Public Consultation Document “Forward Risk-Hedging Products and Harmonisation of Long-Term Capacity Allocation Rules”

We welcome your consultation "Forward Risk-Hedging Products and Harmonisation of Long-Term Capacity Allocation Rules", and thank you for the opportunity you give to all the relevant stakeholders to put forward their positions regarding such a significant issue.

Forward risk-hedging products

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

No.

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?

The importance of long-term hedging products originates from market participants’ need to manage risk hedging against the market price differentials resulting from transmission congestions.

Although the implementation of the day-ahead and intraday target model will probably lead to a more efficient use of the interconnections, increasing price convergence, price differentials will continue to exist at least until significant differences in national fuel mix and prices will persist. Long-term hedging products are therefore likely to remain important in the future, allowing market participants to optimise their exposure to cross-border price differentials.

We deem important to ensure the largest possible participation in long term-markets, since an adequate level of liquidity contributes to providing the right signals on transmission rights pricing and on the state of cross-border interconnections. It is therefore important for market participants to make use of these instruments, whose price level will reflect market
expectations on the evolution of price differentials and the needs for additional cross-border capacity.

The implementation of the day-ahead and intraday target models will probably reduce the importance of physical transmission rights which entitle capacity holders to access transmission lines. Well-functioning day-ahead markets with market coupling will basically lead towards an efficient allocation of the available cross-border capacity in the day-ahead timeframe, while cross-border intraday markets will allow market participants to take advantage of price differentials emerging closer to real-time. According to this scenario, the main interest associated with transmission rights would be the hedging against market price differentials between markets as a result of the coupling, so financial transmission rights seem to be the most efficient solution.

In this initial implementation phase of day-ahead and intraday Target Model, the option of having access to transmission lines through PTRs with UIOSI may still be, however, an useful additional opportunity for market participants.

3. Would long-term hedging markets need to evolve (e.g. in terms of structure, products, liquidity, harmonization, etc.) due to the implementation of:
   (1) the day-ahead market coupling?
   (2) day-ahead flow-based capacity calculation?
   (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?

(1) As mentioned above, the implementation of day-ahead market coupling may bring about a decrease in the interest of market participants to direct access to transmission capacity through PTRs for the transfer of energy;
(2) It should be considered that the possibility to nominate cross-border capacity by PTRs holders may influence the result of flow-based coupling. Moreover, it should be taken into account that the available capacity across interconnections, and price differentials between bidding areas, may be less predictable, especially on a long-term perspective, when flow-based capacity calculation is implemented;
(3) The occasional redefinition of bidding zones may have a strong impact on price differentials among different markets, and therefore on the actual value of financial or physical transmission rights.

In the case of a redefinition of bidding zones, legal certainty on existing long-term contracts, including already allocated transmission rights, has to be ensured, in order to guarantee the stability of contractual obligations in the power markets. For this reason, we think that the implementation of the zoning revisions should always start sufficiently in advance to ensure a lead time longer than the longest forward product available in the market. In any case, any
redefinition of bidding zones should enter into force at the beginning of the year, in order to facilitate (or, even better, to avoid) the amendment of existing contracts’ clauses. In the evaluation of the redefinition of zones, it should also be taken into account that the merger of bidding zones is more desirable than splitting an existing zone, at least in terms of integration of energy markets. However, merger of bidding zones means that existing congestions between two areas are relieved and a single market clearing price can emerge. Existing transmission rights/forward hedging products aimed at covering price differentials between the previously separate areas become therefore useless, and market participants should be adequately compensated if the merger happens before their expiration.

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...)?

We believe that a combination of energy forwards and transmission products would be the most suitable Long-Term Target Model in order to allow market participants to ensure a proper hedging of market price differentials. Transmission rights, physical or financial, are still needed as hedging instruments, taking into account the different level of liquidity in terms of available products which still characterizes European electricity markets.

We think that transmission rights should be linked to the available cross-border capacity, in order to provide proper signals on the state and use of system interconnectors and on the expectations of price differentials between areas.

A proper implementation of this market design in the EU would require the definition of common and efficient market and operational (e.g. nomination) rules, at least at the regional level. This would consistently help to reduce barriers to access long-term hedging products in all European electricity markets, with possible significant improvements in terms of market integration and liquidity, especially in less developed markets. As outlined in the following answers, the current extension of the existing auction platforms (and rules) to all European countries would be a valuable interim solution towards a full harmonization at European level.

Furthermore, the evolution of the European financial market regulation (e.g. the revision of MiFID Directive etc.) should be carefully taken into account, in order to avoid imposing undue burdens to market participants by introducing the compulsory use of specific products.

The criteria for assessing the best market design to hedge long-term positions should therefore be aimed at identifying those features which facilitate the participation to the market, consequently enhancing market liquidity. We suggest:

- Harmonisation of rules and processes (e.g. auction rules, products, firmness, financial guarantees etc.);
- Simplicity of operation;
We wish to highlight that the introduction of financial transmission rights as an obligation may pose problems to market participants, since their financial exposure would be consistently increased due to the obligation to pay negative price differences when occurring. Moreover, the need to manage this higher counterparty risk would entail the implementation of costly solutions, such as in-house guarantee systems or the appointment of a central clearing house. All this factors may contribute to create new barriers to entry, so reducing market liquidity. Furthermore, it doesn’t seem that the possible benefits related to the introduction of FTR obligations, i.e. the higher volumes of available transmission rights through netting and lower auction prices, can outweigh the abovementioned flaws, at least in the short term.

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?

It should be avoided that possible manipulative behaviour in the market for hedging products could have an impact on energy markets, notably on the outcome of day-ahead market coupling. Up to now this risk doesn’t appear overwhelming, and the new regulatory framework introduced by the Regulation 1227/2011 EU on wholesale energy market transparency and integrity (REMIT) and its subsequent implementing acts seems to be sufficient as a measure to prevent abusive behaviour. It should also be taken into consideration that the maximum transparency has to be ensured on the calculation methodology of the available cross-border capacity, which is the reference value for TSOs in the calculation of the amount of financial and physical transmission rights to be allocated to market participants.

Harmonization of long-term capacity allocation rules

Questions regarding the wish-list

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

We believe that the points listed in the wish list are exhaustive and reflective of the best-practice represented by harmonized auction rules in force on the CASC.EU borders.

7. Which aspects of auction rules would be most valuable to be harmonized? Can you provide some concrete examples (what, when, where) of how this could help your commercial operation (e.g. lowering the transaction costs)?
The harmonization of firmness rules and financial arrangements, including payment deposits, is of utmost importance, since they directly affect the financial position of market participants. Regarding the specific point raised in the Annex I of the consultation document (Recovery of Payment, pg. 16), we support the substitution of the current system of bank account deposits required for the participation to yearly auctions (2/12th of the total amount) with a bank guarantee for the same amount. However, given also the current financial turbulences, it is of paramount importance that the requirements (e.g. rating grades etc.) regarding the issuers of bank guarantees are flexible enough, in order to avoid sudden, costly and not adequately justified measures (e.g. the rush to change immediately an issuer of a bank guarantee).

Other significant areas for harmonization are auction timing and deadlines and the IT systems, through the creation of a single auction platform at European level or, at least, few regional platforms with similar rules.

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

As a general rule, auction rules should be harmonized as far as possible. If some local specificities prevent the harmonization of specific aspects, this should be duly clarified and specifically justified.

9. Which aspects should be harmonized in binding codes?

The European network codes should strike the right balance between the harmonization of rules and methodologies needed to achieve an effective integration of the European electricity markets and a sufficient level of flexibility aimed at accommodating local specificities and necessary changes.

We therefore believe that the basic features (capacity calculation, available products, general auction rules etc.) of the Long Term Target Model should be addressed within binding codes, while the more specific and operational rules should be taken out from the European codes, since they may reflect local specificities and/or contingencies and may be subject to relatively frequent changes.

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?

The existence of poorly harmonized products and rules across different European borders increase the difficulties for market participants to manage the risk connected to price differentials at European scale. Furthermore, if products vary significantly, it might be impossible to fully hedge a position between two countries without common borders.
These issues are particularly relevant when it comes to borders (e.g. in some south-eastern European countries) whose capacity is not allocated according to the auction rules set by regional platforms such as CASC.EU or CAO. This lack of harmonization poses therefore an obstacle to the further integration of European energy markets, imposing to market participants significant efforts in adapting to the evolution of specific national rules and procedures.

Questions regarding potential additional requirements

Capacity calculation and allocation method

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

We don’t think that the simultaneous allocation of long term products on different borders may bring consistent advantages to market operators. Simultaneous allocation could indeed result difficult to manage at an operational point of view, whereas market participants wouldn’t have the opportunity to adjust their bidding strategies on a specific border taking into account the outcome of a previous auction on another border. However, we believe that a certain harmonization of auction timing would be useful for long term cross-border capacity auctions related to a specific timeframe (e.g. yearly, monthly etc.) to take place at close range.

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?

It is important that long-term capacity calculation is as accurate as possible (and consistent with short-term ones), in order to provide market participants with the right signals on the available capacity on a specific border. The amount of transmission rights issued by TSOs should then be in line with the available capacity, avoiding unjustified discrepancies with the capacity actually allocated on the day-ahead timeframe through market coupling.

Products

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 availability of different hedging products for different delivery period (other than year and month) might be an opportunity for market participants to use products which better fit their
specific needs. In case of allocation of multiple-year products, however, the possibility of capacity hoarding by some players should be avoided through a well-balanced splitting of allocation of capacity between different timeframes.

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?

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

We believe that products including planned unavailability periods, for instance in case of planned maintenance, should be kept for the future, since they allow TSOs to make available more long-term capacity. This may contribute to limit the transmission reliability margin (TRM) subtracted from the total transfer capacity (TTC) in the NTC calculation by TSOs.

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?

Secondary market

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

We believe that the maximum share of the forecasted available capacity should be sold through long-term auctions. This entails possible “over sales”, basically due to changes in available information and forecast.

The introduction of specific buy-back auctions may allow to correctly price the scarcity information sent to the market by a specific TSOs request. This could help reduce capacity holders exposure in case of a reduction of available capacity, allowing them to receive a compensation which better reflect the actual market conditions compared, for instance, to a reimbursement amounting to the marginal price of the initial auction at which the curtailed capacity was allocated.

Nomination
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?

As long as a border does not have a liquid day-ahead market, it might be useful to keep the nomination process available to allow market participants to execute contracts concluded outside the offering system (organized market) where not enough products are available in the day-ahead timeframe.

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?

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?

It is of utmost importance that nomination rules and procedures are harmonized across different borders, since the rules and regulations currently in force are rather heterogeneous. The harmonization of these rules could substantially improve commercial operation, especially for market participants active in different European countries. We advocate the harmonization of nomination timing, format and aggregation rules (i.e. the methods for nominating capacity allocated for different timeframes, such as netting of nomination etc.). Furthermore, the creation of a centralized nomination platform, as for auctions, may consistently enhance the outcome of this harmonization, while further simplifying commercial operations.

Auction Platforms

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?

In our opinion, the introduction of centralized auction platforms has consistently improved the level of harmonization of auction rules on a large number of European borders. This contributes to facilitate commercial operations of market participants active at European scale, through the availability of a uniform set of rules and a unique IT system for the submission of bids and offers.

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?

The creation of a single auction platform, as envisaged in the CACM Framework Guideline, is a valuable solution to enhance market integration by reducing regulatory and technical barriers which may prevent market operators from being active at European scale. Moreover, the opportunity to create a single nomination platform along with the auction platform should be duly investigated, as a further contribution to the internal market integration. However, we think that a gradual approach in the transition from regional platforms to a single European one could be the best solution to trigger a smooth harmonization process without undue effect on an operational point of view.

We believe that during a first transitional phase existing regional platforms (e.g. CASC.EU and CAO) should extend their scope to borders on which the allocation of long term interconnection capacity is not carried out by any auction platform (e.g. in south-east Europe). Meanwhile, a progressive harmonization of auction rules in force within existing regional auction platforms should be pursued.

We believe that a voluntary process would ensure the smoothest possible transition to a single European auction platform, allowing all involved parties (TSOs, market participants etc.) to agree on the features (auction rules and procedures, access rules etc.) necessary to guarantee the correct functioning of the long-term cross-border capacity allocation.

The inclusion of a specific deadline for the establishment of a single European platform in the European Network Code on forward markets can represent an incentive toward this specific outcome, provided that this deadline allows to accommodate the gradual transition described above.

Thanks and regards,

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(Secretary-General)