E.ON AG

Avenue de Cortenbergh, 60
B-1000 Bruxelles
www.eon.com

Contact:

Political Affairs and Corporate Communications

Political & Regulatory Affairs
Phone: +49-211-4579 4804

marketregulation@eon.com

E.ON General Statement to "Margin requirements for non-centrally-cleared derivatives"

BCBS-IOSCO, July 2012

Düsseldorf, 28th September 2012

General Remarks

E.ON supports the objective of reducing systemic risks in financial markets and welcomes the opportunity to comment on the proposals of the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commission (IOSCO). We are in particular interested to provide comments to some of the proposals of BCBS/IOSCO that could affect the functioning of energy commodity derivative markets in which we are active supporting the group's commercial activity. E.ON believes that when crafting legislation to reduce systemic risk, regulators should strive to strike the right balance between the desire for financial stability while maintaining the possibility for non-financial counterparties to manage their business adequately.

IOSCO/BCBS do not give evidence in the consultative paper that the framework proposed for non-centrally cleared derivatives could work in practice. In most cases, if there is no CCP available to clear a certain type of derivative instrument, this is because such an instrument is not sufficiently standardized, liquid and with reliable price information available on an on-going basis to allow central clearing. Therefore it is possible to replicate the margining approach where the basic conditions are not appropriate: the calculation of margins could require unprecedented efforts, potentially leading to never ending disputes between the parties. Hence the exchange of initial and variation margin (IM, VM) would not always be possible.

More in detail we would like to emphasise that we adopt a comprehensive risk management framework based on achieving the right balance between commodity price risk, credit risk and cash flow risk. Focusing on just credit risk would be at the expense of the other risks, possibly increasing the overall risk profile of the group. This integrated risk management approach allows flexibility to address our needs and this is certainly valid for other types of market participants as well. IOSCO and BCBS should consider a set of tools for credit risk management that address the specific issues of the energy business. The exchange of IM and VM is among these tools but is neither the only one nor always possible: credit limits for counterparties on the basis of external ratings and/or detailed credit risk assessments plus risk monitoring activities are among these tools. Where appropriate, and the law permits netting across all contract forms, we also have Credit Support Annexes (CSAs) in place, under which collateral is posted to or received from counterparties to mitigate the credit risk arising from in-the-money positions. However, CSAs are typically only used in case the underlying products are sufficiently standardised, liquid and with price information available and reliable on a frequent basis for both parties. We believe therefore that the number of contract types that are not eligible for central clearing and will be possibly subject to two-way margining is negligible.

Furthermore IOSCO and BCBS should acknowledge the limited access to cash collateral for non-financial counterparties. Indeed financial firms have access to central banks' liquidity as part of their core business, whilst non-financials are not in such a position and would have to increase line of credits to obtain more cash, if this is possible at all. Capacities to collateralise derivative transactions with cash collateral are therefore constrained and the possibility to use collateral other than cash is very limited. It should also be acknowledged that this effect on the liquidity of non-financial firms comes on top of the expected trend towards cleared markets for derivatives subject to EMIR which already will increase the liquidity risks stemming from margining obligations towards CCPs for non-financials.

Finally the consultative document does not take into consideration the criteria proposed in different jurisdictions to identify Non-Financial Companies (NFCs) deemed to be systemically important. Although this is not explicitly proposed as a topic for discussion in the consultation, IOSCO and BCBS should clearly affirm that the criteria proposed through national or continental standards should be carefully targeted in order to avoid that NFCs which are not of systemic importance will be classified as 'covered entities'. If the scope of systemic important NFCs will be too wide, the negative effects on the real economy of collateralisation requirements for non-centrally-cleared derivatives and the contemporaneous obligation to clear eligible derivatives would be massive. Indeed, these requirements would either constrain cash liquidity sources to cover margin requirements at the expense of investments in the primary business, or make derivative markets not accessible to these NFCs who would have to maintain price risks relatively uncovered. In this context we expect market conditions worsening – less liquidity and more volatility – with significant impact also on the activities of other NFCs not deemed to be systemically important.

Questions for public consultation

1. What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

We believe that any requirement for non-centrally cleared derivatives should not be introduced before tangible feedbacks on the methodology proposed and after coordination with the measures for mandatory central clearing of eligible derivatives.

Element 1: Scope of coverage – instruments subject to the requirements

2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

We support the general view that the above mentioned instruments should be exempted from the margining obligation as the counterparty credit risk involved is very small (due to the very short average maturity of the contracts) and settlement risks are very well addressed especially through the widespread use of payment-versus-payment arrangements. This would also contribute to a global level-playing field and avoid regulatory arbitrage as for example the U.S.-legislator has also proposed such an exemption.

3. Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?

E.ON believes that there should be a specific exemption for contracts for the future physical delivery of energy products. These products may be formally considered to be derivative financial

instruments under certain legislations, although their primary purpose is to transfer ownership of the commodity through delivery and provide a hedging function against volatility of spot prices.

Any requirement to collateralise all these non-centrally cleared transactions would have a huge and unsustainable impact on companies buying and selling energy commodities for future delivery as part of their operative business. Forward transactions intended to be physically settled are commercial merchandising transactions entered into by undertakings active in the commercial business of the underlying products (e.g. production or sale of gas/electricity). This is recognised for instance in the U.S.[1] but not everywhere, therefore a general exclusion would ensure that the proposal of IOSCO and BCBS would be targeted to contracts and counterparties that could create concern of systemic financial risk.

Element 2: Scope of coverage – scope of applicability

4. Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

E.ON has serious concerns that all 'covered entities' should be subject to the proposed requirement. We believe that financial and non-financial entities should be treated differently. Indeed, given the significant consequences associated with capturing firms that do not pose a systemic risk to the financial system, BCBS and IOSCO must carefully consider the extent to which the proposed measures would also be applicable to non-financial firms. At the very least all non-financial counterparties that are below the clearing threshold in EMIR should not subject to these requirements. We strongly believe that capital should not be unnecessarily tied up in margining or segregation requirements without actually improving the stability of the market, limiting liquidity impact, and providing significant benefits in terms of lower or more efficient risk management.

In other words, instead of removing counterparty credit risk, non-financial entities will tend to reduce activities in derivatives and thus the price risk related to their natural long or short positions will remain uncovered, resulting in increased risks which can reverberate in the economy.

[1] The so called 'Forward Exclusion From the Swap and Future Delivery Definitions' under the rulemaking of the Commodity Futures and Trading Commission on the U.S. Dodd-Frank Act (see Federal Register /Vol. 77, No. 156 /Monday, August 13, 2012 /Rules and Regulations, p 48227).

5. Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

E.ON does not support the general requirement that all firms should post IM because the proposal takes a one-size fits all approach to risk mitigation and does not adequately take into consideration the current resilient practices which are well-established and sufficient for risk mitigation of NFCs.

The requirement to generally post IM is inappropriate with potentially severe negative impact on both the financial system and "real economy" companies. Indeed imposing IM on non-centrally cleared "risk-reducing" transactions will inevitably drive up the capital cost of, and dis-incentivise NFCs from, undertaking such transactions. So while the "systemic" risk related to financial markets may be reduced, "commercial" risk will rise instead. We would strongly urge IOSCO and BCBS to refrain from recommending such radical measures which may have unintended consequences. IM thresholds would be appropriate only if applicable in a non- discriminatory manner and if not all non-centrally cleared derivatives would be subject to universal two way margining.

Finally we believe that the consultative paper does not sufficiently deal with the need for the counterparties of a derivative transaction to agree on a single model to quantify IM. This difficulty is inversely proportional to the level of standardization of the contract.

6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (eg notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?

We believe that, if introduced, margin thresholds should be applicable to all counterparties required to post IM. Different entities should be able to use thresholds for IM if it can be demonstrated that sound and robust risk management procedures and a risk model approved by an internal supervisory committee exist. Only objective and non-discriminatory conditions like this would avoid any unlevel playing field.

Concerning the measurement of 'systemic risk', in Europe a clearing threshold approach has been introduced. According to the European Market Infrastructure Regulation (EMIR), 'the value of the clearing threshold should be set at such a level that systemically relevant parties are captured'. The

calibration of such a threshold is absolutely crucial to avoid that market participants which are not of systemic importance become 'covered entities'.

We firmly believe that the notional value of OTC derivatives is not an effective measure to determine the underlying risks of participating in derivative markets. Calculating positions on a net basis would reflect non-financial companies' exposure to counterparties in a more realistic way and would better represent the actual systemic relevance of a specific counterparty.

Q8. How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

E.ON believes that the applicability of IM should distinguish between financial and non-financial entities, because the driving principle should be the access to collateral for different types of entities i.e. financials VS non-financials. Furthermore it should be taken into account that according to data published by BIS, non-financial corporations – including governments and local authorities – represent on average about 5% of the total OTC derivatives markets. Therefore we strongly believe that the recommendations of IOSCO and BCBS should focus on the 95% of the derivative business represented by financial counterparties.

Q9. What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

The consultative document does not provide a definition of 'key market participants' and how these are identified. Our understanding is that this is a subset of all 'covered entities', although we would appreciate IOSCO/BCBS to provide a clarification in this sense. Concerning European regulation, EMIR must be fully considered. The non-financial counterparties that are below the clearing threshold in EMIR should not be considered covered entities or 'key market participants'.

The requirement of universal two-way margining, if applicable, focuses on the minimisation of credit/counterparty risk, whilst price and cash-flow risks are disregarded, though they will be severely impacted. In particular such a requirement would have serious impacts on funds available to non-financials counterparties for investment in their primary business.

Finally, universal two-way margining would exclude the use of other credit risk measures – e.g. an effective credit monitoring system – that are useful to manage all risks in a balanced manner.

Concerning the practical and operational issues, please see the introductory part of this paper.

11. Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?

Yes, non-financials' exemptions from margin requirements are consistent with exemptions from mandatory clearing, as defined in several derivative market regulations (e.g. EMIR and Dodd-Frank). These exemptions reflect the view that derivatives used by non-financial companies in order to reduce their risks, should not be mandatorily cleared.

12. Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?

We refer to our response to Q. 7/8

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

13. Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?

As expressed in the introduction to this document, we are doubtful that the methodology to exchange IM and VM would be practicable for derivatives which will not be eligible for central clearing. We believe that this methodology would not be applicable for instruments which are not sufficiently standardized, liquid and with price information available and reliable on an on-going basis.

15. With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?

We refer to our response to Q13. Furthermore we believe that the initial margin level prescribed in the standardised schedule for commodity derivatives would be extremely penalising, in particular if applied to the gross notional amount of each derivative contract.

We are particularly concerned about the impact that these requirements could have on the entire functioning of energy derivative markets.

As for the regulatory standards under development in Europe by ESMA, we emphasize the need to have more specific clarification about certain definitions e.g. notional exposure and prices applicable as well as clear indications on netting possibilities in case 'a limited degree of netting may be performed' as mentioned in the notes.

16. Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?

We believe that the methodology of two-way margining is applicable only if certain market conditions to enable a reliable evaluation are satisfied, therefore we appreciate and support the view expressed in the consultative paper that '*the valuation of a derivative's current exposure can be complex and, at times, become subject to question or dispute by one or both parties. Moreover, in the case of non-centrally-cleared derivatives, these instruments are likely to be relatively illiquid, often with little or no price transparency making the process of agreeing on current exposure amounts for variation margin purposes even more challenging.*'

17. With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?

The frequency of the VM exchange should depend basically on the availability of reliable price data that could justify the underlying exchange of collateral. Therefore it is desirable to have sufficient flexibility in applying this requirement.

In general for non-financials counterparties this could be done on a monthly basis.

Element 4: Eligible collateral for margin

20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

In light of the considerations expressed above, in particular on the accessibility of non-financial counterparties to cash collateral with rather inflexible limits, we believe that the type of eligible collateral should include commercial bank guarantees. A standard guarantee document issued by a financial institution with a good credit standing is completely sufficient in our view to cover potential losses when a derivatives counterparty fails. As part of our own risk management framework we limit the overall amount of guarantees that we accept from any single financial institution.

Element 5: Treatment of provided margin

22. Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

Whilst the requirement to segregate initial margins received in order to ensure that it is immediately available, it exacerbates the impacts on the cash flow risk . Furthermore we doubt that a general principle of segregation could prevail over local bankruptcy regulation, the need to review local laws should be more than a recommendation.

23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

Again, the scarcity of collateral in general and cash collateral more in particular, makes this requirement extremely penalising and leading to the impacts mentioned in the introductory remarks of this paper.

We do not exclude the possibility that it could create concentration risks, but we believe that such a requirement would most likely lead non-financial entities to use less derivatives and potentially leaving price risk uncovered in order to be able to manage the cash flow risk.

Element 6: Treatment of transactions with affiliates

25. Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?

Intragroup transactions are usually not collateralized. Since the parties to an intra-group transaction are essentially different parts of the same entity they will generally have no credit risk differential between them, hence collateralizing the risk would be inappropriate and not necessary as it is not justified from an economic point of view.

Intragroup transactions in NFC are necessary and common practice because treasury and risk management services are typically performed centrally in order to optimize needs of different entities within the group. Nevertheless they do not affect the net risk position of the entire nonfinancial group.

Therefore we believe that in general there should not be requirements to exchange margins between affiliates, unless there are evident and specific impediments that could justify a similar treatment to transactions with unaffiliated counterparties.

26. Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?

As we do not see any reason to post margins intra-group cross border we do also oppose an exchange of VM between affiliates within the same national jurisdiction. As explained above it would not be appropriate. Possible issues related to local insolvency regimes may arise if located in different countries; however these should be dealt with reasonably to avoid that groups located in different Member States of the EU would be obliged to exchange margins.

The costs of requiring exchange of margins between affiliates are basically due to the additional complexity and administrative burden without any additional benefits. The possibility that one affiliate builds up a large and uncollateralised exposure to another affiliate or parent that could jeopardise the entire group should be dealt within the group through appropriate risk allocation methods and we believe that the intrusion in these internal arrangements has limited or no connection with measures to limit systemic risk.

Element 7: Interaction of national regimes in cross-border transactions

27. Is the proposed approach with respect to the interaction of national regimes in crossborder transactions appropriate? If not, what alternative approach would be preferable, and why?

We believe that the approach suggested would ensure that relevant regulatory regimes are applied consistently across the globe. However it is paramount that the regulatory regimes are equivalent on a substantial point of view to avoid regulatory arbitrage.