

9 July 2024

## The Ancillary Activity Exemption under MiFID II is an important tool to ensure an affordable, secure and sustainable energy supply

### Background

Under Art. 90 (5) MiFID II the European Commission has been given a mandate in consultation with ESMA, EBA and ACER to conduct a comprehensive assessment of the markets for commodity derivatives, emission allowances and derivatives thereof.

Within the framework of that mandate, discussions have emerged as to a need to reduce the possibility for energy market participants to make use of the Ancillary Activity Exemption. The Ancillary Activity Exemption (or “AAE”) is a provision of financial markets regulation MiFID II, that allows energy market participants as non-financial firms mainly to trade on own account in financial instruments related to commodities, without the need of an authorization as an investment firm from their financial regulator. The AAE is motivated by the need for energy market participants to deal on own account in commodity derivatives and emission allowances, within the limits required by their major business activity. Under the impression of unprecedented price spikes in August 2022 after the severe energy supply constraints the Commission is currently revising the AAE in order to curb price volatility, delimitate cash liquidity constraints.

Energy Traders Europe has commissioned a study from Frontier Economics (the “Study”<sup>1</sup>), to contribute to the overall discussion and decision-making process which shows that the existing regulatory framework already offers all the necessary tools to support resilient energy markets in a crisis, to protect its stability and to prevent harm from the customers.

Nordenergi<sup>2</sup> underlines that a rationale for a review of the AAE is missing and that an amendment of the current regime would have detrimental effects on Europe’s energy autonomy, security of supply, green transition and competitiveness. **Nordenergi therefore supports the current scope of the AAE.**

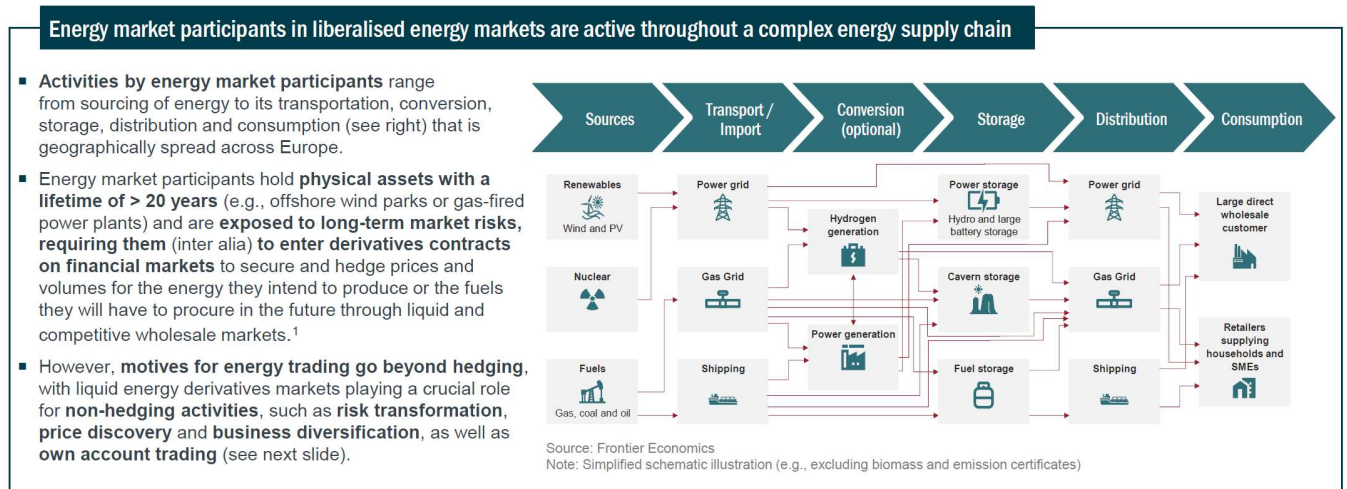
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<sup>1</sup> <https://www.energytraderseurope.org/documents/principles-of/>

<sup>2</sup> Nordenergi is the collaboration between the Nordic associations for electricity producers, suppliers and distributors. Members are Swedenergy, Green Power Denmark, Renewable Norway, Finnish Energy and Samorka. Overall, Nordenergi represents more than 2,000 market actors (member companies), most of them active in the electricity sector, but also in other areas such as district heating, gas and services. For more information regarding Nordenergi please visit [www.nordenergi.eu](http://www.nordenergi.eu). EU Transparency register number: 85161125283-02.

## Energy market participants are a pillar of well-functioning energy markets

Energy market participants (“EMPs”) operate in a complex supply chain, and face various commercial risks from producing, buying and selling (or hereafter “trading”) energy commodities.



<sup>1</sup> In practice, when investing in physical assets, large utilities typically hedge prices and volumes for the early years of the plant's operation through liquid and competitive wholesale markets available (e.g., several years in advance to the physical settlement). For the later years, large utilities then either wait until liquid and competitive trading is available for matching maturities, or upstream and thereby transfer the remaining market risks through integration with the company's group.

Source: Frontier Economics

Trading is a key prerequisite for energy derivatives markets to stay liquid and efficient and to reflect scarcities in the supply and demand balances through corresponding price signals to market participants (See Section 2.1 of the Study for further details).

■ **European end-consumers benefit from energy trading through affordable, secure and sustainable energy supply:** energy trading is essential for liquid and competitive energy markets, with energy resources efficiently allocated through accurate and orderly formed price signals, i.e. underpinning that energy flows from low to high price areas, making the best possible use of production facilities and in this way also supporting security of supply in general. Trading incentivises long-term investments in the energy sector, including those in renewable assets to facilitate the energy transition, reduces wholesale transaction costs and produce energy through the cheapest generation technology (merit order) to the ultimate benefit of end-consumers downstream.

■ **Hedging and non-hedging trading activities by EMPs play a crucial role in achieving liquid, competitive and efficient energy markets:** EMPs engage in trading to hedge prices from energy generation and consumption over location and time. However, motives for energy trading go beyond hedging, and play a crucial role in creating liquid energy derivatives markets. These motives include risk transformation, price discovery and business diversification, as well as own account trading.

■ **Energy commodity markets are closely linked at various levels:** efficient and resilient energy trading requires liquid markets for different commodities (e.g., power or gas) traded across contract types (e.g., spot and derivatives), channels (e.g., exchanges and “over-the-counter”) and geographies that are closely linked amongst each other. The variety of energy commodities (and markets thereof) reflect the complexity of the supply chain EMPs are operating in and highlights the importance for a targeted and consistent regulatory framework.

### Energy markets proved resilient during the energy crisis

**Supply shocks for gas and power, in combination with a high concentration risk in gas supply, were the root cause for price spikes during the energy crisis in Europe.** In August 2022 in particular, market prices for power and gas reached unprecedented levels, due to a “perfect storm”: a massive drop in Russian pipeline gas supplies to Europe that coincided with a significant reduction in available power generation capacity (e.g. low availability of French nuclear power generation, historically low level of reservoirs in the Nordics, abnormal low wind, and disruption of gas deliveries from North Africa) (see Section 3.1.1 of the Study for further details).

The rising wholesale energy prices led to an increase of margin calls at energy exchanges which caused cash liquidity strains for EMPs for the following main reasons:

- In general, EMPs cash is tied in assets (production facilities), which means no excessive liquidity exists
- Commercial banks inability to extend further credit lines to the energy sector due to concentration risk restrictions stemming from the regulatory capital requirement regime,
- margin calls of the exchanges were untransparent and unpredictable (EMIR 3.0 will remedy this constraint)
- EMPs had to provide significant amounts of cash in absence of collateral transformation (e.g. bank guarantee to cash) services of their clearing bank, whilst not having comparable access to central banks standing facilities.

EMPs reacted by reinforcing their cash management measures, optimising their positions and margin calls (for example by the netting effect caused by clearing with fewer clearing houses), strengthening their risk management framework and shifting from exchange trading to OTC trading (see Section 3.1.2 of the Study for further details). Thereby, EMPs managed to meet their materially increased margin calls at exchanges on time (there was no event of default at any CCP), while delivering on their critical role as electricity providers for Europe by reacting on the scarcity signals from the markets: no consumer was left without energy.

**In conclusion:** The energy markets proved resilient and robust, with a regulatory framework fit for purpose.

### Regulating energy market participants as investment firms would severely disrupt the equilibrium

Without the benefit of a reliable AAE, energy market participants would need to comply with disproportionate investment firm regulations, which will affect their ability to contribute to the secure supply of energy for Europe at the lowest possible prices (see Section 3.2.2 of the Study for further details):

- Investment firm regulation triggers additional capital requirements necessary for continuing their usual business activities. A six-month survey led by Energy Traders Europe, held among the largest European energy market participants, shows that the investment firm status would result in mean capital requirements of more than EUR 3 billion for survey participants, and a mean capital deficit of EUR 910 million.
- Investment firm regulation would adversely impact overall market liquidity and efficiency, with the capital required to comply with financial regulation “trapped” and therefore unavailable for investments such as those required for the energy transition (in particular the construction, operation and maintenance of power producing facilities in Europe which are key for the EU’s energy autonomy). The unavailability of funds will lead to (i) less investments in the construction and maintenance of generation assets, (ii) the need for public money to finance security of supply and (iii) production at added costs, that are reflected on European consumers.

- Business models of EMPs are fundamentally different to those targeted under investment firm regulation such as banks where capital requirements serve not least to secure depositors' money. Energy companies do not receive depositors' money. Further, an investment firm status would require EMPs to reconsider their whole group structure for their ancillary trading activity, with the sole purpose of complying with investment firm regulation. Alternatively, EMPs might choose to relocate their activities outside of the EU, or disrupt them altogether, with evident consequences for the energy supply and prices in the EU.
- Investment firm status under MiFID would imply that EMPs gain status as "Financial Counterparty" under EMIR resulting in additional cash burden under mandatory OTC collateralisation for derivatives with an initial margin of around EUR 180 million per survey participant on average, up to EUR 1 billion for one firm. Again, money that is "trapped" and thus cannot be invested in the energy transition.
- Publicly owned energy market participants might be forced to leave the market, on their owner's decision.

EMPs do not pose systemic risk. They are typically companies with long-term generation assets that need to manage the risks of such assets by long term trading. Consequently, unlike banks, they have no choice but to trade in the energy derivatives market which is why the AAE is essential for them.

### Conclusion

Extending the scope of prudential capital requirements to energy traders, by revoking the AAE, would neither address the root cause of the energy crisis (physical scarcity of gas and power), nor improve the cash liquidity crunch from surging collateral requirements ("margin calls") for cleared transactions at energy exchanges. Prudential capital requirements are designed to cover potential losses at adverse market developments but do not result in additional generation capacity or e.g. LNG supply.

Nordenergi acknowledges the importance of an efficient regulatory framework, ensuring well-functioning energy markets. As a lesson learnt from the energy crisis, Nordenergi recommends using the existing regulatory framework for crisis prevention and management which ensure the transparency and robustness of EU energy markets (see Section 3.3 of the Study for further details). Being well suited in minimising the risk on physical and financial energy markets, we support the key policy recommendations outlined in the Study:

- Understand, monitor and contribute to the improvement of surveillance instruments and control mechanisms that are applied by the exchanges,
- Support industry initiatives strengthening the risk and liquidity management of EMPs and monitor the improvements to clearing and margining processes under EMIR 3.0,
- Harmonise the regulatory reporting standards to create a machine readable, single data pool easily available to regulators,
- Increase the national regulatory authorities' competence to deter and stop market distortions proactively (and not retroactively as is currently the case),
- Take action to maintain open and liquid energy markets, supporting private financing of renewable generation facilities, and
- Keep the competitiveness and autonomy of the EU energy markets as a major legislative objective while abstaining from actions that have no precedence in competing jurisdictions and lead to an uneven international playing field, to the detriment of EU EMPs.

Any policy action should be carefully balanced so as not to increase regulatory red tape for EU markets neither imply unjustified costs, that would hinder the dynamism, innovation and competitiveness of our markets and market participants (see for further details Section 3.2.4 and Section 7 of the Study).