REGULATION ON WHOLESALE ENERGY MARKETS INTEGRITY AND TRANSPARENCY - ARE YOU REMIT COMPLIANT?

Date: 5 August 2016

Energy, Infrastructure and Resources Alert

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INTRODUCTION

The regulatory and enforcement landscape of the European natural gas and electricity markets is changing considerably following the last stage in the implementation of the Regulation on Wholesale Energy Markets Integrity and Transparency (EU) No 1227/2011 (REMIT). REMIT is a European Union Regulation designed to deter market abuse in natural gas and electricity markets. It came into force on 28 December 2011, but full implementation in Member States has been phased in over the years since then. Crucial regulator enforcement powers and sanctions were introduced in the UK in 2013 and 2015, and rules relating to data reporting have become fully operational in 2016.

REMIT has introduced an EU-wide monitoring regime to detect and deter market manipulation and insider trading which may distort wholesale energy prices, potentially resulting in higher retail prices. To that end, it requires disclosure of price-sensitive information regarding energy generation, storage and transmission. REMIT provides for a shared compliance responsibility between the Agency for the Cooperation of Energy Regulators (ACER) and applicable National Regulatory Authorities (NRAs). The applicable NRA in the UK is the Office of Gas and Electricity Markets (Ofgem).

ACER and Ofgem have sent strong signals that they are primed to increase the number of investigations into suspected misconduct in Europe's natural gas and power markets. The effect of the new reporting regime is that the regulators will have access to more data to detect market abuse, resulting in an increased likelihood of civil and/or criminal sanctions for individuals as well as corporates.

Ofgem has already engaged with some market participants about certain issues, identified through monitoring and investigation, and is cautioning companies to review their approach to compliance with REMIT.

So, who is caught by REMIT and how can a market participant protect itself from civil or criminal liability?

REMIT REGISTRATION AND DATA REPORTING REQUIREMENT

The REMIT registration and reporting process applies to all market participants who trade wholesale energy products on any market within the European Union. The implementation of the Regulation was divided into three phases:

1. registration of market participants with the NRAs was required by 17 March 2015;

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2. reporting to ACER of wholesale energy supply and derivatives contracts admitted to trading at organised market places commenced on 7 October 2015; and
3. reporting to ACER of the remaining wholesale energy contracts (over-the-counter standard and non-standard supply and derivatives contracts and transportation contracts) has applied since 7 April 2016.

Wholesale energy products for this purpose include:

contracts for the supply of electricity or natural gas where delivery is in the Union;

derivatives relating to electricity or natural gas produced, traded or delivered in the Union;

contracts relating to the transportation of electricity or natural gas in the Union; and

derivatives relating to the transportation of electricity or natural gas in the Union.

Given the broad scope, REMIT is likely to impact non-EU businesses that trade or have operations within the EU. Further, an entity will need to register even if its parent company or subsidiary company is already registered.

Thus far, the roll out of the registration requirement has led to some confusion amongst entities that trade these products, particularly amongst non-EU entities that trade within the EU. For example, would a US investment adviser entering into a derivatives transaction traded on an EU exchange be required to register as a REMIT participant? Generally speaking, the answer is yes.

However, if the investment adviser is merely placing orders in exchange-traded derivatives for financial settlement and the executing broker is an exchange member, ACER's published guidance indicates that it would not have to register. For financially-settled exchange-traded derivatives, only exchange members are considered market participants under REMIT. The investment adviser would be viewed as a client of an exchange member and would on that basis not be required to register.

Further, would a US company trading financially-settled derivative contracts related to EU electricity and natural gas but traded on a non-EU exchange be required to register? No. If the company entered into transactions on derivatives traded outside the EU that are only for financial settlement even though they are related to EU electricity or natural gas (for example a future or a swap that can only be financially settled), that company would not be considered a REMIT market participant, unless the company also entered into transactions on an EU exchange.

An example would be a company that enters into a transaction in an exchange-traded financial swap on two floating gas prices for two monthly contracts, for instance 1) an EU natural gas futures contract and 2) a US futures contract of the corresponding contract month, traded outside the EU. According to ACER's published guidance, the company will not be considered a REMIT market participant. However, if the company also enters into a transaction that would be captured by REMIT (such as a physical trade (or derivative) for the delivery of gas or electricity (or transportation of gas or electricity) within the EU) then the company is a market participant. The company would then have to report all the transactions on wholesale energy products including those trades outside the EU that are only for financial settlement.

PENALTIES AND CORPORATE LIABILITY

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While ACER is responsible for ensuring that the NRAs carry out their monitoring and enforcement tasks in a coordinated and consistent way, it is the role of the NRAs to investigate market abuse cases and prosecute market participants. As a Member State of the EU, the UK was required to adapt its legislation in order to give Ofgem the necessary powers to enforce REMIT. In the UK, Ofgem is now equipped to do so by virtue of the Electricity and Gas (Market Integrity and Transparency) (Enforcement etc.) Regulations 2013 and the Electricity and Gas (Market Integrity and Transparency) (Criminal Sanctions) Regulations 2015 (the latter being referred to as the "UK Criminal Regulations"). Ofgem has the power to take action against those who do not comply with their REMIT requirements. It can: (i) require the production of information for the purpose of monitoring compliance with REMIT and investigate suspected breaches; (ii) impose financial penalties; (iii) apply to Court for a restitution order in respect of profits accrued or losses suffered as a result of non-compliance; (iv) apply to Court for injunctions enforcing the provisions of REMIT; and (v) enter premises for the purposes of an investigation.

On 8 September 2015, Ofgem published an open letter setting out its views on the prohibition of market abuse under REMIT. The letter underlined some key features of the REMIT market manipulation regime. First, that market manipulation may occur without an impact on supply, demand or price. Secondly, that market manipulation can occur even in the absence of intent, that is, recklessly.

The offence of insider dealing under section 52 of the Criminal Justice Act 1993 ("CJA") can only be committed by a natural person. By contrast, the UK Criminal Regulations have made it possible for a company to commit an offence under the insider dealing or market manipulation offences for energy markets.

Given that offences are intended to cover reckless as well as intentional behaviour, it is unsurprising that the maximum sentence under the UK Criminal Regulations is a custodial penalty of 2 years and/or unlimited fine. This is in contrast to the maximum sentence of 7 years and/or unlimited fine for an offence of insider dealing under the CJA.

Companies should protect themselves through compliance training and robust policies and procedures. Consideration will also need to be given to the set-up of trading desks where it may be possible for inside information to pass between purchase and sales, or client and proprietary trading, desks.

UNITED STATES EXPERIENCE

Given the lack of enforcement precedent, there is some uncertainty as to how regulators and the Courts will interpret and deal with insider dealing and market manipulation offences under REMIT. However, a useful starting point is to look at the enforcement of similar rules in the United States, which has experienced an unprecedented volume of legislation relating to abuse of wholesale natural gas and electricity markets.

In the United States, the Energy Policy Act of 2005 gave the Federal Energy Regulatory Commission (FERC) a statutory anti-manipulation mandate. The new market manipulation "Rule 1c" was adopted by FERC in 2006, giving it the ability to prohibit the use of "any device, scheme, or artifice to defraud," the making of "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading," or to "engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any [entity]."

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FERC has been active in exercising its authority since Rule 1c came into effect, levying over $640 million in civil penalties and over $300 million in disgorgement since 2007. A major UK high street bank is currently facing a lawsuit in the US seeking $453 million in fines for alleged manipulation of trades in electricity contracts.

There are grounds to believe that ACER and Ofgem will follow suit, not least because the behaviour prohibited by the United States and EU statutes is remarkably similar. ACER has previously highlighted the success of FERC in imposing multi-million dollar fines in market abuse investigations to justify its focus on effective monitoring in Europe. ACER has also been working with FERC since before REMIT came into force and the two agencies have signed a Memorandum of Understanding on consultation, cooperation and the exchange of information related to the monitoring of wholesale energy markets.

CONCLUSION

It remains to be seen how the investigation and enforcement of REMIT will operate in practice. However, it is clear that this regulatory framework is likely to have the effect of increasing enforcement actions across the industry, including in the UK. The experience in the United States should be seen as a warning sign. Companies should gauge whether they are caught by REMIT, and if so, should implement a higher level of vigilance when trading in wholesale energy products. They should in particular bear in mind that the enforcement regime now covers reckless, as well as intentional, conduct. It is imperative that companies ensure that appropriate training, policies and procedures are put in place to address these new challenges and mitigate the risk of market abuse. Companies will need to monitor Ofgem and ACER's actions in this area carefully and evaluate on a continuing basis whether their reporting activity and disclosure of price sensitive information is adequate, whether their training and policies remain up to date, and whether their trading activity remains acceptable in the view of the newly-equipped regulators.

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