

## **ACER Consultation on forward risk-hedging products and harmonisation of long-term capacity allocation rules**

### **ENTSO-E Response**

ENTSO-E welcomes this public consultation as a valuable opportunity for all stakeholders to provide their views on the evolution of European markets for long term capacity allocation and for forward risk hedging products.

We believe that the results of the consultation will provide useful input to both ENTSO-E work on the Forward Capacity Allocation Network Code and to ACER's work on implementing the Cross-regional Roadmap for the European Platform for the Allocation of Long-Term Transmission Rights.

Here below we include our specific response to some of your public consultation questions.

**1. Are there other products or options which are not considered in this document that would be worth investigating?**

In the ENTSO-E Educational Paper<sup>1</sup> all relevant options/products for cross border risk hedging on energy markets were discussed. Consequently, at present we do not see any other products which should be further investigated.

**2. What will be the importance of the long-term Target Model and specifically the design of the forward market and the structure of long-term hedging products once the Day-Ahead and Intraday Target Models are implemented? Do you think your interest and demand for long-term hedging products will change (either increase or decrease) with the implementation of the Day-Ahead and Intraday Target Models? More specifically, what is your interest in cross-border/zone hedging?**

We believe that the implementation of the target model for forward markets across Europe will add a fundamental building block to the completion of the Internal Energy Market. Long term markets will benefit from more integrated and better functioning day-ahead and intraday markets and vice versa. As liquidity increases and price formation becomes more robust, markets will be more transparent, reliable and further trusted by consumers, investors and regulators.

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<sup>1</sup> Transmission Risk Hedging Products – An ENTSO-E Educational Paper, June 2012.  
[https://www.entsoe.eu/fileadmin/user\\_upload/library/consultations/Network\\_Code\\_CACM/20120619\\_Educational\\_Paper\\_on\\_Risk\\_Hedging\\_Instruments\\_review5.pdf](https://www.entsoe.eu/fileadmin/user_upload/library/consultations/Network_Code_CACM/20120619_Educational_Paper_on_Risk_Hedging_Instruments_review5.pdf)

The role of day-ahead market coupling will be particularly important for long term transmission hedging products. While day-ahead prices will converge more and more, hedging needs of consumers and producers increasingly active across EU borders will still result in a high demand for long term hedging products.

More liquid and integrated day-ahead markets will also facilitate an increasing use of financial or combined physical/financial<sup>2</sup> types of transmission hedging products compared to physical rights, due to more confidence in the underlying price formation mechanisms.

Lastly, the demand for transmission rights and the level of price differentials between bidding zones, if prolonged over time, may provide some additional signals<sup>3</sup> to TSOs and producers where investments in additional transmission capacity and power plants may be needed.

- 3. Would long-term hedging markets need to evolve (e.g. in terms of structure, products, liquidity, harmonisation, etc.) due to the implementation of: 1) the day-ahead market coupling, 2) day-ahead flow-based capacity calculation and 3) occasional redefinition of zones? If so, please describe how these changes would influence your hedging needs and strategy. If no evolution seems necessary, please elaborate why. Can you think of any striking change not considered here?**

No answer to sub-questions 1 and 2.

Regarding question 3, the Framework Guideline Capacity Allocation and Congestion Management requires that zones which are defined for long term products need to be consistent with zones defined for other timeframes.

- 4. What is for you the most suitable Long-Term Target Model (combination of energy forwards and transmission products) that would enable efficient and effective long term hedging? What would be the prerequisites (with respect to the e.g. regulatory, financial, technical, operational framework) to enable this market design in Europe? Which criteria would you use to assess the best market design to hedge long-term positions in the market (e.g. operability, implementation costs, liquidity, efficiency...)?**

Within the evaluation of different long term risk hedging products, pros and cons of each product have been analysed within ENTSO-E resulting in the following conclusions:

- Appropriate cross-border financial hedging in liquid financial markets on both sides of interconnectors gives market participants sufficient opportunities to hedge their risks.
- High degree of harmonisation is important for the creation of a unique European market, but regional specifics (including market participants needs) still need to be considered.
- Creating a fully harmonized market with the same product on all borders would require some time and adequate deadlines for all the regions.

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<sup>2</sup> Such as PTRs with Use It or sell It Option.

<sup>3</sup> Price signals, however, can only cover few years in the future and thus only integrate more detailed and longer term analyses such those performed by TSOs in publications such as the Ten-Year Network Development Plan and the System Adequacy Forecasts

- On borders where no/different hedging instruments or PTR + UIOSI exist a step towards FTR options is recommended, provided they are requested by the market and that TSOs and Auction offices are exempted from MiFID II.
- The overall target model for forward markets cannot be defined in detail yet. A step towards FTRs options might not be the “end of the game”. Always considering regional markets’ needs, a development towards financial cross-border hedging is a possibility in the long-run.

The analysis showed that an important advantage of FTR options is that all available capacity is offered to the day-ahead market and allocated implicitly. This enhances efficiency in the use of interconnection capacity and improves day-ahead market liquidity. On the other hand, an important advantage of PTRs is that they give market participants the option to choose between the physical and financial use of the transmission right. Further they are already widely implemented on most European interconnections, therefore easing market coupling issues. In case the target model envisages PTRs, these shall always be subject to the use-it-or-sell-it provision.

Regarding FTR obligations ENTSO-E’s analysis showed that several prerequisites would have to be met, additional to those in the case of PTRs or FTR options. Since with FTR obligations market participants have to pay TSOs and therefore, TSOs face a higher counterparty risk. Therefore reliance on a financial institution would be necessary in order to guarantee the financial settlement (e.g. through clearing houses). Moreover, netting of FTR obligations introduces the counterparty risk as the payment from market participants resulting with a payment obligation is needed to compensate market participants with the right for remuneration. It is also very questionable if netting is possible, since market participants’ price expectations tend to be similar. In general detailed netting policies would have to be defined to enable the positive effects of netting. These netting policies should also be coordinated with the risk policy of the financial institution in charge of settlement.

Regarding the regulatory framework, we see three areas where an adequate regulatory regime is essential in order to implement a suitable long term target model:

In case the target model envisages the implementation of FTRs allocated by an auction platform, it is important that the entity(ies) who issue or allocate these products are exempted from MiFID2. In case TSOs and auction platforms have to comply with the provisions of MiFID2, their costs will increase as compliance with financial regulatory provisions contained in MiFID 2 would have to be ensured. Depending on the cost recovery scheme, this will result in higher prices for either market participants (if participation fees would be increased due to compliance costs) or end consumers. In the case of FTRs in the electricity market, these higher costs will not be offset by any increase in competition or better consumer protection, the rationale for introducing MiFID2.

Secondly, the regulatory framework needs to establish how long term transmission rights are handled in case of changes in the delimitation of bidding zones, during the duration of the transmission product.

Thirdly, in order to enable TSOs to give optimal capacity to the market, the regulatory framework has to ensure that firmness rules are such that TSOs’ timely cost recovery is not jeopardised. This implies that the compensation to market players in case of curtailments

must not exceed TSO revenues from congestion management for a defined period of time whose duration is to be agreed with NRAs.

Finally, ENTSO-E wants to emphasise the following issues:

- The distribution of Congestions Rents within the flow-based regime, which in turn influences the financing of FTR options (as for PTR+UIOSI), is an issue yet to be solved (compliance of FTRs and the DA target model is essential).
- Hub-to-hub trading of FTRs involving several borders implies additional complexity and potential risks that need further analysis before finding appropriate solutions. Financial products provided by financial market players might be explored as an alternative approach.

**5. What techniques of market manipulation or “gaming” could be associated with the various markets for hedging products? What measures could in your view help prevent such behaviour?**

We believe that potential gaming or market abuse issues by market players are best addressed by an appropriate regulatory framework (e.g. REMIT, MAD or competition law) and effective monitoring and enforcement by regulatory authorities and ACER. Penalties for violating rules and/or gaming should be well defined, credible and proportional to the impacts of the inappropriate behaviour. As a general principle, more liquid and integrated wholesale markets, supported by an appropriate level of transparency and regulatory oversight, will limit significantly the possibilities of such behaviour.

In case it is assessed that gaming opportunities are facilitated by loopholes in the market rules, it must be possible for TSOs to amend the rules with the full support of regulatory authorities in a timely and coordinated way, as soon as the loopholes have been identified (see also answer to question 6 about the modification and amendment of the rules).

**6. Would you like to change, add or delete points in this wish-list? If so, please indicate why and how.**

***Format of Auction Rules***

- TSOs see two main potential issues of incorporating border or country specific provisions into the main body of the Auction Rules: 1) The main body of auction rules may become too long. 2) The amendment and approval procedure of the auction rules will become more difficult, as the identification and separation of issues specific for one border/country will be more complicated.

***Modification of Auction Rules***

- In legal terms Auction Rules represent a contract between “Auction Office” and “Auction Participant”, which has to be approved by NRAs. Currently the responsibilities are separated as follows: TSOs draft and amend auction rules (taking into account market actors’ needs upon consultation). NRAs approve them or request modifications, which are in turn incorporated by the TSOs. We expect this procedure to continue in the future.
- TSOs welcome that NRAs with the support of ACER strive for intensifying the coordination regarding Auction Rules development. This coordination and a further alignment of processes and requirements on NRA side are essential to ensure an effective and efficient development and approval procedure.

***Fall-back for day-ahead market coupling***

- According to the Network Code Capacity Allocation and Congestion Management, system operators develop fallback procedures for day-ahead market coupling in collaboration with nominated electricity market operators (NEMOs) and market coupling operators (MCOs). Inclusion in the auction rules of such procedures depends on the options to be chosen for auction rules harmonization.

***Fall-back for allocation of long-term capacity rights***

- Long-term auctions are usually not that critical in terms of timing. In case there are technical problems to perform a long-term auction, the auction can be postponed. Fallback procedures could be however maintained, for cases when postponement may be problematic due to a busy auction schedule (e.g. December: yearly, monthly auctions...)
- For long-lasting (several days) problems with internet or email, alternative ways of communication may be considered.

***Nomination agents***

- Delegation of nomination tasks to another entity may require major adjustments in TSOs' IT systems and processes. This should only be aimed at if a) PTRs will be maintained in the future and b) market players' benefit from the delegation outweighs TSOs' costs.

***Recovery of payments:***

- TSOs welcome the opportunity to obtain an overview of market participants' preferences regarding collaterals through this consultation.
- However, the purpose of collaterals is, firstly, to protect TSOs and Auction Offices from financial risk in the case of non-payment by a market participant. Secondly, the requirement of collaterals ensures a healthy and fair competition by preventing market participants to speculatively bid for more capacity than they could fund and thereby distort the allocation of capacity.
- Since the risk is simply determined by the due amount of a market participant and the settlement process itself, it is not reasonable to determine the amount of necessary collaterals depending on the way of providing the collateral.
- In the TSOs view the collaterals shall account for at least 2/12 of the total due amount of yearly capacity rights in order to be sufficiently secured against the settlement risk. A monthly post-settlement of yearly 1/12 would not be enough, since the non-payment for Month M can only be detected in the course of the following month (M+1). Consequently, a reallocation of the yearly capacity would practically only be effective from month M+2 and the rights for month M+1 would be delivered to the non-paying market participant. TSOs would not obtain any income.
- To conclude, decreasing the amount of required collaterals is not related to the question of bank guarantee or deposit, but to the question of redistribution of risk and reward between market participants and TSOs/end consumers.

***Duration and amendment of auction rules:***

- ENTSO-E supports the definition and introduction of processes for amendments. These processes are foreseen to be described in the Network Code on Forward Capacity Allocation.

- However, the idea to distinguish between core issues and other issues has to be thoroughly analysed, if the concept of one single document is followed. Due to interdependencies, we question in which cases NRAs may skip the approval of an amendment of auction rules, even if the amendment does not concern the respective border. Normally, the auction rules are approved as a whole document and not piecemeal or with exceptions, even in case of small amendments.

***Firmness of exchange programmes***

- According to the Framework Guidelines Capacity Allocation and Congestion Management, the capacity is firm for market participants. It is also stated that after the nomination deadline, the physical firmness is the preferred approach, but financial firmness may be accepted in case of explicit auctions. The harmonised set of rules should define when held capacity, whether PTRs or FTR options, becomes fully firm and which firmness applies.

**7. Which aspects of auction rules would be most valuable to be harmonised? Can you provide some concrete examples (what, when, where) of how this could help your commercial operation (e.g. lowering the transaction costs)?**

No answer.

**8. Which elements of auction rules have regional, country specific aspects, which should not be harmonised?**

No answer.

**9. Which aspects should be harmonised in binding codes?**

Our understanding is that the Framework Guideline «capacity allocation and capacity management» defines which aspects should be established by the Network Code. In general, we believe that the requirements set out in the code should not be too detailed in order to allow future improvements in the market model and in order to reflect (changing) market needs. As for the CACM NC, we aim at providing a sufficient degree of regulatory guidance – with more detailed requirements and methodologies to be proposed and later approved by NRAs - without incurring a constant need for amendments of the Network Code text.

**10. If you are to trade from the Iberian Peninsula to the Nordic region and there existed PTRs with UIOSI, FTR Options or Obligations and CfDs in different regions – what obstacles, if any, would you face? How would you deal with them?**

No answer.

**11. Would allocating the products at the same time represent an improvement for market players? Why? Where, if not everywhere, and under which conditions?**

No answer.

**12. How important is it that capacity calculation for the long-term timeframe is compatible and/or consistent with the short-term capacity calculation and that capacity is interdependent and optimised across different borders?**

The draft Network Code on Capacity Allocation and Congestion Management ensures this compatibility because both the flow-based approach and Coordinated NTC are compatible in this context. Both methods take into account interdependencies between borders, flow-based inherently and Coordinated NTC through sharing rules defined within the capacity calculation methodology. Some specificities of capacity calculation at the long term timeframes may be treated in the Network Code on Forward Capacity Allocation in order to ensure consistency in all timeframes. One needs to account for the fact that capacity calculation for longer term timeframes are naturally associated with more uncertainty.

**13. Please indicate the importance of availability of different hedging products with respect to their delivery period (e.g. multi-year, year, semester, season) for efficient hedging against price differential between bidding zones. What do you think of multiple-year products in particular?**

The timeframes and the design (reduction periods, base/peak) of long term capacity rights as well as the split of capacity between timeframes should be defined according to market needs. However, it must be noted that TSOs cannot allocate in total more capacity than there is physically available. This means: the more allocation timeframes or products, the less capacity can be allocated per timeframe. This may lead to less liquidity per time frame (assuming PTRs or FTRs are not obligations). Furthermore, the more into the future the product is allocated, the larger the associated uncertainties and hence the allocated product entails more risk of being reduced. Therefore, special compensation rules may become necessary in order to avoid TSO revenue inadequacy.

To ensure further hedging possibilities, financial market players can develop and offer products which are not related to the physical capacity such as CfDs. This includes products traded in financial markets like Nasdaq OMX, Endex etc. Liquid financial markets on both sides of bidding zone borders should be equally valid as the FTR /PTR when hedging possibilities are considered.

If it is envisaged for the future that the allocation of long term capacity rights is performed simultaneously and in a coordinated way (taking into account interdependencies), then a higher degree of harmonization among borders is required for the issues raised in questions 13, 14, 15, 16.

**14. What would be your preferred splitting of available interconnection capacity between the different timeframes of forward hedging products? Which criteria should drive the splitting between timeframes of forward hedging products?**

See answer to question 13.

**15. While products with planned unavailability cannot be standardised and harmonised throughout Europe, they enable TSOs to offer more long-term capacity on average than standardised and harmonised products would allow. Do you think these products should be kept in the future and, if so, how could they be improved?**

See answer to question 13.

- 16. Products for specific hours reflect market participants' needs. What should drive the decision to implement such products? How should the available capacity be split between such products and base load ones in the long-term timeframe?**

See answer to question 13.

- 17. Should this possibility be investigated and why (please provide pros and cons)? In case you favour this possibility, how should this buyback be organised?**

The buy-back of capacity by TSOs has nothing in common with secondary markets for market participants. While the latter is a means for traders to efficiently manage their capacity rights, TSOs would buy back capacity in order to maintain security of supply. In this context, we do not fully understand the relationship between the TSO buy-back mechanism and the firmness rules established by the Framework Guideline.

The capacity buy-back as a TSO measure implies a redistribution of money between end consumers and market participants (since a premium<sup>4</sup> for the buy-backs to market participants with respect to the expected market spread would need to be financed via tariffs and borne by end customers). We believe this is a political and regulatory question if this is desired.

Having stated this, we do not see how introducing a TSO capacity buy-back scheme would increase the overall efficiency of the market, facilitate system operation or contribute to achieving the internal market. Furthermore the buy-back of capacity implies a trader activity which is out of the core business of TSOs, and would cause higher costs (forecasting prices, etc) and risks for TSOs and thus end consumers. Therefore, we think this approach and its feasibility needs to be thoroughly investigated.

- 18. With the potential evolution from PTRs with UIOSI to FTR options, does the removal of the nomination process constitute a problem for you? If so, why and on which borders, if not on all of them?**

No answer.

- 19. How could the potential evolution from PTRs with UIOSI to FTRs on border(s) you are active impact your current long-term hedging strategy?**

No answer.

- 20. If nomination possibility exists only on some borders (in case of wide FTRs implementation), is it worth for TSOs to work on harmonising the nomination rules and procedures? If so, should this harmonisation consider both the contractual and technical**

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<sup>4</sup> As TSOs are obliged to publish unavailabilities of capacities between bidding areas, owners of the capacity right have full insight on the necessity of TSOs to buy back already sold capacities. This could determine an artificial increase of prices for buying back capacities.



**side? How important is such harmonisation for your commercial operation? Which aspects are the most crucial to be harmonised?**

ENTSO-E has analysed the different nomination procedures for long term products which are currently applied in Europe. With the exception of a few regions (e.g. CEE), the comparison shows a variety in gate opening and closure times, types of nominations and technical standards used for nomination.

ENTSO-E's conclusion is that harmonisation of the nomination procedures across Europe is possible. However, it will be time consuming and tie up both human and financial resources of both TSOs and market participants. Therefore, the priority of this harmonisation process needs to be assessed in relation to other existing projects and in relation to the target model, which might render nomination obsolete.

**21. Looking at the current features offered by the different auction platforms (e.g. CASC.EU, CAO, individual TSO systems) and financial market platforms in Europe, what are the main advantages and weaknesses of each of them?**

No answer.

**22. How do you think the single auction platform required by the CACM Framework Guidelines should be established and organised?**

The CACM Framework Guideline requires that the TSOs provide a single platform (single point of contact) for the allocation of long-term transmission rights (PTR and FTR) at European level. Therefore, depending on the outcome of MiFID it is the task of the TSOs or TSO designated entities (with TSOs remaining the only responsible entities in such a case) to establish and organise the single auction platform. The CACM Framework Guideline also provides that TSOs are to provide a single platform for anonymous secondary trading at the European level. The Network Code on Forward Capacity Allocation will define preconditions for the establishment and organisation of the single auction platform and determine the tasks associated with it. If possible, a single auction platform for both primary and secondary trading should be established.

**• How do you see the management of a transitional phase from regional platforms to the single EU platform?**

The CACM Framework Guideline provides that as a transitional arrangement, regional platforms may operate, as long as this does not hamper the improvement and harmonisation of allocation rules. The management of a transitional phase from regional platforms to the single auction platform will need to be cognisant of the regional specificities that exist between regional markets and the time required to phase out regional platforms for a single auction platform.

**• Should current regional platforms merge via a voluntary process or should a procurement procedure be organised at European Union level (and by whom)?**

The Network Code on Forward Capacity Allocation will define circumstances under which regional platforms would be allowed for a transitional period. Respective criteria should be based on a common set of TSO requirements, in order to minimise costs and ensure a transparent process. Therefore, existing platforms may evolve naturally into a common set-up. A procurement procedure could be applied if the voluntary process does prove infeasible. However, if a procurement procedure is required this responsibility will fall under the remit of the TSOs who are responsible for the establishment and organisation of the single auction platform and the tasks associated with it.

- **Should the Network Code on Forward Markets define a deadline for the establishment of the single European platform? If so, what would be a desirable and realistic date?**

The Network Code on Forward Capacity Allocation will define the preconditions of the single auction platform and the tasks associated with it. Before deciding on whether to define a date for the establishment of a single auction platform in the Network Code it would first need to be determined the extent of regional specificities and the time required to phase out the regional platforms and transitional arrangements in favour of a single auction platform with a single harmonised set of allocation rules.