EUROPEAN COMMISSION

Brussels, 8.12.2010
SEC(2010) 1511 final

COMMISSION STAFF WORKING PAPER

SUMMARY OF THE IMPACT ASSESSMENT

Accompanying document to the

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on energy market integrity and transparency

{COM(2010) 726 final}
{SEC(2010) 1510 final}

Reliable prices formed on liquid wholesale markets send crucial short term signals for the optimal operation of energy production facilities and consumption units. They also give long term guidance where future investments in energy infrastructure are needed. They give confidence to businesses that they will be able to respond to changes in the markets. This will be vital, since tomorrow's low carbon economy will require long term visibility to underwrite high capital investments in new generation facilities. Last, but not least outcomes on wholesale markets serve as a reliable benchmark for retail prices for household consumers and industrial users, and encourage efficient use of energy.

Because they are crucial to the well being of Europe's citizens, and to the competitiveness of Europe's businesses, it is of central importance that citizens, businesses and national authorities can have confidence in the integrity of energy markets. Unless effectively addressed, the potential for unfair trading practice undermines public trust, deter investment, increases volatility of energy prices and may lead to higher energy prices in general. This in turn may also reduce competitiveness of other sectors and energy intensive industries.

EU level financial regulation, the Market Abuse Directive (MAD), only partly covers energy markets as it is designed for financial markets. Though its measures are currently under review, due to its overarching nature it will not fully capture energy specific market misconducts (e.g. strategic withholding of generation assets). Internal energy market legislation does not set out standards to ensure the integrity of such markets. Some other rules may exist on the level of Member States but they are only limited in scope, often relating only to a single trading platform and covering a single Member State.

In summary, the rules governing energy markets are insufficient to ensure their stable and orderly functioning. Markets cannot be comprehensively monitored and specific misconducts, such as cross-border, cross-commodity and cross-market misconducts are difficult to detect. This view is supported by sectoral regulators in their advice to the Commission, and by the respondents to the Commission's consultation.

Objectives

(1) There should be an efficient and effective framework which ensures that Europe's traded energy markets function properly, i.e. their outcomes are not distorted by abusive market behaviour, but truly reflect market fundamentals. This shall generate an increased level of trust of all stakeholders, which in turn will lead to higher participation, more depth and liquidity and lower transactional costs.

(2) The rules need to effectively capture energy specific market misconducts. They need to be consistent throughout Europe so as to ensure that traders are able to apply the same compliance standards and are not faced with diverging rules and requirements when trading in different Member States. Furthermore, they have to be also complete and cover all relevant transactions. This also means that rules have to be compatible with existing financial legislation. To this end the present initiative will introduce the concepts of insider dealing and market manipulation, enshrined in MAD, to wholesale energy market. The detailed rulebook will, however, be specified in delegated acts.

(3) In order for market misconduct to be detected, wholesale energy markets need to be regularly monitored To this end, an effectively functioning market monitor would need to have timely access to complete and verified sets of transactional data. Once market misconduct is detected, compliance with the rules needs to be enforced. For

this purpose, competent enforcement authorities need to be defined who can effectively investigate and prove instances of market abuses on energy markets. They would need to have effective sanctioning powers to deter market participants from future misconduct. To tackle complex cross border and cross commodity market abuses a proper coordination mechanism between financial and energy regulators needs to be established.

Policy options

Apart from the 'Business As Usual' scenario we considered seven options with the following features:

Option 0: Business as usual

Under this option no sector-specific initiative is taken, regulatory authorities supervise only some parts of the traded market. There are no market conduct rules agreed at EU-level which could be coherently implemented in Member States. The supervisory frameworks are different between each Member State, and, although national energy regulatory authorities will increasingly cooperate within the Agency for the Cooperation of Energy Regulators (ACER), there is no established process of data access and exchange for market monitoring purposes. Therefore, market misconducts taking place in several markets and involving different but interrelated products/commodities are difficult if not possible to detect.

No EU action does not mean that actions will not be taken on Member State level. Already national legislators have already started filling this gap and introduced national measures including transactional data collection, regulatory monitoring and reporting schemes. These schemes, though clearly increase the scope of regulatory supervision, will inevitably remain incomplete. By monitoring transactions relating to a single Member State, the cross-commodity and cross-border aspects of traded energy markets remain uncovered and certain market manipulations will go undetected.

Option 1a – Rules defined at EU level, Member States monitor and enforce

This option foresees market misconduct rules defined at EU-level. Markets are monitored on the Member State level based on decentralised transaction reporting to competent regulatory authorities. National Regulators would assume monitoring responsibility for transactions that are delivered in (or related to) the Member State in which they have jurisdiction[1]. Transactions are reported to each Regulator separately by traders or third parties. Traders and/or brokers would report all their wholesale energy transactions to the Regulator where they are established irrespective where the delivery takes place[2]. Reported transaction details and data formats are defined on EU-level. Transactional data are stored in different ways, in separate systems of the 27 national regulatory authorities. Regulators operate a decentralised data exchange mechanism which enables them to monitor all transactions which are delivered in their jurisdiction and enforce the tailor-made market conduct rules. In case the transactions concern a number of Member States (e.g. contracts for location price differences), appropriate

[1] If a trader established in Country A engages in a transaction with another trader established in Country B concerning electricity for delivery in Country C, the Regulator of Country C would assume monitoring responsibility.

[2] If a trader established in Country A engaged in transactions which are delivered in (or relating to) Country B, C and D it would have to report these transactions to the Regulator having jurisdiction in Country A.

rules and coordination mechanisms would have to be put in place. Such rules and mechanisms would also define enforcement responsibilities and obligations to cooperate. Regulatory cooperation can be supported by an EU body (e.g. ACER).

Option 1b – Rules defined at EU level, Member States report, monitor and enforce, EU Agency process data and monitors cross-border and cross-commodity misconduct

In this option, just like under Option 1a, market misconduct rules, reporting obligations, data formats and monitoring and enforcement obligations are defined on EU-level. However, when comparing with Option 1, there are two differences.

Firstly, while competent authorities of the Member States continue monitoring transactions for which they assume responsibility, there is an additional layer of monitoring introduced on EU level. This monitoring function would concentrate on the detection of market abuses of cross-border and cross-commodity nature.

Secondly, instead of operating a decentralised data exchange mechanism, Regulators directly send transactional data to the EU Agency which sorts them by place of delivery. The sorted data sets are then sent back to the respective competent Regulator. A copy of all received data remains with the EU Agency enabling it to monitor the referred market abuses.

Option 2 – Rules defined at EU level, shared monitoring in a unique EU Agency and Member States, enforcement by Member States

Unlike in Option 1b, transactions are reported to the EU Agency. No direct reporting to Regulators is foreseen, but national authorities have access to the data held by the EU body. In the same process as described under Option 1b, the EU Agency sorts the transactions and sends the dedicated data sets to the respective regulators. This enables them to monitor transactions in their jurisdiction without collecting data themselves.

Option 3 – Rules defined at EU level, shared monitoring by ACER and Member States, enforcement by Member States

This option is equivalent to Option 2, however, all functions and competences of the EU level body are assumed by ACER.

Option 4 – Rules defined at EU level, monitoring and enforcement by ACER or unique EU Agency in cross-border cases

This option is equivalent to Options 2 and 3, however, in all cross-border cases of detected misconduct, ACER or the EU Agency would assume responsibility for enforcement. This option is however discarded for further analysis because the Commission has no reason to believe that in case misconduct is detected, Member States would not be able to enforce rules as efficiently as the Agency or ACER. In accordance with the subsidiarity principle where abuse is detected national authorities should take enforcement action.

Option 5 – Self-regulation of the markets.

This option assumes that there will be no action undertaken by public authorities at the EU level or by Member States, neither regarding definition of rules nor regarding monitoring. It is assumed that the industry itself will agree upon some market integrity rules. In case misconduct would become known, national Courts or public authorities on level of general

market oversight could get involved in enforcement of such rules. It cannot be excluded that in some ways the industry would agree to establish market misconduct rules. Monitoring and enforcement of such rules would be expected however, *a priori* ineffective as the incentive to transfer data by market participants and have them monitored by other market participants or private companies without the level of independence of public authorities will be limited. Weak monitoring is likely to result in an ineffective market integrity regime. For these reasons this option is discarded.

Option 6 – Extension of MAD (No sector specific action)

Extension of financial market legislation to cover all relevant energy markets would bring these markets within the financial regulatory framework. Notwithstanding, the close links between energy markets and some financial markets, including physical energy markets and defining prohibitions of energy specific misconducts (e.g witholding of production assets, definition of inside information) within MAD is not desirable and would fragment its overarching character. This was recognised by CESR/ERGEG in their advice to the Commission where they state "A mere extension of the scope of market abuse regulations…in MAD to physical products is not reccomended… [it] would bear the risk of leading to an inappropiate application of MAD in other areas"[3]. It the light of this strong advice, and the distinct scope of MAD, this option was not considered in detail.

Evaluation of options

In general, options 1-3 examined proved to be better as the BAU scenario as they can, to varying degrees, detect better and deter market misconduct and reduce related costs to society. At the same time all of these options involve higher administrative costs. Policy options 1b, 2 and 3 have the significant advantage over option 1a that they better enable the detection of cross-border and cross-commodity abuses. Options 2 and 3 have the advantage over option 1b that they have the potential to increase the efficiency of the overall monitoring exercise. Directly and centrally captured data would simplify and speed up overall data handling by reducing the number of data supply routes. This would also reduce the occurrence of data transmission and handling errors.

Option 3 is likely to detects and deter energy specific market abuses most effectively because of ACER's the overall regulatory expertise and its special energy focus. As ACER already exists the administrative cost of running the market monitor attached to this agency will also be lower when compared to option 2 where a new Agency would need to be set up. Therefore option 3 matches best the identified objectives. Though the overall benefits of the proposed measures are difficult to quantify it appears that they clearly outweigh the cost of administrative burden they generate.

Other Issues

Elaboration of sector specific rules – legal form

Because important venues for energy trading are already covered by MAD, definitions relating to market misconduct specifically covering the physical energy markets will need to interact very well with MAD. To the extent possible and logical, the rules should be inspired by the concepts underlying the definitions in MAD. However, it is essential that a tailor made

[3] CESR ERGEG advice to the European Commission – response to Question F.20 – Market Abuse.

regime takes account of the specific characteristics of energy markets, in particular, their high level of susceptibility to significant changes in price as a result of economic or physical withholding of capacity.

In order to allow for flexibility and legal certainty the rules should be elaborated in guidelines in consultation with market participants. These could then be made binding through delegated acts adopted by the Commission. This suggestion was reflected in the majority of industry responses. This represents a sensible approach for each of the options requiring EU level rules. It fits in with the approach taken in financial sector regulation under the Lamfalussy arrangements, and would therefore also aid interaction between financial regulation and sector specific regulation. Where an EU agency is responsible for monitoring, and the elaboration of more detailed guidelines, the most appropriate form for the basic act would be a Regulation.

Commodity scope

Electricity and gas markets are interlinked with other commodity markets, in particular with markets for primary energy products and for emission allowances (EUAs) within the EU Emissions Trading System (EU ETS).

Coal is an important primary fuel used in power generation, while oil and oil product prices influence electricity prices through their role as reference in long-term gas supply contracts. However, these markets are globally traded with major participants established in third countries. An isolated, EU-level market monitoring would remain incomplete and misconduct rules partly unenforceable. This view was also shared by the respondents to the consultation.

This is, however, different in case of the emission allowances. Emission trading under the EU ETS is by definition European in scope. With its introduction, carbon became central to European electricity markets. The power generation sector is the single largest emitting sector in the EU, representing around 40% of the emissions under EU ETS. The supply of emission allowances impacts generators' fuel choice and, with that, the demand for different fuels; just like relative price developments of fuels influence plant dispatch and, as a result, determine the demand for carbon. The two markets are therefore mutually interdependent. Recognising these interlinkages and the growing importance of traded carbon markets the Commission has decided to initiate an in depth review into how best to ensure the integrity of these markets. The results of the review are due in 2011.

Monitoring and evaluation

Ongoing evaluation and monitoring of the implementation of a tailor made regime for ensuring the integrity of energy markets will need to cover a number of areas including the appropriateness of market abuse rules covering energy markets, interaction with financial market regulation, the impact on MS level market oversight and how coordination of enforcement works in practice, the effectiveness of EU level monitoring, and the actual impact of transaction reporting on market participants.

We envisage a monitoring and review schedule along the following lines:

After two years a report from ACER to the Commission on the impact of on new regime on MS level oversight, experience on the cooperation between national level authorities including in enforcement and the impact of new arrangements on market participants, particularly with respect to transactions reporting. Building on the ACER report, the Commission shall review the effectiveness of EU level monitoring.

After five years, a joint review by ACER and financial regulators of the interaction between the tailor made integrity regime for energy and wider financial regulation at an EU and national level.

Based on the joint review by ACER and financial regulators, the Commission should then review the overall effectiveness of the tailor made market integrity regime.