

The importance of keeping energy markets open in times of turmoil

The role of exchanges in these uncertain times:

- The current situation in the energy market – caused by the price spikes in the past months and exacerbated by Russia's invasion into Ukraine - is characterized by an environment where uncertainty makes it unusually hard to price assets.
- Regulated exchanges operating the wholesale energy markets provide essential transparency on prices and the physical underlying of energy supply and demand and allows for an optimized European-wide redispatch using cross-border capacities.
- Especially during times of stress, it is important to have access to central and transparent liquidity that enable participants to manage and transfer their risk through trading and central clearing. Coupled power markets represent a safety net to smoothen the individual markets' price spikes.

Why caution before intervention is warranted:

- Shutting down exchanges, limiting certain trading strategies or capping wholesale market prices does not change the market's valuation of the underlying commodity.
- Market participants will move away from trading on exchange towards the over-the-counter space without any visibility on price movements. Transparent price determination would therefore not take place and price changes would just be delayed and potentially even amplified because of the increased uncertainty.
- The market reflects the physical reality of energy supply and demand. This situation (Europe's dependence on import of Russian gas) does not go away if the market is closed or capped.
- It is impossible to halt spot markets without disrupting security of near to real time supply of power and gas to the physical grid.
- Prohibiting derivative trades can exacerbate negative implications on the ability of companies in the energy sector (both demand and supply side) to do business and withstand times of crisis.

Trading on EEX/EPEX SPOT

- At EEX and EPEX SPOT, power and gas can be traded in the last minutes before delivery until up to 10 years in advance. Both spot and derivative markets, and subsequent clearing, perform essential functions for the overall energy markets and its participants.

What happens at the exchange in case of extreme volatility:

- Operational resilience is ensured by the market surveillance and operations teams on high alert.
- Volatility interruption processes and harmonized technical price limits are in place with the purpose of containing excessive volatility. While derivative market can, under extraordinary conditions, be halted, the gas and power spot markets will be kept open provided technical conditions are met.
- All safeguard mechanisms operated by trading venues are subject to the discretion of the management board of the exchange to uphold fair and orderly markets.
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The importance of keeping energy markets open in times of turmoil

Movements on the energy markets following the Russian invasion of Ukraine bring energy prices and the wider market infrastructure under a magnifying glass. Regulated exchanges operating the wholesale energy markets are one part of this value chain and provide essential transparency on prices and the physical underlying of energy supply and demand, providing an important function for energy supply. A robust and transparent price formation process, combined with sound policies to ensure an orderly market, is essential under any market circumstances but especially when markets are moving.

In an environment where uncertainty makes it unusually hard to price assets, exchanges provide real time information which serve as an indicator for response measures to this crisis by the companies most affected and the economy overall. In addition, by trading on an exchange, possible risks of market participants, in particular default risk are secured by the clearing house - a function especially important during economic turmoil.

Mechanisms to safeguard the efficient functioning of energy markets and avoid undue price movements exist and are operated by the exchange's market surveillance and market operations departments. Examples are volatility interruption mechanisms. Shutting down a market for a prolonged time to avoid extreme price hikes on the contrary would only delay or even exacerbate the problem.

The set-up of a regulated exchange and clearing house

Energy exchanges bring together a broad and diverse set of market participants to enable buyers and sellers of power or gas to find a counterpart to trade at all times. At EEX and EPEX SPOT, power and gas can be traded in the last minutes before delivery until up to 10 years in advance.

Power and gas have in common that they are continuously produced and consumed. Power has the additional characteristic that it cannot be stored in large quantities and demand and supply have to be balanced at all times. Because of this, especially short term ("spot") prices are generally very volatile which creates price risks for market participants which they can manage at long term ("derivative") markets.

In sum, spot trading with immediate or prompt delivery are decisive for generation and consumption decisions and ensure a balanced grid. The price signal best reflects the equilibrium of supply and demand at any point in time. Derivatives trading is especially relevant for hedging and risk management activities. Derivative markets are used to buy or sell a specific volume of gas or power, at a fixed price, for settlement on a specific date in the future. This is a key part of the risk coverage strategy of energy producers and suppliers.

As a critical part of this set-up, central counterparties such as the European Commodity Clearing AG (ECC) initiate all payment flows between the seller and the buyer. It assumes the counterparty risk and guarantees the physical and financial settlement of transactions, providing security and cross-margining benefits for its customers.

Preserving the role of exchanges during market stress

Especially during times of stress, it is important to have access to central and transparent liquidity that enables participants to manage and transfer their risk through trading and that offer a price signal for the different time horizons. Market players need to adjust positions to make sense of novel market dynamics. In the energy sector, utilities for instance needed to adjust to lower demand or supply by modifying short-term trading as well as long-term contracts.

Taking imprudent actions such as shutting down regulated markets for prolonged periods of time (e.g. multiple days) if they show extreme price movements, capping the wholesale market prices or imposing trading/short selling bans, does not change the fact that the market's valuation of the good might have significantly changed.

On the contrary, if an exchange platform would close, price determination might not take place at all, just be delayed, or at least not occur in a transparent and accessible fashion. Indeed, trading companies would move away from trading on exchanges and seek their counterparties in the dark and more opaque over-the-counter space, with no reference prices to base their transaction on. This lack of transparency can create significant uncertainty and therefore even more extreme price movements. Or even worse, it might lead to a situation in which demand is no longer physically met, resulting in a security of supply crisis.

Beyond the price, it is important to note that the exchange market also reflects the physical reality of energy supply and demand. This reality is formed by the current geopolitical situation and the uncertainty around potential sanctions on companies in the energy sector as well as voluntary action from energy suppliers putting in question the gas import from Russia, on which Europe's gas use relies heavily.¹ This situation does not go away if the market is closed as the wholesale price mechanism will always match supply and demand. Furthermore, closing the coupled power spot markets would also mean a loss of welfare benefits at European level since scarce cross-border capacity is allocated implicitly, making sure that the infrastructure is used when and where it is needed.

In similar fashion, a hasty ban of certain trading strategies (e.g. short selling or taking on opposite risks by selling at lower prices) could have unintended negative consequences. Limiting trades and thus overall liquidity² on secure exchanges is the opposite of what companies in the energy markets require in order to flexibly adapt their positions to new developments in this crisis situation.

Concretely, energy spot markets fulfill a critical role of balancing the grid by the operators and market area managers. It is thus impossible to halt spot markets without disrupting security of near to real time supply of power and gas to the physical grid. For derivatives, if an energy consumer is unable to hedge its consumption cost this can result in a significant loss if prices change against them. This can exacerbate negative implications on the ability of companies in the energy sector (both on demand and supply side) to do business and withstand times of crisis.

Furthermore, the current uncertain economic context further increases credit risk for European businesses and financial institutions. This highlights the relevance of the European central counterparty model for the integrity of the economic and financial system. It would thus be undesirable to take away the option of trading and subsequent clearing on exchanges.

What happens at the exchange in case of extreme volatility

As highly regulated entities, operational resilience in a broad spectrum of scenarios is not only a choice but a commitment and requirement. This is also true for times like the current one where operational departments function on high alert.

First and foremost, market surveillance and market operations departments have a large toolkit at hand and fulfill their task of ensuring orderly markets. Its task is to monitor the execution of orderly trading and the orderly settlement of exchange transactions in its entirety. In the event EEX/EPEX SPOT

¹ As described in "A 10-point plan to reduce the European Union's reliance on Russian natural gas", IEA, 3/3/2022

² As described in the study "The 2020 European Short-Selling Ban and the Effects on Market Quality" from W. Bessler and M. Vendrasco, 12/2020, the bans imposed in 2020 at the height of the Covid-19 related market stress had mixed results. They entailed a deterioration of market liquidity and negative market-quality effects especially for smaller markets and firms.

Market Surveillance Offices suspect that certain behavior is not compliant with applicable laws or the exchanges' Rules and Regulations, it investigates such cases. In highly volatile periods such as currently is the case, they increasingly look for patterns pointing towards excessive trading behavior i.e. attempts to unduly influence or manipulate prices. Trading beyond concrete hedging needs or short selling at itself are not prohibited practices yet are closely monitored at all times. EEX/EPEX SPOT Market Surveillance Offices have so far observed no unusual behavior that would lead to undue price changes.

Second, additional safeguard mechanisms are in place on the derivative markets with the purpose of containing volatility. Since 2018, EEX introduced the volatility interruption process, as required by the Markets in Financial Instruments Directive, MiFIDII.³ Depending on price variations within a certain price range, continuous trading temporarily stops following which a call auction may be triggered.

Importantly, safeguards operated by trading venues are subject to the discretion of the management board of the exchange when it comes to the design and functionality of mechanisms to protect the price discovery process and to avoid significant disruptions to the orderliness of trading. In case of major disruptions of physical gas supply to Europe, the management board, in dialogue with market participants, would be prepared to decide to temporarily halt all European power and gas derivative markets, giving the market sufficient time to find an equilibrium and ensure fair and orderly markets.⁴ Due to immediate delivery and market coupling, the gas and power spot markets shall remain open, provided the technical preconditions (availability of Virtual Trading Points, etc.) remain fulfilled.

Finally, European-wide harmonized technical price limits for the power spot market are in place as foreseen in the CACM Regulation.

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³ As prescribed by MiFID II and described in the EEX exchange rules §45 (2)

⁴ For more information, please refer to the EEX Customer Information of 11 April 2022 on "Potential emergency measures taken by EEX in case of major disruptions of gas delivery".