Energy firms playing catch-up with the banks

The introduction of the EU Market Abuse Regulation (MAR) last year placed new demands on a wide variety of market participants, not just banks. One such section of market participants is energy firms, who now have to implement systems and processes – from which they were previously exempt – in a range of areas.

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Prior to the introduction of MAR, companies that traded energy products largely escaped the type of market abuse regulation that banks – by virtue of their trading in financial products – have had to deal with for years. The lack of such regulation has, in part, ensured that energy firms have not had to face the regulatory scrutiny and scale of fines for no compliance that banks have endured over the last decade. In general there has not been the pressure across energy markets to scale up compliance departments and regulation-focused technology to respond to these new requirements. As a result, the maturity profile of compliance departments within energy markets is more varied than we see in those firms participating in the financial markets.

Rob Weston, Managing Director, Risk Consulting, KPMG believes that regulators will not show leniency based on sector. "Energy firms cannot ignore MAR or MiFID2 [the recast EU Markets in Financial Instruments Directive] any longer and the regulators will not treat them differently just because they are energy firms. When it comes to enforcement there cannot meaningfully be differing standards applied to energy firms as compared to financial services firms."

This was the case in early 2017 when the UK Financial Conduct Authority (FCA) ordered a retailer to compensate investors to the tune of an estimated £85 million for alleged abuse arising from a mis-statement of profits, despite this crime not being related to trader behaviour in a traditional sense.

James Maycock, Director within the Energy and Commodity Trading Risk and Regulation Team at KPMG, says the move shows how "financial regulators have been granted the tools to pursue corporates."

Energy within MAR's scope

MAR specifically widens the scope of products that are subject to market abuse regulations. It prohibits any market abuse occurring across both the spot commodity and related derivative markets, including those products which are traded over the counter and which can have an effect on an in-scope exchange-traded product. As a result, the activities of energy firms are now firmly within the scope of MAR.

MAR requires firms that engage in the commodity markets to have processes and controls in place to monitor the risks of intentional or perceived market abuse by employees. To this end, energy firms now need to be regularly monitoring their trading systems, emails, messages and voice communications. "For energy firms, this is a big shift," Maycock says. "The banking world has long been required to surveil their own, often client-facing traders in a way that has, until recently, largely bypassed energy firms who trade on their own account."

MiFID2, a cornerstone of European regulation has, as one of its objectives, an aim to increase transparency and efficiency within markets. Whilst those firms fully in scope of MiFID2 ('regulated firms'), including some energy firms, have a higher degree of obligation arising from MiFID2, certain aspects, such as Commodity Position Limits, will apply to all energy market participants. MiFID2 Commodity Position Limits were conceived to limit the potential for abusive trading. In practice this require energy firms, among others, to monitor their own positions – and have a clear, defensible rationale for the treatment of their 'risk mitigating' transactions (i.e. hedging activities). This requirement raises the stakes for energy firms to justify their exposures to financial regulators, in discoverable documents, which may also have implications for their ongoing surveillance regimes.

Legacy systems versus green field

However, it isn't all bad news for energy firms. "The banks have decades of legacy systems," says Weston. This means that it's difficult for them to patch new compliance processes on top of the old ones. "But the energy firms are, in many ways, a 'green field' site: they can buy new systems and new technology that fits their platforms and meets their current needs without having to worry about old-generation systems."

Moreover, energy firms can learn from banks. "Banks have spent a lot of time investing in improving old platforms and testing new ones. They know what works and what doesn't," observes Weston. "Energy firms can leverage this experience and reduce their costs."

As well as the work that KPMG has conducted in trader surveillance and investigations for banks, the firm has many years of experience advising energy businesses in everything from strategy and regulation, to asset valuations, to internal audit across the value chain. "That gives us a combination of subject matter expertise in technology and the energy industry," says Weston.

This is crucial. The energy sector clearly isn't a single, homogenous market; industry players range from proprietary energy traders to multinational vertically-integrated energy firms. There are also many asset classes to consider. The regulatory treatment of spot crude in the physical market, is as different from power futures in the derivatives market as foreign exchange is from more exotic financial products such as credit default swaps or alternative investment products.

"The products and asset classes have wholly different characteristics in their marketplaces and in the way price formation happens," says Maycock. "Some markets are still dominated by voice brokerage, while others are more electronic. You need to fine-tune the trader surveillance technology and go to the heart of the problematic trades in each market rather than just picking up a lot of false positives, which can stretch firms' compliance resources and open them up to a heightened risk of missing potential market abuse."

The challenge for energy firms is to bring all this knowledge together, especially with the compliance deadline for certain aspects of MAR now overdue. "Although MAR has already come in, there is still a window to become fully compliant," Maycock says. "Energy firms need to be demonstrating that they are alive to this and that they have plans in place."

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