EDF Trading

1 August 2008

Consultation paper on CESR's/CEBS' technical advice to the European Commission on the review of commodity businesses

EDF Trading welcomes the opportunity to respond to the above consultation. Where applicable we have provided answers to the questions highlighted in the document. For ease of reference we have followed the original numbering.

1. In practice, what proportion and/or amount of OTC commodity derivative transactions are financial instruments falling within the MiFID and what proportion are spot?

The advice[1] provided by the European Securities Markets Expert (ESME) group in July 2008 to the European Commission on commodities includes relevant figures where they are available.

2. Do you agree that the level of direct participation by unsophisticated investors is mainly limited to corporate clients such as producers or wholesale distributors (with a lack of experience and knowledge in derivatives markets but not in trading in physical commodity markets), that participation by private clients is very low, and that most other participants in commodity derivatives markets are sophisticated firms?

We agree that the vast majority of participants in the commodity derivatives markets are sophisticated investors and as such the potential for significant problems regarding the client-firm relationship (such as misselling) should not arise.

3. What informational advantages persist in commodity derivatives markets and in particular to what extent do those also active in the underlying physical market have informational advantage?

Information advantages can exist for a number of reasons. The key is whether they are unfair and if so whether they lead to market distortion.

In this respect it is not appropriate to draw a distinction between firms that are active in the underlying physical market and those that are not - as information advantages exist on both sides. Owners of physical assets clearly have access to better information on their assets than other market participants. Similarly, banks for example have access to information on customer positions that is not accessible to other market participants. Information on both has the potential to impact on price formation.

[1] http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf

EDF Trading Markets Limited
80 Victoria Street
Cardinal Place, 3rd Floor
London SW1E 5JL
Tel +44 (0)20 7061 4000
Fax +44 (0)20 7061 5000
www.edftrading.com
A company registered in England
Registration Number 4255974
Regulated by the Financial Services Authority

However, asset owners must be allowed to use information on their assets in order for them to be utilised and optimised efficiently (as is the case in other markets). Optimisation of assets is crucial, as suboptimal optimisation would result in inefficiencies and potentially higher prices. No other party than the asset owner can undertake the optimisation so having access to this information should not be seen as an asymmetry compared to other market participants

In any case, there are already significant transparency requirements on the use of physical infrastructure and more is envisaged by the 3rd energy package. Taken together there will be a high level of transparency on physical infrastructure. Conversely, there are currently no requirements for disclosure of investor demand for commodities (for example on banks to disclose information on customer positions) and we suggest this is arguably a more important regulatory gap that warrants further investigation given the requirements already in place (and envisaged) for transparency on physical infrastructure.

4. Do information asymmetries in commodity derivatives markets lead to misselling concerns or to other concerns about potential client detriment?

Given our response to questions 1 and 2 we do not believe any such concerns exist.

5. Do you have any transparency related concerns relating to the trading of non electricity and gas derivatives? If so, in which markets and why?

We do not have any specific concerns regarding transparency in non electricity and gas derivatives.

6. Do you have evidence of informational asymmetries in commodity derivatives markets in relation to market abuse?

We have no evidence of information asymmetries leading to market abuse in commodity derivative markets.

7. Please provide any information you may have on the levels of lending and trading exposures between specialist commodity derivative firms and institutions.

We do not have any information in this area.

8. What level of risk do specialist commodity derivative firms pose to financial system?

We believe specialist commodity derivative firms pose very little (if any) risk to the financial system. The wholesale nature of the commodity market and the lack on interconnection with payment systems and other mechanisms, that magnify the effect of individual shocks in

EDF Trading Markets Limited
80 Victoria Street
Cardinal Place, 3rd Floor
London SW1E 5JL
Tel +44 (0)20 7061 4000
Fax +44 (0)20 7061 5000
www.edftrading.com
A company registered in England
Registration Number 4255974
Regulated by the Financial Services Authority

financial markets, means that there are no risks to the systemic integrity of markets from the activities of specialist commodity derivative firms. The energy market has already demonstrated that it can effectively absorb the failure of very large companies (e.g. Enron, TXU Europe and Amaranth) without any significant disruption or threat to integrity and without knock-on consequences for the financial markets.

9. To what extent does the level of systemic financial risk posed by specialist commodity derivative firms differ from that generated by banks and ISD investment firms?

This current situation in the financial markets resulting from the 'credit crunch' demonstrates that banks and ISD investment firms pose a much greater risk to the integrity of financial markets.

10. Do the risks generated by energy only investment firms differ materially from those posed by investment firms engaging in other commodity derivative activities/services? If so, how do they differ?

We do not see any material differences between the risks generated by energy only investment firms and those engaged in other commodities.

11. Do you have any transparency related concerns relating to the trading of non-energy commodity derivatives and if so in which markets, what are the concerns and what solutions could be applied?

We are not active in non-energy commodity derivatives and therefore cannot comment on this issue.

12. Do you believe that for non-electricity and gas derivatives contracts, the transaction reporting requirements in the MiFID support market regulation? If so, can you explain why you think they do?

EDF Trading is a MiFID exempted firm and we therefore have no practical experience of the issues identified in this section.

13. Do you have any evidence on potential problems and if so on the scale of the problems that are posed by current client categorisation rules?

Given our response to question 2, and from our own experience, we do not believe there are any significant problems associated with client categorisation rules in the commodities derivatives market.

EDF Trading Markets Limited
80 Victoria Street
Cardinal Place, 3rd Floor
London SW1E 5JL
Tel +44 (0)20 7061 4000
Fax +44 (0)20 7061 5000
www.edftrading.com
A company registered in England
Registration Number 4255974
Regulated by the Financial Services Authority

14. Do you have any evidence that regulation according to the main business of the group may cause competitive distortions?

No. EDF Trading is only active in the wholesale market and accordingly we are not involved in the sort of activities described in this section.

15. Do you agree that full application of CRD capital requirements to specialist commodity derivative firms is likely to impose a regulatory burden that is misaligned with their potential systemic risk?

See our answer to question 16.

16. Do you believe that full application of CRD large exposure requirements to specialist commodity derivative firms is likely to impose a regulatory burden that is misaligned with their business and their potential systemic risk?

Given that specialist commodity derivative firms present limited, if any, risks to financial stability of markets, it would not be appropriate to apply either current CRD capital or large exposure requirements to these firms.

Any requirements in these areas would not be proportionate to the risks that exist. It would also create significant barriers to entry, force withdrawal and damage market competitiveness and liquidity.

17. Do you believe there is potential for regulatory arbitrage? If so, can you provide evidence?

It is important that the regulatory framework applicable to specialist commodity derivative firms is applied on an equal basis across the EU. If Member States do take different approaches to regulating firms there is a risk that regulatory costs will also differ significantly consequently potentially impacting on location decisions. This arbitrage would not lead to better functioning or more efficient markets and should be avoided.

18. Do you believe that the application of the MiFID organisational requirements support the intended aims of market regulation when applied to specialist commodity derivative forms or commodity derivative businesses? If not, what aspects of the organisational requirements do you believe do not support the aims of market regulation when applied to such firms and why?

EDF Trading Markets Limited
80 Victoria Street
Cardinal Place, 3rd Floor
London SW1E 5JL
Tel +44 (0)20 7061 4000
Fax +44 (0)20 7061 5000
www.edftrading.com
A company registered in England
Registration Number 4255974
Regulated by the Financial Services Authority

We agree that where investment firms provide investment services in relation to commodity derivatives this should be subject to the organisational principles required by MiFID. The nature of the investment should not determine the level of protection afforded to investors. The application of the principles should not cause investment firms any difficulties (given they apply to other investment services) or any significant additional costs.

19. Do you believe that there is a case for changing the client categorisation regime as it applies to commodity derivatives businesses? If so, do you any evidence on the scale of problem or potential problem posed by the existing rules?

The primary aim of the client categorisation regime is to ensure appropriate protection is afforded to investors depending on their circumstances. We do not believe the current arrangements give rise to any undue barriers for investors' participation in the commodity derivatives market.

20. Do you believe that the conduct of business rules in the MiFID effectively support the aims of regulation with respect of commodity derivatives businesses? If not, can you explain why and in what respects, and whether your response is contingent upon the client categorisation definitions applied to commodity derivatives businesses?

EDF Trading is a MiFID exempted firm and we therefore have no practical experience of the issues identified in this section.

21. Do each of the following elements of the criteria for determining which commodity derivatives contracts are financial instruments offer sufficient clarity to market participants to understand where the boundaries of the MiFID lie?

> ***a). the phrase "...that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event";***
>
> ***b). the phrase "traded on a regulated market and/or MTF"***
>
> ***c). the definition of a spot contract in Article 38(2) of the MiFID implementing regulation;***
>
> ***d). the criteria in articles 38(1)(a), (b) and (c);***
>
> ***e). the definition of a commodity in Article 2 of the MiFID implementing regulation;***
>
> ***f). the list of underlying exotic derivatives mentioned in Section C(10) of Annex I to the MiFID and Article 39 of the MiFID implementing regulation***

EDF Trading Markets Limited
80 Victoria Street
Cardinal Place, 3rd Floor
London SW1E 5JL
Tel +44 (0)20 7061 4000
Fax +44 (0)20 7061 5000
www.edftrading.com
A company registered in England
Registration Number 4255974
Regulated by the Financial Services Authority

We agree the current arrangements provide sufficient clarity as to the definition of a financial instrument and that no changes are necessary.

22. Do you have any evidence of physically settled commodity OTC contracts being written in a way that removes them from the definition of financial instruments?

We do not have any evidence that physically settled OTC contracts are being written in a way that excludes them from the definition of financial instruments and agree that no changes are needed in this area.

23. Do you believe there are sufficient similarities between different commodity derivatives markets to make it inappropriate to differentiate the regulatory regime on the basis of the underlying being traded?

As above with question 10 we do not believe there are any significant differences between commodity derivative markets that would justify differential treatment. Different regulatory regimes would risk creating distortions between markets.

24. If the capital treatment of specialist commodity derivative firms is resolved do you think there is still a case for retaining both of the exemptions in Articles 2(1)(i) and (k)? If not, how do you think the exemptions should be modified or eliminated? If the exemptions in Article 2(1)(i) and (k) were eliminated what effect do you think this would have on the commodity derivatives markets?

We support the advice provided by the European Securities Markets Expert (ESME) group to the European Commission on these issues – in particular:

- it would not be appropriate to remove some or all of the exemptions entirely considering the low risks to systemic stability and investor protection involved in this type of activity. By removing the present exemptions altogether, a number of firms that are not currently subject to regulation would suddenly be faced with a disproportionate regulatory burden. This is likely to have a significant impact on some firms and could lead to immediate withdrawal from the market and the creation of entry barriers that would limit further entry to the market. This would significantly impact the competitiveness and liquidity of the market;

- there may be scope to rationalise the current MiFID exemptions by combining the second limb of article 2.1(i) and article 2.1(k) with a single exemption applicable to firms (other than operators of an MTF or a regulated market) whose main business consists of dealing on own account with professional investors in relation to commodities and/or

EDF Trading Markets Limited
80 Victoria Street
Cardinal Place, 3rd Floor
London SW1E 5JL
Tel +44 (0)20 7061 4000
Fax +44 (0)20 7061 5000
www.edftrading.com
A company registered in England
Registration Number 4255974
Regulated by the Financial Services Authority

commodity derivatives or other non-financial derivatives contracts covered by MiFID (points 5, 6, 7, 9 and 10, Section C, Annex I).

- because firms may also need to be able to deal in other financial instruments (for normal treasury purposes to invest surplus cash, or to hedge foreign exchange or interest rate exposures), it should be made clear that a firm can combine the new exemption with the first limb of article 2.1(i) or with article 2.1(d). The firm should also be able to combine the exemption with other exemptions, such as article 2.1(b).

25. Do you believe based on the above analysis that the application of the CRD large exposure regime to specialist commodity derivatives firms is disproportionate?

We agree that application of the CRD large exposure regime to specialist commodity derivatives firms would be disproportionate. As highlighted above, such firms pose little or no risk to the integrity of the market and if applied the large exposure regime would constitute a significant barrier to entry and would lead to significant withdrawal from the market as firms would not be able to obtain access to the required amount of capital.

26. Do you agree that the maturity ladder approach is unsuitable for calculating capital requirements for non-storable commodities? If yes, are the proposed alternatives better suited to that task?

Yes. Our understanding of the maturity ladder approach is that it can either significantly understate or significantly overstate the level of risk in portfolios of electricity or gas positions. We do not have any views on the proposed alternatives given that we are a MiFID exempted firm.

27. Do you believe that the shortcomings identified in 2.b and c. and 3 are relevant? Are there others that need consideration?

EDF Trading is not active in ancillary agricultural commodities and therefore cannot comment on the issues in this section.

28. Do you think the solutions outlined above are adequate to address these problems?

Please see our answer to question 27.

29. Do you agree with the conclusion above?

As explained in our answers above, the scope of the existing exemptions under CRD and MiFID should not be changed although there may be a case for rationalising the MiFID exemptions.

edF Trading

30. Which of the options presented above do you consider appropriate for the application to specialist commodity derivative firms?

The prudential regime that is adopted for specialist commodity derivative firms must reflect the risk they pose to systemic integrity of the market. The consultation document concludes that this risk is not significant for such firms. Therefore, if additional measures are introduced we would support option 1 – i.e. a risk control and disclosure framework. Quantitative measures, such as recalibrating the CRD or applying it in full for specialist commodity derivative firms, would be a disproportionate regulatory response resulting in significant additional costs and the creation of barriers to entry.

Robust risk management policies and processes already underpin our business. Disclosure requirements could help foster best practice and discipline, providing confidence to regulators that appropriate steps are being taken to manage risk effectively and efficiently. However, strict requirements on the specific measures that should be taken could be too restrictive, and firms should have flexibility to adopt arrangements that are appropriate to their business.

If you have any questions regarding this response please do not hesitate to contact Cemil Altin on +44 (0)20 7061 4386 or on email at cemil.altin@edftrading.com.

Yours sincerely

Jonas Törnquist
Head of Transmission & Regulation

EDF Trading Markets Limited

80 Victoria Street
Cardinal Place, 3rd Floor
London SW1E 5JL

Tel +44 (0)20 7061 4000
Fax +44 (0)20 7061 5000

www.edftrading.com
A company registered in England
Registration Number 4255974
Regulated by the Financial Services Authority