

On the left side of the page, there are two overlapping geometric shapes: a light green triangle pointing right and a light blue triangle pointing left, partially overlapping the green one.

A Futures Industry Perspective: How EU Policymakers Should Respond to the Energy Crisis

A short, thick, light green horizontal line.

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A large, light grey geometric shape on the right side of the page, consisting of several overlapping triangles and quadrilaterals, creating a complex, abstract form.



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About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C.

FIA's mission is to:

- » *support open, transparent and competitive markets,*
- » *protect and enhance the integrity of the financial system, and*
- » *promote high standards of professional conduct.*

As the leading global trade association for the futures, options and centrally cleared derivatives markets, FIA represents all sectors of the industry, including clearing firms, exchanges, clearing houses, trading firms and commodities specialists from about 50 countries, as well as technology vendors, law firms, and other industry service providers.



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INTRODUCTION

Europe today is facing an energy crisis. A number of unusual circumstances, most notably the war in Ukraine, have caused a severe shortage in the supply of natural gas and oil. This is leading to extreme increases in the price of electricity, which is causing severe hardships for consumers and putting tremendous pressure on all sectors of the economy.

Political leaders are now urgently seeking solutions to this crisis. The range of solutions under consideration is quite broad, and some of them are targeted at the trading of futures on electricity, gas and other energy commodities. As the main trade association for the global futures industry, we believe it is important to contribute our expertise to this discussion.

On 14 September, the European Commission announced a package of emergency measures aimed at addressing the crisis. This package included a "workstream" of measures focused specifically on energy firms participating in wholesale markets for gas and power. We fully understand the Commission's determination to move quickly on these measures and we look forward to providing our input.



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ROOTS OF THE CRISIS

Why are gas and electricity prices so high? The source of the problem is in the underlying physical market—there is an extreme shortage of fuel for power generation. At a high level, this has several causes: the post-pandemic rebound of demand, relatively low inventories of energy in storage, unusual weather conditions, and relatively high dependence on imports.

The catalyst was of course Russia's invasion of Ukraine, which triggered Western sanctions on the Russian economy and then Russian retaliation. Before the invasion, Russia supplied roughly 40% of the gas that Europe imported. That has now fallen to 9% and will soon be zero.

Making matters worse, one of the most important alternative sources of power within the EU—the nuclear power plants in France—have suffered maintenance problems that have reduced their capacity at the very moment when they are needed the most. At the end of August, more than half of the country's nuclear generation capacity was offline, according to Électricité de France. For the year as a whole, EDF forecasts that the amount of electricity produced by its reactors will be the lowest since 1993.

Not surprisingly, prices for gas in the futures markets have skyrocketed. In August, the price of gas at the Dutch TTF hub, the main benchmark for gas trading in the European Union, reached a record of €236 per megawatt. That has been estimated to be the equivalent of \$410 per barrel of oil, far above anything that Europe or indeed the world has seen before.

One of the main uses of gas is in the generation of electricity, and the rise in gas prices has caused an equally extreme reaction in the electricity futures markets. In many parts of Europe, electricity prices are 10 times higher than last year. This is having a tremendous impact on virtually every household and business across the European Union.

Futures exchanges play a key role in the pricing of commodities. They operate transparent and competitive markets that reveal what buyers are willing to pay and what sellers are willing to receive. The interaction between buyers and sellers provides what economists call "price discovery," and this process gives all economic actors a benchmark for their pricing decisions.

But when there is a shock to supply, as we are seeing now, prices will rise very rapidly. This is especially true in markets for essential commodities such as energy—demand is relatively inelastic, so interruptions in supply lead to prices shooting up.



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DON'T SHOOT THE MESSENGER

In situations like this, it is often tempting to say, "the markets are broken." We are seeing this type of response from politicians worried about the impact on consumers as well as companies harmed by higher costs. Some officials have called for closing or suspending the futures markets, thinking that if the markets are closed, then prices cannot rise.

We believe such efforts are doomed to fail. Closing the futures markets will not change the underlying imbalance in supply and demand. In fact, such actions very easily could make matters worse by damaging confidence in the market and causing participants to withdraw.

When market participants withdraw from a market, the loss of liquidity reduces its efficiency. In practical terms, when there are fewer participants, the spreads between bids and offers widen, the cost of trading rises, and large trades are harder to fill.

This is not just an issue for the firms that trade on the exchanges. It also affects the real economy by raising the cost of hedging. For example, companies that store gas use derivatives to protect themselves from price volatility while the gas is in storage. In the worst-case scenario, those companies either stop hedging their risks or reduce their physical holdings. This in turn leads to yet higher price increases for consumers.

For these reasons, we are very concerned by calls for interventions into the European gas and electricity markets. We strongly believe that these markets work best when the rules of the exchanges and clearinghouses are applied clearly and consistently. Price discovery, margin adequacy and settlement finality are key to ensuring that the markets serve their original purpose. Any action must take these into consideration.

Another idea under discussion is to set a cap on gas prices. This has been tried before, with limited success at best. The problem is that government intervention to depress prices on the wholesale market has the effect of subsidizing consumption, which ultimately undermines the effort to reduce prices. Equally important, the European gas market does not exist in isolation. A cap in Europe could have the effect of diverting supply to other regions that offer higher prices, making the current shortage even worse.



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HELP THE HEDGERS

One of the consequences of the energy crisis is that protection from price volatility is now very expensive. This is proving to be especially problematic for certain utilities.

Many utilities use derivatives to hedge the risk that the price of electricity will fall, which would force them to operate at a loss. Consequently, they use electricity futures to lock in the price for their future sales.

Under normal market conditions, the gains and losses on these positions offset gains and losses in the underlying business. In effect, the futures insulate the utilities from the ups and downs of the market and allows them to concentrate on their core business—providing a reliable source of electricity to their customers.

Under the current market conditions, however, the value of the futures has changed so much that the margin required by the clearinghouses—which functions like a guarantee—has risen far above normal levels. The utilities need cash to cover these margin calls, and in some cases, they had to borrow large amounts of money or seek government support.

In recent months several governments have recognized the urgency of the situation and provided emergency funding to give these companies a large but temporary source of liquidity. We strongly support these measures because they allow the utilities to avoid a default, which would be extremely damaging for both the individual companies and the market as a whole.

Examples:

- **8 Sep** - The Danish government announced that it will offer up to 100 billion Danish crowns in credit guarantees to energy firms affected by collateral demands.
- **8 Sep** - The UK Treasury and the Bank of England announced a plan to establish a £40 billion scheme to address the extraordinary liquidity requirements faced by energy firms operating in UK wholesale gas and electricity markets. The UK government said the scheme will provide "short term financial support" and will be used as a "last resort."
- **4 Sep** - The Finnish government launched a €10 billion loans and guarantees scheme for electricity producers at risk of insolvency. Finance Minister Annikka Saarikko said the scheme would be limited to "last resort" guarantees and loans with "extremely strict conditions."



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- **4 Sep** - The Swedish government said it will provide up to 250 billion kronor in credit guarantees to electricity producers. The government said the credit guarantees would address the "lack of liquidity" caused by the rise in margin requirements and prevent "contagion" to other parts of the financial system.
- **31 Aug** - Austria's government granted a €2 billion credit line to the City of Vienna to help the Wien Energie power company manage the margin calls on its futures.
- **22 Jul**—The German government arranged a €15 billion rescue package for Uniper, one of the largest German utilities and one of the most heavily affected by margin requirements. Under the terms of the agreement, the German government will acquire 30% of the utility.

At present these liquidity support mechanisms are being rolled out on an ad-hoc basis by individual governments within the European Union. This is understandable, given the urgency of the situation. In some cases, however, the details are lacking, and more generally we are concerned about the potential for inconsistencies and over-use. We therefore urge policymakers to consider the following three recommendations:

1. These mechanisms should be targeted and temporary—targeted to the gas and electricity markets and limited to the duration of the crisis.
2. The funding should be provided only to end-users, such as utilities, that are engaged in these markets primarily for the purpose of hedging their risks in the generation and distribution of electricity.
3. Some coordination at the EU level would be beneficial to ensure a level playing field.



EASE THE RESTRICTIONS ON COLLATERAL

There is another area where policymakers can help ease the impact of higher margin requirements. Currently there are rules that limit the types of collateral that market participants can use to meet their margin requirements. As proposed by the European Commission on 14 September, the time is ripe to re-examine these restrictions and consider ways to provide utilities and other end-users with more flexibility in how they meet their margin requirements.

Cash will always be king, but there are other forms of collateral, such as letters of credit, that can be used to supplement cash. We encourage policymakers to allow utilities and other market participants to provide letters of credit to their clearing members as a form of collateral and allow clearinghouses to accept these letters of credit as a substitute for cash. This would reduce the need for these firms to borrow money to meet their margin calls, and experience in other parts of the world show that this can be done without putting clearinghouses at risk.

We caution, however, against taking any steps that simply would move risk from one part of the trading process to another or introduce new types of risk into the clearing process. Any type of alternative collateral should be used within an appropriate framework of protections that allow immediate liquidation if needed. FIA also strongly encourages banking regulators to consider the implications for the capital requirements on clearing firms if their clients in the gas and electricity markets are able to use alternative forms of collateral.

It has been suggested that utilities also should be allowed to post emission allowances as collateral. This is a novel idea that needs careful consideration, but in principle FIA strongly supports innovative thinking on this issue. We welcome any steps that ease the cash crunch for energy firms without creating new risks for clearinghouses or their members.



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MANAGE VOLATILITY

Another critique of the futures market is that prices have become so volatile that the markets are not serving their purpose. We fully understand this concern because prices have indeed become extremely volatile, and this is challenging for all market participants.

We strongly believe, however, that most of the European exchanges are already well equipped to handle this problem. Many have in place mechanisms to prevent runaway price movements either up or down. Some use "circuit breakers" that impose a short pause of trading. Others use "price limits" that set boundaries on how far prices can move during a single day.

These types of controls are intended to maintain orderly trading during periods of market turmoil. These controls have been developed over many years and their use is well understood by market participants. As long as the controls are transparent to market participants and predictable, they can work to prevent exceptional market runs. We caution against sudden changes to these controls or unexpected closures; the uncertainty would be extremely problematic for all market participants.

One of the measures announced by the European Commission on 14 September is focused on these controls. Specifically, the Commission has asked the European Securities and Markets Authority to examine the use of circuit breakers and price limits. We welcome this initiative. Given the extraordinary volatility being experienced in the gas and electricity markets, it makes sense to reassess how they are applied and consider whether they need to be recalibrated. We also agree with the Commission's interest in harmonizing the use of these controls across the European Union, though we caution that this effort should take into account the nuances of each market.



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SUPPORT THE ENERGY TRANSITION

Looking beyond the immediate situation, it is clear that one of the longer term solutions to the energy crisis is to increase the supply of renewable energy. Investing in more generation from wind and solar not only helps Europe meet its targets for reducing emissions, it also reduces the need to import energy from other parts of the world. In addition, with fossil fuels now at much higher prices, it has become relatively less expensive to generate power from wind and solar, which helps improve the competitiveness of European industry.

Accelerating the transition away from fossil fuels will require massive investment of capital into infrastructure. Futures markets can play an indirect but important supporting role by providing price discovery and risk transfer for the companies involved in the development of renewable energy, including utilities, energy companies, banks and investment funds.

Financing the development of solar and wind facilities requires long term supply contracts to ensure that the facilities will be able to repay the loans. These supply contracts often include derivatives tied to electricity futures to hedge price risk and protect profit margins. The more liquidity the exchanges can attract, the more they can support this type of risk transfer.

The price discovery function is equally important. Futures on emissions allow energy consumers to calculate the all-in costs of using coal, oil and gas to generate electricity, heat buildings, or run factories. Setting a price on carbon is essential to calculating costs in the near term and allocating capital in the longer term. A well-regulated and well-functioning futures market for carbon allowances is therefore essential.

This should give policymakers all the more reason to avoid distorting the price signals that futures markets provide. Good regulation should encourage healthy markets with broad participation and deep liquidity. Anything that interferes with setting price signals—such as setting price caps or restricting trading—will damage confidence in these markets and impede the energy transition.

FIA also supports actions that would encourage more trading firms to enter the power and gas markets. For exchange-traded markets to function efficiently, they need a broad range of market participants, including not only buyers and sellers of the underlying commodities but also the independent market makers that provide liquidity for trading. This improves competition, makes markets more resilient, and allows the exchanges to list contracts that are more distant in time.



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