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## Remit: to what problem is it the solution?

Olav Aamlid Syversen of Statoil examines whether the core provisions of Remit are sufficiently clear to safeguard trading in European energy markets



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## REMIT: TO WHAT PROBLEM IS IT THE SOLUTION?

**Olav Aamlid Syversen** examines whether the core provisions of Remit are sufficiently clear to safeguard energy trading and prohibit insider dealing in European energy markets

The European Commission put forward a Regulation on Energy Market Integrity and Transparency (Remit) in December 2010. The regulation is portrayed as an important complement to legislation driving the liberalisation of the European energy markets, as well as a response to the upheaval in financial markets and the economic crisis, forming part of Europe's G20 commitment to strengthen regulations in financial and commodity markets.

The core provisions of the regulation are:

- Prohibition of insider trading of wholesale energy products based on a definition of inside information and mandatory publication of inside information;
- Prohibition of market manipulation based on a definition of such manipulation;
- Improved market monitoring by Acer<sup>1</sup> and NRAs<sup>2</sup> through enhanced market data collection, information sharing and Union level co-operation;
- Enhanced investigatory powers and Member State-determined penalties for non-compliance.

While one can fully support the aim of these provisions, no law is without its flaws and it can be questioned whether the language, as originally drafted by the commission, or the currently proposed amendments from both the Council and the European Parliament, is sufficiently workable for the industry to which it will apply. Is it, therefore, truly conducive to further enhancing the functioning of European energy markets and the public trust in these?

As trilogue discussions between the Council of the European Union, the European Parliament and the European Commission are soon to start, legislators have a last chance to make sure that Remit provides a workable solution to the perceived problems it is meant to solve.

### In markets we do (not) trust

The commission sees Remit as a central contribution to prevent an erosion of public trust in Europe's energy markets<sup>3</sup> following cases of energy companies' abusive behaviour in wholesale markets.

As stated in the commission's impact assessment, the initiative's purpose is "... to create a 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."<sup>4</sup>

The European Commission further stated that "[t]rust in the functioning of traded energy markets can only be created if there is a framework which appropriately governs the conduct of market participants. This framework needs to define rules that are complete, consistent, adapted to the specifics of energy markets and be designed to effectively detect and deter market misconduct."

As a general remark the role of trust in relation to markets is a very complex issue, as research shows:

- "... it is unclear whether trust plays an independent and sustainable causal role for important economic outcomes such as the trading volume, the gains from trade, or the overall welfare of social groups";<sup>5</sup>
- "... strict laws may even displace public trust from the market altogether and in some cases more government intervention may actually lead to less aggregate investment and lower economic growth";<sup>6</sup>
- "... government regulation is less likely and may even be value-destroying when social capital is important in a society."<sup>7</sup>

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This complexity also makes it difficult to assess whether Remit is the appropriate solution to the perceived problem of flagging trust. Arguably, the evidence points to increasing confidence in energy markets across Europe.

First, it is difficult to imagine that the European public is increasingly distrustful of their energy markets, when only six percent rate energy as one of the most important issues they are facing at present.<sup>8</sup>

For the general public, trust in markets and dissatisfaction with their working is more likely to be significantly correlated to the level of prices.<sup>9</sup> Arguably, the increasing levels of energy prices over the last decade better explains the public's level of trust in the European energy market than conduct of energy market participants. At the core, therefore, a public distrust in European energy markets might be one more related to a slower and more laborious liberalisation process which has denied them access to competitive prices.<sup>10</sup>

Second, albeit slowly, improving liquidity across European energy markets is a fairly good indicator of industry's improving trust in these markets. So is the evolution in the variety of market participants with both financial actors as well as a broad spectre of large, medium and smaller sized energy providers and traders. Markets have also been found to be robust during multiple supply crises. Overall, it is therefore more likely that industry's trust in European energy markets has increased over the last decade.

When it comes to the presence of abusive behaviour, a feature that would make industry and the general public equally distrustful of the market, the impact assessment of the commission bring to the fore three examples, two occurring in the US and one in the EU:<sup>11</sup>

- California 2001 electricity market crisis – market surveillance failure;
- E.ON 2008 market practices – short-term withdrawal of generation capacity;
- The Amaranth case – manipulation of several US gas markets;

Despite this low number of cited cases, the European Commission concluded in its impact assessment that “likelihood of occurrence of market misconducts remains high.”<sup>12</sup> This contrasts with CESR/ERGEG's opinion of the difficulty in evaluating the extent of such practices taking place in European markets.<sup>13</sup> It seems hence that insufficient distinction is made

between possibilities for misconducts and actual frequency of misconduct.

Many factors can contribute to keep misconduct at bay, and so far the combined effect of European energy liberalisation legislation and EU and national enforcement of competition law has served well to secure a high level of market discipline throughout the European internal market. That is naturally not an argument for leaving regulatory loopholes open where these exist.

What must be secured, though, is that any solution does not come to represent a complication and a contribution to enhanced regulatory uncertainty. However, a number of improvements have been brought to the initial commission proposal by the Council of the European Union and the European Parliament – this is also where the jury might still be out when it comes to Remit.

**Lowering uncertainty, enhancing workability**

Industry understands the need for laws and regulations. They are important for creating a level playing field in which businesses can pursue legitimate

interests on the basis of their comparative advantages and set strategic goals.

While presenting opportunities, laws and regulations also represent risks to business. The business community will therefore always look to lower uncertainties associated with legislation and seek designs that can be made to work in daily operations.

Regulatory uncertainty damages both investment and the ability of companies to act, according to recent findings by Ernst&Young.<sup>14</sup> To the degree Remit is incomplete there will be an impact on markets and individual firms' market behaviour.

Before dwelling on the particular problems a natural-gas producer could identify in respect of Remit, it is worth recalling three main sources of regulatory uncertainty related to the proposal.

The first element of uncertainty embedded in Remit stems from the reliance on delegated acts to make the regulation operational.<sup>15</sup> Only with such later “L2” acts will industry fully understand how to run their business in compliance with the new framework. Both the amount of time it takes for lawmakers to establish such L2 acts as well as their content will be important in respect of the effects.

While laudable, Member States' effort to somewhat restrict the

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use of delegated acts is one about procedure rather than one of scope. Contrasting with industry's likely preference of an approach where future adaptation through instruments such as delegated or implementing acts is kept to a minimum, Member States have chosen to keep the number of issues that can be adapted through such acts fairly constant, but adjusting which issue is dealt with through delegated and implementing acts respectively.

This naturally respects the concerns that Member States and the European Parliament might have in respect of legislative procedures and democratic control, but does little to reduce the regulatory uncertainty as perceived by industry.

Secondly there is uncertainty over the interplay between Remit and financial market legislation such as Emir, Mifid, MAD and CRD. It is difficult to find in the European energy business community today anybody who is convinced that coherence can be found. An additional complication is the non-synchronised way this legislation is put forward for consideration of lawmakers and industry. Overlaps and residual risks will ensue, further amplifying the need for subsequent adjustments. The resulting regulatory complexity may indeed, at least for a period, be less conducive of enhanced liquidity, reduced transaction costs and fundamentals-driven energy prices than initially hoped for. The concern is that it will mean the benefits of liberalisation take even longer to materialise in some parts of Europe.

The final complex of uncertainties relates to the relation between Remit and competition law. According to its Article 1, the regulation is “without prejudice to ... the application of the provisions of European competition law to the practices covered by this Regulation.” This is naturally a reflection of the supremacy of Treaty provisions over secondary legislation, but it is also recognition of the effectiveness of competition law enforcement, at national or at EU level, in ensuring lawful market practices and deterring misconduct across the various sectors of the European economy.

The uncertainties that could arise relate to obligations of information release, as well as to actual conduct in the market. Market participants will at all times have to consider their actions both in respect of Remit as well as competition law. The diverse participants in European energy markets (financial institutions, energy producers, energy traders, transmission system operators, etc.) will all individually, in respect of their role as well as size, have to make sure they exercise their obligations under Remit in full compliance with competition law. In this lies an embedded risk of non-compliance of either, and hence a source of legal/regulatory risk.

As is shown, regulatory uncertainties arise from incompleteness or inconsistencies. Industry will have to find practical ways to operate under such uncertainties, and work processes and systems will have to be adapted or developed – naturally at a cost. This also explains the importance that industry generally places on the workability of any piece of legislation. The assessment of workability will naturally vary from actor to actor – the one of natural gas producers being no exception.

**Making Remit work for natural gas**

Natural gas is not electricity. Nevertheless, Remit sets out to treat the two commodities in an almost identical manner. Also, some of the difficulties one will encounter in making Remit workable and operational for industry are the insufficient coherence with a number of industry concepts as defined by internal energy market legislation in force.

There are only two possibilities to account for the specificities of electricity and natural gas within Remit. One – as part of the technical update of the regulation through delegated acts as per Article 5, and two – the implementing acts in respect of data collection as provided for in Article 7. This could be understood as:

- Defining inside information, market manipulation and attempt thereof;
- Rules on reporting of information such as type of information, thresholds and frequency

The differences in characteristics in the commodity itself, its production and distribution as well as the related industrial structures validate a higher degree of differentiation between

the two through the above-mentioned mechanisms. A timely introduction of such differentiation will be important for making the regulation work in both sectors. However, the possibility for later modification should not serve as an excuse for deploying all efforts now in the late phases of the legislative process to iron out a few particular difficulties in relation to natural gas that are worth highlighting.

*What constitutes a wholesale energy product?*

Natural gas undertakings will have no easy task identifying what constitutes wholesale products in their product portfolios. Article 1 para. 2 stipulates that the regulation applies to trading in wholesale energy products. In coherence with Article 2 (4), natural gas wholesale traded energy products that certainly fall within the scope of the regulation are:<sup>16</sup>

- Contracts for the supply of natural gas with delivery in the Union;
- Derivatives relating to natural gas produced in the Union;
- Derivatives relating to natural gas traded in the Union;
- Derivatives relating to natural gas delivered in the Union;
- Contracts related to the transportation of natural gas in the Union;
- Derivatives related to the transportation of natural gas in the Union

However, also in the scope, by way of Article 2 (4) are contracts for the supply and distribution of natural gas for the use of final customers<sup>17</sup> with a capacity to consume more than 600 GWh per year of either electricity or gas. Such contracts for supply or distribution are not traded contracts, they represent bilateral contractual relationship of a medium-to-longer-term nature and are notably recognised as important security-of-supply instruments in EU legislation.

Arguably, the long-term contracts between producers outside the European Union and European utilities (insofar as they use a large proportion of the imported volumes for their own use) must be considered as wholesale energy products under the regulation. This sets out a raft of complications in relation to reporting, monitoring and confidentiality in addition to difficulties of compliance with the regulation's insider-information and market-abuse provisions.

Outside the scope are:

- Contracts for the supply and distribution of natural gas for the use of final customers with a capacity to consume less than 600 GWh per year of either electricity or gas;
- Contracts for the supply and distribution of natural gas for the use of final customers with a capacity to consume more than 600 GWh per year of either electricity or gas, unless:
  - Such capacity to consume can be proven not to take place on markets with interrelated wholesale prices;
  - Such capacity to consume takes place at separated plants in different geographical markets capable of exercising joint influence on wholesale energy market prices.

The latter contracts for supply represent a particular difficult category to assess and seem an unnecessary complication. The reference to plant in this latter part is also somewhat confusing, as it is not clear whether the condition seeks to refer to electric power plants, or industrial plants where either natural gas or electricity is consumed.

Making traded contracts related to transportation of natural gas and traded derivatives related to such transportation part of the scope seem somewhat inconsistent with internal energy market legislation that does not contain a definition of transportation, but one of 'transmission.' In using the term 'transportation,' it is unclear how the separation internal energy market legislation makes between upstream pipeline systems, transmission systems and distribution systems is to be upheld in relation to Remit. Arguably, these inconsistencies, but not the complications, are absent when it comes to traded contracts for LNG freight rates and derivatives related to LNG transportation in Union waters.

*When does publishing inside information become a breach of competition law?*

While the definition of inside information has been sharpened throughout the legislative process, it remains for the individual market participants to vigilantly consider whether the release of inside information can constitute a breach of competition law.

The definition of inside information refers to both direct and indirect information likely to significantly affect the price of a wholesale energy product. The issue at stake here is whether releasing information would facilitate collusion in the marketplace.

Central to the issue is any release of information in relation to future capacity and utilisation of facilities for production, storage, consumption or transmission of natural gas that could impact on prices of wholesale energy products at a future time. Releasing such information could also come to represent a signal to other participants in the market and increase the probability of collusion. A clarification through delegated acts is likely necessary to ensure that Remit becomes workable to industry.

*Are distressed producers sufficiently protected by the prohibition of market abuse?*

In the case of unplanned outages, natural gas producers could under Remit come to find it difficult and costly to orderly unwind a physical position. This could come as other market players make undue interpretation of the significance of

**The difficulties highlight how natural gas producers will have no simple task adapting operations to Remit in its current form**

the outage. To smaller companies this naturally represents a particular challenge, however, larger players could also come to face material damage when closing such physical positions.

The prohibition of market abuse as it reads at present might not sufficiently protect producers from market misconduct by other market players in reaction to information that producers are required to release. This underlines the need for the introduction of provisions in the regulation that cater for the possibility of producers to safely and economically unwind physical positions. Such a provision has been tabled by the European Parliament as part of its suggested amendments, however, that language is in need of further fine-tuning to become sufficiently robust for producers to act upon.

**Steps from this point on**

The above highlighted difficulties do not represent an exhaustive list of difficulties natural gas producers could encounter under Remit. However, they illustrate well that natural gas producers will have no simple task adapting operations and practices to Remit in its current form. While the Council of the European Union, the European Parliament and the European Commission will be making finishing touches throughout their trilogue meetings, it is clear that further clarifications will be needed through delegated or implementing acts. While starting to prepare for adaptation, the natural gas industry needs to remain vigilant in terms of making sure that such acts contribute to make Remit a real solution to real problems. ■

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**Footnotes**

- 1 Agency for the Cooperation of Energy Regulators
- 2 National Regulatory Authorities
- 3 "Unless effectively addressed, the potential for unfair trading practice undermines public trust, ...". European Commission Staff Working Document, SEC(2010) 1510, p. 7.
- 4 European Commission Staff Working Document, SEC(2010) 1510, p. 21.
- 5 Ernst Fehr, *On the economics and biology of trust*, Journal of the European Economic Association April–May 2009 7(2–3):235–266.
- 6 Carlin et al, *Public Trust, The Law, and Financial Investment*, June 9, 2008.
- 7 Idem.
- 8 Standard Eurobarometer 73, November 2010. When asked what the most important issues facing their country 3% of respondents consider energy. Only in Malta do respondents see energy as the country's main concern. When asked to choose the policies on which the European institutions should focus in order to strengthen the EU in the coming years 26% of respondents indicated energy, behind policy areas such as economic and monetary policy, health, fight against crime and immigration.
- 9 In the Parliament of 31 January 2011 (EB74.3 EP) respondents ranked policy priorities as follows: price stability 29%; increased share of renewables 27%; security of energy supply 20%; energy efficiency 16%. This is also reflected in the Standard Eurobarometer 73, November 2010, p. 237.
- 10 The European Commission has correctly been careful to talk of liberalisation and increased competition delivering efficient pricing of energy rather than lower levels of energy prices.
- 11 A case not mentioned is the raid of EDF's premises by representatives of the Commission and French competition authorities in March 2009 on the suspicion of illegal conduct possibly including actions to raise prices on the French wholesale electricity market.
- 12 European Commission Staff Working Document, SEC(2010) 1510, p. 30.
- 13 Idem, p. 18.
- 14 Ernst&Young, *The top 10 risks for business - A sector-wide view of the risks facing businesses across the globe*. 2010.
- 15 A stronger reliance on implementing acts does not necessarily constitute a reduction in uncertainty. It merely alters the possibilities of industry to be heard and to influence the outcome throughout the process of establishing such acts.
- 16 Wholesale energy products which are financial instruments to which Article 9 of Directive 2003/6/EC applies are exempted from certain provisions of the regulation not the regulation in its entirety.
- 17 According to Article 2(27) of Directive 2009/73/EC 'final customer' means a customer purchasing natural gas for his own use and 'customer' means a wholesale or final customer of natural gas or a natural gas undertaking which purchases natural gas. As the regulation does not define final customer it is, however, not given that the above definition would apply.