



Denmark's position paper on systemic risks

Denmark's main priorities in relation to ensure an electricity and gas market fit for future crisis and increased price volatility

- Important to moderate the European companies' risk appetite in order to ensure a higher security of supply by avoiding cascade bankruptcies.
- Due to the cross-border nature of the electricity market, a European-wide regulation would be most suitable to ensure the European security of supply.

2022 was a special year for the European energy markets. Europe experienced not only extreme prices, especially in the autumn, but also high volatility and significant price differences. This led to a situation where some market actors experienced substantial earnings and losses. On the backdrop of this experience, it would be relevant to assess whether it could be relevant to regulate the sector, in order to make sure that the risk-taking of market participants trading energy in the electricity and gas markets does not constitute a risk for security of supply and the broader financial system.

Background

Increased volatility in the energy markets can lead to increased exposure to economic losses due to, for example, insufficient hedging or higher liquidity requirements for companies. It can also provide incentives for increased risk-taking especially among companies that are active in energy trading due to the possibility of extraordinary high profits.

A number of energy trading companies have (legitimately) generated significant profits from trading energy on European markets during the energy crisis. However, it is currently unclear to what extent those profits were gained through 'smart decisions' underpinned by resilient risk management or risky decisions that could have led to bankruptcies, and even could have impacts beyond the companies themselves. The very large profits have also led to significant remuneration (including bonus-es) in certain companies. As the electricity and gas markets are cross-border markets, participants based in one member state, may be active in several other member states. Therefore, bankruptcies of market participants based in one member state may influence security of supply in other member states. This also apply to the generation of profits, where market actors, even though based in one member state, trade on various markets and thereby generate profits. Handling bankruptcies, thus, must be seen in a pan-European context.

In itself, individual bankruptcies are not necessarily a problem for the energy market. In most cases, this could be handled by the existing regulation, e.g. in provisions addressing situations where a balancing responsible party with control over electricity production enters bankruptcy proceedings. Those provisions intend to ensure that, initially, the bankruptcy of one actor with electricity production will not have any impact on security of supply. The question is, whether these systems can handle the consequences of significant cascading effects if major suppliers or balance-responsible parties, for example, go bankrupt or for other reasons leave the market.

Moreover, a significantly sized company under bankruptcy can experience a decline in employees, including those with control over electricity production. Furthermore, it may struggle to procure parts, fuels, and other necessities to maintain operations. If the electricity system is already operating at its limits, a bankruptcy affecting a larger portion of the market could potentially affect not only electricity prices but also security of supply. Also, bankruptcy of significantly sized companies might lead to termination or bankruptcy of other companies within the energy sector challenging the intentions of the provisions of the existing legislation and the market participants itself.



Similarly, it can affect security of supply if a very large balancing responsible party or several companies exposed to the same risk go bankrupt. This would entail a risk that the consumption of end-users cannot be covered, as not all customers of the balance responsible party can be taken on by other balance responsible parties. This could result in market imbalances, which ultimately could lead to issues with security of supply.

Balancing responsible parties' and other energy trading companies' bankruptcy can potentially also have broader effects on the energy market. This begs the question whether a situation with large or many bankruptcies in the energy market could, in addition, also cause cascading effects on the financial market.

Further assessments of this are, however, needed in order to gain more knowledge about what consequences risk exposure of balancing responsible parties and other energy traders can have for bankruptcies in the energy sector, and whether – and if so, how – it can affect security of supply and financial stability.

Potential need for more regulation: Where could we look for inspiration?

In case there is a need to further regulate the energy sector, it would be relevant to look beyond those measures, already in place, to address the risk of bankruptcies. It would therefore be relevant to look specifically into whether a case could be made for introducing regulation of systemic risks inspired by what applies in the financial sector. It is clear that the energy sector shares similar characteristics as the financial sector in terms of presence of systemic roles, societal importance, product types, and markets.

The former financial crisis showed that if banks and similar institutions were not adequately cushioned against unexpected losses, it could threaten their existence and have significant consequences for the wider society. On that basis, a number of regulatory measures were introduced at EU level. They include mechanisms to secure the continuation of business towards the customer, capital requirements and capital buffers to ensure that the sector's actors have sufficient capital to absorb large losses, as well as liquidity requirements to ensure that companies can meet their obligations in the short term. Such types of requirements aim to increase the resilience of banks and reduce systemic risks.

Another area that has special regulation to cater for its broader importance is private insurance, as this area is not as heavily regulated as the financial sector due to less exposure to 'bank runs'. It would therefore also be relevant to look into the possibilities to draw inspiration from regulation of this particular business.

Furthermore, new rules and guidelines have been introduced in European legislation that addresses earnings of management and other relevant employees in financial sector companies following the financial crisis. This ensures that their remuneration policy is in line with and promotes sound and effective risk management, including specific requirements and frameworks for variable remuneration that must not conflict with risk management considerations and the financial robustness of the company. It should be considered whether similar requirements could make sense to introduce in the energy sector.

Need for more analysis?

A task force has been established in Denmark with participation of relevant authorities. Over the coming months the task force will be analysing those questions and if relevant give advice on the potential need for more regulation of the energy markets in order to make them fit for future crisis and increased volatility.

It would, however, also be relevant at European level to look into defining systemic risks and actors in the electricity and gas sector, and uncover whether systemic risks exist in the European electricity and gas sector. Energy trading takes place across borders on the internal energy market, and European legislation will be necessary if systemic risks exist cross border.

