



– Position Paper –

Europex FAQ on circuit breakers

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What is the purpose of energy exchanges?

The purpose of energy exchanges is to provide an open and transparent risk transfer mechanism to market participants. They do so by operating facilities through which the price of financial instruments based on commodities and other value measures may be discovered through the free interaction of the forces of supply and demand. Subject to the exchange's overarching duty to run an orderly market, an exchange will allow those forces to determine the price at any given time.

The role of exchanges is to be the neutral operator of the market mechanism. An inherent feature of that neutrality is that exchanges do not have a preconceived notion of the intrinsic value of the financial instruments that it admits to trading, which is separate from the price discovery that occurs through the market mechanism. The exchange's role is to ensure that the market participants that use its facilities can obtain the best price available at the time in question for their size and type of trade; and to allow them to execute such trades when they need to do so through facilities that are technically sound and operationally resilient.

Europex's strong conviction is that risk transfer mechanisms are most needed during periods of heightened uncertainty and volatility, as it is at such times that risks in the underlying commodity and financial markets are most acute. As a result, an exchange's purpose is fulfilled most meaningfully during such periods, which is why it should remain open and available to market participants during times of increased stress. Energy exchanges have done so consistently through wars, natural disasters and global pandemics.

What is the purpose of circuit breakers?

Exchanges have a tried and tested suite of dynamic and configurable systems and controls which enables them to manage periods of increased price volatility and to ensure that new information and rapidly changing events can be expressed in the demand and supply conditions in its market in an orderly manner. Circuit breaker functionalities diminish the likelihood and extent of short-term price spikes or aberrant market moves.

Which type of circuit breakers do energy exchanges typically have in place?

As said, most energy exchanges have dynamic and configurable systems and controls in place. There are two reasons for this:

1) A certain degree of volatility is inherent to power and gas markets. This is because power and gas cannot easily be stored, and demand and supply need to be balanced at all times. In addition, demand is highly weather dependent and does not easily react to prices, at least not in the short term. The energy transition is set to increase the volatility of the market, with intermittent renewable generation becoming a larger part of the energy mix. This means that also supply will become increasingly more volatile and even more weather dependent.

2) Energy derivatives are generally less liquid than cash equity instruments. There are fewer market makers and a smaller number of active market participants, which make these markets generally more volatile.

Because of these reasons static circuit breakers are less suitable to distinguish disorderly market conditions from volatility induced by market fundamentals.

Would a European trading halt mechanism be helpful?

Generally, we believe the volatility safeguards that exchanges have in place have been working as intended and hence we do not see an immediate need for a new type of trading halt mechanism on top of the established mechanisms. It is noteworthy, however, that in light of the increased uncertainty about supply and demand balances for European gas, exchanges have considered or still are considering various adjustments to the calibration of existing circuit breakers including for example to make them of longer duration to allow market participants additional time to pause and process in case of major price movements.

When considering changes to circuit breakers, exchanges consider the following criteria to be of crucial importance:

Limited duration: Any halt or constraint should be short in duration in order to minimise the disruption to the market. The exchange aims for a window that would leave the market sufficient time to pause and process, without the absence of a price signal causing material market issues or forcing trading activity to alternative, less transparent and less liquid channels. If a new trading halt mechanism for example would trigger halts which would last longer than 5 to 10 minutes, it will become very difficult to restart the market. Trader's confidence in the market will have disappeared and a similar scenario as the halt of the LME nickel market in March 2022 may materialise again. During the latter event, the exchange could not reopen for several days and had to make several attempts to restart the market. As supply and demand fundamentals of the underlying commodity continue to change regardless of markets being suspended or not, market participants will try to hedge their positions OTC with no reference prices to base their transactions on. On the central limit order book, price changes would just be delayed and potentially even amplified because of the increased uncertainty. If halted for a longer period of time, not having a reference price to base the transaction on could also become a substantial problem from a clearing perspective.

If there is no transparent price formation taking place on the exchange, the CCP will have to take other information into account, such as prices established on other venues, OTC prices and market call rounds (if available). Importantly, a potential undercollateralisation of positions could lead to increased system risk.

Triggered by exception: The market should be able to function as normal and a circuit breaker should only be triggered in rare circumstances, such as where significant price sensitive information becomes available and allows the market to pause and process. As suggested by ESMA in its report dated 22 September 2022, we believe it is important that the intention of the trading halt mechanism is to “provide more time to market participants to process the flow of information during extreme market stress scenarios”. This is the purpose of circuit breakers and should not be mixed up with the political desire to reduce market volatility stretched out over a one or multiple days or even reduce price levels. If used for this purpose, the above-mentioned counterproductive effects will unfold.

Market and exchange specific: The circuit breaker should take the liquidity, the nature of the market model and the type of users into account for the market it applies to. This is in line with ESMA report which notes that the trading halt is calibrated “in light of the specificities and liquidity profiles of different types of energy markets”. For example, the German Power benchmark sees around 90 different maturities. These maturities all have different liquidity profiles, quotation levels and volatility profiles. These again vary across trading venues. Parameters should therefore be calibrated to take the specificities of the market structure at the trading venue into account.

When can harmonised circuit breakers be implemented?

The recalibration of existing circuit breakers that exchanges have in place could take place relatively quickly, following the appropriate level of market consultation and testing. A fundamental change to the way circuit breakers are currently designed, however, would require at least multiple months to be build, tested and implemented.

About

Europex is a not-for-profit association of European energy exchanges with 30 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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