The EMIR 3.0 proposal is a cornerstone of security of supply
15 May 2023

- **Open, robust, liquid and transparent EU energy markets are key to ensuring a secure, sustainable, affordable and competitive energy supply to end consumers.**
- **The EMIR 3.0 proposal supports the energy market participants' efforts to achieve these aims and helps them to manage the challenges of the current energy crisis, whilst safeguarding transparent and safe financial markets.**
- **Furthermore, EMIR 3.0 is well-suited for facilitating the European energy transition and achieving the climate targets of the European Green Deal.**

The signing European and national associations of the Joint Energy Associations' Group – "JEAG" (Bdew, EFET, EnergyUK, eurelectric, Eurogas, IOGP, VKU), support the EU Commission's proposal to amend the Regulation (EU) No 648/2012 ("EMIR 3.0"), as part of the larger EU's Capital Markets Union (CMU) package adopted on 7 December 2022.

The EMIR 3.0 proposal supports the energy market participants' efforts to achieve the aims of the EU internal energy market and helps them to manage the challenges of the current energy crisis, whilst safeguarding transparent and safe financial markets.

The main aim of the EU internal energy market is to guarantee open, robust, liquid and transparent EU energy markets to ensure a secure, sustainable, affordable and competitive energy supply to end consumers. The energy market participants such as power and gas producers, suppliers and energy trading firms are expected to deliver on these goals.

In this context, the energy market participants currently face numerous challenges caused by the energy crisis in the EU. These include unprecedented and continuous energy market volatility and energy price increases, fundamental shortage in gas and power supplies, poor market liquidity in energy markets as well as increased collateral and margin requirements and the consequential liquidity stress for energy firms.

The EMIR 3.0 proposal draws the right lessons from these recent developments in energy markets as in particular the following proposed changes to the EMIR framework will help energy market participants to maintain and develop liquid, competitive and well-functioning EU energy markets and to secure the energy supply:

- The **amendments to the clearing thresholds calculation and review** under Article 10. However, European non-financial counterparties should be able to continue to centrally hedge the risks relating to the commercial and treasury financing activities on behalf of their entire group;
- the **improvement of transparency and predictability of margin calls** under the new Art. 38 (7); and
- the **extension of eligible collateral to (uncollateralised) commercial bank guarantees** under the new Art. 46 (1).

However, we **oppose the proposal to delete the exemption from intra-group reporting (amended Art. 9 (1)) and believe that it will have unintended adverse consequences**, such as burdensome and costly reporting requirements for firms.

Here is our detailed explanation of JEAG's assessment of the EMIR 3.0 proposal:

<u>General background</u>:
Energy market participants are predominately active in the (physical and derivatives) energy markets to cover their needs for commodity supply and demand and to execute transactions to mitigate the market risk of their own or their counterparties' commercial activities (hedging). For example, the operator of a gas fired power plant can hedge its commercial risk (market risk) which consists of the constant change in value of the gas procurement and of the produced power. These firms also provide liquidity in particular to exchange traded markets which facilitates the aforementioned hedging activities of energy market participants and the wider real economy. For these purposes, it is important to promote a regulatory framework for energy derivatives trading in the EU that supports energy firms' ability to trade on liquid and well-functioning EU wholesale energy markets via bilateral transactions (carried out over the counter, "OTC") and/or via centrally cleared, regulated markets.

Furthermore, it is important to note that EMIR 3.0 is well-suited for facilitating the European energy transition and achieving the climate targets of the European Green Deal. The European Green Deal requires hundreds of billions of euros' worth of investments in the energy sector in the current decade. Private investments in renewable energy installation will a play a key role in this regard. As government support phases out, the availability of market-based opportunities for reducing commercial risks, such as OTC derivative trading, becomes increasingly important to make new renewable investments financeable. For example, operators of a large-scale offshore wind park will only invest in the construction and operation if they can ensure stable revenues in today's highly volatile energy markets. Only a liquid OTC derivatives market enable them to hedge their (long term and non-standardised) market price risks with OTC derivative transactions, so-called financial Power Purchase Agreements.

JEAG short supportive comments on the specific EMIR 3.0 proposals with relevance for energy market participants:

Amended EMIR Clearing Threshold calculation and review - new Art. 10 para. 2a to 5

The proposed changes reflect the above-mentioned developments of energy markets, foster the liquidity and competitiveness of EU marketplaces and support the European Green Deal and investments in renewable energy sources.

We support the change to the methodology for the calculation of the clearing threshold. This proposal moves away from the current approach consisting in assessing whether a derivative is OTC or not, to considering whether a derivative is cleared or not. This change in approach correctly addresses the credit risks associated with OTC derivative contracts. Considering the purpose of EMIR, which is to reduce systemic credit risk in the financial system by central clearing, it appears logical to exclude those instruments which do not pose such a risk because they are centrally cleared already.

We also welcome the proposal to count only the OTC derivate transactions entered into by EU established counterparties against the clearing thresholds as this will ensure the competitiveness of EU energy markets and participants. The current EMIR – unlike international financial regulation in other G20 countries – has a global reach without any restriction as it extends the clearing threshold calculations to the non-EU activities of international subsidiaries of EU companies. This puts European groups at a competitive disadvantage when compared to firms that are bound by less restrictive national financial regulation in the home jurisdiction.

However, **we are concerned that, as drafted by the EU Commission, Article 10 (3) would no longer allow for centralised risk management of corporates**. A centralised counterparty fulfilling the trading/treasury function within a corporate group would no longer be allowed to hedge on behalf of its group entities without those trades being counted towards the clearing threshold (as those are trades that do not hedge risks of that trading/treasury entity). **We urge to reinstate the possibility for European non-financial counterparties to centrally hedge the risks relating to the commercial and treasury financing activities (in particular commodity, foreign exchange (FX) and interest rate (IR)) of their entire corporate group.** Further explanations and an appropriate wording proposal can be found in the annex to this paper.

The more dynamic, **regular review of the clearing thresholds is helpful** as it will allow ESMA to consult, understand and take account of market developments in a timely manner, such as in the case of the recent increase of prices and volatility in energy markets.

Finally, we appreciate the statement in Recital 16 that ESMA shall consult with energy market participants when it reviews the clearing thresholds and hedging definition.

NFCs can continue to act as direct clearing member at CCPs – new Art. 37(1a)

We fully support maintaining robust CCP membership requirements. In this context, we welcome that NFCs can continue to act as direct clearing members, which is relevant especially in the Nordic energy markets. The robustness and resilience of the central clearing structure is guaranteed where they meet the required participation criteria as proposed, in particular if they are able to fulfill the margin requirements and default fund contributions, and only keep accounts at the CCP for assets and positions held for their own account.

Improvement of Transparency and Predictability of Margin Calls – new Art. 38 (7)

We welcome that the clearing members (clearing banks) shall inform their clients (energy market participants) in a clear and transparent manner of the way the margin models of the CCP work, including in stress situations, and provide them with a simulation of the margin requirements they may be subject to under different (stress) scenarios. We would like to emphasise that the transparency and predictability of margin calls needs to be improved throughout the clearing chain, including appropriate obligations for clearing members and CCPs, so that energy market participants are put in a better position to predict and prepare themselves for collateral requests.

Extension of eligible collateral to (uncollateralised) commercial bank guarantees – new Art. 46 (1)

We support that public bank guarantees, commercial bank guarantees or public guarantees are considered eligible as highly liquid collateral under certain conditions. We request in this context that the reference to "commercial bank guarantees" be clarified to also include uncollateralised commercial bank guarantees issued to energy market participants. The recognition of uncollateralised commercial bank guarantees will facilitate and encourage central clearing of derivatives by energy market participants. Those entities usually have constrained access to sufficient amounts of highly liquid assets (cash), which can lead to substantial liquidity stress of those firms in times of very volatile energy markets. Enabling energy market participants acting as indirect or direct clearing members to post non-cash collateral to cover at least an appropriate portion of the margin requirements will provide relief from that liquidity stress.

Changes regarding to the implementation of an NFC+ status

Finally, we welcome the helpful changes introduced for NFC+. The proposed additional phase-in of mark-to-market and margining obligation for NFCs+ (amended Art. 11 (2) and (3)) helps them with the orderly implementation of an NFC+ status when they exceed the clearing threshold(s). The amended definition of intragroup transactions facilitates the exemption for NFCs+ from the intragroup clearing and margining obligation (new Article 3).

Deletion of the exemption from intra-group reporting is not required and overly burdensome

However, we oppose the deletion of the exemption from intra-group reporting (amended Art. 9 (1)) and believe that it will have unintended adverse consequences, such as burdensome, disproportionate and costly reporting requirements.

In practice, energy firms make wide use of the possibilities available in EMIR to simplify their derivatives reporting obligations:

- Exchange traded derivatives are all reported by their clearing banks (clearing members);
- OTC derivatives are reported by their financial or/and non-financial counterparties (applying the single sided reporting obligation in Art. 9.1(a) or a delegated reporting agreement);
- Intragroup derivative transactions (IGT), mainly entered into for risk reducing purposes, benefit from the reporting exemption introduced by EMIR Refit in 2019.

This means that concerned energy firms, including those of small and medium size, making use of the combination of these alternatives have stopped operating an own reporting infrastructure. Additionally, larger corporate energy groups have made use of these alternatives not only for their energy derivatives business. They have usually one group entity (Treasury Function) – often the group parent company entering into IGTs with the group entities – dealing in interest rate and foreign exchange derivatives transactions – for the purpose of reducing related risks of its wider group – with external financial counterparties to which this entity has delegated the reporting of those transactions. Reintroducing IGT reporting would imply for all those firms the need to reinvest in a reporting infrastructure, which is becoming even more complex with the introduction of the changes to the reporting rules as of

29th April 2024 (CDR (EU) 2022/1855). This proposal contradicts the purpose of the previous reform of EMIR (Refit) to lower operational efforts by adding burdensome, disproportionate and costly requirements on energy firms.

Annex: Continuation of centralised risk management by corporate energy firms

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EMIR 3.0 – re-instate wording of Article 10(3)

The wording highlighted in red and bold hereunder shall be re-instated in Art. 10(3) of EMIR to allow corporate groups, in particular energy firms, to continue having a centralised trading or/and treasury entity in their non-financial group which role is to reduce (hedge) the group-wide risks of their commercial activities or treasury financing activities:

> *"In calculating the positions referred to in paragraph 1, the non-financial counterparty shall include all the OTC derivative contracts that are not cleared in a CCP authorised under Article 14 or recognised under Article 25 entered into by the non-financial counterparty which are not objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty* ***or of the group to which the non-financial counterparty belongs****."*

Reasoning:

A European non-financial counterparty should be able to continue to centrally hedge the risks relating to the commercial and treasury financing activities (in particular commodity, foreign exchange (FX) and interest rate (IR)) of its entire corporate group. This means that also in the future a centralized risk management by a central group entity should remain possible, i.e., on behalf of the other group entities. A specific contractual transfer of these risks through intra-group transactions between a group entity and the centralised trading and/or treasury entity is – as it is currently the case – not required for this purpose. The current EMIR legislation explicitly allows that a centralised group entity can hedge not only its own risks, but also those of its wider group. This centralised hedging approach is supported by the applicable regulatory framework, i.e., by the wording of the level 1 text of EMIR Art 10(3) as well as of the level 2 text of Art. 10 Commission Delegated Act (EU) 149/2013 and of the ESMA Q&As on the implementation of EMIR (OTC Answers 3 and 10).

If the possibility of a centralised risk management is not re-instated all entities within a corporate group would have to set up and perform their own risk management functions and activities. The reason is that a centralised counterparty fulfilling the trading/treasury function within its respective corporate group would no longer be allowed to hedge on behalf of the other group entities without those trades being counted towards the clearing threshold (as those are trades do not hedge risks of that trading/treasury entity). Consequently, as drafted, the legislative proposal for Article 10 (3) would lead to a very inefficient and costly multiplication of risk management functions and activities across a corporate group or alternatively might force the group to become an NFC+. Forcing corporate groups to move away from a centralised approach to risk management will mean that each of the concerned group entities would need their own market access, including in terms of technical and legal set up, to hedge their own commercial and treasury risks. This leads to a loss of payment and close-out netting possibilities and, hence, to increased risks and to a multiplication of positions and of exposures vis-à-vis counterparties which potentially triggers increased liquidity requirements in the framework of bilateral collateralisation agreements. Overall, this would mean that the advantages of a central risk management, such as a more professional and efficient central steering and hedging of risks relating to commercial and treasury financing activities, a better understanding of the overall risks to which a group is exposed, an improved definition of risk strategies and effective netting of exposures would be lost. Hence, it is obvious that such a de-centralised risk management approach would make hedging across a group much more expensive for the real economy, including the energy industry. These additional costs would have to be borne ultimately by the consumers.

Background:

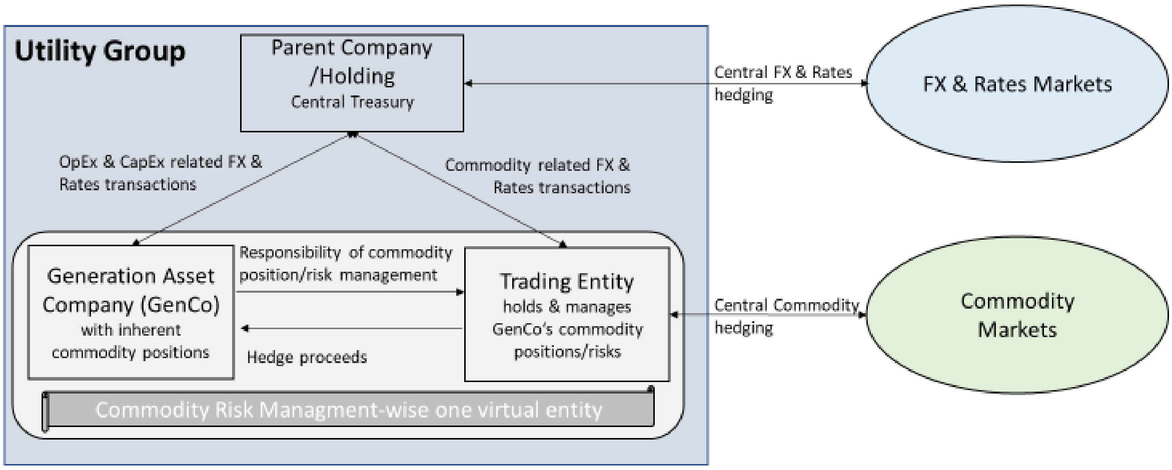
The non-financial counterparty's central trading and treasury functions are hedging both risks that they own and the commodity, FX and IR risks of other group entities. Hence, energy companies often consist of several legal entities for the different economic activities (e.g., generation, exploration, supply, trading, etc.) and sometimes also due to regulatory reasons, e.g., that each wind park has to be its own legal entity.

In case of **FX and IR** risks, it is common practice in the market to transfer the full risk of the group entities in such a manner that their commercial / treasury financing risks become – through intragroup transactions – the proprietary risks of the group's central Treasury function. The Treasury function then aggregates these risks and centrally hedges those in the market.

In case of **Commodities risks** (market price risks), in a non-financial group, typically there is one (or more) entity (entities) specialized in dealing in commodities and commodity derivatives with entities outside the group. This centralised risk management entity holds the access to trading venues and OTC markets and the necessary contractual relationships with trading venues, brokers, central counterparties, clearing members and external counterparties. This central entity hedges the commercial commodity risks (market price risks) of the other group entities which stem from their own commercial businesses, such as power production or gas exploration. For this purpose, the central entity will enter into external commodity derivative transactions to reduce the commercial risks of other group entities, often through proxy hedging and macro or portfolio hedging. For example, the central entity sells to-be-produced power, on behalf of the generation company, via futures entered into on an exchange. This approach ensures efficient route-to-market solutions and is supported by central commodity risk management practices.

A full risk transfer is usually not undertaken between the risk generating group entity (e.g., the power generation company) and the externalising central entity. It is in many instances not feasible nor efficient to transfer the underlying commercial position (e.g., the generated power) to the trading entity.

Please see below a simplified example of a centralised risk management within a non-financial group having a parent company or holding structure with power production activities of a generation asset company.


Utility Group
Parent Company /Holding
Central Treasury
Central FX & Rates hedging
FX & Rates Markets
OpEx & CapEx related FX & Rates transactions
Commodity related FX & Rates transactions
Generation Asset Company (GenCo) with inherent commodity positions
Responsibility of commodity position/risk management
Hedge proceeds
Trading Entity holds & manages GenCo's commodity positions/risks
Central Commodity hedging
Commodity Markets
Commodity Risk Managment-wise one virtual entity