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Italy Is Now a Netting Friendly Jurisdiction for Physical Energy Trading

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Introduction

On 2 August 2017 the Italian Parliament approved Article 1, paragraphs 86 and 87 of the Competition Bill ("*DDL Concorrenza*") on "close-out netting" clauses. This amendment, supported by the Italian Ministry of Economic Development, is aimed at stipulating the validity and effectiveness, in accordance with their terms, of close-out netting clauses included in "wholesale energy products" (i.e., contracts for the supply of and derivatives relating to electricity or natural gas delivered in the EU) entered into with a counterparty (other than a final customer) subject to any insolvency proceedings.

Close-out netting clauses are defined as clauses providing for (i) the automatic or voluntary termination of all outstanding trades between two parties and (ii) a resulting obligation on the party with the greater debt to pay the single net payable, arising by the setting off of the parties' respective payables and receivables, which by virtue of the same clause become immediately due. The greater benefit of such contractual mechanism is to limit a party's exposure to the net value (instead of the gross value) owed by the counterparty and, hence, to reduce the credit risk associated with the multiple trades that are subject to simultaneous early termination.

Close-out netting clauses are a common feature of framework agreements for physical trading of power and gas, such as the standard master agreements for the wholesale trade and supply of energy drafted by the European Federation of Energy Traders ("EFET"), which are the core point of reference in the industry.[1]

Former Italian Netting Regime and Economic Impact

Validity and enforceability of close-out netting provisions are mainly related to the possibility of terminating an agreement in case of a counterparty's insolvency. Before the acceptance of the amendment to the Competition Bill, the relevant regulation was the Royal Decree No. 267 of 16 March 1942 ("Italian Bankruptcy Law"). In particular, Article 72, paragraph 6 of the Italian Bankruptcy Law prevents bankruptcy-based early termination clauses, which, as such, are considered void outright.

Moreover, under Articles 72 and 74 of the Bankruptcy Law, the debtor's insolvency declaration entails the freeze of all outstanding sale and supply agreements, until the insolvency official chooses whether to terminate or perform them. The non-insolvent party may only try to expedite the insolvency official's decision by making a request to the supervising judge for a term not exceeding 60 days by which the insolvency official must decide. If the insolvency official elects to perform the agreement, the counterparty will have a preferred right to the payment with respect to other creditors ("*credito prededucibile*"). On the other hand, if the insolvency official elects to

terminate the agreement, the non-insolvent party will be paid together with the other creditors under the *pari passu* principle. Even though those principles do not apply in all insolvency proceedings in the same manner,[2] the right of the insolvency official to elect either the termination or the performance of the agreement creates a high level of uncertainty in the energy trading industry.

Moreover, Article 56 of the Bankruptcy Law provides for an immediate contractual set-off right for both credits payable before the bankruptcy declaration and credits not yet payable as of the date of the bankruptcy declaration. However, termination amount clauses provided for under master agreements could possibly qualify as liquidated damages ("*penali*") and, as such, may not be acted upon, given that, under Article 72, paragraph 4 of the Bankruptcy Law, damages cannot be claimed.

In sum, before the insolvency declaration both the early termination and the set-off are generally enforceable whilst thereafter, neither the early termination clauses nor claims for damages would be enforceable in respect to transactions which have not been performed.

It is noteworthy that a more netting-friendly regulation applies to agreements having a financial nature. In fact, on the one hand, Article 76 of the Bankruptcy Law and Article 203 of the Legislative Decree No. 58 of 24 February 1998 ("Financial Law") provide for the automatic termination as of the date on which bankruptcy is declared of both exchange traded forward contracts having a financial nature ("*contratti di borsa a termine*") and OTC derivative financial instruments. This mechanism is quite helpful in that it prevents any "cherry-picking" by the insolvency official. Moreover, under Legislative Decree No. 170 of 21 May 2004 (implementing the EU Collateral Directive), close-out netting provisions can take effect in accordance with their terms notwithstanding the commencement or continuation of winding-up proceedings or reorganization measures in respect of financial collateral arrangements or agreements including financial collateral arrangements entered into by: (i) a bank; (ii) public authorities; (iii) a central counterparty, settlement agent, or clearing house; or (iv) any other legal person if the counterparty is an above-listed entity. Finally, under Article 95-*ter* of the Legislative Decree No. 385 of 1 September 1993 ("Banking Law"), if the insolvent party is a bank, netting agreements are governed by the same governing law as the contract.

The consequences of the unfriendly and patchy Italian netting regime were rather serious. In particular, the main issue was the hefty guarantees that Italian energy traders were requested by counterparties to provide in connection with their gross exposure in order to trade. The economic impact deriving from the lack of robustness of the Italian close-out netting mechanism was particularly significant for small and medium scale Italian companies as their non-Italian counterparties were constantly asking for a much higher level of guarantees than those requested in netting friendly jurisdictions. Moreover, the need for higher collateralization increased operating costs because the perceived risk discouraged greater credit lines available to the energy traders. From an economic standpoint these limitations have hindered the development of a more liquid wholesale energy market and, ultimately, resulted in higher energy prices.

New Netting Regime

With the goal not to re-invent the wheel, Legislative Decree No. 170 of 21 May 2004 and the definition of wholesale products set out in Regulation (EU) No. 1227/2011 ("REMIT") were the starting points of the new netting regime.

Article 38 of the Competition Bill stipulates that close-out netting clauses provided in wholesale energy products[3] under the REMIT definition, other than contracts entered into with end customers, are valid and effective also in the event of proceedings aimed at restructuring or winding up the debtor, whether of an insolvency nature or pre-insolvency, with or without

dispossession of the debtor.[4] The legislators' intention clearly is to not exclude any insolvency proceedings including those which may be introduced in the future.

A close-out netting clause is defined as any voluntary or automatic termination clause and consequent obligation upon the party owing the greater amount to pay a net settlement amount, as resulting from the netting of the parties' positions, that by virtue of the same clause have been accelerated and converted into the obligation to pay an amount equal to their current value, as estimated according to commercial reasonableness standards, or which expired and superseded by the obligation to pay such amount.[5] Again, the legislators' commendable catch-all intention is clear alongside the goal to capture the mark-to-market value.

In the same vein, in order to avoid any possible abuse in the market evaluation, the clause states that in the event of the opening of bankruptcy or restructuring proceedings that imply the dispossession of the debtor, the insolvency official may claim, within six months from the opening of such proceedings, the violation of the standard of reasonableness of the commercial value if the evaluation of the current value of the debtor's position intervened in the year before the opening of the proceedings.[6]

However, Article 38 of the Competition Bill provides for a presumption of reasonableness of the commercial value of the parties' positions with respect to evaluations under standard international agreements, such as the EFET agreements,[7] which typically set out that the non-insolvent party has the right to terminate all the outstanding energy transactions and obtain the compensation for the relevant costs and losses. The new provision of law, therefore, grants the benefit of reducing the legal risk, which is the core element of the effective functioning of the energy markets in Europe.

In sum, the following points are noteworthy: (i) the reference to REMIT ensures that all wholesale energy products (gas and power sales and derivatives) are included; (ii) a "catch-all" drafting technique seems to make this principle resilient to possible future bankruptcy law reforms; (iii) the text specifically refers to, thus allowing, termination; (iv) a provision allowing payment of the mark-to-market is included; and (v) the presumption of reasonableness stemming from the international standard agreements, such as the EFET agreements, should further promote the spread of the close-out netting clauses.

Benefits for Both the Operators and the System

In the near future we expect an array of benefits for the energy trading sector stemming from the lower legal risk and the full enforceability of the close-out netting mechanism. These include: (i) a sheer reduction of collateral required to Italian counterparties; (ii) the possibility for Italian counterparties to have access to greater credit lines granted by financial institutions, because they will consider only the net value of the possible exposure instead of the full value of the insolvent counterparty's payment obligations; and (iii) the applicability to energy commodities traders of more internationally standardized contractual terms.

It has been estimated that the financial burden for Italian companies required to provide guarantees to counterparties in order to operate on the commodities market will be reduced by 50-60% from current values[8] due to the reduction of the credit risk calculated on a net basis, with a clear decrease in all related operating costs.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings Milan lawyers:

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[1] The relevant EFET framework agreements are the *EFET General Agreement Concerning the Delivery and Acceptance of Electricity* and the *EFET General Agreement Concerning the Delivery and Acceptance of Gas* (available on www.efet.org).

[2] E.g., in an extraordinary administration ("*amministrazione straordinaria*"), contracts are not suspended until the decision of the commissioner but the timeframe applicable to speed up the insolvency official's decision is much longer.

[3] Article 2, paragraph 4, of REMIT defines wholesale energy products as "*the following contracts and derivatives, irrespective of where and how they are traded: (a) contracts for the supply of electricity or natural gas where delivery is in the Union; (b) derivatives relating to electricity or natural gas produced, traded or delivered in the Union; (c) contracts relating to the transportation of electricity or natural gas in the Union; (d) derivatives relating to the transportation of electricity or natural gas in the Union.*

Contracts for the supply and distribution of electricity or natural gas for the use of final customers are not wholesale energy products. However, contracts for the supply and distribution of electricity or natural gas to final customers with a consumption capacity greater than the threshold set out in the second paragraph of point (5) shall be treated as wholesale energy products."

The second paragraph of point (5) sets out that "*for the purposes of this definition* [the definition of "consumption capacity"], *consumption at individual plants under the control of a single economic entity that have a consumption capacity of less than 600 GWh per year shall not be taken into account in so far as those plants do not exert a joint influence on wholesale energy market prices due to their being located in different relevant geographical markets.*"

[4] "*Al fine di aumentare la liquidità dei mercati dell'energia, riducendo i costi delle transazioni, a vantaggio dei consumatori, la clausola di «close-out netting» prevista per i prodotti energetici all'ingrosso di cui al regolamento (UE) n. 1227/2011 del Parlamento europeo e del Consiglio, del 25 ottobre 2011, ad eccezione dei contratti conclusi con clienti finali a prescindere dalla loro capacità di consumo, è valida ed efficace, in conformità a quanto dalla stessa previsto, anche in caso di apertura di una procedura di risanamento, di ristrutturazione economico-finanziaria o di liquidazione, di natura concorsuale o pre-concorsuale, con o senza spossessamento del debitore, nei confronti di una delle parti.*"

[5] "[…] *per clausola di «close-out netting» deve intendersi qualsiasi clausola di interruzione volontaria o automatica dei rapporti e di conseguente obbligo, gravante sul contraente il cui debito risulti più elevato, di pagamento del saldo netto delle obbligazioni, come risultante dalla compensazione delle posizioni reciproche, che, in forza di detta clausola, sono divenute immediatamente esigibili e convertite nell'obbligazione di versare un importo pari al loro valore corrente stimato secondo criteri di ragionevolezza commerciale, oppure estinte e sostituite dall'obbligazione di versare tale importo.*"

[6] "[…] *in caso di apertura di una procedura di risanamento, di ristrutturazione economico-finanziaria o di liquidazione, che abbia natura concorsuale e che preveda lo spossessamento del debitore, gli organi della procedura, entro sei mesi dal momento di apertura della procedura stessa, possono far valere la violazione della ragionevolezza sotto il profilo commerciale qualora la determinazione del valore corrente stimato sia intervenuta entro l'anno che precede l'apertura della procedura stessa*."

[7] "[…] *fatto salvo che detta ragionevolezza si presume nel caso in cui le clausole contrattuali concernenti i criteri di valutazione del valore corrente stimato siano coerenti con gli schemi contrattuali elaborati nell'ambito della prassi internazionale riconosciuta da associazioni rappresentative internazionali ovvero allorché prevedano il ricorso a quotazioni fornite da uno o più soggetti terzi indipendenti riconosciuti a livello internazionale*."

[8] EFET source.