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E.ON Position on

**CONSULTATION DOCUMENT ON THE REGULATION OF INDICES
A Possible Framework for the Regulation of the Production
and Use of Indices serving as Benchmarks in Financial and
other Contracts**

**EU Commission | Financial Markets | Securities Markets
Brussels, 5th September 2012**

Düsseldorf, 29th November 2012



1 General Remarks

The E.ON group is active in wholesale energy commodity markets and in the related commercial activities e.g. producing, consuming, buying and selling energy commodities. To this purpose we deal with non-financial and financial entities in wholesale markets.

Energy wholesale markets evolved rapidly as a result of the liberalization process introduced in particular in Europe. Nevertheless national markets developed at different speed and in some cases are still immature. In this context the importance of benchmarks and indices is two-fold: i) they facilitate the **management of risks** of firms naturally exposed to the products underlying their commercial activity, and ii) they support the **development of liquid wholesale energy markets**, in particular where markets are still immature or liquidity is scarce, thereby assisting the objective of a single energy market for energy in Europe.

Users of benchmarks and indices seek **reliable parameters** to measure the value of specific products/contracts at different points in time. Indices and benchmarks are sufficiently reliable if they adequately reflect this value on an on-going basis. This activity may include the utilisation of estimates and proxies since it would be impossible to have exact market signals for each single contract or product traded.

E.ON supports **measures to ensure the integrity of markets** and their proper functioning. We have a natural interest that market signals, including indices, can be trusted by market participants.

The global nature of certain benchmarks highlights that a common approach must be sought; nevertheless any possible regulatory framework on benchmarks must be proportionate.

Concerning the European wholesale energy markets in detail, we would like to stress that the framework introduced with the Reg. No.1227/2011/EC (Regulation for Market Integrity and Transparency, REMIT) provides the adequate basis to ensure that European energy markets are protected in terms of market integrity by considering abusive behaviour the provision of false or misleading information to index providers or the manipulation of the calculation of a benchmark.

Specific considerations on benchmarks and indices in the energy commodity sector can be found in the answers to the specific questions of the consultation.



2 Specific Remarks/ Questions

Draft Recommendations as regards Article 8(1) of the Regulation

(1) Which benchmarks does your organisation produce or contribute data to?

E.ON subsidiaries deal in wholesale energy commodity markets on own account with non-financial and financial entities to manage the risks related to the commodities that the E.ON group produces, sells or buys to be used as inputs. We tend to distinguish between market data based on actual trades, and other benchmarks/indices published by Price Reporting Agencies or brokers and based on surveys, estimations or request of quotes. In general benchmarks based on real transactions are preferred.

E.ON contributes indirectly to indices derived from market data through our trading, e.g. ICE, or derived from reporting activities to regulators / institutions, e.g. import declarations, trade reporting. We contribute directly to the API 2 Coal Price Index (published by Argus & McCloskey's) which is based on a panel survey of a certain number of market participants. This may include both estimates and actual trade data. We provide reference prices to ENDEX as part of the Pricing Panel for futures for gas (TTF) and power markets (BE, NL) and wood pellets in the situations where there is no actual data to determine the reference price. We are phoned by Price Reporting Agencies such as ICIS Heren, or Argus or Platts and asked to provide quotes and bid- and offer spreads. The frequency of contribution depends on the Price Reporting Agencies, for instance ICIS Heren phone daily at 12:00:00 and 17:30:00 local time, whereas for instance Argus and Platts call more infrequently. All such calls usually take place on recorded lines.

(2) Which benchmarks does your organisation use? What do you use each of these benchmarks for? Has your organisation adopted different benchmarks recently and if so why?

The use of benchmarks/indices related to energy commodities and related derivatives supports our trading activity. These are available either for free or on a commercial basis, and they are published by energy exchanges, broker platforms or price reporting agencies (PRAs).

The level of use of benchmarks or market data is different depending on the type of energy commodity and the geographical scope of the relevant markets. Market data available on a commercial basis are used more extensively in liquid markets, whilst benchmarks published by PRAs are more used in cases where market data is not, or only scarcely, available.

Benchmarks and market data are used internally for analysis to increase understanding of market trends, making trading decisions or evaluating trading strategies. In case a particular benchmark is not considered sufficiently reliable, it is not taken into consideration. Where available, market data is used to evaluate open positions; for more illiquid markets benchmarks are also used together with other information as inputs of models elaborated for marking-to-model open positions.

Reference prices are also used by clearing houses to derive margining requirements and sometimes they may be formed by estimated values.

(3) Have you recently launched a new benchmark or discontinued existing ones?

No. We have neither created nor launched benchmarks.

(4) How many contracts are referenced to benchmarks in your sector? Which persons or entities use these contracts? And for which purposes?

Most of the forward wholesale energy commodity contracts are referenced to indices and market data. These contracts are used with counterparties acting in the wholesale market.

(5) To what extent are these benchmarks used to price financial instruments? Please provide a list of benchmarks which are used for pricing financial instruments and if possible estimates of the notional value of financial instruments referenced to them.

In some cases the indices may be referred to derivative financial instruments used for carrying out the trading activities in the wholesale energy commodity market. However these are limited compared with other type of contracts which a contracts for the physical delivery of energy commodities. We are not in the position to provide estimates of the notional value associated to derivative financial instruments.

(6) How are benchmarks in your sector set? Are they based on real transactions, offered rates or quotes, tradable prices, panel submissions, samples? Please provide a description of the benchmark setting methodology.

Benchmarks may be set in many different ways. In general we are aware of benchmarks be based on real transactions, requests to submit bid/ask quotes or panel submissions.

Real transactions: Benchmarks are normally derived as weighted average values of trades concluded during a pre-defined trading period e.g. day, week, month. If mandatory reporting requirements are in place, or if they refer to a particular contract trading on a specific platform, they take into consideration all transactions; in case they are created by (third party) individuals, they may represent a sample of the population of market participants trading over-the-counter. In case no actual data is available either a specific formula is applied (e.g. interpolation) or the values are not published.

Request of quotes/panel submissions: platform operators or price reporting agencies may ask a certain number of market participants their bid and offer views related to forward markets, in particular when markets/products are not sufficiently liquid and there is a lack of pricing information. These processes may be subject to different levels of standardisation.

Methodology: Most commonly quotes are collected from known market participants at pre-defined deadlines, outlier values are excluded, and the average of the remaining submissions is taken into consideration and is published.

(7) What factors do you consider to be the most important in choosing a reliable benchmark? Could you provide examples of benchmarks which incorporate these factors?

The most important factors to evaluate the reliability of a benchmark is the transparency on the methodology adopted to determine it, and the ability to reflect the value of the underlying products that is tested when negotiations take place in the market.

(8) What kinds of data are used for the construction of the main indices used in your sector? Which benchmarks use actual data and which use a mixture of actual and estimated data?

See response to question 1 and 6. In general, platforms operators uses real data, samples of actual trades or bid/offers asked to panel contributors. Price reporting agencies may request both data of transaction concluded and estimations.

(9) Do you consider that indices that do not use actual data have particular informational or other advantages over indices based on actual data?

In general indices that use actual data of all concluded trades are preferred because we believe they are more reliable than those based on estimations. However we recognise that this is not always possible mainly due to the scarce liquidity of certain markets/products or the costs to collect transactional data.

(10) What do you consider are the advantages and disadvantages of using a mixture of actual transaction data and other data in a tiered approach?

The availability of pricing information along different trading periods and across interrelated energy commodity products is important to support internal analysis, to understand market trends, and to support trading decisions. Therefore in case actual transactions are not available for certain timeframes, the availability of proxies is considered useful. Hence the main benefit of using also data other than actual transaction is the possibility to supplement and complete the forward curve.

(11) What do you consider are the costs and benefits of using actual transactions data for benchmarks in your sector? Please provide examples and estimates.

Actual transactional data are not always available. In the energy commodity space there are many different locational products e.g. national power/gas markets. The cost for collecting, reporting and publishing all these data is very high. In particular we have experienced some European national regulators requiring the report of trades concluded in their national market in different languages, formats, timelines and for different purposes. This is highly burdensome and costly, and could be difficult to manage across all markets and countries. However we see benefits in reporting of transactional data for standardised wholesale energy products because this can be done at a relatively limited cost, for instance requiring platform operators to collect and report data of transactions concluded on their facilities.

The Regulation for Energy Market Integrity and Transparency (REMIT, Reg. 1227/2011/EC) introduced data collection obligations that will become effective after the final approval of the delegated acts of the EU Commission that are currently under consultation¹.

¹ The 'Pilot Project for an Energy Trade Data Reporting Scheme' (CEER, 2011) is a relevant example in our sector. Please see <http://www.energy->

(12) What specific transparency and governance arrangements are necessary to ensure the integrity of benchmarks?

In extreme summary, these are the ideal arrangements to ensure integrity in establishing benchmarks/indices:

- (1) A specific committee established by the index provider
- (2) List of pricing members publicly available
- (3) Objective requirements and a specific agreement to become pricing member and regular review of pricing members
- (4) Confidentiality in managing submissions made by the contributors
- (5) IT standards that ensure that data submitted cannot be manipulated after submission
- (6) Objective and transparent methodology with minimal discretionary powers, including a fall back procedure and minimum conditions to be met in order to publish reliable data (e.g. number of inputs)
- (7) Explicit mention, when data is disseminated, whether reference prices are based on estimates, actual data or a combination of the two
- (8) The methodology should be subject to regular review, or it should be possible to revise it if it does not reflect accurately, and closely as possible, the prices and trends of products traded
- (9) Possibly independent review of the process of the index provider by third professional parties.

(13) What are the advantages and disadvantages of imposing governance and transparency requirements through regulation or self-regulation?

We believe that the costs and benefits of imposing governance and transparency requirements through regulation depend on the level of granularity of such requirements. If they are too prescriptive, the costs for establishing and maintaining the benchmark may be excessive; this would be counterproductive for emerging markets that are not yet sufficiently liquid because the absence of pricing data does not stimulate additional liquidity, and rather prolongs the immaturity of a market.

(14) What are the advantages and disadvantages of making contributing data or estimates to produce benchmarks a regulated activity? Please provide your arguments.

Advantages could be: more secure and reliable indices that can further aid and ensure market transparency. The costs would be associated to stricter internal procedures to identify individual contributors, regular and formal auditing and recording according to specific rules of contribution submitted, specific trainings and other on-going compliance and monitoring costs, including

independent external audits. If contributing to benchmarks becomes too burdensome, it may become unattractive for potential contributors who normally act on voluntary basis. Indeed, depending on the level of detail of the rules, the costs and controls associated may overtake the benefits for potential indices providers.

However we believe that transmitting data to index providers should fully remain an activity on a voluntary basis.

(15) Who in your sector submits data for inclusion in benchmarks? What are the current eligibility requirements for benchmarks' contributors?

In energy commodity markets, wholesale market participants commonly submit data for the publication of benchmarks. They may be approached by platforms operators, brokers or price reporting agencies. Eligibility requirements are different depending on the level of standardisation of the process. They may vary from specific agreements, including commitments for contributors, to simple verbal or written ad hoc requests. For example, contribution requirements can include:

- A minimum time of employment in the energy business;
- The full knowledge of the rules governing the market for which the individual provides data;
- that the regular/main activity of the individual is trading in products for which he/she provides data;

(16) How should panels be chosen? Should safeguards be provided for the selection of panel members, and if so which safeguards?

Panel members should ensure the representativeness of the population of market participants in a certain specific product/contract. Specific requirements for individuals representing market participants may be introduced, although they should not be excessive and they should be sufficiently general so that can be met by the average market participant.

(17) How should surveys of data used in benchmarks be performed? What safeguards are necessary to ensure the representativeness and integrity of data gathered in this way?

It is advisable that the process for organizing surveys to gather inputs for benchmarks is transparent and that potential contributors are consulted. It should be performed at regular intervals and the representativeness of the panel is ensured by public disclosure of the panel participants. For other elements see response to question (12).

(18) What are the advantages and disadvantages of large panels? Even in the case of large panels could one panel member influence the benchmark?

All contributors providing information for the calculation of the benchmark influence its calculation by definition. Large panels normally minimise the possibility that an individual can arbitrarily influence or manipulate the benchmark. The possibility to arbitrarily influence benchmarks may be further reduced through specific methodologies in calculating the benchmark e.g. exclusion of outliers / extreme values (min, max) submitted. However, large panels cannot be established in case the number of market participants is low and the market is immature. Requirements for a minimum size of panels may become a barrier to develop new benchmarks and hence an obstacle for liquidity development.

(19) What would be the main advantages and disadvantages of auditing of panels? Please provide examples.

The requirement of an audit of panels seems highly burdensome, and it could be difficult to establish without a high degree of subjectivity.

It is more likely that contributors may want to withdraw from 'contributing agreements'

It may seem more pragmatic to introduce process auditing at the level of the index provider

(20) Where indices rely on voluntary contributions, do you consider that there are factors which may discourage the making of these contributions and if so why?

Yes, we believe that too prescriptive requirements for contributors would discourage participation.

The reasons for this can be found in answers to questions above, in particular (14) and (19).

(21) What do you consider to be the advantages and disadvantages of mandatory reporting of data? Please provide examples.

Please see response to question (12).

(23) Do you consider that responsibility for making adjustments if inadequate data is available should rest with the contributor of the data, the index provider or the user of the index?

The provisions to contribute to the index should be clear enough to avoid occurrences where adjustments to contributions are needed. The index provider should be able to evaluate if the submissions are accurate and in line with the processes to set up the index. However, it would be difficult to assign the responsibility to adjust contributions, and this may give excessive discretion in particular when indices are based on estimations.

We believe that measures including a Policy about the purpose of the index, a code of conduct for contribution and calculation of the index, the review of the methodology when necessary and the regular change of contributors, if possible, are deemed as sufficient measures to ensure consistency in the final results. In the energy commodity markets users of a benchmark are normally in the position to verify the degree of reliability of an index published for their trading activity.

(28) Who should have the responsibility for auditing contributed data, the index provider or an independent auditor or supervisor?

It should be sufficient that the index provider validate the data submitted based on the provisions in force for calculating the index.

(29) What are the advantages and disadvantages of making benchmarks a regulated activity? Please provide your arguments.

Please see our response to question (13) on governance and transparency requirements. In general the type and level of regulation to which this activity would be subject are essential to evaluate a proposal in this sense. More in general, users of benchmarks and indices look for reliable measures to evaluate specific products/contracts at different points in time. This may include the utilisation of estimates and proxies since it would be impossible to have exact market signals for each single contract or product that is traded. Therefore the availability of benchmarks supports risk management activities. If the contribution to, or creation of, benchmarks becomes a regulated

activity, and if the regulation is too prescriptive, the costs for establishing and maintaining the benchmark may be excessive. This would be counterproductive for emerging markets / contracts not yet sufficiently liquid because the absence of pricing data does not stimulate additional liquidity and rather prolongs the immaturity of a market.

(30) Is it possible and desirable to restrict the use of benchmarks? If so, how, and what are the associated costs and benefits? Please provide estimates.

We do not believe that it is desirable to restrict the use of benchmarks, and it would probably be very difficult and very intrusive to try to do so..

(33) Who should have the responsibility for ensuring that indices used as benchmarks are fit for purpose, the provider, the user (firms issuing contracts referenced to benchmarks), the trading venues or regulators?

We believe it is reasonable that firms issuing contracts referenced to contracts with retail customers have the responsibility to verify if the benchmark fits with the purpose of the contract. However, this responsibility should remain general and not too specific, otherwise the necessary bureaucratic work would make infeasible to propose benchmarks even if they 'fit the purpose'.

(34) Do you consider some or all indices to be public goods? Please state your reasons.

It could be acknowledged that some indices have the fundamental characteristics of public goods i.e. non-excludability and non-rivalry, however often they tend to be more 'club goods' because of licensing rights for the possible utilisation in contracts with third parties.

(35) Which role do you think public institutions should play in governance and provision of benchmarks?

We believe that it cannot be generalised that public institutions have the best access to the relevant underlying data, nor that they may be better placed to address conflict of interests.

We believe that independent index providers have the primary interest produce reliable and enduring indices in particular because of the profitability of this activity.

Governance and transparency requirements may be needed to ensure that eventual conflicts of interests are managed properly, although they should not be extremely intrusive.

(36) What do you consider to be the advantages and disadvantages of the provision of indices by public bodies?

Main advantages: independent by definition

Main disadvantages: lack of interest in producing reliable data; possible limited access to underlying data; limited understanding of the functioning of markets underlying to the benchmark.

Public bodies can be however among the index providers, but not exclusively.

(38) What conflicts of interest would arise in the provision of indices by public bodies? What would be the best way of avoiding these conflicts of interest?

Public bodies should also be obliged to comply with all necessary legal provision to avoid possible conflicts of interest and misuse of the data provided.

As mentioned in response to question (36), the potential flaws of this approach should be managed in a way that ensures incentives and interest in producing correct information, competence and access to the relevant data.

(39) What are the likely transition challenges, costs and timelines for relevant benchmarks? Please provide examples.

Since the scope and the deepness of a possible regulatory intervention on benchmarks is not clear from the consultation paper, it is difficult to estimate the possible costs and timelines.

The main challenges are related to time and costs needed to:

- renegotiate contracts with counterparties that refer to certain benchmarks that are changed or not published anymore.
- Adopt new methodologies or update the existing methodologies used to evaluate open positions when they take into considerations benchmarks affected by the regulatory framework.
- Introduce policies and processes compliant with the new framework for the utilisation and the contribution for the calculation of benchmarks, including trainings.

(40) How do you consider that the adoption of new benchmarks could be ensured? Is this best framed in terms of encouraging or mandating the use of particular benchmarks?

Benchmarks are useful and necessary if they can measure the value of certain products that are effectively traded. We do not see useful to mandate the use or the contribution of particular benchmarks in the energy commodity sector.

(44) In which countries are benchmarks used in your sector produced? From which countries are data used for the production of benchmarks in your sector sourced? In which countries are benchmarks used in your sector used?

Benchmarks used in the energy commodity sector are produced and may be used worldwide,

This may depend:

- on the nature of the energy commodity e.g. benchmarks on grid-related energy commodities tend to be produced to the area/country to which the price refers and used e.g. at European level.
- where the main market places (exchanges, broker platforms,...) available for trading of the underlying products are located, more in general from global energy commodities.

(45) Are there non-EU benchmarks which could serve as substitutes? Are there non-EU benchmark providers which could produce similar benchmarks?

(46) Are there international benchmarks which could serve as substitutes for national benchmarks?

In the energy commodity sector the possibility may depend on the elements highlighted in the previous answer. In general we do not believe that it is practicable that non-EU benchmarks could serve as substitutes for EU-grid related energy commodities. On global energy commodity this is possible and it is already a fact in most of the cases (e.g. Brent-dated).