

## Position Paper

# ACER Consultation on Forward Risk-Hedging Products and Harmonisation of Long-Term Capacity Allocation

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## Introduction

The German Association of Energy and Water Industries (BDEW) represents 1,800 members of the electricity, gas and water industry. In the energy sector, we represent companies active in generation, trading, transmission, distribution and retail.

BDEW welcomes the opportunity to answer on ACERs consultation paper regarding the design of forward risk-hedging products and the harmonisation of long term capacity allocation rules. The actual design of products that can be used for hedging between different price zones in Europe will have an essential effect on the acceptance and usage by market participants. BDEW is convinced that forward products that provide improved hedging possibilities will further promote the pan European trade of electricity and will lead to increased social overall welfare through cross-border competition also in the forward market. BDEW answers the questionnaire as follows:

## Questions

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

No, BDEW believes that ACER should focus on Physical Transmission Rights (PTRs) with “Use It Or Sell it”-obligation and Financial Transmission Rights (FTRs) designed as options, as they are the most common products for cross border forward trading in Europe. Contract for Difference (CfDs) are not cross-border hedging instruments as they hedge the local bidding area price in relation to a virtual system price.

#### Our understanding of the concepts:

*A physical transmission right designed as an option* gives the holder the right to use a particular transmission line, or set of lines, to transfer electricity from one location to another. In order to transfer the electricity the holder has to nominate the amount which he is transferring. The amount is limited to the PTRs he holds. If the holder nominates less electricity for transfer, remaining PTRs are sold at the market in case it is defined as UIOSI. The price is the price difference between the two locations. If there is no congestion the price of the PTR is zero. The total amount of PTRs is limited to the transfer capacity between locations. The nominated PTRs are netted in the market coupling process to ensure an efficient flow.

*A financial transmission right as an option* gives the holder the right to be compensated against price differences between two neighboring locations. The total amount of FTRs is limited to the transfer capacity between the two locations, so that hedging against price differences is limited to actual capacity. The design as an option allows the holder to be compensated if there is a positive price difference in the direction he has hedged.

*A contract for difference* can only be used in specific market design where a system price is implemented. Without such a system price, CfDs are not applicable. CfDs as a pure financial instrument are used to hedge price differences between price zones and the virtual system price without giving any access to another price zone and creating cross border competition.

The amount of CfDs is not limited to any cross-border physical transmission capacity to other price zones.

**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?**

BDEW believes the design of the cross-border forward market and the design of long-term hedging products will be crucial when the target model is implemented in Europe. BDEW believes it is important that the design of the forward market must be consistent to the day-ahead and intraday target model. The market design for hedging products must allow easy access for market participants in order to achieve high liquidity on forward markets which leads to efficient market results. No transmission capacity should be reserved for day-ahead, intraday or balancing activities. A maximum of cross border capacity should be offered on the forward market.

BDEW believes that the demand for long term cross-border hedging products will be influenced by the implementation of the target model. Market coupling results ideally in a single price signal in the day-ahead market for the coupled price zones. However, due to cross border capacity congestion, price differences will still occur. Hence, the need for long term cross-border hedging products depends on the price differences between price zones regardless if market coupling is implemented. Necessary conditions for price convergence under day-ahead market coupling are sufficient transmission capacity and liquid spot markets at the exchanges of the coupled price zones.

Cross border hedging products should allow market participants to compete across borders in forward power markets. BDEW believes the cross border hedging products should be consistent with the forward power products used within the price zones in order to offer these products in different price zones; this includes that e.g. the products are offered several years ahead.

**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?**

Long term hedging markets will develop further to the needs of the markets. However, it is essential that the market conditions are stable; e.g. risk of the redefinition of price zones would be detrimental to the liquidity.

Market coupling allows efficient use of cross border capacities in the day-ahead market. The implementation of flow based capacity calculation will theoretically use cross border capacity even more efficiently. BDEW expects that long term markets will take the development into account by providing the hedging products market participants need. Products and terms of structure are not fundamentally changed by the implementation of market coupling or flow based capacity calculation.

However, redefinitions of price zones would have a significant negative impact on the demand for hedging products. BDEW does not believe that occasional redefinitions of price zones are the best way to solve problems of the grid infrastructure and to deal with congestions.

In cases where price zones are redefined, there must be harmonisation with the contract times of currently traded hedging products and forwards. Otherwise this would have significant negative impact on the liquidity of forward markets and overall welfare.

**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...)?**

The overall goal for the design of a pan European forward market and the design for cross border hedging products is to foster competition on the electricity market. A transparent design should allow easy access to a foreseen platform for all market participants in order to increase risk management tools for market parties, which leads to high liquidity for hedging products at all borders of price zones.

**BDEW is convinced that the use of PTRs with UIOSI or FTRs designed as options qualifies best for cross border hedging needs in Europe.** Already today PTRs or FTRs are used to hedge forward contracts cross-border. Liquidity will also increase when the design of the products and the access to an auctioning platform are well designed. PTRs in combination with UIOSI – as foreseen by the CACM FG – are basically already a FTR (with option): If capacity holders decide not to use the capacity, the transmission right will be settled financially. We would recommend starting with PTRs; this makes also sense, as on the continental wholesale market the vast majority (> 80%) of forward products are physical products. If experience shows that market participants mainly opt for UIOSI, there should be a consultation with all stakeholders in order to assess whether there should be a change from PTRs to FTRs. It would be acceptable to the market to have FTRs within certain zones and PTRs in others. In any case, FTRs (with options) should be implemented, if there are liquid financial markets on both sides of the border and no transmission rights exist.

The clear advantage of PTRs or FTRs is that the amount of issued transmission rights is limited to the actual transport capacity. So the price for PTRs and FTRs is a true indicator for scarcity of long term transmission rights. BDEW believes that the concept of PTRs is a suc-

successful story, as on most European borders PTRs are already implemented. Thus, additional costs for the implementation of PTRs at all borders are low. Furthermore, BDEW sees a clear plus in the use of PTRs as they do not qualify as “financial instrument” under MiFID. Hence, requirements for market participants are kept adequate, avoiding entry barriers and leading to high liquidity and effective market results.

CfDs are only needed in the Nordic market, because of the specific market design and trading of a system price. Without such a system price, CfDs are not applicable. CfDs have no connection to physical transmission capacity to other price zones. CfDs as a pure financial instrument instead are used to hedge price differences between price zones and the virtual system price without giving any access to another price zone and creating cross border competition. Additionally, an implementation of CfDs in the EU might cause extra costs for clearing, margining or other securities due to financial regulation (MiFID). This obligation would have clear negative effects in the development of cross border forward markets and lead to a decreasing number of market participants, less liquidity and higher volatility in the market. Thus, BDEW is convinced that CfDs are not an instrument to be considered for markets not designed as in the Nordics.

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

BDEW does not believe that “gaming” is a specific point in the market for hedging products. Market abuse is prohibited by the EU-Regulation on wholesale energy market integrity and transparency (REMIT). Regulators already have several instruments in REMIT (and also in MAD/MAR) which allow for detailed monitoring of the bidding behaviour of market participants.

BDEW is convinced that the necessary measures are already implemented and that no further measures are needed.

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

BDEW believes the wish list gives a solid overview of the needs for cross border forward trading.

**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)?**

Harmonisation is essential to allow efficiency on pan European forward markets. BDEW believes that access rules, scheduling, billing, pricing models, character for deposit of securities, and the contact time of hedging products on the primary auction should be harmonized.

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

BDEW does not see a need for regional or country specific aspects.

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

BDEW believes that all aspects, defined in network codes should be crystal clear. The network code should encompass the timeline and changing procedures, to allow a flexible code, which can be changed to market needs. From today's perspective, BDEW believes that the network code should define access rules to the platform, prequalification rules and if necessary any deposit of securities.

**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 opinion.

**Questions regarding potential additional requirements**

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

BDEW believes that a clear and reliable auction calendar for long term capacity allocation is necessary. Closing times might differ between regions. Market participants need early information on the auction calendar in order to offer their bids on forward hedging products on the borders where they are active. The allocation calendar should be linked to other allocation calendars of other platforms, or even better a website should be implemented for central access to all existing allocation platforms.

**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?**

BDEW believes that all time frames for cross border capacity calculation should be consistent.

Cross border trading is based on a true physical asset, the cross border capacity of the grid. In order to allow market participants to develop expectations on possible capacities in the day-ahead or intraday timeframes, all borders should use an identical capacity calculation algorithm, at least within one region where market coupling is implemented (e.g. CWE). The

capacity allocation over all timeframes must ensure that a maximum of cross border capacity is allocated to the market. There should be no reservation of cross border capacity for day-ahead, intraday or balancing activities.

A maximum of cross border capacity should be allocated in the long term timeframe. Only remaining capacity which is not used in the long term time frame should be used for day ahead and after that in the cross border intraday market. If any cross border capacity is remaining after the closing of the intraday market, it should be used for balancing services.

**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?**

Currently energy companies in Germany use forward contracts to trade electricity in advance within a liquid timescale of up to three years. Referring the "Monitoring Report 2011" of the German energy regulator, trading quarterly forward products account 16%, trading yearly products account 57% and trading multiple-year products account 22% of total trading volume (OTC and Exchange). The remaining 5% of the volume is traded on day-ahead and intraday markets. Thus BDEW is convinced that all time frames are necessary to optimize hedging against price differentials between price zones. BDEW is convinced that a maximum of cross border capacity should be allocated for long term hedging as standardized multiple-year products. BDEW is convinced that hedging products on a multiple-year base are necessary to hedge price risks in the spot markets also across price zones. However, structuring of multiple-year hedging products into products of a shorter timeframes should be left to market participants who know best which shorter timeframes for hedging are needed.

**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?**

BDEW believes that a maximum of long term capacity should be offered on a multiple-year basis (e.g. 3-years forward hedging product). BDEW is convinced that structuring of long term products into products of shorter time frames (e.g. yearly hedging products) could be done by market parties on the secondary market. Market participants know best which timeframes for forward hedging products are needed.

**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?**

BDEW believes long term contracts should be released as firm PTR or FTR products, so that standardized and harmonized products are possible across Europe, without any limitations to

necessary maintenance activities on the cross border lines. BDEW believes that TSOs should be able buyback capacity on a secondary market in a transparent way or compensate if the issued hedging product is a FTR in order to allow for necessary maintenance. This also means that TSOs have to publish all data concerning planned maintenance and unavailability on a central platform (ENTSO-E Transparency platform).

**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?**

No, BDEW believes that market participants should be allowed to structure products to their needs.

**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?**

Yes, TSOs should have the possibility to buyback capacity. However, BDEW sees it as essential to publish outages and planned non-availability of interconnectors. The rules for the buyback procedure should be transparent.

**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?**

PTRs with UIOSI are needed at borders where liquidity in the respective bidding zones is low. PTRs can give market participants more flexibility and make cross border trading more reliable.

**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?**

The key indicator for the evolution should be liquidity. As PTRs with UIOSI have basically the same characteristics as FTRs (if designed as options), BDEW sees currently no essential obstacles for an evolution towards FTRs. However, market parties should be consulted before a change from PTRs to FTRs is implemented.

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

BDEW believes that market participants have an interest in harmonisation of nomination rules. Using FTRs makes nomination obsolete, so harmonisation on this procedure might be obsolete as well. However as long as PTRs are still in use, harmonisation should be aimed for. This harmonisation process should be started early. So when switching from PTRs to FTRs the harmonisation process concerning contractual and technical issues is already accomplished.

**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?**

- **How do you see the management of a transitional phase from regional platforms to the single EU platform?**
- **Should current regional platforms merge via a voluntary process or should a procurement procedure be organised at European Union level (and by whom)?**
- **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?**

BDEW is convinced that harmonisation and establishment of a single auction platform is desirable. However, we also see that already there has been great improvement in forward markets within the regions as well as well functioning auction platforms for different borders. BDEW believes that a voluntary approach for a single platform allows an efficient solution for market participants. Market parties have an interest in a robust and well-functioning platform. Hence, any framework should be consulted with market parties.

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