Commodity Markets Council Europe (CMCE)

8 December 2022

Statement on the negative implications of the proposed market correction mechanism

CMCE appreciates that the EU Member States Governments are ready to work with the European institutions to introduce measures which would alleviate the burden stemming from the unprecedented situation in the European energy markets.

CMCE strongly agree with recent European Commission's statements pointing to the direction that market developments in the price of gas are primarily caused by the geo-political situation. In fact, the price of gas in Europe is high because of an imbalance between demand and supply caused by reductions in the usual quantities of natural gas imported into Europe by pipeline from Russia and mandated gas purchases by member states to replenish storage supplies ahead of winter.

Additionally, lack of access to LNG cargoes due to lack of LNG terminals as well as limited connectivity between the EU markets worsened the situation as global gas supplies could not reach the markets where reduction of Russian gas was the most. Since then, considerable measures have been taken to improve access to LNG and improve market connectivity.

In this context, we are aware of the current discussions in Brussels based on the recently published European Commission draft measures to address the energy crisis in Europe and, in particular, the proposed market correction mechanism related to gas. In this statement we would like to point out our **serious concerns about the development of such a mechanism**.

Put simply, we believe that the proposal for a market correction mechanism will not achieve its primary objective of lowering energy prices but will increase them because it creates a more costly market mechanism, while introducing risks to financial stability in Europe and seriously threatening the EU's security of supply. Further, it will leave Europe without access to the necessary marginal volumes that so far it has been able to attract on the global LNG market. For all practical purposes, such proposal would be counterproductive and is likely to exacerbate Europe's energy crisis.

1. **A price cap risks increasing demand and reducing supply**. Artificially lowering the price of gas would weaken the EU's ability to secure supplies from international markets that are prepared to pay more worsening the supply shortage. This would exacerbate EU difficulties in obtaining access to gas deliveries from the international markets. Further, as seen with the Iberian example earlier this year, a capped price will reduce the incentive to save energy at the times when it is most valuable. The consequence could be higher gas consumption.

2. A price cap may trigger the **renegotiation of long-term contracts**, which **would increase prices** at the worst possible time. In this context, it would be also likely to see sellers start to incorporate clauses to void contracts and therefore divert LNG supply away from Europe if better

price elsewhere. This would increase legal risk for market participants as well as defeats the purpose of securing supply of gas to Europe.

3. Artificially capping natural gas prices would entail a **significant impact on the financial markets and businesses' ability trading in physical commodities** to hedge future prices through the use of derivatives. If a cap is in place, it needs to be noted that liquidity will begin to shift away from the exchange to the OTC bilateral market or exchanges outside of the EU27 as participants will not want to manage price exposures across a disrupted market. Impaired price signals will impact the CCP's and clearing banks' risk management which will trigger a significant increase in margins. This by no means aims to say that an extension of the scope to OTC trading is recommended. An extension to the OTC markets would simply cripple Europe's ability to pay the right price for the commodity which is vital for the European citizens and companies.

4. A cap on natural gas prices at European trading venues may drive **price formation to other options outside the EU**. This means that the prices ultimately paid for gas by consumers and businesses will not be capped at the level envisaged by the market correction mechanism. As a consequence, if market participants exit the market due to the uncertainty a cap introduces, **liquidity in energy derivatives will be reduced so that increased volatility will lead to more costs being incurred due to higher margin costs** as well as wider bid-offer spreads to reflect the increased risk.

5. **Volatility will increase as financials will be disincentivised to hold positions into the prompt period** (subject to the bidding limit). Financial firms such as hedge funds or market makers that are a good source of liquidity for hedgers are not set up operationally to go to delivery. Therefore, any financial entities that are short TTF heading into the prompt period are going to be incentivised to bid up the index to close out their position, or else risk hitting the bidding limit and not being able to close out their positions. This is likely to increase volatility and pricing pressure rather than reducing it, at the same time as reducing liquidity in the market.

6. **LNG producers and sellers will be disincentivised from using TTF as a reference price** if they are not able to achieve fair value for their product. This in turn is likely to reduce LNG supplies delivered into Europe and thereby lead to increased energy costs.

It is our understanding that the proposed mechanism fails to consider the above issues. As the EU has now secured enough gas to see it through this winter season, we would urge the European Commission to allocate time for an appropriate **ex-ante assessment** undertaken by different EU Institutions and bodies responsible for energy and for financial stability before the legislation enters into force.

About Commodity Markets Council Europe (CMCE)
CMCE is the only association in Europe representing the range of commodity market participants - agriculture, energy, metals and other commodity market participants, benchmark providers, price reporting agencies, and trading venues operating in the EU, EEA, Switzerland and neighbouring countries. The majority of CMCE members use commodity derivative markets to hedge the risks related to their physical activities and assets. CMCE's key purpose is to engage with policymakers and regulators to promote liquid and well-functioning commodity derivative markets in Europe.