Consultation Document 05/2014

INTEGRATED GUARANTEE MANAGEMENT WITHIN THE ENERGY MARKETS (ME AND MGAS) AND THE OTC REGISTRATION PLATFORM (PCE)

With this consultation document, GME would like to gather comments among interested parties about a proposal to introduce an integrated guarantee management system within its energy markets (ME and MGAS) and OTC Registration Platform (PCE). The purpose of the system is to minimise the costs that participants incur for posting the financial guarantees required for participation in the above markets.

The integrated guarantee management system would enable the individual market participant to cover the overall exposure resulting from his/her/its purchases and sales on the above markets/platform.

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Please submit your comments in writing to **GME – Legale e Regolazione** (Legal & Regulatory Office) by **<u>8 October 2014</u>** at the latest (end date of the consultation) in one of the following ways:

by e-mail to: **info@mercatoelettrico.org**

by fax to: **+39 06 80124524**

by mail to: **Gestore dei mercati energetici S.p.A.**
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If you want us to keep all or part of your comments confidential, please specify which parts of your document are to be kept confidential.

1. Foreword

As is known, GME currently adopts differentiated and separate guarantee systems for each of the individual markets/platforms that it organises and manages.

In particular, the respective rules of operation provide that participants may post and/or make:

- bank guarantees and/or non-interest-bearing cash deposits, for participation in the Electricity Market (ME) and in the Natural-Gas Market (MGAS);
- bank guarantees with the option, in urgent cases, to integrate them with non-interest-bearing cash deposits, for participation in the OTC Registration Platform (PCE);
- cash deposits, only for participation in the Environmental Markets.

With a view to managing guarantees and payables/receivables arising on markets/platforms in more flexible and efficient ways, while continuing to manage the risk in an adequate and prudential manner, GME is assessing the assumption of adopting an integrated guarantee management system. The latter would enable the individual participant to cover the overall exposure (resulting from his/her/its purchases and sales on the energy markets - ME and MGAS - and the OTC registration platform - PCE - where he/she/it operates[1]) with a single guarantee, offsetting where possible the positions taken on the different markets.

This solution would yield a number of benefits (described in the following paragraphs) to the same participant.

[1] Considering the differences in the operation of the energy markets/platforms and of the environmental markets, the introduction of an integrated guarantee management system has been assumed, for the time being, only on the ME and MGAS markets and on the PCE, excluding in the first stage the so-called environmental markets.

2. GENERAL PRINCIPLES OF THE PROPOSED INTEGRATED GUARANTEE MANAGEMENT SYSTEM

The proposed change of the current guarantee system model involves the following principles:

a) Principle of "one participant, many markets/platforms, single exposure"

The application of an integrated guarantee management system will imply a single net credit/debit position of the participant towards GME, regardless of the markets/platforms from which such position originates.

This single exposure is given by the netting of credit and debit positions (i.e. overall registration of the various positions in the system) that the participant holds on each market/platform.

b) Principle of "one participant, many markets/platforms, single guarantee"

Through the integrated management system, the posted guarantees will be considered in a unitary way, in order to cover the positions that the participant holds on all the electricity and gas markets (ME and MGAS) and on the PCE platform.

The required types of guarantees will remain unaltered: bank guarantees and cash deposits. However, as the exposure of the participant will no longer be determined separately for each market/platform, the participant will not be required to specify the allocation of the guaranteed amount among the different markets/platforms where he/she/it operates.

It is worth pointing out that, as the bank guarantee will also cover trading on forward markets, it may be posted through a single bank guarantee form, without specifying the end date of its validity. However, the bank issuing the guarantee may revoke it, but the guarantee will remain in effect for trades made prior to the revocation, even if the settlement occurs at a later stage.

c) Principle of the so-called “virtual” guarantee from sales

When posting guarantees, the participant would also benefit from a so-called “virtual” guarantee, consisting of receivables arising on one or more markets and having a positive sign as a result of sale transactions. In the integrated guarantee management system, these receivables would automatically net all or part of the debit positions resulting from purchase transactions or orders of negative sign concluded/entered into other markets.

As is obvious, this form of “virtual” guarantee will be used to cover the exposures of participants, provided that their net debit positions have a maturity date not before the one of the credit.

Therefore, through this process of integration, the participant will not be required to post guarantees in favour of GME to cover his/her/its exposure on a given market, if he/she/it qualifies as a creditor of GME on another market.

d) Principle of payability of receivables to be settled

GME will consider the market participant’s net receivables with a maturity date in the month of settlement to be payable only if, after making the payment, the market participant’s debit – arising from transactions to be settled in subsequent periods – remains covered by the guarantees.

If this requirement is not satisfied, GME will not pay to the participant the share of the credit corresponding to the net debit positions not adequately covered, since the payability of this credit will be automatically suspended until the first date of settlement, on which all the debit positions of the participant, even after the appearance of the credit, are covered.

Therefore, the virtual credit arising from a selling position of credit will continue to remain such until the subsequent settlement.

It is worth stressing that as, from a financial standpoint, the settlement is linked to discreet maturity dates, the integrated guarantee management system will not allow the market participant to receive - before the subsequent date of settlement S+1 - the credit accrued but not settled upon the date of settlement S (offset with his/her/its debit position) if, in the period between S and S+1, his/her/its exposure proves to be reduced/zeroed due to the closing of positions. Thus, the participant will benefit from such credit in terms of a corresponding reduction of guarantees.

In operational terms, after issuing invoices for receivables and payables, GME will determine the "balance to be settled" of all the receivables and payables accrued by the participant (on the markets where the integrated guarantee management system is applied) and having reached their maturity date, and it will pay the share of the credit accrued by the participant that is necessary to cover his/her/its debit positions that have not yet reached their maturity date only upon the subsequent payment maturity date, provided that the requirement of payability of such credit, under a rolling mechanism, is satisfied.

Where the participant's exposure decreases or becomes zero as a result of other transactions, the corresponding share of the credit - suspended because it will become payable upon the first subsequent date of settlement - may be utilised to cover new purchase transactions, provided that their settlement date coincides with or follows the one related to the credit.

Considering the different ordinary payment time limits currently adopted on the ME/PCE and MGAS[2], an appropriate time of observation of the participant's net position will be identified after the introduction of the integrated guarantee management system. This time may be the end of each calendar month, when the payables and receivables pertaining to the previous month for the gas market and to the second previous month for the electricity market and the PCE are consolidated and the net debit or the available net credit is determined.

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[2] The ordinary payment time limits on the ME and PCE coincide with M+2, i.e. with the second month following the one (month M) of conclusion of transactions on the ME and of registration of transactions onto the PCE, respectively. Conversely, the ordinary payment time limits on the MGAS coincide with M+1, i.e. with the month following the one (month M) of conclusion of transactions on such market.

In brief, upon the date of determination of the balance to be settled, the following situations might occur:

1. if the participant has a net debit balance to be settled towards GME, he/she/it will be required to make the payment within the ordinary time limit[3];
2. if the participant has a net credit balance to be settled towards GME, the following cases may arise:
   a. if the full payment of the balance makes the guarantee insufficient, the share of the credit necessary to cover the participant's debit positions towards GME will be considered to be non-payable[4]; therefore, on the maturity date, GME will only pay the share of the credit that is actually payable;
   b. if the payment of the balance does not make the guarantee insufficient, then GME will make the payment to the participant upon the maturity date.

Question for consultation no. 1

Do you see any problems in this system of integrated guarantee management? If your answer is yes, do you think that these problems may be overcome through appropriate measures? Which measures?

3. INTEGRATED GUARANTEE MANAGEMENT INFORMATION SYSTEM

To improve the efficiency of the guarantee system process, the market participant will be equipped with an appropriate technological platform and, via a user-friendly interface, he/she/it will have access to:

[3] See note 2.

[4] The payability of each credit of the market participant is suspended until complete coverage of his/her/its debit positions.

- all the data about the guarantees posted[5] (giving rise to a single overall guarantee),
- the exposures arising from trading on the different markets (contributing to determining a single exposure),
- the balances to be settled and the identification data.

This platform will also enable the participant to autonomously make a few choices, which will improve internal efficiency and techniques of communication with GME. Indeed, the participant will be able to:

- query the information system to know the overall amount of the guarantee posted, of the one already used and, consequently, of the one still available;
- query the system to know his/her/its overall exposure, investigating the details of the transactions generating it;
- carry out simulations of utilisation of the guarantee for a given transaction to be made;
- requesting the total or partial refund of a bank guarantee or a cash deposit, by entering a direct request into the platform;
- loading a bank guarantee or a cash deposit directly into the platform;
- obtaining real-time and historical reports (in tabular and graphic form).

To be valid and accepted by the system, each change of the amount of the guarantee by the participant will be validated by GME.

4. DEFAULT WITHIN THE INTEGRATED GUARANTEE MANAGEMENT SYSTEM

As described above, the integrated guarantee management system will result into a single overall net credit/debit position of the participant towards GME, whatever the markets/platform from which it originates. Therefore, in case of default of a participant on one of the markets/platforms, all the receivables of participants towards GME (and not only those pertaining to the

[5] In the form of bank guarantees and cash deposits or "virtually" as a result of receivables arising from selling positions.

market/platform where the default has occurred) will be temporarily[6] reduced on a *pro quota* basis in order to allow GME to make the settlement.

In operational terms, the *pro quota* mechanism in case of default will be proportionally applied to all participants that, upon that maturity date, qualify as net creditors towards GME. In this regard, it is worth emphasising that, within the integrated guarantee system, the use of the *pro quota* mechanism under the proportional criterion will be in continuity with what is being done today on each market/platform in case of default.

Obviously, in order to ensure the coverage of GME's risk as central counterparty, the net credit position to be reduced on a *pro quota* basis will be determined after deducting the possible credit that has been moved forward to cover a previously acquired debit exposure. Consequently, the *pro quota* mechanism will only be applied to the net credit positions pertaining to purchase and sale transactions having a maturity date in the same period of settlement as the one in which the default has occurred.

5. REGULATORY/OPERATIONAL IMPACTS OF THE INTEGRATED GUARANTEE MANAGEMENT SYSTEM

The integrated guarantee management system would become the only guarantee system applicable on the PCE and on the spot and forward electricity and gas markets[7], fully replacing the current system focused on the individual markets/platforms. It follows that the introduction of such a mechanism will require the revision of the rules of the markets.

The integrated guarantee management system will be covered by a single and separate body of rules, which will concern both the guarantee system and the procedures for invoicing and settlement of payments applicable to all the markets falling under the integrated management system, including the management of default.

[6] Only in the period preceding the redemption of the guarantees of the defaulting participant. Upon redemption or after finding the liquidity necessary to ensure its financial equilibrium, GME will pay the remaining credit owed to creditor participants.

[7] Environmental markets will be excluded and continue to have a specific guarantee system.

A party applying for participation in a given market will have to sign the participation agreement (form enclosed to the rules/regulations governing the market/platform in which he/she/it wishes to participate). In the participation agreement, the applicant will have to specifically accept also the provisions governing the integrated guarantee system, the settlement of payments and the management of default; these provisions will be gathered in the single body of rules to be adopted.

In operational terms, with a view to ensuring the operational continuity of the energy markets, appropriate procedures and timescales will be identified to switch from the current guarantee system to the new integrated guarantee management one.

If the participant has already posted bank guarantees through the appropriate forms, then, before the take-off of the integrated guarantee management system, he/she/it will have to replace them with a new single bank guarantee, conforming to the specified standards, for an amount at least equal to the amount of obligations acquired until that time. In this case, the participant may file an appropriate application with GME and with the bank in charge of GME's treasury services in order to use only the new guarantee to cover his/her/its overall exposure, thus freeing up the previous guarantees issued through the old forms. Hence, the new bank guarantee will cover the prior and future exposure. As an alternative, the participant will be offered the option to modify his/her/its existing guarantees, by asking the issuing bank to issue a letter modifying the text of the guarantees to conform to the new bank guarantee format, without specifying the related end dates of validity.

More details about the switching procedure will be made known near the date of take-off of the integrated management system.

6. ADVANTAGES OF THE INTEGRATED GUARANTEE MANGEMENT SYSTEM

The implementation of the integrated guarantee management system would yield a number of benefits (described above) to the market participant.

In the first place, the system would introduce an operational simplification, as each participant should post a single guarantee (bank guarantee and/or cash deposit) covering a single exposure. The participant would enter orders into the market in a more effective and responsible way: by querying the supporting information system, he/she/it might know both the overall amount of the guarantee already used and, consequently, of the one still available and make potential simulations concerning the utilisation of the guarantee for covering a supposed exposure.

A further benefit is the lower financial commitment of participants. Indeed, moving from the “one market, one guarantee” principle to the “one participant, one guarantee” concept would have the direct consequence of netting positions of opposite sign, i.e. payables and receivables arising on the different markets, and of requiring participants to post lower guarantees.

Furthermore, the integrated guarantee management system offers the opportunity to utilise the credit resulting from a sale, as early as its appearance, ahead of the actual settlement, to cover consequent orders and transactions.

Finally, a further positive aspect is the fact that the credit for covering exposure may be maintained even after the related settlement, if this is necessary to cover prior debit positions with a future maturity date. If, between one settlement and the subsequent one to which the maturity of the credit is postponed, this virtual guarantee is freed up (due to the closing of positions giving rise to such an exposure as to absorb the guarantee), it may be utilised to cover further exposures.

Question for consultation no. 2

Do you agree on the benefits associated with the assumption of introducing an integrated guarantee system on the ME, MGAS and PCE?

Do you think that the assumed benefits may be achieved, among others, with solutions other than those potentially achievable through the integrated guarantee management system? If your answer is yes, which solutions?