active in the energy derivative market is here subject to the most stringent requirements (see infra).

Although this article focuses on the EEA area, its content is also of great relevance to non-EU market practitioners as non-EU market participants (i.e. investors or clearing members) represent 46% in terms of the total number of positions in the European Union. In addition, TTF derivatives (see infra) are also available for trading in the United States on Chicago

[14] <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648> accessed 10 May 2023.
[15] <https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart202211_01~173476301a.en.html> accessed 10 May 2023
[16] <https://www.esma.europa.eu/sites/default/files/library/esma70-446-775_preliminary_data_report_on_mcm.pdf > accessed 10 May 2023

Mercantile Exchange (CME). Hence, regulatory measures applied in Europe on these derivatives markets could also have spill-over effects to the United States.

By examining the rationale for legislative changes, this article further contributes to the academic work on the financial regulation of commodity derivatives, and more specifically energy markets.[17] To date, there exist only a handful of legislative articles applicable to financial energy products. Daiz-Rainey et al. (2011)[18] is one of the rare studies that provide an overview of the various European pieces of financial legislation applicable to energy products but their study has become outdated as many European laws, like the Markets in Financial Instruments Regulation (MiFIR)[19] and the European Market Infrastructures Regulation (EMIR),[20] has been introduced or reformed in the meantime, added with the establishment of the Agency for the Cooperation of Energy Regulators (ACER) and the European Securities and Markets Authority (ESMA). In addition to this study, Priem (2023)[21] discusses the temporary relaxation of commodity derivatives clearing legislation as a consequence of the 2021-2023 energy crisis in which it is documented that CCPs are temporarily allowed to accept unsecured bank guarantees and public guarantees as margins in order for energy firms to continue to have access to central clearing. In addition, Priem (2023) discusses the new intra-day volatility

[17] See Ivan Daiz-Rainey, Mathias Simes and John K. Ashton, 'The financial regulation of energy and environmental markets' (2011) 19(4) Journal of Financial Regulation and Compliance 355.
[18] See Ivan Daiz-Rainey, Mathias Simes and John K. Ashton, 'The financial regulation of energy and environmental markets' (2011) 19(4) Journal of Financial Regulation and Compliance 355.
[19] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012. See <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0600> accessed 10 May 2023
[20] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. See <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32012R0648> accessed 10 May 2023
[21] See Randy Priem, 'A relaxation of commodity derivatives clearing legislation as a consequence of the 2021-2023 energy crisis' (2023). SSRN Working Paper. <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4448470> accessed 10 May 2023.

mechanisms trading venues have to implement[22], whereas Priem (2023)[23] provides an overview of the Market Correction Mechanisms Regulation that was introduced, both to make sure that excessive volatility in gas derivatives markets is reduced. This relaxation of the collateral margin requirements and government intervention mechanisms can be useful in the short term to avoid energy firms going bankrupt but one may ask whether a more structural approach is needed to avoid that energy firms active in the energy derivatives markets can no longer adhere to margin calls. It might therefore be useful to examine in more detail which legislative measures could be taken to make sure that energy firms are prudentially safer, and that financial entities active in the same derivatives market need to adhere to the same financial requirements.

This article further contributes to the literature on EMIR. Until now, the literature on OTC derivatives regulation[24] has largely ignored the impact of the requirements for non-financial counterparties and their hedging activities. By discussing the change of the initial clearing threshold for commodity derivatives, and the hedging definition of EMIR relevant to see which derivatives need to be taken into consideration for calculating the clearing threshold, this article attempts to close this gap.

The remainder of this paper is organized as follows. Section 2 provides an overview of energy derivatives markets in Europe. Section 3 discusses various legislative proposals applicable to energy firms, while Section 4 concludes.

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[22] See Randy Priem, 'Intra-day volatility mechanisms as a consequence of the 2021-2023 energy crisis' (2023) SSRN Working Paper. <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4448498> accessed 10 May 2023

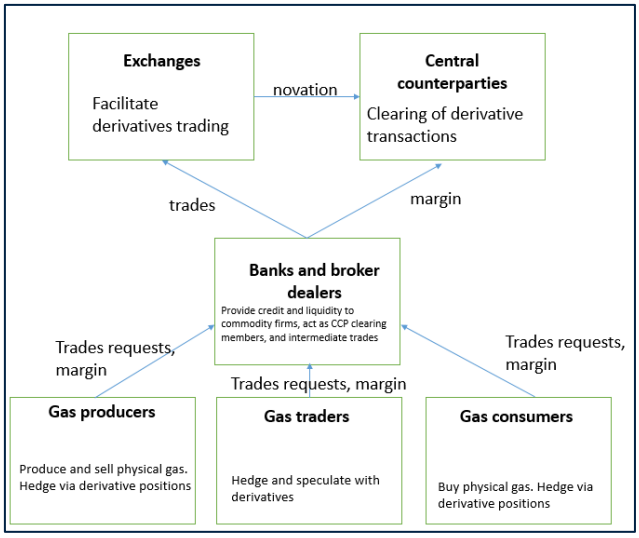
[23] See Randy Priem, 'Introduction of a Market Correction Mechanism Regulation as a consequence of the 2021-2023 energy crisis' (2023) SSRN Working Paper. <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4452681> accessed 10 May 2023.

[24] See e.g. Peter Knaack, 'Innovation and deadlock in global financial governance: Transatlantic coordination failure in OTC derivatives regulation' (2015) 22(6) Review of International Political Economy 1217; John Biggins and Colin Scott, 'Public-private relations in a transnational private regulatory regime: ISDA, the State and OTC Derivatives market reform' (2012) 13(3) European Business Organization Law Review 309; Joanne P. Braithwaite, 'OTC derivatives, the courts and regulatory reform' (2012) 7(4) Capital Markets Law Journal 364.

2. The energy derivatives market

The commodity derivative financial ecosystem is displayed in Figure 1 below. [25]

Figure 1: The commodity derivatives financial ecosystem:



In the energy market, companies can – via their brokers / dealers – buy e.g. gas directly on gas exchanges[26], such as the TTF (i.e. Title Transfer Facility); a virtual trading point located in the Netherlands operated by Gasunie Transport Services (GTS)[27], the Vienna-based virtual trading point (VTP)[28] operated by the Central European Gas Hub[29], the UK National Balancing Point exchange, the NetConnect German gas exchange, or the Hungarian Gas Exchange NFKP. In addition, companies typically use futures[30] as the primary instruments to trade oil, gas, and

[25] This figure does not display the role of commodity funds or hedge funds that are also active in the market. For more information, see <https://www.fsb.org/2023/02/the-financial-stability-aspects-of-commodities-markets/ > accessed 10 May 2023.
[26] In the gas market, a gas exchange allows a shipper or trader to buy or sell gas without the other party to the gas transfer being known to the shipper or trader. The gas exchange operator is responsible for brining together the volumes of gas offered and the volumes of gas requested.
[27] The TTF is a virtual market place where gas that is already present in the Dutch gas system ('entry-paid 'gas) is traded (i.e. after import a regasification and injection in the EU pipeline system).
[28] In the gas market, a virtual trading point is a non-physical commercial point for trading in natural gas markets representing all entry and exit points in that market area. Gas is exchanged between sellers and buyers without the need to book transmission or distribution capacity.
[29] In the gas market, a hub is a central pricing point for the infrastructure network's natural gas.
[30] The ICE TTF futures contracts, for instance, are for physical delivery through the transfer of rights in respect of TTF. Trading will cease at the close of business, two business days prior to the first calendar day of the delivery month, quarter, season, or calendar. Delivery is made equally each hour throughout the delivery period. Around 50% of all TTF-gas future contracts are held until maturity, which results in physical gas delivery.

electricity. Most of them are traded on trading venues[31] like ICE Endex BV located in the Netherlands, EEX domiciled in Germany, Nasdaq Oslo domiciled in Norway, and ICE Futures Europe located in the UK (i.e. 85% of energy derivatives are exchanged-traded derivatives, while only 15% of them are traded over the counter).[32] The ICE Endex TTF future[33] is the most liquid energy contract in the EU with an open interest of around 920,000 lots as of December 2022, while open interest on EEX TTF derivatives was around 300,000 lots. TTF derivatives are only traded to a very limited extent on Nasdaq Oslo. As of January 2023, gross notional exposures of EEA30 counterparties amounted to EUR 411 billion.

Futures contracts, with a physical settlement, are mostly used - more than options[34] - by energy producers to hedge against an increase or a drop in energy prices.[35] Indeed, when the energy prices drop, for instance, the payoff of a short position in the future is positive, leading to a compensation for the selling energy producer. When energy prices increase, the spot prices increase but the futures payoff also drops in case of a short position, often leading to a break-even scenario. Gas producers, on average, benefit from an increase in gas prices. They have thus been shortening gas derivatives. Power distributors, in contrast, are more vulnerable to unexpected margin calls as they have long positions in power derivatives to protect against increased prices. In case prices fall, they suffer losses in their output value and in their derivative portfolios.

[31] A trading venue means a regulated market, as defined in Article 4(1), point (21) of Directive 2014/65/EU (MiFID II), a multilateral trading facility as defined in Article 4(1), point (22) of Directive 2014/65/EU (MiFID II), and an organized trading facility as defined in Article 4(1), point (23) of Directive 2014/65/EU (MiFID II) (see infra).
[32] European gas futures are also traded outside of the Europe at e.g. the NYMEX / CME.
[33] TTF derivative is a commodity derivative as defined in Article 2(1) of Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments (i.e. MiFID II) traded on a regulated market, the underlying of which is a transaction in the Title Transfer Facility (TTF) operated by Gasunie Transport Services.
[34] 94 % of the volumes in gas derivatives are in the form of futures, with the remaining in the form of options. See <esma70-446-775_preliminary_data_report_on_mcm.pdf (europa.eu) > accessed 10 May 2023.
[35] On ICE Endex, around 60% of the long and around 80% of the short positions were held in 2022 for hedging purposes. See <esma70-446-775_preliminary_data_report_on_mcm.pdf (europa.eu) > accessed 10 May 2023.

In general, banks account for the largest share of outstanding energy derivative positions in terms of gross notional value, partly because of their role in intermediating transactions in the centrally cleared space. However, when measuring the market size by net notional, non-financial corporations appear to be the key participants and the main holders of market risk from energy derivatives. A quarter of all firms belong to the energy production chain, meaning they are extracting oil and gas or distributing energy. The remainder belongs to energy-intensive sectors, like transport and manufacturing.[36] In the energy business, the positions are also heavily concentrated amongst a few energy firms, which could lead to financial stability issues in case some of these would default. There is a very high concentration of gas derivatives traded volumes in TTF derivatives (95% of EU gas derivative volume). Traders also typically borrow to build short positions, with 85% to 90% of the funding being provided by credit institutions.

A very large fraction of the futures are centrally cleared, typically at ICE Clear Europe located in the United Kingdom for ICE Endex, the Deutsche Börse-owned energy clearing house ECC for EEX, and Nasdaq Clearing in Sweden for Nasdaq Oslo. Most energy firms are a member of a central counterparty via a clearing member, being credit institutions, but some central counterparties, like Nasdaq Clearing, also allow energy firms to be direct participants. As clients, market participants have to post initial margins with a clearing member of the CCP when opening a future position. If the price moves adversely, they need to post variation margins and sometimes more initial margins.[37] These margin methodologies typically consider the volatility of the prices meaning that the more volatile prices become, the more margins need to be posted. In case a clearing member is no longer able to meet its margin obligations, the CCP has the right to put this firm into default.

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[36] <https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart202211_01~173476301a.en.html> accessed 10 May 2023.

[37] Variation margins are mark-to-market and initial margins often increase because margin models used by CCPs require higher levels of collateral to compensate for heightened volatility of derivatives.

In the natural gas derivatives markets, clearing members are mainly large banks and to a lesser extent energy firms. Energy firms (utilities or independent commodity trading firms) act more as ultimate investors, which can be EU or non-EU entities. 70% of all positions are held by non-financial counterparties (utilities and commodity trading firms), followed by financial institutions (banks) at around 22% and investment firms.[38] In addition, in the exchange-traded derivative markets, there is a large concentration of banks being clearing members of central counterparties. At the end of August 2022, four banks were directing approximately 85% of the positions to CCPs.[39]

Note that energy futures based on e.g. the TTF are not included in the list published by ESMA of financial instruments that fall under the clearing obligation[40] making central clearing here a voluntary decision. Nevertheless, the benefits of CCPs for clearing members in terms of reducing counterparty risk have been extensively documented.[41] Bilateral contracts are novated to the CCP (i.e. the CCP becomes the buyer towards the seller and the seller towards the buyer), thereby facilitating multilateral netting of exposures.[42] This multilateral netting between multiple counterparties reduces the total credit exposure in the market, as the number and values of outstanding settlements (deliveries of assets and corresponding payments) between various parties decrease. By concentrating credit risk, CCPs isolate the effects of a potential bankruptcy of a market participant. The concentration of credit risk is beneficial for market participants but

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[38] See <https://www.esma.europa.eu/sites/default/files/library/esma70-446-775_preliminary_data_report_on_mcm.pdf> accessed 10 May 2023

[39] See <https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart202211_01~173476301a.en.html > accessed 10 May 2023

[40] See <https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf > accessed 10 May 2023

[41] See Ben S. Bernanke, ' Clearing and settlement during the crash' (1990) 3(1) Review of Financial Studies 133; Bruno Biais, Florian Heider and Marie Hoerova, 'Clearing, counterparty risk and aggregate risk' (2011) 21 IMF Economic Review 193; Thorsten Koeppl, Cyril Monnet and Ted Temzelides, 'Optimal clearing arrangements for financial trades' (2012) 103(1) Journal of Financial Economics 189; Yee Cheng Loon and Zhaodong Ken Zhong, 'The impact of central clearing on counterparty risk, liquidity and trading: Evidence from the credit default swap market' (2014) 112 Journal of Financial Economics 91.

[42] Kirsi Ripatti, ' Central counterparty clearing: Constructing a framework for evaluation of risks and benefits' (2004) Bank of Finland Discussion Papers 1 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3022510> accessed 10 May 2023.

leads to an exposure for the CCP until the transaction is finally settled. As clients, market participants have to post initial margins with a clearing member of the CCP when opening a future position. If the price moves adversely, they need to post variation margins and sometimes more initial margins. In case a clearing member is no longer able to meet its margin obligations, the CCP can consider the clearing member in default.

3. Legislative proposals

This section of the article puts forward several legislative proposals to assure that there exists a level playing field between financial actors active in the commodity derivatives markets compared to energy firms currently being subject to lighter financial requirements. The proposals put forward also intend to make sure that energy firms are prudentially safer and thus that government intervention can be avoided.

3.1 Decrease of the clearing threshold for commodity derivatives

Given the benefits of central clearing, Article 4(1) of EMIR obliges counterparties to clear all OTC derivative contracts pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation in accordance with Article 5(2) of EMIR[43]. Central clearing is obliged between a) two financial counterparties, b) between a financial counterparty and a non-financial counterparty that meets the conditions referred to in Article 10(1)(b)[44], c) between two non-financial counterparties that meet the conditions referred to in Article 10(1)(b), d) between a

[43] ESMA needs to submit to the European Commission for endorsement draft regulatory technical standards specifying a) the class of OTC derivatives that should be subject to the clearing obligation and b) the date or dates from which the clearing obligation takes effect, including any phase in and the categories of counterparties to which the obligation apply. Even when certain energy derivatives do not fall within the list published by ESMA (see supra), it is still important to see whether a non-financial counterparty falls above or below the clearing threshold (see infra).

[44] Meaning that they have positions exceeding the clearing threshold as specified under Article 10(3) of EMIR and become subject to the clearing obligation for future contracts in accordance with Article 4 of EMIR if the rolling average position over 30 working days exceeds the threshold.

financial counterparty or a non-financial counterparty meeting the conditions referred to in Article 10(1)(b) and an entity established in a third country that would be subject to the clearing obligation if it were established in the European Union, or e) between two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the European Union, provided that the contract has a direct, substantial, and foreseeable effect within the European Union, or where such an obligation is necessary or appropriate to prevent the evasion of any provision of EMIR. Concerning non-financial counterparties, it is thus important whether their positions exceed the clearing threshold, which was initially determined by ESMA to be 3 billion EUR for commodity derivatives according to Article 10(4) of EMIR.[45] For non-financial counterparties to determine whether they fall above (i.e. NFC+) or below the clearing threshold (i.e. NFC-), the non-financial counterparty has to include all the OTC derivative contracts entered into by the non-financial counterparty or by the other non-financial entities within the group to which the non-financial counterparty belongs, which are not objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of the non-financial counterparty or of that group. This entails that contracts concluded for hedging purposes (see infra for a detailed discussion) do not have to be taken into consideration. Note that this exclusion does not hold for financial counterparties.

Being above or below the clearing threshold is also important for the risk-management requirements a non-financial counterparty has to adhere to for the contracts that are not centrally cleared. Under Article 11 of EMIR, non-financial counterparties falling above the clearing threshold are subject to the bilateral margin requirements. [46] That is, NFCs+ have to have risk-

[45] See <https://www.esma.europa.eu/press-news/esma-news/esma-proposes-eur-1-billion-increase-commodity-derivatives-emir-clearing> accessed 10 May 2023.

[46] For commodities, the standard initial margin model (Simm) was developed by the International Swaps and Derivatives Association (ISDA) and calculates regulatory initial margin based on the risk sensitivity of portfolios. It differs, however, from central counterparty models, as it ignores contract tenors and uses spot price as the sole

management procedures that require the timely, accurate, and appropriately segregated exchange of collateral concerning OTC derivative contracts that are entered into on or after the clearing threshold is exceeded. When bilateral margins are above the 8 billion EUR threshold set in Commission Delegated Regulation (EU) 2016/2251[47], the bilateral margin requirements also include the initial margin requirements. Hence, when a non-financial counterparty exceeds the clearing threshold, it will not only impact its clearing obligation in that asset class but will also trigger the bilateral margin requirements for all of its uncleared OTC derivatives. This means that the firm will need to post variation margin for non-cleared derivatives from the moment they fall above the initial margins and initial margins according to the phase-in established in Commission Delegated Regulation (EU) 2016/2251[48] depending on their aggregate average notional amount of non-centrally cleared derivatives. Note that EMIR foresees 4 months to start clearing after counterparties exceed the clearing threshold, while such a preparatory period does not exist for the bilateral margin requirements. Non-financial counterparties falling above the clearing threshold also need to mark-to-market on a daily basis the value of outstanding contracts. When market conditions prevent marking-to-market, reliable and prudent marking-to-models have to be used.

Although both non-financial counterparties falling below and above the clearing threshold need to provide timely confirmations under Article 12 of Commission Delegated

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risk factor. Hence, commodities often have a term structure but this is not taken into consideration. As a consequence, the model can lead to lower margin amounts.

[47] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&rid=1> accessed 10 May 2023.

[48] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulating (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&rid=1> accessed 10 May 2023.

Regulation (EU) No 149/2013[49], the time limit is shorter for those falling above the clearing threshold. That is, these are required to provide confirmations by the end of the business day following the date of execution of the derivative contract, while non-financial counterparties falling below the clearing threshold are only required to provide confirmations by the end of the second business day following the date of execution of the derivative contract.

All counterparties are required to perform portfolio reconciliation under Article 13 of Commission Delegated Regulation (EU) No 149/2013 but non-financial counterparties falling above the clearing threshold are required to do this more regularly than those falling below the threshold. That is, the former need to perform portfolio reconciliation: i) each business day when the counterparties have 500 or more OTC derivative contracts outstanding with each other, ii) once per week when the counterparties have between 51 and 499 OTC derivative contracts outstanding with each other at any time during the week, and iii) once per quarter when the counterparties have 50 or less OTC derivative contracts outstanding with each other at any time during the quarter. Non-financial counterparties falling below the clearing threshold are only required to perform portfolio reconciliation: i) once per quarter when the counterparties have more than 100 OTC derivative contracts outstanding with each other at any time during the quarter, and ii) once per year when the counterparties have 100 or less OTC derivative contracts outstanding with each other.

After publishing a discussion paper on 19 November 2021[50] and running a public consultation until 19 January 2022[51], ESMA proposed to the European Commission to increase

[49] Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP. <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF> accessed 10 May 2023.

[50] <Discussion paper on the review of the clearing thresholds under EMIR (europa.eu)> accessed 10 May 2023.

[51] <https://www.esma.europa.eu/sites/default/files/library/esma70-451-502_report_on_the_review_of_the_clearing_thresholds_under_emir.pdf> accessed 10 May 2023.

the clearing threshold for commodity derivatives, based on a firm's aggregate month-end average positions in OTC derivative contracts for the previous 12 months from 3 billion EUR to 4 billion EUR because of increased electricity prices.[52] The threshold would namely be reached more easily for non-financial counterparties making sure that these do not only need to centrally clear – although commodity derivatives are not yet on ESMA's lists of derivatives falling under the clearing obligation - but also that they would need to fulfill all the risk-mitigation techniques described in Article 11 of EMIR, such as the bilateral margin requirements and the daily valuation of collateral in case of non-central clearing. The conclusion of ESMA was largely based on the view of the energy sector, which raised to ESMA's attention their issues concerning the current clearing threshold framework.[53] The initial EMIR clearing threshold of 3 billion EUR for commodity derivatives was established in 2012 and, compared to the prices in 2021, gas power and emission allowances increased considerably. The energy sector stated that non-financial counterparties could have passively exceeded the clearing threshold because of the continued rise of commodity prices. The energy sector also referred to non-EU regulations as being less severe. That is, the European Union contained a commodity derivatives clearing threshold of 3 billion EUR per group against 8 billion USD (i.e. 7 billion EUR) per group in the USA, 20 billion SGD (i.e. 12 billion EUR) per entity in Singapore, and 100 billion AUD (i.e. 64 billion EUR) per entity in Australia. In terms of scope, the European Union is also more inclusive. For instance, the term 'swap' in US regulation does not include physically settled products and excludes from its scope a certain

[52] Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (i.e. EMIR Refit) introduced a mandate for ESMA to periodically review the clearing thresholds and, when necessary, propose amendments to update them.

[53] See <https://www.esma.europa.eu/press-news/consultations/discussion-paper-review-clearing-thresholds-under-emir > accessed 10 May 2023.

number of situations such as the trading of Designated Contract Markets (DCM) and Swap Executing Facility (SEF) cleared swaps.[54] The calculation required for the clearing thresholds in EMIR also includes the OTC positions of all non-financial counterparties within the group independent of whether their activities take place in the European Union or not.

Another argument for the increase of the threshold was that many energy firms trade derivatives on a UK market, like ICE Futures Europe, which has the risk of not being recognized by the European Commission after Brexit. In case of non-recognition, these exchange-traded derivatives would classify as over-the-counter thereby increasing the probability for the non-financial counterparty to fall above the clearing threshold of EMIR and having to install all costly bilateral clearing requirements, like the exchange of bilateral capital. Note that, given the urgency of the change to increase the clearing threshold for commodity derivatives according to ESMA, no additional public consultation was launched.

Deutsche Börse Group answered to the discussion paper that the current clearing thresholds proved useful and were well-calibrated. They did not see a need for any substantial changes to the level of the clearing threshold concerning commodity derivatives. According to them, the main criterion to review a clearing threshold should be the systemic risk a market participant brings to the market and the whole energy crisis shows a need for energy traders to clear their transactions via a CCP to mitigate counterparty risk. A comparison with other jurisdictions with higher thresholds falls short as more products are included in those thresholds, while EMIR has a more granular approach by asset class. Also, the Global Foreign Exchange Division (DGXD), the Global Financial Markets Association (GFMA), and the Swedish Securities Markets Association (SSMA) answered that the current clearing thresholds were

[54] See the no-action letter of the CFTC (i.e. <https://www.cftc.gov/system/files/csl/final/pdfs/19/1561667900/19-14.pdf > accessed 10 May 2023).

appropriate across asset classes, thereby strongly recommending not to change them.[55] In addition, the European Systemic Risk Board (ESRB) expressed concerns regarding the increase of the clearing threshold for commodity derivatives as article 10(4) of EMIR states that the clearing thresholds are to be determined taking into account the systemic relevance of the sum of net positions and exposures per counterparty and per class of OTC derivatives and that there is no evidence that this systemic relevance has decreased. [56] On the contrary, the ESRB believed that the increase in market volatility of commodity prices since the start of the COVID-19 pandemic points to a greater need for energy traders to clear their transactions via a central counterparty to mitigate counterparty risk. Yet, the ESRB highlighted that an increase would be useful for a short, predefined time and with an accompanied deadline to avoid unintended negative consequences. ESMA acknowledged the concerns of the ESRB and also considered the increase as an interim solution that can help EU counterparties to remain competitive. Yet, ESMA did not recommend a pre-defined end date.

The question of whether a clearing threshold of 4 billion EUR is appropriate is thus subject to divergent views. Given that gas prices decreased again in the European Union after August 2022, it is the momentum to ask whether the commodity derivatives clearing threshold should not be reduced again. Also, the question of whether energy firms being active in the commodity derivatives market should adhere to all the risk-mitigation factors when not centrally clearing OTC derivatives, equivalent to financial counterparties, should be brought forward to ensure a level playing field. Smaller investment firms nowadays need to adhere to e.g. the bilateral margining requirements compared to larger energy firms not needing to do so because of the high clearing threshold.

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[55] See <https://www.esma.europa.eu/press-news/consultations/discussion-paper-review-clearing-thresholds-under-emir > accessed 10 May 2023

[56] See <https://www.esma.europa.eu/sites/default/files/library/esma70-451-114_final_report_review_of_the_commodity_derivative_clearing_threshold_under_emir.pdf > accessed 10 May 2023.

3.2 Narrowing down the definition of hedging

Related to the question on the appropriate height of the clearing threshold is the notion of 'hedging'[57] as non-financial counterparties can benefit from a so-called hedging exemption whereby OTC derivatives that are entered into to reduce risks related to their commercial activity are excluded from the calculations of positions towards the clearing threshold (see supra). EMIR provides criteria to establish which OTC derivative contracts are to be considered as hedging transactions, which includes the accounting definition of hedging based on International Financial Reporting Standards (IFRS) rules, as well as proxy hedging and portfolio hedging. That is, article 10 of Commission Delegated Regulation 149/2013 defines hedging for the purpose of EMIR and includes OTC derivative contracts which meet one of three criteria. First, they need to cover the risks arising from the potential change in the value of assets, services, inputs, products, commodities, or liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the normal course of its business. Second, they need to cover the risks arising from the potential indirect impact on the value of assets, services, inputs, products, commodities, or liabilities, resulting from fluctuations in interest rates, inflation rates, foreign exchange rates, or

[57] Hedging has been defined in the literature as a) a generic insurance contract, b) any action reducing covariance between a firm's value and a state contingent variable or c) the activity of holding derivative financial instruments to reduce the exposure to marketable risk. See Kifle Henok, 'The impact of regulation on corporate hedging activities and the response of corporates – a preliminary conceptual framework' (2017) 6(4) Business and Management Research 1; Marcello Spanò, 'Theoretical explanations of corporate hedging' (2013) 3(7) International Journal of Business and Social Research 18; . See also Pankaj Gupta, 'A review of corporate hedging models and their relevance in corporate finance' (2017) 7(2) Theoretical Economic Letters 102. In this article, the later definition is used.

credit risk. Lastly, they need to qualify as a hedging contract according to international financial reporting standards (IFRS) adopted by Article 3 of Regulation (EU) No 1606/2002[58].

Because the notion of hedging can be interpreted in a very broad manner, ESMA EMIR OTC Q&A 10[59] provides some further supervisory guidance regarding the definition of hedging, thereby including specific criteria to be considered when using portfolio or macro hedging. That is, ESMA is of the view that the definition of hedging for EMIR purposes includes and is broader than the IFRS accounting rules. That is, some OTC derivative contracts may qualify as hedging for EMIR purposes (which includes also proxy hedging and macro or portfolio hedging) although they do not qualify as hedging under the definition of the IFRS rules. To know whether one can speak of hedging, the policies adopted by a counterparty can provide an indication but the indication should be comforted by the analysis of the OTC derivative contracts concluded and the effective hedging that needs to take place when the contract is concluded and during the lifetime of the contract. ESMA is then also of the view that neither audited accounts nor internal policies per se are sufficient to demonstrate that the relevant contracts are for hedging purposes, but need to be supplemented by evidence of the actual risk directly related to the commercial or treasury financing activity that the contract is covering. ESMA is also of the view that the frequency of the OTC derivative contract is not a criterion to determine whether it is considered in the scope of the commercial activity or treasury financing activity or non-financial counterparties. Hence, the hedging definition is not strictly defined but ESMA is the view that it should nevertheless be examined very closely to see whether it can be used to fall out of the clearing threshold calculation.

[58] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. <https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32002R1606 > accessed 10 May 2023.
[59] See <https://www.esma.europa.eu/document/qa-emir-implementation> accessed 10 May 2023.

In the case of portfolio or macro hedging, ESMA acknowledges that it may not always be possible to establish a one-to-one link between a specific transaction in an OTC derivative and a specific risk directly related to the commercial activity or treasuring financing activities entered into to hedge it. The national competent authority will thus need to assess the situation on a case-by-case basis, but ESMA proposed some criteria that should be fulfilled in any case. First, the risk management systems should prevent non-hedging transactions to be qualified as hedging solely because they form part of a risk-reducing portfolio on an overall basis. Second, quantitative risk management systems should be complemented by qualitative statements as part of internal policies, defining a priori types of OTC derivative contracts included in the hedging portfolios and the eligibility criteria, and stating that the transactions in contracts included in the hedging portfolios are limited to covering risks directly related to commercial or treasury financing activities. The risk management systems should provide for a sufficiently disaggregate view of the hedging portfolios in terms of e.g. asset class, product, and time horizon, to establish the direct link between the portfolio of hedging transactions and the risks that this portfolio is hedging. There should be a clear link between the type of contracts entered into and the commercial or treasury financing activity of the group. If a portfolio has a part hedging and speculative components, the latter have to be counted towards the clearing threshold. Fourth, when a group has non-financial counterparties established in different countries of the European Union, and that group has a central unit responsible for the risk management systems of several entities of the group, the systems should be used consistently in all the entities of the group. Finally, the risk management systems should not be limited to a binary mechanism whereby, up to a certain limit (i.e. a predefined risk metric reaches a predefined value in absolute or relative terms), all OTC derivative transactions are classified as hedging, and once this limit is exceeded, all OTC derivative transactions are classified as non-hedging.

In addition to the fact that there is a lot of room for discretion regarding the interpretation of hedging and ESMA therefore lists many criteria that have to be in place but that nevertheless have to be addressed on a case-by-case basis, there is even no consensus within the industry on whether the concept of hedging is defined too narrow or too broad. That is, the hedging definition can be interpreted in a very broad manner and active energy firms thus can find arguments to claim that their derivatives are for hedging purposes only in order to fall below the clearing threshold. For instance, the Joint Energy Association Group claims that the definition of eligible risks for hedging under EMIR is rather restrictive and should be elaborated.[60] According to them, only liquid wholesale energy markets will enable the European Union to make foreseen investments of 350 billion EUR per year over this decade to meet the 2030 emission-reduction target and so these environmentally sustainable activities carry long-term market risks which require corresponding long-term hedging opportunities that can be achieved when liquidity provided by a non-financial counterparty to third parties is allowed as hedging. Also, they argue that commodity derivatives can be denominated in another currency than the one of the country of the energy firm and that these therefore also conclude FX derivatives to hedge their currency risk. Yet, as these FX derivatives are concluded to hedge the financial risk related to another derivative, they can nowadays not be taken into consideration for the hedging definition under EMIR. Because these FX derivatives indirectly reduce the risk of the group, the European Federation of Energy Traders is of the view that these should nevertheless be included.[61]

In contrast, Deutsche Börse Group highlighted in its feedback to ESMA the importance of narrowing down the hedging exemption to only cover true commercial hedging and treasury

[60] See < https://www.esma.europa.eu/press-news/consultations/discussion-paper-review-clearing-thresholds-under-emir > accessed 10 May 2023.
[61] See < https://www.esma.europa.eu/press-news/consultations/discussion-paper-review-clearing-thresholds-under-emir > accessed 10 May 2023.

financing activities.[62] Given the lack of consensus, the question would then also be whether the notion of hedging should be further specified or narrowed down to supervise energy firms more severely, given that they can provide risks to the financial system. In addition, the question can be asked whether it is fair that financial counterparties cannot benefit from the hedging definition compared to non-financial counterparties. Removing the hedging exclusion altogether could be a solution, but would perhaps lead to energy firms using fewer derivatives for hedging purposes, which might also be avoided.

3.3. Increased regulatory reporting on commodity derivatives trading

On 22 September 2022, ESMA advised the European Commission to improve the regulatory reporting on commodity derivatives trading to allow enhanced market supervision and proper risk assessment of market participants' positions.[63] Currently, Article 9 of EMIR states that counterparties and central counterparties have to ensure that the details of any derivative contract they have concluded and of any modification or termination of the contract are reported to a trade repository. The details have to be reported no later than the working day following the conclusion, modification, or termination of the contract. Regulation (EU) 2019/834 ("EMIR Refit")[64] modified this article by adding that the reporting obligation does not apply to derivative contracts within the same group where at least one of the counterparties is a non-financial counterparty or would be qualified as a non-financial counterparty if it were established in the European Union provided that a) both counterparties are included in the same

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[62] See <https://www.esma.europa.eu/press-news/consultations/discussion-paper-review-clearing-thresholds-under-emir > accessed 10 May 2023

[63] See <https://www.esma.europa.eu/press-news/esma-news/esma-responds-eu-commission-regarding-recent-developments-in-energy-derivatives > accessed 10 May 2023.

[64] Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0834 > accessed 10 May 2023.

consolidation on a full basis, b) both counterparties are subject to appropriate centralized risk evaluation, measurement and control procedures, and c) the parent undertaking is not a financial counterparty. To obtain this reporting exemption, counterparties need to notify their competent authorities of their intention to apply for the exemption. The exemption is valid unless the notified competent authority does not agree to the fulfillment of the conditions within three months of the date of notification.

In case the requirements are thus fulfilled and the exemption is obtained, the transactions do not have to be reported to a trade repository and are thus also visible to regulators. This situation is acute for cross-border EU groups, where only the derivatives that are concluded with entities outside the group are reported and these are often centralized in one subsidiary of the group (i.e. the trading arm of the group). EU authorities therefore lost an important source of information to monitor derivatives markets in general and in particular the exposures of subsidiaries of the group based in a Member State different from the one where the trading arm is based. ESMA advised removing the exemption given the large number of intragroup energy derivatives. Also, the EMIR framework presents some limitations due to the geographical scope of its application as only EU counterparties are covered. That is, OTC transactions between two non-EU counterparties are not captured by the EMIR reporting obligations and thus this information is not available to the national competent authorities nor ESMA. If two e.g. American firms thus trade OTC in e.g. TTF futures being listed on ICE Endex, the information is not reported while these trades can influence the final market price.

In addition, Article 58 of Directive 2014/65/EU (MiFID II)[65] states that Member States have to ensure that an investment firm or a market operator operating a trading venue that trades commodity derivatives or emission allowances or derivatives thereof makes public a weekly

[65] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065 > accessed 10 May 2023

report with the aggregate positions held by the different categories of persons for the different commodity derivatives or emission allowances or derivatives thereof traded on their trading venue, specifying the number of long and short positions by such categories, changes thereto since the previous report, the percentage of the total open interest represented by each category and the number of persons holding a position in each category. This information has to be communicated to the competent authority and ESMA. ESMA has to proceed to a centralized publication of the information included in those reports. On top of that, investment firms or market operators operating a trading venue that trade commodity derivatives or emission allowances or derivatives thereof need to provide the competent authority with a complete breakdown of the positions held by all persons, including the members or participants and the clients thereof, on that trading venue, at least daily.

On top of this, Article 58 of MiFID II requires that Member States ensure that investment firms trading in commodity derivatives or emission allowances or derivatives thereof outside a trading venue provide the competent authority of the trading venue where the commodity derivatives or emission allowances or derivatives thereof are traded or the central competent authority where the commodity derivatives or emission allowances or derivatives thereof are traded in significant volumes on trading venues in more than one jurisdiction at least daily with a complete breakdown of their positions taken in commodity derivatives or emission allowances or derivatives thereof traded on a trading venue and economically equivalent OTC contracts, as well as of those of their clients and the clients of those clients until the end client is reached. To enable monitoring of compliance with this position limit requirement of MiFID II, Member States need to require members or participants or regulated markets[66], multilateral

[66] A regulated market is defined in Article 4(1), point (21) of Directive 2014/65/EU (MiFID II) as 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 facilities[67] , or organized trading facilities[68] to report to the investment firm or market operator operating that trading venue the details of their own positions held through contracts traded on that trading venue at least daily, as well as those of their clients and the clients of those clients until the end client is reached. In that way, it might thus be possible to detect the positions that energy firms have. Note, however, that Article 57(1) of MiFID II states that position limits do not apply to positions held by or on behalf of a non-financial entity and which are objectively measurable as reducing risks directly related to the commercial activity of that non-financial entity. The hedging definition discussion is thus also here relevant.

Nevertheless, the reporting requirements for non-financial counterparties are narrowed down considerably in Commission Delegated Regulation (EU) 2022/1302.[69] For instance, positions held by a non-financial entity in commodity derivatives that are objectively measurable as reducing risks shall not be aggregated when comparing the net positions of that non-financial entity with the limits for that commodity derivative. Also, a non-financial entity holding a qualifying position in an agricultural commodity derivative or in a critical or significant commodity derivative has to apply for an exemption from the competent authority. Furthermore, under MiFID II, wholesale energy products (i.e. gas and electricity) that must be physically settled and traded on an organized trading facility (OTF) do not qualify as financial instruments (i.e. the C6 carve-out). As such, these instruments are also not covered by the

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trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with Title III of MiFID II.

[67] A multilateral trading facility is defined in Article 4(1), point 22 of Directive 2014/65/EU (MiFID II) as 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 Title II of MiFID II.

[68] An organized trading facility is defined in Article 4(1), point 23 of Directive 2014/65/EU (MiFID II) as a multilateral system which is not a regulated market or an MTF an in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of MiFID II.

[69] Commission Delegated Regulation (EU) 2022/1302 of 20 April 2022 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives and procedures for applying for exemption from position limits. < https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32022R1302 > accessed 10 May 2023.

MiFIR transparency and reporting requirements[70] nor by the EMIR reporting requirements[71], making again that no information on them is available to national competent authorities or ESMA on the amount of trading taking place in those derivative products, or on the firms trading those instruments.

Another issue regarding natural gas derivatives is data fragmentation and data gaps. Data fragmentation relates to the fact that information on some derivatives is only reported to energy regulators or only to financial regulators. For instance, wholesale energy products physically settled and traded on an organized trading facility do not qualify as financial instruments under MiFID II and are not covered by the transparency and reporting requirements under MiFIR and EMIR available to financial regulators (see supra). Yet, these are reported to ACER under REMIT[72]. ESMA therefore suggested modifying this so that national competent authorities get daily transaction and position reporting. Hence, to have a better view of the energy derivative market, one can argue that the exemption for intragroup transactions or position limit reporting should be removed and that both financial and energy regulators need to get equivalent information.

3.4. Considering energy firms as investment firms

Another option to mitigate the unlevel-playing field between non-financial counterparties and financial ones is to make sure that the non-financial counterparties being very active in the energy derivatives markets are treated as financial ones. In that way, the issues highlighted above in this article would also be solved. Hence, further advice that ESMA provided to the

[70] See e.g. Articles 3, 6, and 26 of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (MiFIR) <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600 > accessed 10 May 2023.
[71] See supra.
[72] Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1227> accessed 10 May 2023.

European Commission was to consider non-financial entities trading extensively and providing investment services in commodity derivatives to quantify them as investment firms.[73] This would then require them to also raise significant amounts of extra capital to fulfill the prudential requirements laid down in the EU's prudential regulations, such as Regulation (EU) No 575/2013.[74] This entails that energy price moves could result in energy firms' net positions increasing substantially, leading to a necessity to find more capital either in the forms of shares or retained earnings. Having a capital requirement in place would thus give a mandatory cushion to protect energy firms against market losses.

Currently, all energy firms benefit from the MiFID II[75] ancillary activity exemption. That is, Article 2(1), point j of MiFID II states that the directive does not apply to persons i) dealing on their own account, including market makers, in commodity derivatives or emission allowances or derivatives thereof, excluding persons who deal on own account when executing client orders, or ii) providing investment services, other than dealing on own account, in commodity derivatives or emission allowances or derivatives thereof to the customer or suppliers of their main business. To benefit from these exemptions, several conditions have to be fulfilled. First, for each of those cases individually or on an aggregate basis, it has to be an ancillary activity to the main business, when considered on a group basis, and that main business cannot be the provision of investment services within the meaning of MiFID II or

[73] See <https://www.esma.europa.eu/press-news/esma-news/esma-responds-eu-commission-regarding-recent-developments-in-energy-derivatives > accessed 10 May 2023

[74] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575> accessed 10 May 2023. For instance investment firms would need have capital that accounts for the risks stemming from the market risk of their derivatives portfolios, potential counterparty defaults, operational risks and the concentration of exposure to a single counterparty. Regarding the market risk of their derivatives positions, known as net position risk (NPR), many trading firms use the simplified approach contained in the capital requirements regulation (CRR) for banks. Trading firms would need to hold capital amounting to 15% of their net positions and 3% of their gross derivatives exposure. Energy firms would also need to hold liquid assets equivalent to at least one third of their fixed overhead costs, making them more resilient to margin calls.

[75] Directive 2016/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065 > accessed 10 May 2023.

banking activities under Directive 2013/36/EU[76], or acting as a market-maker in relation to commodity derivatives. Second, those persons cannot apply high-frequency algorithm trading techniques. Finally, those persons have to notify annually the relevant competent authority that they make use of this exemption and upon request report to the competent authority the basis on which they consider that their activity under points i) and ii) is ancillary to their main business. As part of the COVID-19 recovery package[77], the last requirement was eliminated.

Commission Delegated Regulation (EU) 2021/1833[78] specifies the criteria for establishing when an activity can be considered as ancillary to the main business at the group level. That is, the net outstanding notional exposure in commodity derivatives for cash settlement or emission allowances or derivatives thereof for cash settlement traded in the European Union, excluding derivatives or emission allowances or derivatives thereof traded on a trading venue, has to be below an annual threshold of 3 billion EUR. Note that the latter threshold was introduced as part of the COVID-19 recovery package. This threshold, which is substantially large, makes it easier for firms to exploit their business without needing to fulfill all MiFID II requirements for investment firms. Other criteria to be considered as ancillary is when the size of the ancillary activities accounts for 50% or less of the total size of the other trading activities of the group or when the estimated capital employed for carrying out those activities accounts for not more than 50% of the capital employed at group level for carrying out the main business.

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[76] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036 > accessed 10 May 2023.

[77] See <https://finance.ec.europa.eu/publications/coronavirus-response-how-capital-markets-union-can-support-europes-recovery_en> accessed 10 May 2023.

[78] Commission Delegated Regulation (EU) 2021/1833 of 14 July 2021 supplementing Directive 2014/65/EU of the European Parliament and of the Council by specifying the criteria for establishing when an activity is to be considered to be ancillary to the main business at group level. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R1833 > accessed 10 May 2023.

Nowadays, all European energy firms have been able to benefit from this exemption. Yet, considering the systemic size and nature of the business of some of the energy firms, it would be useful to revise this and e.g. lower the threshold of 3 billion EUR. Being categorized as an investment firm when being substantially active would make sure that prudential and conduct rules would apply and make active energy firms subject to prudential and conduct supervision by financial market regulators.

4. Conclusion

This article discusses the question of whether energy firms extensively active in the energy derivatives markets should be subject to more stringent financial regulation to avoid potential government interventions. If governmental support would indeed be needed, it means that tax money would have to be used. Several legislative proposals are put forward in this article to make energy firms prudentially safer and to ensure that there exists a level playing field between financial actors active in the commodity derivatives markets compared to energy firms currently being subject to lighter financial requirements. Indeed, EMIR is more stringent regarding the clearing obligation for financial counterparties compared to non-financial ones and also imposes more severe risk-mitigation requirements on financial entities for OTC derivative contracts that are not cleared by a CCP. Knowing that energy firms are key users in the energy derivatives markets; much more compared to e.g. smaller investment firms being subject to severe legal requirements, one can argue that a level-playing-field issue is perhaps at stake.

In terms of legislative proposals, this article advises lowering the clearing threshold of 4 billion EUR for commodity derivatives to make energy firms easier subject to the clearing requirement under EMIR or to the risk-mitigation requirements for OTC contracts not centrally cleared. On 7 December 2022, the European Commission proposed an amendment of EMIR as regards measures to mitigate excessive exposures to third-country counterparties and improve

the efficiency of Union clearing markets.[79] In that proposal, the European Commission asks ESMA to specify the values of the clearing thresholds, which have to take into consideration the systemic relevance of the open positions and future net exposures per counterparty and per class of OTC derivatives. In that way, the 4 billion EUR clearing threshold for commodity derivatives will be re-examined. Even more, ESMA even has to develop technical standards specifying the mechanisms triggering a review of the values of the clearing thresholds following significant price fluctuations in the underlying class of OTC derivatives. ESMA would need to review the clearing thresholds at least every 2 years and earlier when necessary. When reviewing the clearing thresholds, ESMA would have to consider whether the classes of OTC derivatives for which a clearing threshold has been set are still the relevant classes of OTC derivatives or if new classes should be introduced. Regarding commodity derivatives, ESMA is encouraged to consider and provide more granularity. This could be achieved by separating the clearing thresholds by sector and type, such as differentiating between agriculture, energy, or metal-related commodities or differentiating those commodities based on other features such as environmental, social, and governance criteria, environmentally sustainable investments, or crypto-related features.

A second proposal in this article is to further specify or narrow down the notion of hedging so that energy firms would be above the clearing threshold more easily. In addition, the question can be asked whether it is fair that financial counterparties cannot benefit from the hedging definition compared to non-financial counterparties. Removing the hedging exemption altogether could be a solution, but would perhaps lead to energy firms using fewer derivatives for hedging purposes, which should perhaps also be avoided. A trade-off should thus be found, perhaps proposed by the European Commission or ESMA. In the proposal of the European

[79] See <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022PC0697&from=EN > accessed 10 May 2023.

Commission to amend EMIR,[80] the European Commission proposes that the European supervisory authorities to develop draft regulatory technical standards, after consulting the ESRB and other relevant authorities, specifying the criteria for establishing which OTC derivative contracts are objectively measurable as reducing risk directly relating to the commercial activity or treasury financing decisions.

Another proposal addressed in this article is to have a better view on the energy derivatives markets by removing the exemption for intragroup transactions or position limit reporting, as well as making sure that both financial and energy regulators get equivalent information. In the proposal of the European Commission to amend EMIR,[81] the European Commission already proposes to remove the intragroup exemption for reporting. Finally, another option to mitigate the unlevel-playing field between non-financial counterparties and financial ones is to make sure that the non-financial counterparties being very active in the energy derivatives markets are treated as financial ones. Until now, there seems to be no appetite for legislators to take regulatory actions in this respect.

When proposing legislative changes, it is relevant to take into account that new requirements could have side effects. That is, if energy firms would be subject to too much stringent financial regulation when being active in the energy derivatives markets, it might lead to a situation that these firms stop using derivatives for hedging purposes altogether, which might lead to more risk for them. Alternatively, they would have incentives to conduct their trading activities outside of the European Union. A trade-off thus has to be found and it is up to European lawmakers, also depending on their political preference, to make the final decision.

[80] See <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022PC0697&from=EN > accessed 10 May 2023.
[81] See <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022PC0697&from=EN > accessed 10 May 2023.

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