RWE Trading

Call for Advice No. 6 on commodities firms and commodities business - Second part of CEBS technical advice to the European Commission on the review of commodities business under Article 48 of Directive 2006/49/EC

Assessment of the prudential risks that arise from the conduct of commodities business and the activities of firms carrying out commodities business

RWE appreciates the opportunity of commenting on the CEBS draft of the review of commodities business. In our view it is a very comprehensive and holistic description of relevant aspects of the commodities business and characteristics. However, we would like to make some remarks on a few aspects that are not correct from our perspective.

General Observations

The report gives the general impression that commodities derivatives business is characterised by a very high degree of counterparty credit risk resulting from a high proportion of OTC trading on the one and low risk mitigation on the other hand. Some descriptions (e.g. practise of collateralisation) are wrong (see detailed comments). They might be true for smaller companies. Larger commodity entities apply extensive credit risk management techniques and require intensive credit approval processes before trading can commence.

Against the background of this overestimation of credit risk the conclusion drawn (existence of systemic risk) is not correct (please see detailed comments). It gives rise to systemic risk concerns which are not appropriate.

In the following we do not comment on the executive summary at length. However, all remarks relating to counterparty credit risks within the executive summary should be adjusted according to the detailed remarks.

Detailed comments

Paragraph 26:

In the graph it is not quite sure what “Economy” does refer to. It could be a country, just a region or a sector. Furthermore, it is not made really clear what systemic risk is and whether it also refers to the provision of security of supply.

Paragraph 39:

The conclusion that the reason for exchanges allowing for physically settled forward transactions may be the competition from multilateral trading facilities is not accurate. The reason for this enhancement of trading opportunities was rather the nature of the energy business: commodities firms usually try to hedge their exposure and use energy derivatives to optimise their assets. Hence they were looking for a possibility of physical settlement.

Paragraph 53:

It is asserted that "in order to avoid a reduction of liquidity from frequent margining requirements bilateral agreements require a less frequent re-margining or even only initial margining… and that some do not require any collateralisation unless a material adverse change in the creditworthiness of the counterparty has occurred". This description may be true for very small entities. However, larger energy firms calculate a daily mark-to-market of bilateral agreements and require collateral in cash or via a bank guarantee if certain limits have been exceeded. The granting of (internal) limits depend on external and internal credit ratings and is calculated before trading with any counterparty commences on the basis of a 95% confidence interval. So with reference to systemic risks it has to be noted that the vast part of bilateral agreements is collateralised and credit risk is mitigated at large scale.

Paragraph 57:

In this part it is stated that for a significant volume of positions CCR is not completely mitigated. With reference to the above mentioned this gives a completely wrong impression and seems to be exaggerated especially before the background of the description of internal ratings practices in paragraph 55. This part gives the impression of the existence of systemic risk which is not the case given the broad use of credit risk mitigation techniques.

In this context it may be of interest that all bilateral agreements are based on ISDA (for financial contracts) or EFET (for physical contracts) master agreements.

Paragraph 84:

The conclusion that from significant relationships between commodities markets and the wider financial industry systemic risks can be concluded seems too general and does not consider the common risk mitigation practice. Furthermore this is not a characteristic of the commodities business but refers also to any credit risk of financial institutions: A credit default of a major customer like Daimler Chrysler could cause systemic risks in the financial industry as well.

Paragraph 87:

In the second part of this paragraph it is asserted that exchanges do not mitigate the portion of systemic risk that is caused by the impacts of reduced liquidity. We would like to point out that it has never been part of the exchanges to increase liquidity. Rather by providing a platform for standardised contracts liquidity can be enhanced. We would suggest to rephrase this section accordingly.

Paragraph 95:

The term "institutions" is described at the beginning of the report and refers purely to financial institutions. However, it might be misleading here and recipients might get the impression that the issue is about retail involvement in commodities business whereas the commodities business is characterised by wholesale market participants only.

Paragraph 123:

We think that the argumentation that regulatory capital was the reason for other entities to continue trading with Enron Metals Ltd. is misleading because members of the LME were obliged to continue trading with that affiliate of Enron for other reasons but regulatory capital.

Paragraph 150:

This section is a contradiction to paragraph 147 which describes correctly that (spot-) price fluctuations refer only to a small amount of power that has to be delivered in the short term. The major part is not at risk because it has already been sold or procured. In power markets a backwardated volatility curve is common as a result of non-storeability. If spot prices are used to calculate risks within the Maturity Ladder Approach than the risks are overestimated by far. A risk adequate approach would be to use forward prices as it is done for internal purposes as well. To justify the usage of spot prices to mark-to-market forward positions simply because they "tend to be more frequent and more readily observable is wrong because quantities are not taken into account and liquid market prices for forward products do exist.

Paragraph 202:

Given the comments above we do not see why it can be asserted that the analysis in parts B and C shows that the conduct of business has at least the potential to raise systemic risk concerns. As it is said later that "the assessment provides little evidence of a particular need for regulation" we would propose to delete this paragraph.

Paragraph 204:

It is said that even a limited differentiated treatment of commodities business would easily result in a very complex regime. This does not need to be the case. A qualitative risk based supervisory regime like the Alternative Approach which has been issued in May 2007 by the CFRC Working Group (a joint initiative of ISDA, EFET, FOA and representatives of the energy industry) could be risk adequate alternative to the existing financial market regulation for commodities firms.

Annex III 2.b Risk arising from the power market:

According to the comments made above we do not think that it is correct to say that the power market has a particular exposure to systemic risk because of the OTC nature of this market and because a large percentage of contracts are not sufficiently protected against CCR. This statement does not consider the intensive credit approval processes, daily mark-to-market of bilateral agreements and extensive collateralisation of the business.