Outline of a gas market correction mechanism[1]

With a view to submitting a legal proposal for a gas market correction mechanism to the TTE-Council, this paper describes the main elements of such a legal proposal, which will constitute an essential part of the Commission's crisis response. The proposed market correction mechanism builds upon Articles 23 and 24 of the proposal for the Council Regulation *Enhancing solidarity through better coordination of gas purchases, exchanges of gas across borders and reliable price benchmarks* of 18.10.2022 ('October Proposal').

Based on the Conclusions of the European Council of 21.10.2022[2] and the safeguards in Article 23(2) of the October Proposal[3], the Market Correction mechanism needs to meet two basic criteria:

(i) act as an effective instrument against excessive and episodes of extraordinarily high gas prices and
(ii) be activated only if prices reach exceptional levels (compared to global markets), in order to avoid significant market disturbances and disruptions of supply contracts, potentially resulting in severe security of supply risks.

Past evidence, such as the exceptional price hike evidenced in the month of August 2022, may provide guidance to define price levels at which a market correction mechanism could be triggered.

The proposed mechanism consists essentially of a safety ceiling for the price of month-ahead TTF-derivatives ('TTF-price'), which plays a key role as a reference price in the European wholesale gas market. The ceiling is activated if the TTF-Price basis reaches a pre-defined level *and* if the price hike does not correspond to a similar hike at world market level (comparison with LNG prices).

In order to ensure an immediate effect, it is proposed that the values to trigger the mechanism should be fixed upfront, so as to avoid lengthy decision-making procedures which could significantly delay its activation and the intended price-dampening effect.

With a view to possible changes in the market situation, and to be able to react to possible unintended negative consequences of the price limit, efficient safeguards should be built into the proposal to guarantee that the mechanism can be suspended at any time if it were to lead to serious market disturbances affecting security of supply and intra-EU flows. The price limit would be automatically deactivated if a monthly review shows that the conditions for its activation are no longer present. Compliance with EU demand reduction targets should also be taken into account when assessing the effects of the mechanism.

The table below sets out the main elements of the mechanism:

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[1] This outline aims to serve as a basis for further discussion of the mechanism at issue.

[2] See recital 18 of the Conclusions of 20/21.10.22:
"The European Council calls on the Council and the Commission to urgently submit concrete decisions on the following additional measures, as well as on the Commission proposals, having assessed their impact notably on existing contracts, including the non-affectation of long-term contracts, and taking into account the different energy mixes and national circumstances: (…)
c) a temporary dynamic price corridor on natural gas transactions to immediately limit episodes of excessive gas prices, taking into account the safeguards set out in Article 23(2) of the draft Council Regulation proposed on 18 October 2022;"

[3] Art. 23(2) of the October Proposal provides that a future market correction mechanism shall comply with the following safeguards: be without prejudice to over-the-counter gas trades; not jeopardise the Union's security of gas supply; depend on progress made in implementing the gas savings target; not lead to an overall increase in gas consumption; be designed in such a manner that it will not prevent market-based intra-EU flows of gas; not affect the stability and orderly functioning of energy derivative markets; and take into account the gas market prices in the different organised market places across the Union.

Design Element	Description of legal proposal
What is capped?	**TTF month-ahead products** (as opposed to targeting spot / day ahead products, which would involve higher risk for liquidity of short-term markets & security of supply)
Level of ceiling	**Pre-fixed maximum price level: € [XXX]**
Static/dynamic ceiling?	**Static ceiling**, but *dynamic elements*: monthly review, leading to de-activation, if elements triggering ceiling no longer applicable; suspension mechanism *at any time* if unintended security of supply/financial market problems
Over the counter (OTC) trading capped?	**No** (arg.; OTC cannot be effectively monitored; 'safety valve' in terms of security of supply)
Trigger/activation:	Trigger with two conditions: 1. Month-ahead TTF above €[XXX.-] for [X] week(s) *and* 2. Spread between spot TTF and basket of spot LNG prices above € [XXX.-] for [x] days
Further political decision to activate mechanism (e.g. Council decision)?	**No** In order to provide certainty for markets and to guarantee an immediate effect, no delay between the price hike and the activation, with safeguards /suspension mechanism built in for the case of unintended consequences.
Dynamic element/ duration of ceiling	**Safeguard conditions corresponding to the current conditions under Article 23 (2)** **1. Monthly control points:** Verification if ceiling still justified, conditions still apply (e.g. spread LNG vs. TTF); **2. "Plug"/suspension mechanism:** Immediate suspension at any point in time by Commission decision if unintended market disturbances affecting security of supply (e.g. emergency/rationing) and intra-EU flows (=> see elements from Art. 23(2) of the October Proposal).
Monitoring/supervision	Close monitoring by Commission, with support from ACER, ECB, ESMA and competent authorities under Security of Supply Regulation
Duration of measure	1 year; must be temporary, as based on Article 122 TFEU

Advantages and risks

Advantages

Impact on prices and deterrence of future speculative behaviour

- The Market Correction Mechanism can limit temporary episodes of excessive prices as experienced in August 2022. It is not a tool to structurally lower the level of prices, which can only be achieved by additional supply-side and demand reduction measures.
- The establishment of a maximum price ceiling can have the positive effect of impacting price expectations for the future, limiting possible future speculative behaviours, and lead to an adjustment in the behaviour of market participants
- It may prevent that a limited number of marginal market players (with exceptionally low-price elasticity) set the price for all.

Improve market certainty

- If tailored to well-defined temporary episodes of excessive prices, and communicated in a transparent way with sufficient lead-time, the impact on markets and contracts, including futures, may remain limited.

Security of supply safeguards

- Comprehensive set of safeguards, allowing for the suspension of the mechanism at any time if undesirable effects on the economy (ranging from security of supply to financial stability) are observed, see criteria of Art. 23(2).
- Possibility for markets to conclude still either bilateral or over-the-counter (OTC) transactions when mechanism is activated to prevent security of supply issues by helping to ensure the balancing of markets. Over the counter trading would be very difficult to monitor.

Disadvantages

Trading

- Move to OTC trading. OTC trading is less transparent and implies greater risks of defaulting on obligations for the parties involved. OTC trading may only be accessible to large and better financed firms. Risk of gas trading moving to off-exchange markets not subject to the mechanism and supervision / regulation.
- Depending on the level of a price ceiling, it might limit hedging possibilities for traders, which might consequently seek hedges in other jurisdictions; an intervention could result in the clearing counterpart needing to rebalance the cash underpinning derivatives positions to reflect the capped settlement price (triggering margin calls).
- Unless set at a high enough level, the ceiling could prevent the formation of a futures curve, affecting the functioning of derivatives markets. Some market participants, including energy firms, could face difficulties in meeting margin calls and liquidity constraints, potentially resulting in defaults. Some actors (in particular smaller ones) could no longer hedge their positions further exacerbating volatility in spot markets, resulting in possibly higher price spikes.

Security of supply

- If not respecting the condition that the ceiling should be higher than the global prices for LNG, it could have an impact in attracting cargoes into the EU.
- Futures serve as a reference for long-term investments. Low ceilings could hamper longer term security of supply.
- Security of supply issues due to gas providers potentially withholding supplies when ceilings activated to maximise profits by selling just after the de-activation of the ceilings.
- Ceilings on futures market is likely to lead to less forward trading; could increase stress on the spot market and increase overall price volatility. This may make it harder for the relevant players to maintain the gas system in balance.

Market Correction Mechanism - possible text elements

Article [X]

Market correction mechanism

(1) To limit episodes of excessive natural gas prices which are unrelated to prices at other gas exchanges, a temporary market correction mechanism shall apply to the front-month TTF derivative settlement price as of 1.1.2023.

(2) The market correction mechanism shall apply where

(a) the front-month TTF derivative settlement price exceeds € [XXX] for [x] week(s) and

(b) the TTF European Gas Spot Index as published by the European Energy Exchange (EEX) is € [XX] higher than the LNG benchmark or, for the period before the LNG benchmark pursuant to Article 19(1) of Council Regulation (EU) [XXX/2022] is published, the reference price during the last [x] trading days before the end of the period referred to in subparagraph (a) ('market correction event').

(3) ACER shall, after consulting ESMA, notify the Commission without delay where it considers, based on the information it receives pursuant to Regulation (EU) No 1227/2011, Commission Implementing Regulation (EU) No 1348/2014 and Articles 18 to 22 of Council Regulation (EU) [XXX/2022] that a market correction event has occurred. Upon such notification, the Commission shall without delay publish a notice in the *Official Journal of the European Union* that a market correction event has occurred ('market correction notice').

(4) Orders for front-month TTF derivatives with prices above € [XXX] may not be executed as from the day after the publication of a market correction notice ('bidding limit').

Article [Y]

Monthly review and suspension of the Market correction mechanism

(1) ACER shall constantly monitor whether the conditions referred to in Article [X] are fulfilled, based on the information it receives pursuant to Regulation (EU) No 1227/2011, Commission Implementing Regulation (EU) No 1348/2014 and Articles 18 to 22 of Council Regulation (EU) [XXX/2022]. In case the condition referred to in Article [X](2)(b) is no longer met during [x] consecutive trading days before the end of the month after the market correction event, it shall, after consultation of ESMA, notify to the Commission that the condition referred to in Article [X](2)(b) are no longer met ('deactivation event'). Upon reception of this notification, the Commission shall publish a notice in the *Official Journal of the European Union* that a deactivation event has occurred ('deactivation notice').

(2) The Commission shall, by decision, suspend the market correction mechanism, if unintended market disturbances occur, negatively affecting security of supply and intra-EU flows ('suspension decision'). In the assessment, the Commission shall notably take into account if the continued activation of the market correction mechanism

(a) does not jeopardise the Union's security of gas supply, which is deemed to be the case if the Commission has declared a regional or Union emergency pursuant to Article 12 of Regulation (EU) 2017/1938;

(b) does not occur during a period where the mandatory demand reduction targets pursuant to Article 5 of Council Regulation (EU) 2022/1369 are not met at EU level, does not negatively affect the progress made in implementing the gas savings target pursuant to Article 3 of Council Regulation (EU) 2022/1369, and does not lead to an overall increase in gas consumption, on the basis of data on gas consumption and demand reduction received from Member States pursuant to Article 8 of Council Regulation (EU) 2022/1369);

(c) does not prevent market-based intra-EU flows of gas according to ACER monitoring data,

(d) does, on the basis of a report on the impact of the activation of the market correction measure by ESMA and an opinion of the European Central Bank for that purpose, not affect the stability and orderly functioning of energy derivative markets;

(e) takes into account the gas market prices in the different organised market places across the Union and

(f) does not affect existing long-term gas supply contracts.

(3) A suspension decision shall be published in the Official Journal of the European Union. From the day following publication of a suspension decision, and for as long as specified in the suspension decision, the bidding limit referred to in Article 23(4) shall cease to apply. From the day following publication of a deactivation notice, the bidding limit referred to in Article 23(5) shall cease to apply.

(4) ACER, the ECB and ESMA shall assist the Commission in the tasks pursuant to Article [X] and [Y].

(5) The market correction mechanism shall apply only for as long as this Regulation is in force.

Article [Z]

Definitions

(1) ‘front-month TTF derivative’ means an energy-related derivative traded at a trading venue as defined under Directive (EU) 2014/65, whose underlying is a transaction in the Title Transfer Facility (TTF) Virtual Trading Point, operated by Gasunie Transport Services B.V, and whose expiration date is the nearest among the derivatives with a one-month maturity traded on a given trading venue;

(2) ‘reference price’ means the average price of the price of the LNG assessments “Daily Spot Mediterranean Marker (MED)” and “Daily Spot Northwest Europe Marker (NWE)”, published by S&P Global Inc., New York.

Final Article

Entry into force /review

This Regulation shall enter into force on the day following that of its publication in the Official Journal of the European Union. It shall apply for a period of one year from its entry into force. By [XX.XX.2023] at the latest, the Commission shall carry out a review of this Regulation in view of the general situation of the gas supply to the Union, and present a report on the main findings of that review to the Council. The Commission may, based on that report, propose to prolong the validity of this Regulation.