Energy Compliance Intelligence Series

Your Monthly Update

September, 2016

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From the editor

I am proud to present the first issue of our Energy Compliance Intelligence Series. We would like to become the leading source for electricity and gas trading compliance by sharing crucial know how and information that will support you in adequately executing your compliance tasks.

The reason why we have launched this publication is that in our advisory practice we do find that for many power and gas companies introducing a compliance culture and implementing a compliance framework and processes within their company is still work in progress.

By sharing the latest regulatory changes and its impacts on your organization, recently launched investigations into suspected violations and Compliance Best practices we will support you in reaching an adequate compliance system within your company.

I wish you good business.

Amsterdam, September 2016

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Questions from the Trading Floor

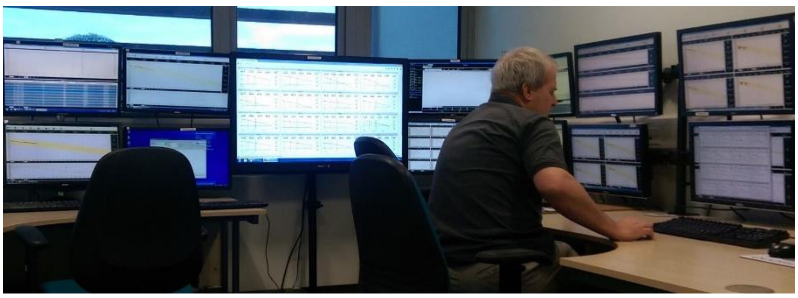
Despite the Guidance's and Q&As to overcome the lack of clarity and uncertainty surrounding REMIT and MAR, in practice there still are many trading issues of which it is still not clear whether these would be considered a suspicious trade or order by the regulator. To prevent market abuse, your company is expected to proactively analyze your trading activities on a daily basis and diagnose whether there are possible violations. To support you with this task we will deal with 2 cases coming directly from the trading floor in each edition.

Case: Tripping Power Plant and publication

A trader calls a producer to learn whether they are interested to sell. The producer's trader tells the buying trader that they are buying themselves as one of their plants just did trip. When the buyer's trader checks he notice that this information has not been published yet by the producer.

<u>*Question:*</u>

Can the trader trade on this information and increase the volume of his buying order to be able to benefit from the expected price increase once the information will be known by the rest of the market?



What the experts say:

No, this potentially would be insider trading what is prohibited. Until the information is published the trader can only execute up to the volume of the initial buying order. For the rest the trader should stay away from the market until publication of the outage.

The above outcome is quite obvious, but in practice traders do not want to show to their counterparties for how much they are really in the market. So what if the trader actually wanted to buy 200 MW, but only told the trader of the producer that he wanted to buy 50 MW? As all the telephone conversations will be recorded this is what is on the voice log.

Question

Can the trader still buy 200 MW elsewhere on the market?

What the experts say

If there is no other proof that the trader actually wanted to buy 200 MW, the trader can best only buy 50 MW in the market. Otherwise the trader is facing the risk that the regulator might suspect that this is trading on insider information and would launch an investigation. Unless it is properly documented and time stamped, i.e. there is an order trail that could be used to prove that the initial order was 200 MW.

Case: Trading on coupled Intraday markets in times of system constraints

A trader is buying in Germany and selling in France on the coupled Intraday Market. However, the trader is unable to net the positions by flowing the power as there is a reverse flow. Most likely the trader will have to settle the positions by buying and selling at the same price or sell lower than the initial buy price with seconds/minutes in between. In that case the trader is facing the risk that this would be considered as a wash trade or a false/misleading transaction by the regulators,

Question

What should the trader do?

What the experts say

Due to the constraints in the system the trader actually does not have any other alternative than to immediately close his position. However, the trader should make sure that the transactions actually reflect the underlying supply and demand conditions of the two markets involved. Very important, there should be no intention to influence the supply and demand.

Of course this situation could trigger an investigation by the regulator, as this will be most likely flagged as a susceptive trade in their monitoring system. In that case the trader will have to prove that the trades were entered for legitimate reasons and that it is conform to accepted market practices on the coupled intraday markets concerned

For a strong defense careful documentation of the trading strategies and its execution would be crucial. For instance by using a shift trade log.

Lessons Compliance Best Practices

The more comfortable regulators will be with the adequacy of your compliance program and the role of the compliance professionals, the less likely they will be willing to take enforcement actions against you. To give you the necessary tools for implementing an adequate compliance program, in each edition we will deal with a Compliance Best Practice.

Close relation Compliance and the Front Office

For an adequate compliance framework you have to start thinking like a regulator; what is good practice and do we have all the procedures in place to guarantee an early detection of any potentially illegal trading activity?

The energy regulators do not have much experience with monitoring markets for market abuse, their financial peers, however, do already have many years of experience with this. They got their experience from monitoring the financial industry and will bring those best practices to the energy industry as their benchmark as well. It therefor is an interesting exercise to learn what the financial regulators consider to be best practices for 'effective monitoring" and the place and organization of the Compliance function within your organization.

The FCA, the UK Financial Conduct Authority, published the results of a review focused on firms trading and broking across different commodity sectors and considered the adequacy of their front office and market abuse controls. They also reviewed the governance arrangements, culture and processes in place.

Below we have highlighted some of the most interesting outcomes of the review, that reveals the way of their thinking as a regulator as well as the way they considers to be "Compliance Best Practices".

The FCA believes that for effective monitoring to prevent market abuse at least the following 3 controls need to be in place.

1. Good governance;
2. Culture of abuse avoidance;
3. Well integrated risk management and abuse detection systems.

The FCA also provides insights into what they believe are the internal monitoring best practices:

- Your culture should fully recognize the potential risks from your front office activities:
- Embed the lessons learned from recent market abuse enforcement cases and educate your Front Office staff about this via a mandatory training program;
- Carry out a Market Conduct Risk assessment, this would allow you to demonstrate adequate monitoring and surveillance across the full range of market abuse risks to which your company is exposed;
- Demonstrate effective procedures to identify suspicious transactions and escalate them to the relevant Regulator;
- Demonstrate that senior management has clear sight and control of the conduct risks presented by the front office in terms of conflicts of interest or more serious issues around market abuse, such as a rogue trader, or potential market manipulation

About the Compliance function they stress that the following features seem to provide the best results:

- Compliance should be integrated with the Front Office and have a permanent physical presence on the trading floor;
- Proactive risk identification with Compliance participating in the flow of information and traders able to receive guidance on acceptable market conduct.
- Compliance functions should regularly attend trader meetings for creating good awareness of current trading issues and market abuse risks.

Takeaways

The lessons that could be learned from the FCA assessment for energy companies are the required adequate levels of surveillance, enforcement and escalation of any monitored possible violation. The report also highlights that Compliance should not be organized as a back office function, but should be right on top where the real risk exposure is; the trading floor.

Regulations and New Investigations

It will cost you a lot of time tracking and analyzing regulatory change and interpretations by the regulator. To support you with this time consuming task, in each edition we will deal with the latest changes and violation cases by regulators.

Italian Balancing Market abuse investigation

Autorità per l'energia
elettrica e il gas

Italian energy regulator AEEGSI has widened and extended an investigation into potential market abuse on Italians electricity balancing market. The behaviour under investigation might constitute market manipulation under REMIT. The regulator notified the Italian competition watchdog and ACER. The regulator now it aims to finish the investigation by early November.

The regulator launched the investigation following a streak of high balancing prices in the first six months of 2016. The irregularities were first recorded in the south macro zone of the ancillary services market (MSD), managed by GME and used by transmission system operator Terna to balance the grid. Balancing costs climbed above €400/MWh in Sardinia and to €800/MWh in the Brindisi production area several times.

The spikes came as certain power producers seemed to withhold power production from the Intraday market. The reduced power on offer meant that Terna had to buy electricity from some of these plants at a much higher price on the balancing market, in order to keep the grid balanced.

The regulator said that fresh information it obtained from Terna and the Italian power exchange GME suggests more market participants in different market zones might have put in place, or might put in place in the future behaviour similar to that of the power producers involved in the original investigation.

The regulator did not say how many operators are involved. According to data from Terna, in 2015 the balancing market had 120 injection users and 185 withdrawal users.

The situation has now gone back to normal as the regulator ordered the operators involved to immediately cease any behaviour that would influence the regular price formation process. Meanwhile, the regulator hiked imbalance charges from 1 August in order to discourage arbitrage between the balancing market and the day-ahead and intraday market less appealing.

(source: icis)

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