NAVIGANT

Oil & Gas
Market Notes

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Assessing the Impact of MiFID II on Energy Trading Firms – Why Fix Something That Isn't Broken

"The European energy trading landscape is changing" if you acknowledge the accepted wisdom that the catalogue of new regulations in Europe and the shift in the global energy markets are forcing energy trading firms to review their business model and their role in the marketplace. The great unknown with regard to the regulations is what exactly it means for them, how to coordinate between various reporting needs, and how to practically apply regulations without adversely affecting their entrepreneurial spirit.

One thing that is clear is that more energy trading firms will become subject to these regulations. Up until now, some firms have been exempt (especially around Markets in Financial Instruments Directive I, also referred to as MiFID I) due to carve-outs that exempt most commodities businesses. The new tranche of regulations narrow these exemptions, meaning that many energy trading firms will have to prepare themselves for the inevitable.

Many column inches have been dedicated to challenging the suitability of these regulations, which were originally intended for traditional financial service firms but have now entangled energy trading firms, as well. Let's now be pragmatic, accept that change is on the horizon, and examine how energy trading firms are preparing themselves for the challenges that lie ahead and how they can learn from the financial services sector.

The key regulation that majority of the energy trading firms are concerned about is MiFID II and the accompanying Regulation on Markets in Financial Instruments and Amending Regulation (MiFIR)—often referred to without distinction simply as MiFID II. The regulation comes into effect in January 2017. Many of the finer points of the regulations are yet to be finalized, with many energy trading firms using the European Securities and Markets Authority's (ESMA's) ancillary exemptions threshold value publication in September 2015 as a key date to mobilize resources to address the challenges the regulations pose. If they are within the threshold, then this gives the energy firms 15 months to prepare for the start of the regime.

What is MiFID II? Which of the energy traders are affected by this extended MiFID regime? And how are they preparing themselves for this challenge?

In essence, MiFID II in its wider definition focuses on the framework of venues and structures in which financial instruments are traded and on regulating the operations of these trading venues and structures. It looks at processes, systems, and governance measures for these venues, as well as their future supervision. It extends the governance that the first MiFID iteration bought to equity markets to a wider range of asset class, covering (but not limited to) physically settled over-the-counter (OTC) commodity derivatives. The legislation has four main objectives:

1. Increase investor protection
2. Align regulations across the European Union (EU)
3. Increase competition across the financial markets
4. Introduce reinforced supervisory powers

In layman's terms, this means energy trading firms involved in the distribution and trading of financial instruments in the EU—in other words, operating OTC trades and within a notional threshold (ancillary exemption) based on their main businesses relative to the size of trading activity and capital employed—are likely to be affected across a number of areas. These areas have been summarised below.

IMPACTED AREAS	
STRATEGY	» Commercial and strategic benefits in the use of Over The Counter (OTC) trades » Role of the trading function (speculative trading versus hedging) » Legal Entity structure » Attitude to regulation
ORGANISATION	» Operating model » License application for in-scope activities » Some restricted activities » Governance and Contol framework
TECHNICAL	» Move from Non Financial Counterparty (NFC) to Financial Counterparty (FC) or NFC+ » Mandatory use of venues for those trades deemed eligible: Regulated Market (RM), Multilateral Trading Facilities (MTF), Organized Trading facilities (OTF) » Change in position limits and reporting of position limits » Use of central clearing for Over The Counter (OTC) trades
TRADE TRANSPARENCY	» Pre/Post Trade transparency reporting to an “approved” reporting mechanism
INVESTOR PROTECTION	» Best execution » Know Your Customer (KYC)
CAPITAL REQUIREMENTS	» Regulatory capital (temporary exemption applies until start of 2018) » COREP/FINREP reporting for CRD IV exempt firms

Source: Navigant

Navigant spoke with a large cross section of energy and commodity trading firms and energy exchanges across Europe to gauge how each group of firms are preparing themselves and to share learning from the United States on implementing the transparency rule contained in the Dodd-Frank Act. A common thread throughout these conversations was that planning for compliance was a difficult process, as there is still uncertainty on how MiFID II will be translated into practically applicable rules and regulations. In general, the contributors can be split into four groups:

Firms unlikely to be impacted

A small population of the energy traders we spoke to believe their activity is predominantly focused on hedging and does not involve significant distribution and trading of financial instruments in the EU with speculative intent. Therefore, they expect be excluded under the ancillary exemption. The common trait amongst traders in this group is that they are closely monitoring the regulatory developments and plan to review the implication after the ancillary exemptions threshold publication in September to ensure they are indeed exempt.

A subset of this group is actively embracing the implications and have mobilized projects to take advantage of the unintended consequences of other firms leaving the OTC derivative market because of the costs of remaining compliant and competitive outweigh the benefits.

Firms very likely to be impacted and are fully embracing the regulations

As expected, some of the larger, more established energy traders with multijurisdictional trading activity and established presence in the United States who have abided by the Dodd-Frank regulations are in this group. What was unexpected was the number of mid-tier commodity trading firms that have used this as the trigger to carry out an enterprisewide review of their approaches to risk and regulation.

The key characteristic of this group is the mindset of the CRO, the leadership to the current set of regulations, and the expectation that the current tranche is just the tip of the iceberg. Firms in this group see these regulatory challenges as an opportunity to get ahead of the regulatory curve and create an environment where bad behavior is not tolerated. As one CRO we spoke to in the United Kingdom said, *"We're using this as a opportunity to clean house and get ourselves into a place where we don't have to spend more time and money each time a new regulations comes our way."*

This group has created cross-disciplinary teams that include the Finance, Risk, Technology, and Treasury to look at MiFID II in context of an overall regulatory plan, with the CEO acting as the overall sponsor. They have engaged specialist advisors, analyzed their portfolio of trading activities, carried out impact analyses on their corporate strategy and operations, engaged their national regulators, and mobilized project teams to identify options for responding.

Firms very likely to be impacted and looking for ways to minimize or remove the impact and cost of adherence

This group of firms sees the regulations as a challenge and maintain that their impact should be minimized. They see the cost of full adherence outweighing the commercial benefits to the organization. This group of firms, while not large, does share a common characteristic; they tended to hold OTC portfolios that were on the brink of the current understanding of the notional threshold for ancillary activity exemption.

This group also tended to have proactive CROs who had taken an enterprisewide view to regulatory challenges. However, the key difference between this group and the previous group that had actively embraced the pending regulations was the timespan they were looking at. The focus was on minimizing or removing the impact of the regulations on the business in the short term and reassessing the plan once the requirements were clearer or when the organization's strategy changed.

Some of the ideas that were considered by this group, taking learning from the financial institutions, include optimizing activities and organization to minimize impact without changing the commercial benefits; removing (winding down or disposing) activities that expose the business to additional regulatory requirements; taking advantage of possible geographical arbitrage by relocating activities to geographies outside of the EU; and modelling the impact of noncompliance or partial compliance.

Firms likely to be impacted but are sitting back and waiting for confirmation of the September ancillary activity exemptions

A large portion of the energy trading firms we spoke to revealed MiFID II was on their radar and they were closely monitoring progress. They also admitted that their level of readiness was poor. In general, this group tends to address each regulation in a piecemeal way and exhibited a silo mentality to regulation. One CRO based in Europe that we spoke to said, "I see REMIT [Regulation on Wholesale Energy Market Integrity and Transparency] as my CIO's problem; MiFID is my problem."

In the majority of the cases, the compliance mindset was one of how to practically apply the regulation without disrupting the business rhythm and to leverage existing systems and processes for adherence. We found that basic levels of impact analysis had been carried out at strategic level, but the cultural, operational, or cross-functional considerations, which are crucial in ensuring adherence in sprit (perhaps not in the word of the text), were not considered important until further clarity was provided. Firms in this group were particularly interested in understanding how their peers were preparing for the MiFID II challenge and in benchmarking themselves against their peers.

Another common trait with this set of firms was the lack of sponsorship or engagement from organizational leadership on the regulatory challenges. This set of firms was eager to engage specialist advice as soon as the exact value of ancillary activity exemption becomes clearer in the draft regulatory technical standards to be published in September 2015.

What should firms be doing now?

While the go-live date of January 2017 might seem a long way off, the September 2015 date— which is anticipated to provide clarity on ancillary activity exemption—is a milestone in understanding the magnitude of the impact of MiFID II on energy trading firms. It is vital that firms scrutinize these developments closely and interpret the regulations and understand the strategic and operational the impacts on their businesses. Even if these firms avoid full regulation under MiFID II, a number of requirements will apply to those that trade commodity instruments in-scope. This includes adherence to regulatory position limits, as well as the reporting of positions in such commodities.

There is no one-size-fits-all solution or approach to addressing this challenge; where firms are placed in the four groups identified above and how far along they are in the regulatory readiness journey will inform your actions. In general, compliance teams should be engaging with the wider organization, including finance, tax, and treasury functions at a strategic level in order to assess the following:

- Realigning a firm's legal entity structure to drive compliance efficiencies or arbitrate opportunities in respect to the MiFID II requirements.
- The extend and purpose of the group's trading function (own-use vs. speculative trading) and how these activities influence the firm's approach under MiFID II requirements.
- The regulatory capital requirement impact operating costs and revenues in the context of a firm's corporate strategy.
- The optimal mix of trading venues on which to execute trades.

At an operational level, these firms should assess:

» Their ability to calculate and report on their position to the regulatory authorities in a timely manner. This would typically mean carrying out a gap analysis across all the components of their operations, including technology, data, documentation, and capability.

» The impacts on credit risk policies in line with the new position limit that MiFID II will set.

» Their existing control framework and how it can be used to evidence MiFID II compliance.

» Engage with the front and middle office functions to assess their ability to segregate own-use trading from speculative trading from an intent, technology, data, and process prospective.

Energy trading firms should, if they have not already, engage their national regulators to understand expectations and discuss their readiness. Not all national regulators have the same level of experience and maturity in dealing with regulations of this nature, and while some regulators like the Financial Conduct Authority (FCA) will have a clearer view of requirement, other less mature regulators may prefer a more consultative approach, especially in the build up to the go-live date.

The key to successfully addressing the MiFID II challenge is to start preparing for it now. The reality for most energy trading organizations is that the changes are likely to extend beyond simple operational tweaks and affect more of a firm's strategy and structure in the long term.

How Can Navigant Help?

Using its in-depth industry knowledge and experience, Navigant's Oil and Gas consulting practice specializes in helping clients understand the issues, develop solutions, and execute on their strategy. Our team has deep experience in helping to drive value in highly volatile times, through upstream, midstream, and downstream operations.

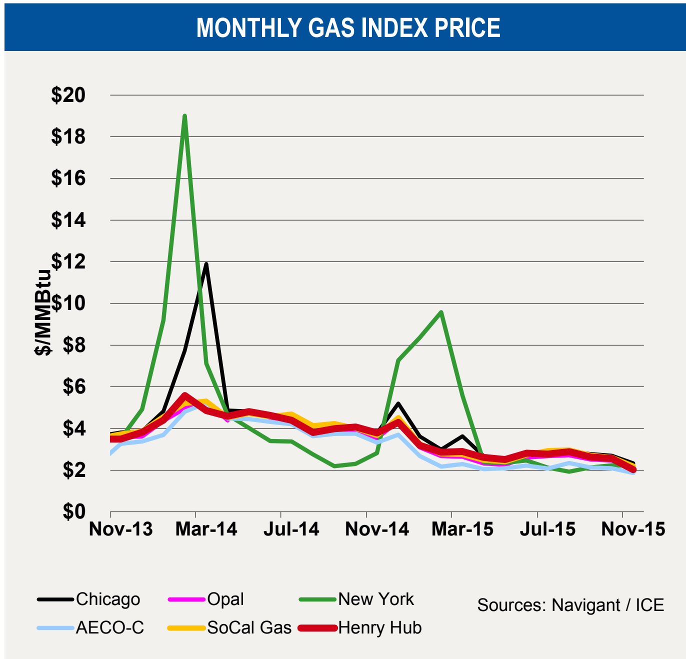
— *Gajan Sritharan*

About the Author »
Gajan Sritharan is a Director with the Global Energy Practice based in London. He has a track record of leading large, multi-disciplinary teams in delivering complex transformation programs in the Oil & Gas sector.

The opinions expressed in these article are those of the authors and do not necessarily represent the views of Navigant Consulting, Inc.

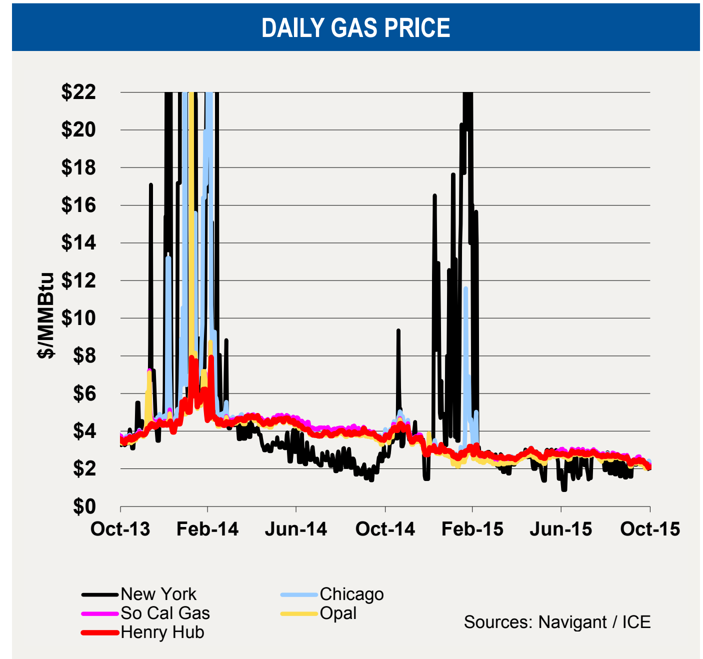
Natural Gas Market Charts

MONTHLY GAS INDEX PRICE



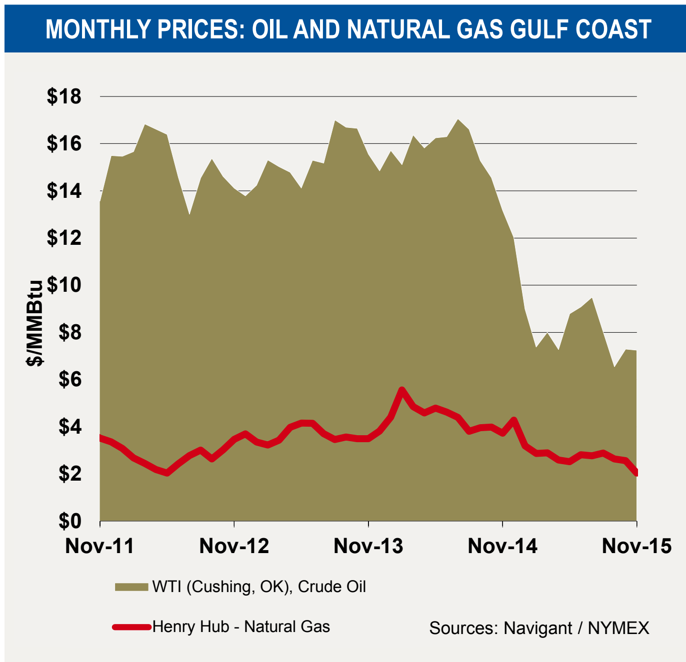
Monthly index gas prices decreased 21%, with Henry Hub at $2.03/MMBtu for November versus $2.56/MMBtu for October. The November 2015 price was below the November 2014 price of $3.79/MMBtu by $1.76/MMBtu.

DAILY GAS PRICE



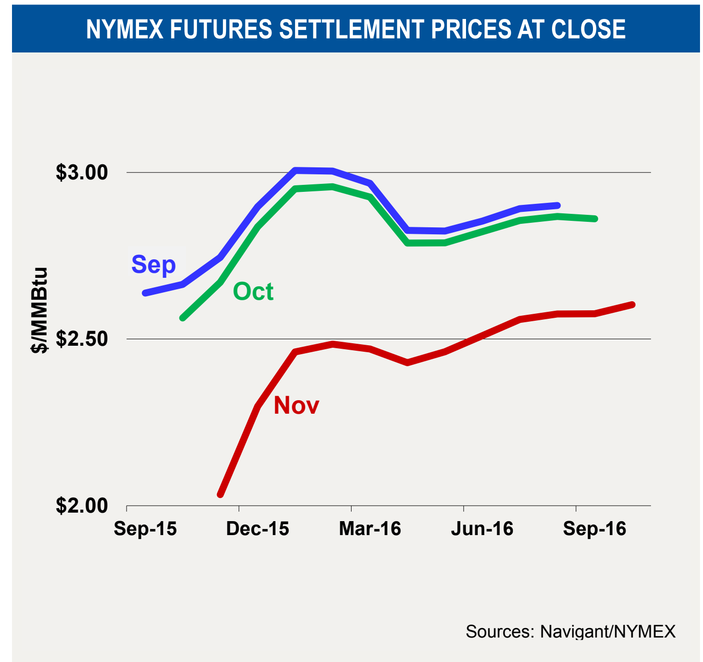
The daily spot prices ended October down 17% versus the end of September, with Henry Hub at $2.10/MMBtu versus $2.53/MMBtu.

MONTHLY PRICES: OIL AND NATURAL GAS GULF COAST



The most recent gas/oil price ratio increased to 3.6 times, with Henry Hub natural gas price at $2.03 versus WTI crude oil price at $7.25. The ratio one year prior was 3.5 times.

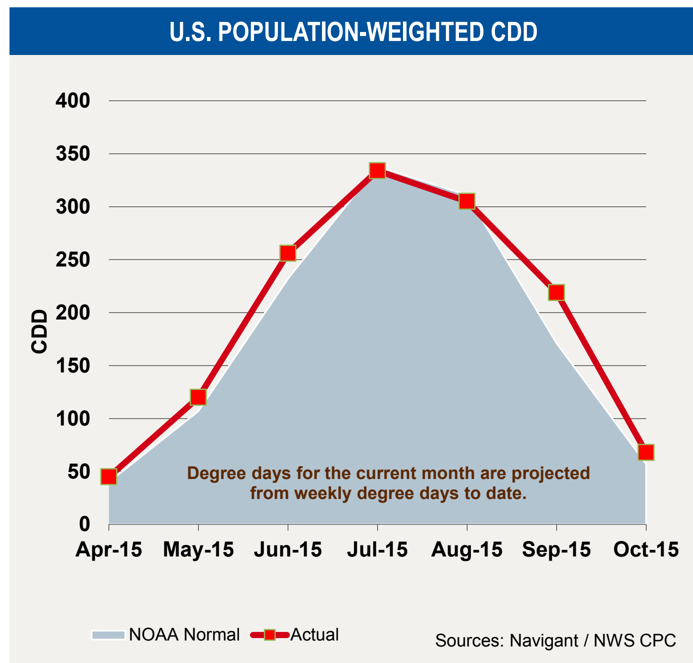
NYMEX FUTURES SETTLEMENT PRICES AT CLOSE



The average 12-month strip price was down 13% at $2.46/MMbtu for the strip starting November 2015, versus $2.82/MMbtu for the October strip.

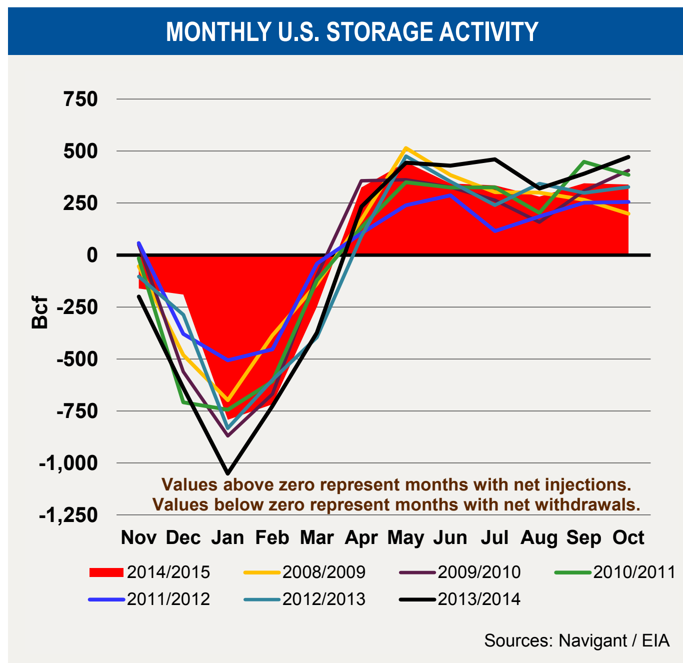
Natural Gas Market Charts

U.S. POPULATION-WEIGHTED CDD



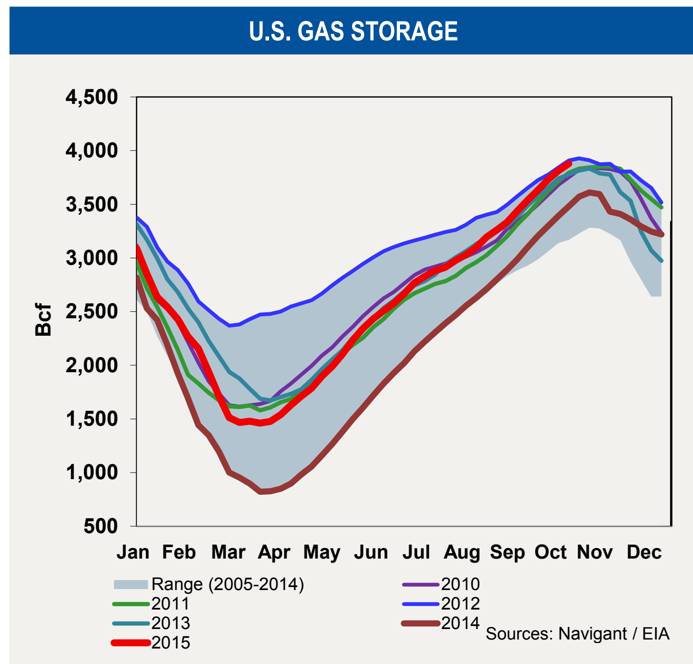
The cooling season ended with cooling degree days at to 7% above normal, driven by a warm September.

MONTHLY U.S. STORAGE ACTIVITY



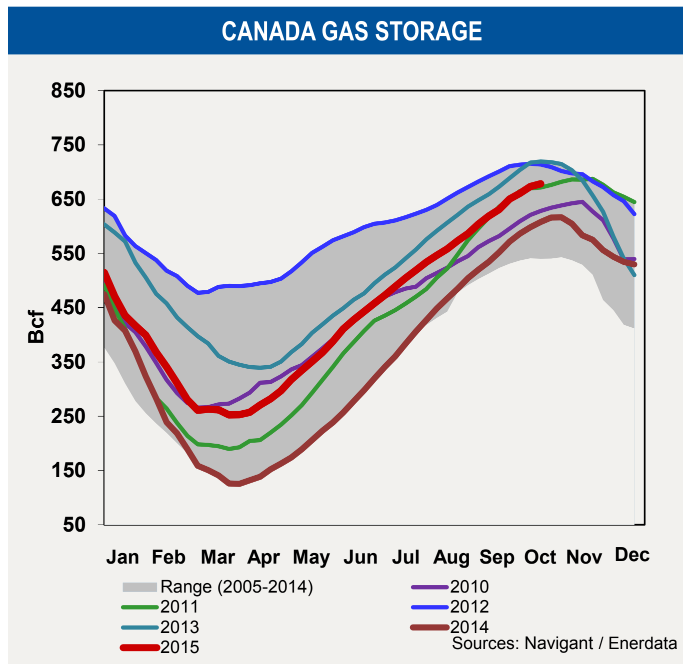
Above normal U.S. storage injections continued in October at 339 Bcf versus 296 Bcf, greater than seven of the prior ten years at this time.

U.S. GAS STORAGE



U.S. storage inventories increased in October to 3,877 Bcf, 8% above the average of the prior ten years at this time.

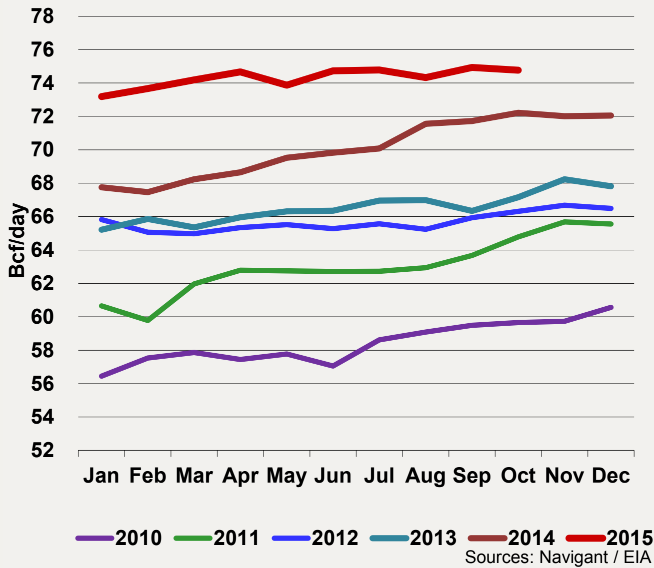
CANADA GAS STORAGE



Canadian storage inventories increased in October to 678 Bcf, about 10% above the 619 Bcf average for the last ten years at this time.

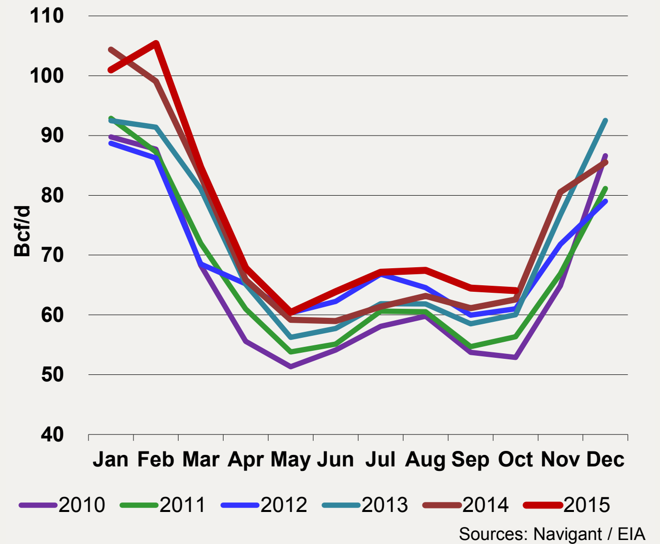
Natural Gas Market Charts

U.S. DRY GAS PRODUCTION



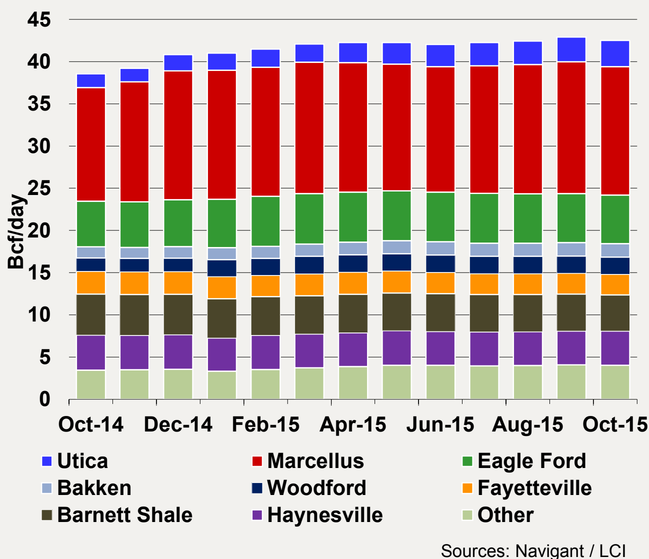
U.S. dry gas production maintained record high levels at just under 75 Bcfd.

U.S. MONTHLY NATURAL GAS DEMAND



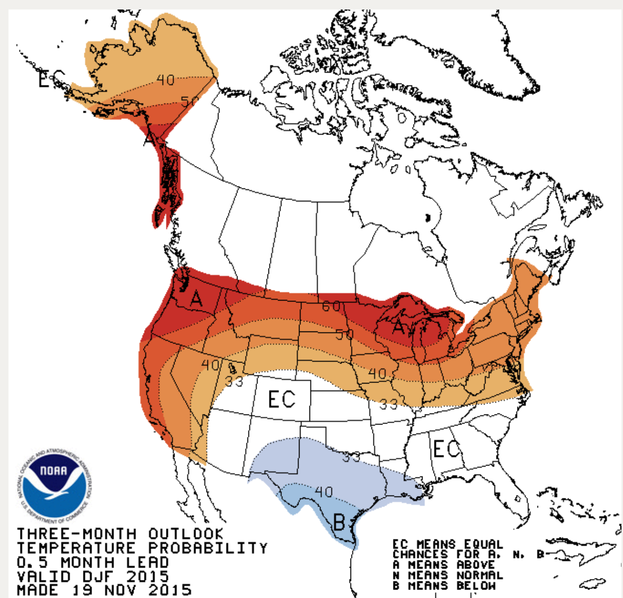
U.S. gas demand continued strong at all-time high levels for this time, with demand for the month of October at 64.1 Bcf, versus the prior high for the month in 2014 at 62.6 Bcf.

U.S. WELLHEAD SHALE GAS PRODUCTION



U.S. shale gas production continued strong in October at 42.5 Bcfd, about 1% below September.

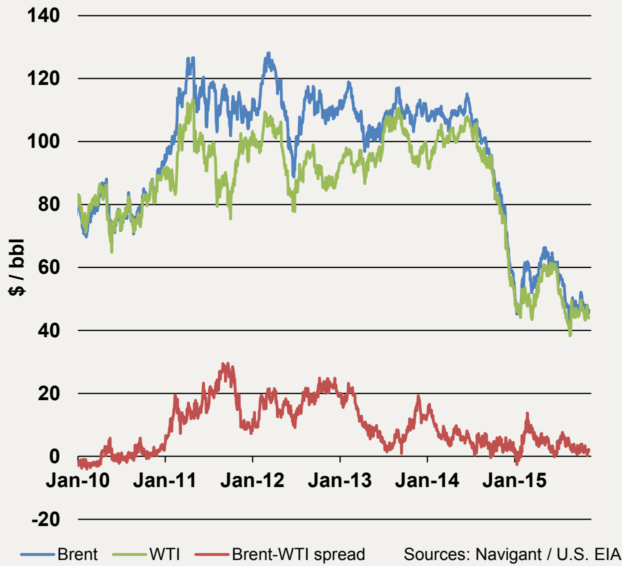
U.S. TEMPERATURE OUTLOOK



The temperature outlook is for above-normal temperatures west of the Rockies, and across the northern and central U.S. through the Midwest to the Northeast and Mid-Atlantic. Below normal temperatures are favored for most of New Mexico, Texas and Louisiana.

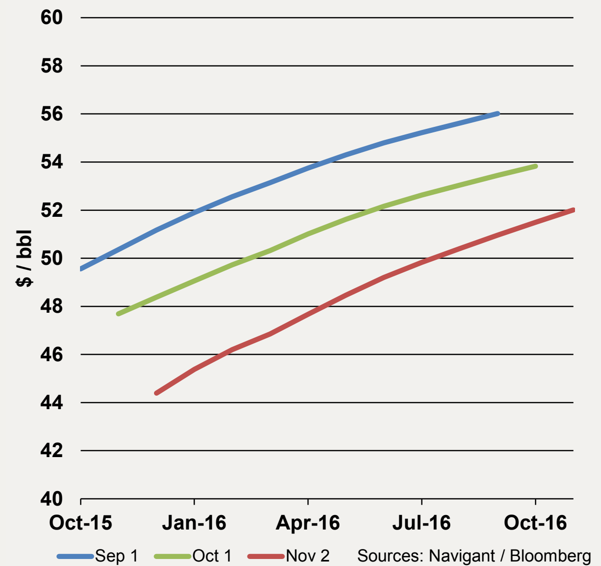
Oil Market Charts

SPOT CRUDE PRICES



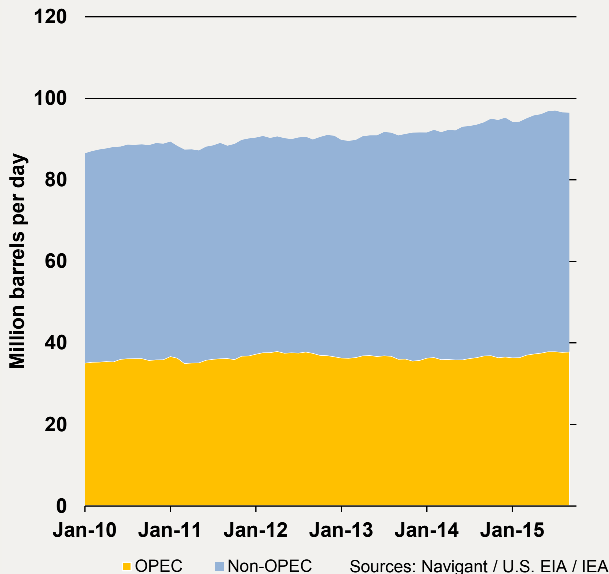
After three years of relative stability in the $90-110/bbl range, crude prices plunged 60% from June 2014 levels. Prices averaged $48/bbl (Brent) and $46/bbl (WTI) in October 2015.

ICE BRENT FUTURES CURVE



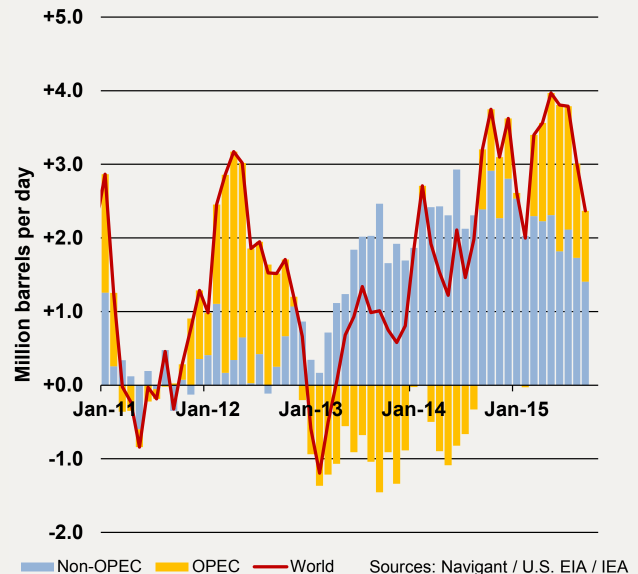
The average 12-month strip price at the beginning of November was $49/bbl, a 5% fall from the previous month.

OPEC & NON-OPEC OIL PRODUCTION



Global oil production increased from 94.1 million barrels per day a year ago to an estimated 96.5 million barrels per day in September 2015, of which 39% was supplied by OPEC.

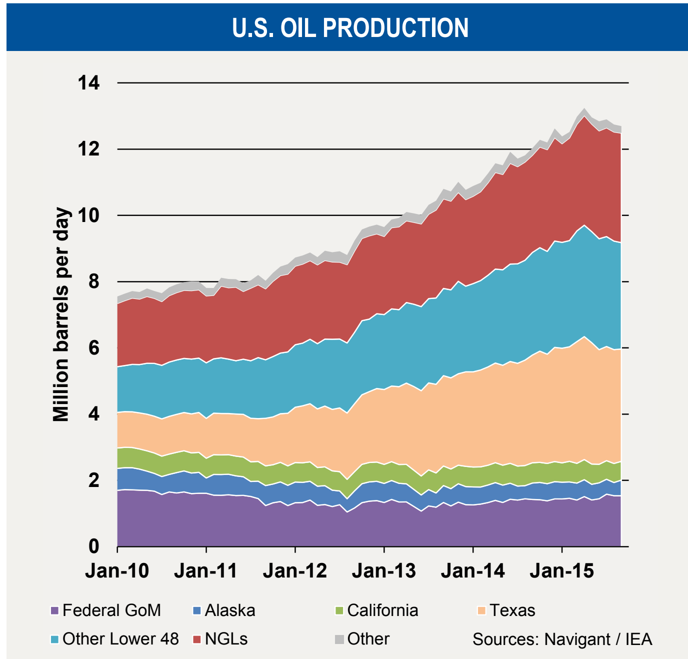
YEAR-ON-YEAR CHANGE IN OIL PRODUCTION



Oil production growth in recent years has been led by non-OPEC countries, particularly the U.S.

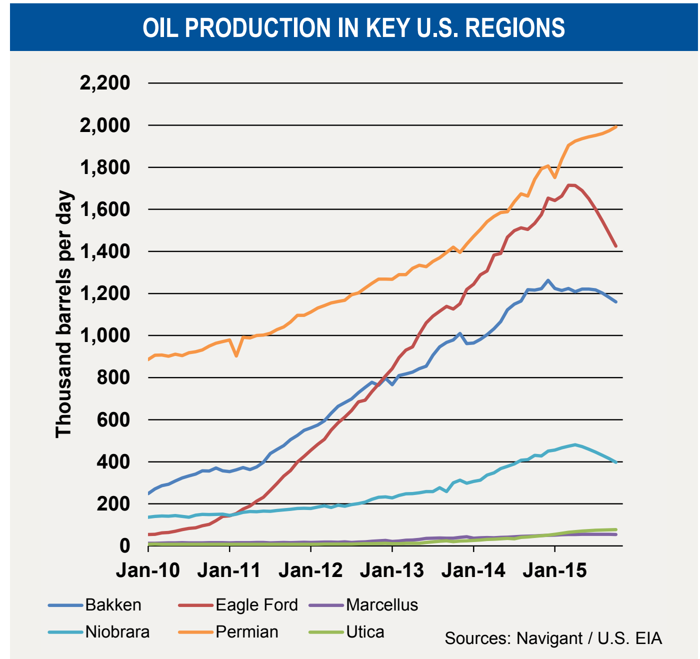
Oil Market Charts

U.S. OIL PRODUCTION



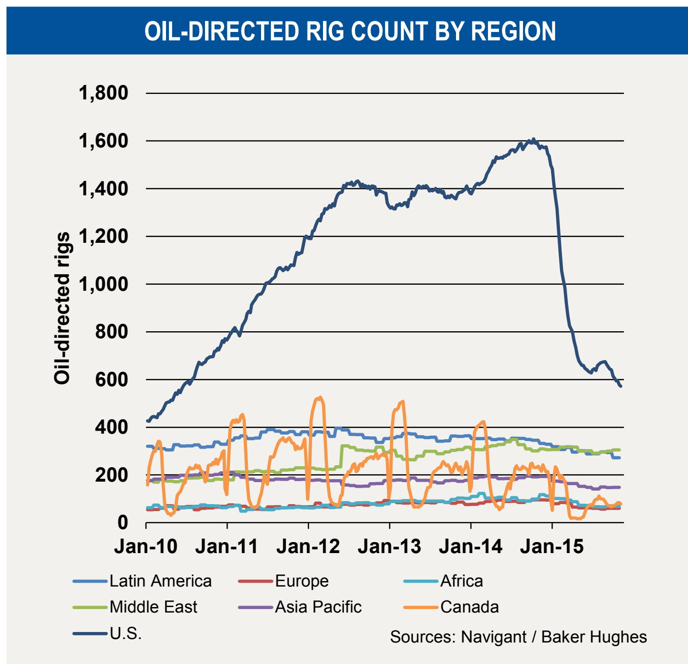
In the United States, oil production climbed by 6% over the year to an estimated 12.7 million barrels per day in September 2015. However, production has fallen 4% since April.

OIL PRODUCTION IN KEY U.S. REGIONS



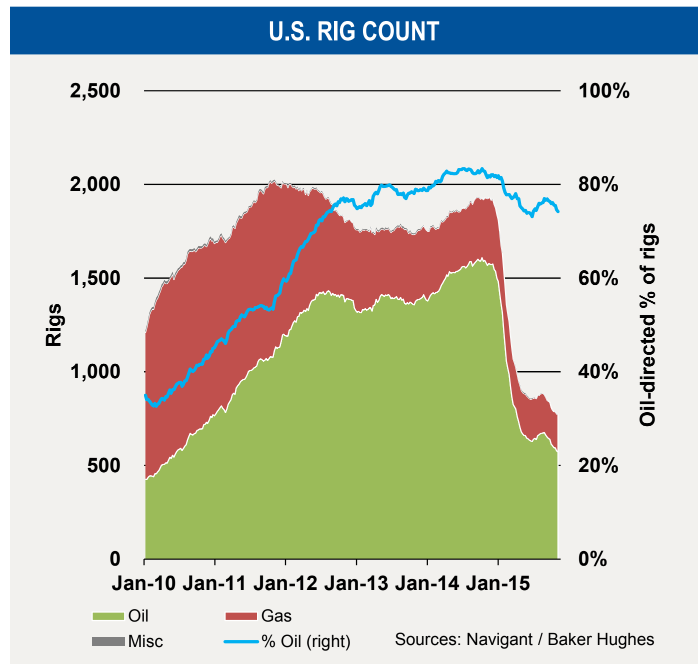
In October 2015, oil production reached an estimated 1.99 million barrels per day in the Permian but continued to dip in other regions. Eagle Ford and Niobrara are both down 17% from their peaks earlier in 2015.

OIL-DIRECTED RIG COUNT BY REGION



Rig counts have continued their decline in response to lower oil prices. The U.S. hit a fresh low of 572 oil rigs at the start of November, a level last seen in June 2010.

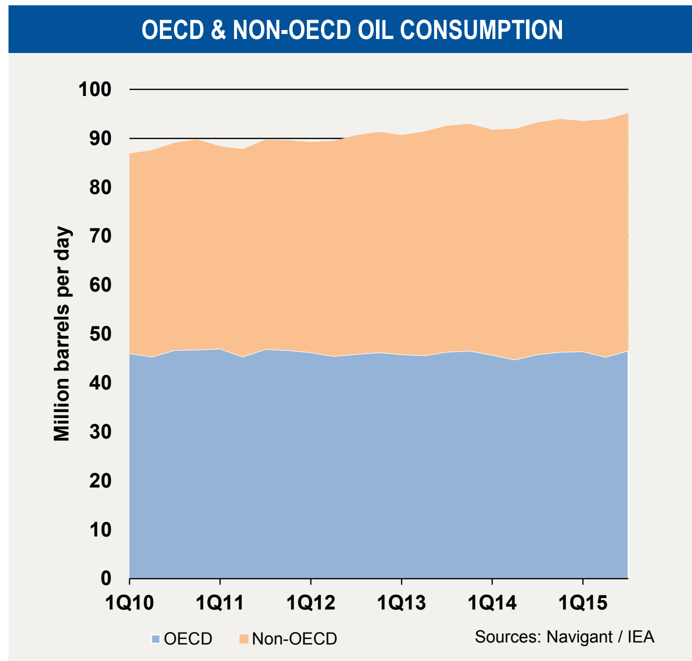
U.S. RIG COUNT



74% of U.S. rigs were oil-directed at the start of November.

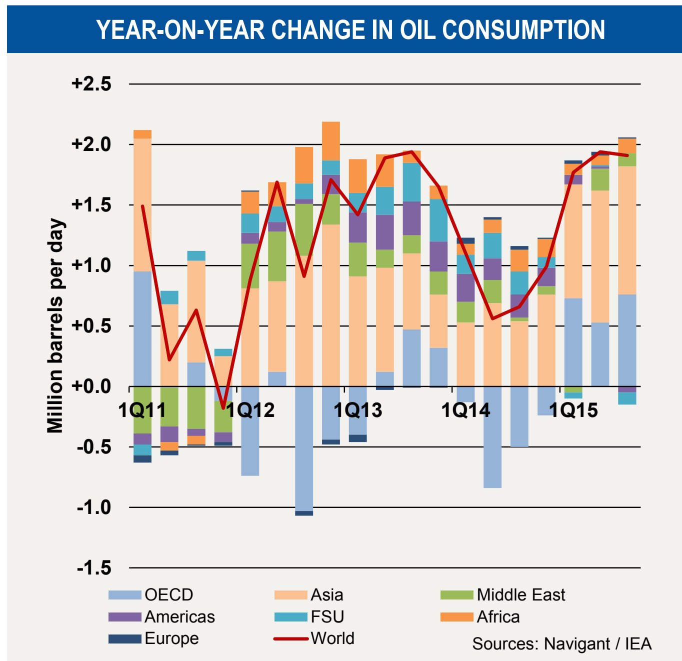
Oil Market Charts

OECD & NON-OECD OIL CONSUMPTION



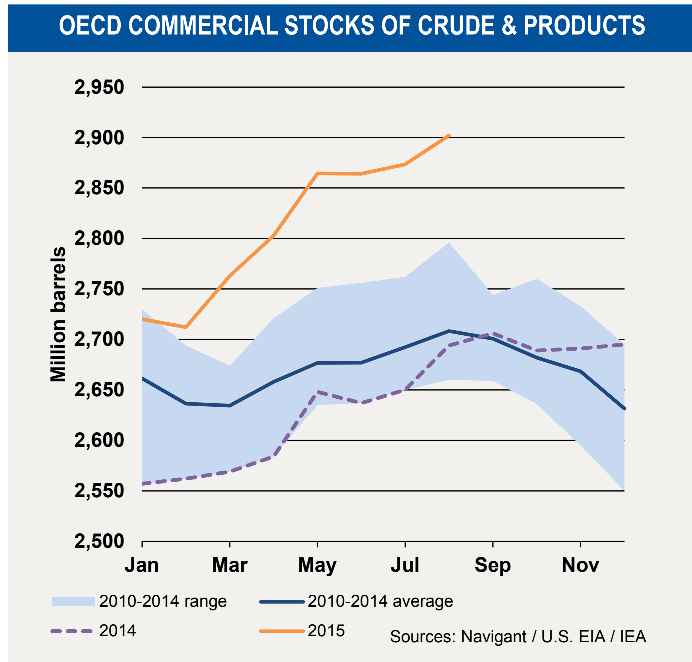
Global oil consumption increased from 93.3 million barrels per day in Q3 2014 to an estimated 95.2 million barrels per day in Q3 2015, of which 49% was consumed by OECD countries.

YEAR-ON-YEAR CHANGE IN OIL CONSUMPTION



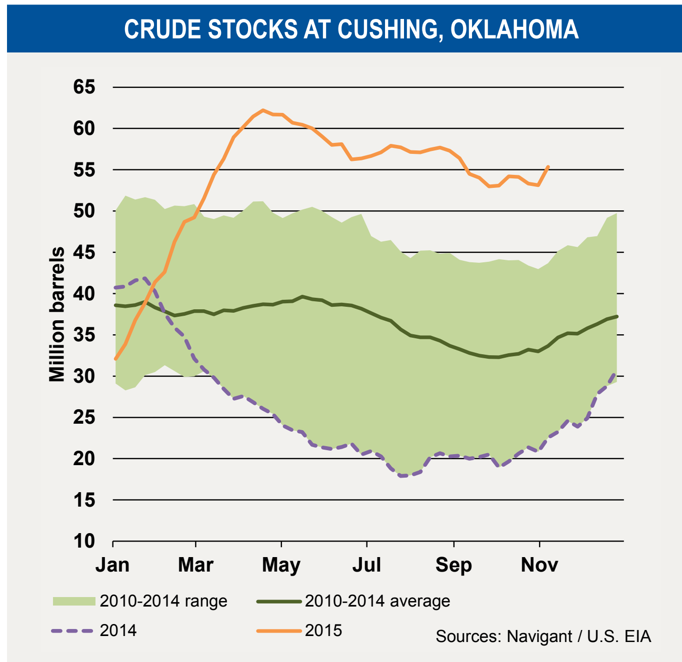
Oil demand growth in recent years has been led by non-OECD countries, particularly in Asia (e.g. China).

OECD COMMERCIAL STOCKS OF CRUDE & PRODUCTS



OECD commercial inventories reached an estimated 2,900 million barrels of crude and products in August 2015, remaining 7% above the five-year average.

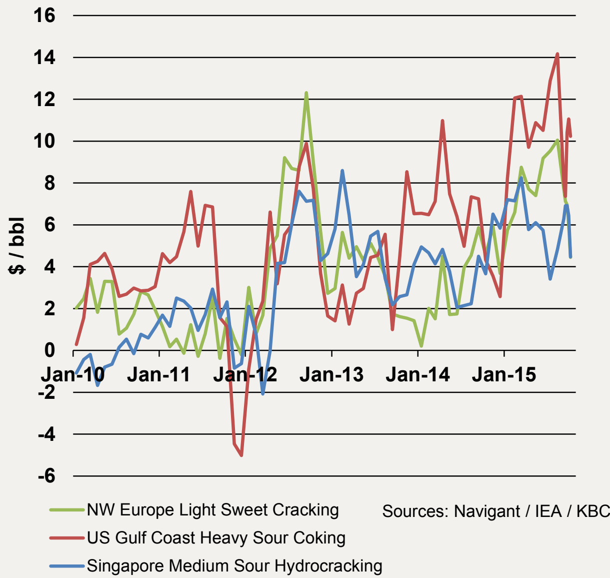
CRUDE STOCKS AT CUSHING, OKLAHOMA



Crude inventories at the Cushing hub (the delivery point of the WTI contract) totalled 55.4 million barrels in early November, remaining 65% above the five-year average.

Oil Market Charts

INDICATIVE REFINING MARGINS



At the start of October 2015, indicative refining margins were $4.45/bbl for NWE light sweet cracking, $10.23/bbl for USGC heavy sour coking and $4.47/bbl for Singapore medium sour hydrocracking.

EU CARBON ALLOWANCE PRICES

EU carbon allowances have recovered to above €8/tonne since the lows of April 2013.

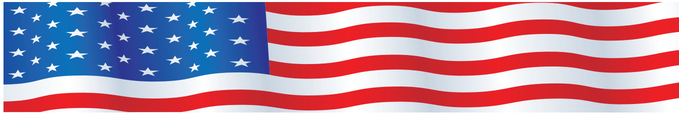
U.S. ETHANOL RIN PRICES

U.S. ethanol RINs have more than halved in value since May when the EPA announced proposals to cut quotas.

U.S. BIODIESEL RIN PRICES

U.S. biodiesel RIN prices have also collapsed because of falling soybean oil prices and rising biodiesel imports.

Legislative and Regulatory Highlights



Appalachia / Northeast

Spectra Applies for FERC Authorization for Atlantic Bridge Expansion Project

On October 22, Spectra Energy Partners applied to FERC for authority to site, construct and operate its proposed Atlantic Bridge project on its Algonquin Gas Transmission and Maritimes & Northeast Pipeline systems. The proposed expansion would increase firm transport to New England and Canada by about 132 MMcfd, with a targeted in-service date in November 2017.

Mountain Valley Pipeline Applies for FERC Authorization

On October 23, Mountain Valley Pipeline applied to FERC for authority to site, construct and operate its proposed 300-mile natural gas pipeline from northwestern West Virginia to southern Virginia. The project is intended to provide access to at least 2 Bcfd of Marcellus and Utica gas supplies to markets in the Mid-Atlantic and Southeast states, with an in-service date in late 2018. Mountain Valley Pipeline is a joint venture between EQT Midstream Partners and affiliates of NextEra Energy, WGL Holdings, Vega Energy Partners, and RGC Resources.

Gulf

Cameron LNG Submits Application for Expansion Project to FERC

On September 28, Cameron LNG submitted its application to FERC for authority to site, construct, and operate its liquefaction facility expansion at its project site near the City of Hackberry, Louisiana. The Cameron Expansion will consist of Trains Four and Five, with a liquefaction capacity of 1.4 Bcfd of natural gas. Cameron LNG plans for construction of the expansion to begin in June 2016, with an in-service date by the end of 2019.

FERC Approves Transco's Gulf Trace Pipeline Project

On October 21, FERC issued an approval for the Transco pipeline's Gulf Trace expansion project to serve the Sabine Pass LNG export project. The Gulf Trace project will add 1.2 Bcfd of transmission capacity from Transco's Station 65 in St. Helena Parish, Louisiana to the Sabine Pass terminal in Cameron Parish, a seven-mile addition of 36-inch pipeline and associated compression additions. Transco plans for construction to begin in the first half of 2016, with an in-service date by January 1, 2017.

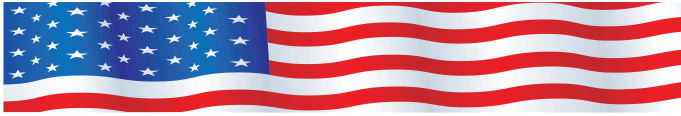
Cheniere Energy to Sell LNG to France's ENGIE S.A.

On October 28, Cheniere Energy announced that Cheniere Energy Marketing entered into a five-year LNG supply agreement with French energy company ENGIE S.A. The agreement calls for delivery of up to approximately 220 Bcf between 2018 and 2023 (based on 12 cargoes per year), primarily to ENGIE's regas terminal at Montoir de Bretagne. Pricing is to be linked to Northern European gas price indices. Cheniere Energy Marketing will source the LNG from the Cheniere liquefaction projects at Sabine Pass, Louisiana and Corpus Christi, Texas.

Northwest

Jordan Cove LNG and Pacific Connector Pipeline Receive Final EIS

On September 30, Verasen Inc. announced the issuance by FERC of a favorable Final Environmental Impact Statement for its Jordan Cove LNG project and its Pacific Connector Gas Pipeline project (a joint venture with Williams Companies). The projects will enable the transport of natural gas over the proposed 232-mile pipeline from Malin, Oregon to the proposed Jordan Cove liquefaction project in Coos Bay, Oregon, where liquefaction and export would take place. Verasen, anticipates a FERC siting decision by the end of 2015, with a notice to proceed by mid-2016, followed thereafter by Verasen's final investment decision.



Southwest

Roadrunner Gas Transmission Receives Presidential Permit

On October 15, FERC issued a Presidential Permit to ONEOK and Fermaca RR Holdings joint venture Roadrunner Gas Transmission LLC authorizing the siting, construction and operation of cross-border facilities from El Paso County, Texas to Mexico's State of Chihuahua. The cross-border facilities will consist of 900 feet of 30-inch pipeline designed to transport 875 MMcfd of natural gas under the Rio Grande River. The source of the gas will be the proposed 205-mile Roadrunner intrastate pipeline in Texas.

Kinder Morgan Subsidiary Signs Transport Agreement with Mexico's CFE

On October 21, Kinder Morgan announced that its Texas intrastate pipeline subsidiary signed an agreement to provide up to approximately 525 MMcfd of firm transport capacity to Mexican electric utility CFE. Service is expected to begin June 2016.

British Columbia

TransCanada Receives B.C. Approval for Prince Rupert Gas Transmission Pipeline

On October 27, TransCanada announced that its Prince Rupert Gas Transmission pipeline project received final permits from the B.C. Oil and Gas Commission. Together with the environmental clearance issued in 2014 by the B.C. Environmental Assessment Office, the project's provincial regulatory requirements are substantially complete. Construction could begin once federal approval is received, and a final investment decision to proceed is made by the Pacific NorthWest LNG project that is to be served by the pipeline.

Woodfibre LNG Receives B.C. Environmental Certificate

On October 26, Woodfibre LNG announced its receipt of an Environmental Assessment Certificate from the British Columbia Environmental Assessment Office. The certificate, subject to certain conditions, indicates that the project has met federal and provincial requirements. In addition, the EAO certificate follows the October 14 granting of a conditional environmental report by the Squamish Nation. The Woodfibre LNG proposal is for a 0.3 Bcfd liquefaction facility to be located on the site of a former paper pulp mill.