Maintaining the current scope of the Ancillary Activity Exemption to ensure EU competitiveness

24 October 2024 - The European Commission's assessment of commodity derivatives markets under MiFID II should retain the current scope of the Ancillary Activity Exemption for Energy Market Participants to maintain EU's global competitiveness and foster the energy transition.

Key recommendation of the Joint Energy Associations Group (BDEW, Energy Traders Europe, Eurelectric, Eurogas) for the review of the commodities market under MiFID II:

1. Retain the Ancillary Activity Exemption for Energy Market Participants[1]
2. Maintain the EU's global competitiveness, and avoid creating an uneven international playing field by keeping the current scope of the Ancillary Activity Exemption
3. Recognize the key role that energy markets play to promote the energy transition under the Green Deal and REPowerEU plan
4. Conduct a comprehensive assessment of energy markets during the MiFID II commodities review, considering existing regulations (MiFID/IFR) and recent legislative changes (EMIR/REMIT) of the Ancillary Activity Exemption as well as the necessity of a secure supply of energy for the EU

Background

- The Ancillary Activity Exemption exempts Energy Market Participants (EMPs) from requiring a MiFID investment firm licence and to comply with the associated significant prudential capital requirements.
- The European Commission (DG FISMA) is reviewing commodity derivatives regulation under Art. 90 (5) of the Markets in Financial Instruments Directive II ("MiFID II"). The European Commission is expected to conclude this MiFID II commodities review by mid-2025.
- In parallel, Art. 60 of Regulation (EU) 2019/2033 ("Investment Firm Regulation – "IFR") mandates the European Commission to review IFR with regard to the prudential regulation for EMPs that are investment firms trading on commodity markets, i.e., whether and how the current prudential regime could be extended to these firms.
- A recent study of an independent consultant and law firm ("Frontier Economics and Luther Law Firm"), who carried out a comprehensive MiFID II review supports our key recommendations.

[1] Energy Market Participants is used as synonym for non-financial entities, which may be an energy producer or supplier or an energy intensive industrial user.

Key recommendations in detail

1. Retain the Ancillary Activity Exemption for Energy Market Participants

- **Essential for market functioning:** Liquid, competitive and efficient EU energy markets are key to ensuring an affordable, secure and sustainable energy supply for all EU consumers and businesses. The current Ancillary Activity Exemption scope is appropriately calibrated, to ensure proper market functioning and guarantee liquid markets, recognizing that motives for energy trading cover both, hedging and non-hedging. Although, EMPs use the EU energy markets primarily for purposes of hedging, they are market makers and provide most of the liquidity through non-hedging activities, such as risk transformation, price discovery and business diversification, as well as own account trading. Revoking the Ancillary Activity Exemption and consequently putting EMPs under investment firm status would imply that EMPs would no longer be in a position to trade-off their market, cash liquidity and credits risks according to their individual needs and preference, which was a key mitigating measure during the energy crisis.
- **Avoiding adverse consequences:** The recent energy crisis and related policy interventions provided a stress test for the resilience of energy markets. Supply shocks (gas and power) were the root cause for price spikes during the energy crisis. An existing study shows that narrowing the AAE and thereby subjecting EMPs to prudential capital requirements would not have helped during the crisis, and instead would have made it worse. EMPs would have faced even more severe liquidity pressure from prudential capital requirements and mandatory collateralization of bilateral trading, and may have been forced to exit the energy/commodity derivatives market. This would have drained further liquidity from the energy wholesale market during a challenging period, hence reducing the needed increase of energy flows and jeopardising EMPs ability to efficiently manage their risks. Requiring energy firms to become licensed investment firms by revoking the AAE could trigger adverse and unintended consequences on energy markets, consumers, and the real economy. Restricting energy firms' ability to efficiently manage liquidity and risks would lead to more volatile prices, higher hedging costs, poorer market price signals and higher costs to consumers.
- **Recognising the different business models of EMPs:** Business models of EMPs are fundamentally different to those targeted under prudential regulation, such as banks. For banks, capital requirements serve to secure depositors' money. EMPs as part of the real economy trade to mitigate their own commercial risk from energy generation and consumption, and invest their own capital foremost in the construction, operation and maintenance of power production assets while trading exclusively among professional counterparties with sound risk management practices (collaterals/margins, counterparty credit limits, etc.).
- **EMPs do not pose a systemic risk**: The default of a (major) EMP trading on energy derivatives would neither pose a security of energy supply nor a systemic risk to the wider economy. Physical generation assets of a defaulting EMP would remain operational under new ownership, ensuring energy demand is met. The EMP's trading positions, collateralized on energy exchanges, would be auctioned off by CCPs, while OTC replacement risk is mitigated by credit risk management. EMPs primarily trade to manage their own commercial risks from energy generation, not using end-consumer fund, thus negating the need for investor protection as seen in the financial sector.

2. Maintain EU's global competitiveness and an international level playing field by retaining the current scope of the AAE

- **Align to international standards:** The EU regulatory framework must ensure an international level playing field and avoid regulatory arbitrage with other international jurisdictions in order to maintain the EU's global competitiveness. Aligning EU regulations with international principles set by organizations like the International Organisation of Securities Commissions (IOSCO), prevents regulatory arbitrage and maintains market attractiveness for European and third country market participants.
- **Ensure international competitiveness of EU markets:** The MiFID II AAE is key for maintaining a competitive EU energy market. There is no precedent for requiring EMPs to hold an investment firm licence and comply with associated prudential capital requirements in any other key jurisdiction (including Singapore, UK and the United States). Requiring such, would put at risk the international competitiveness and attractiveness of European markets and undermine the ability to maintain European market liquidity. Compared to the other G20 jurisdictions the EU financial regulation scrutiny is already more far-reaching in terms of coverage of products.
- **Avoid regulatory burdens**: Any policy action should be carefully balanced so as to neither increase regulatory red tape for EU markets nor imply unjustified costs, that would hinder the dynamism, innovation and competitiveness of EU markets and market participants. Ultimately additional regulatory burden would affect the EU consumer through higher energy costs.

3. Liquid energy markets facilitate the energy transition as set out in the Green Deal and REPowerEU Plan

- **Significant investment requirements needed:** The Green Deal and REPowerEU aim for a clean energy supply, requiring 400 billion euros of investments for 2021-2030 alone. Leveraging private investment is key for the energy transition[2].
- **Market-based mechanisms help deliver transition at low cost**: Market-based opportunities for reducing risks (such as renewable PPAs and futures contracts) in liquid wholesale energy markets are crucial for attracting and securing new investments. Operators of renewable assets use liquid energy derivatives markets to reduce (e.g., hedge) their commercial risks, ensure stable long-term income and make investments financeable by banks. Renewable investors need energy firms to offer hedging products, either by taking on risks or trading them off on wholesale energy markets. Consequently, energy trading is essential to support the transition to a carbon-neutral energy system.
- **Keep liquid markets to promote the energy transition:** Requiring an investment firm licence for EMPs, with the associated prudential capital requirements, would reduce market liquidity, increase investment costs for renewables, and ultimately hinder the energy transition. Capital required under investment firm status would be 'trapped' and unavailable for long-term capital-intense renewable investments, negatively impacting investment levels and costs.

[2] EC (2020), "Impact Assessment – 2030 Climate Target Plan, SWD (2020) 176 final", Table 46, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020SC0176

4. Conduct a comprehensive assessment of energy markets during the MiFID II Commodities Review, considering existing regulations and recent legislative changes

- **Comprehensive review required:** The MiFID II and IFR commodities reviews must be performed as one single holistic review, considering the interdependencies between physical and financial energy markets.
- **Acknowledge existing regulations:** The power and gas markets are already subject to stringent transparency and market conduct requirements under the substantially strengthened Regulation on Wholesale Energy Market Integrity and Transparency (REMIT II), the updated Market Abuse Regulation and Directive (MAR/D), and wider obligations under financial regulation including the updated European Market Infrastructure Regulation ("EMIR 3.0"). An isolated review focusing on MiFID II alone would fail to recognise that the energy markets are already regulated by similar and industry targeted standards, making it redundant to extend the investment firm regime to cover EMPs. Any review should therefore also be coordinated with relevant energy stakeholders and regulators.
- **Take recent regulatory changes into account**: In addition, the Commission's review should acknowledge recent regulatory developments, and avoid any immediate actions without taking full account of changes already in progress. Some helpful changes have already been implemented, such as i) Enhanced market surveillance instruments and control mechanisms under MiFID II, as applied by exchanges (and resharpened in response to the energy crisis), and ii) enhanced liquidity management by improved rules under EMIR 3.0, which increase transparency and predictability of margin calls and broaden the scope of eligible collateral. The Commission should assess how these measures have worked in practice before recommending further changes. Moreover, given the resilience of the central clearing system and margining process during the energy crisis further intervention should not be pursued before the MiFID II position limit regime review (foreseen for 2025), is concluded.

In conclusion, retaining the Ancillary Activity Exemption is essential for the proper functioning of energy markets, supporting the energy transition, and maintaining Europe's global competitiveness. The Commission's holistic assessment should consider existing regulations and recent legislative changes to avoid unnecessary burdens respectively hampering valuable EU initiatives.

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About BDEW

The German Association of Energy and Water Industries (BDEW), Berlin, represents over 1,900 companies. The range of members stretches from local and communal through regional and up to national and international businesses. It represents around 90 percent of the electricity production, over 60 percent of local and district heating supply, 90 percent of natural gas, over 90 percent of energy grid as well as 80 percent of drinking water extraction as well as around a third of wastewater disposal in Germany.

For more information: www.bdew.de

About Energy Traders Europe

Energy Traders Europe promote and facilitate European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. We build trust in power and gas markets across Europe, so that they may underpin a sustainable and secure energy supply and enable the transition to a carbon neutral economy. Energy Traders Europe currently represents more than 150 energy trading companies, active in over 27 European countries.

For more information: www.energytraderseurope.org

About Eurelectric

Eurelectric is the federation of the European electricity industry. We represent more than 3,500 European utilities active in electricity generation, distribution and supply.

For more information: www.eurelectric.org

About Eurogas

Eurogas is the association representing the European gas sector. Our 78 members and associate members are active throughout the energy gas value chain, covering production, trading, distributor, and supply of natural gas, biomethane and hydrogen.

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