

## **ASSOELETTRICA RESPONSE**

### **ACER CONSULTATION ON FORWARD RISK-HEDGING PRODUCTS AND HARMONISATION OF LONG-TERM CAPACITY ALLOCATION RULES**

*26th October 2012*

#### **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 due to transmission congestions.

Although the implementation of the Day-ahead and Intraday Target Model will probably lead to a more efficient use of interconnection capacity increasing price convergence, price differentials will continue to exist at least until significant differences in national generation-mix and prices persist. Therefore, long term hedging products are likely to remain an

important instrument in the future, allowing market participants to manage their exposition to cross-border price differentials.

Assoelettrica deems it important to ensure the largest possible participation in long term-markets since an adequate level of liquidity contributes to provide right signals on transmission rights pricing and on the state of cross-border interconnections. Thus, it is important for market participants to make use of this instrument whose price level should reflect market expectations on the evolution of price differentials and the need of 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 use transmission lines. Well-functioning day-ahead markets with market coupling basically lead towards an efficient allocation of the available cross-border capacity in the day-ahead timeframe while cross-border intraday markets allow market participants to take advantage of price differentials emerging close to real-time. According to this scenario the main interest associated with transmission rights would be the hedging against price differentials between markets emerging from the coupling, so Financial Transmission Right seem to be the most efficient solution.

Nevertheless, in this initial implementation phase of Day-ahead and Intraday Target Model the possibility to have access to transmission lines through PTRs with UIOSI may still be valuable opportunity to for market participants, especially where the level of liquidity of day-ahead markets is still low.

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) : the day-ahead market coupling?

As mentioned above, the implementation of day-ahead market coupling may bring about a decrease in the interest of market participants in direct access to transmission capacity through PTRs for the transfer of energy.

(2) : day-ahead flow-based capacity calculation ?

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 flow-based capacity calculation may reduce the predictability of the available capacity across interconnections and price differentials between bidding areas, especially on a long term perspective.

(3) : occasional redefinition of zones?

The occasional redefinition of bidding zones may have a strong impact on price differentials among different markets, therefore on the actual value of financial or physical transmission rights.

In case of redefinition of bidding zones, legal certainty of existing (long term) contracts, including already allocated transmission rights has to be ensured in order to guarantee the stability of contractual obligations in the electricity markets. For this reason we think that the implementation of the revision of zones should 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/avoid the amendment of existing contracts' clauses.

In the evaluation of redefinition of zones, it should be finally taken into account that 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. Thus, existing transmission rights/forward hedging products aimed at covering price differentials between the previously separate areas become 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 from market price differentials. Transmission rights, either physical or financial, are still needed as a hedging instrument, taken into account the different level of liquidity in terms of available products which characterizes European electricity markets.

In our opinion, 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 Europe would require the definition of common and efficient market and operational (e.g. nomination) rules, at least at regional level. This would consistently help reducing barriers to the access to 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 borders would be a valuable interim solution towards an efficient 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.

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

- Harmonization of rules and processes (e.g. auction rules, products, firmness, financial guarantees etc.);
- Simplicity of operations;
- Transparency on rules and market design;
- Efficiency and implementation costs.

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 these elements may contribute to create new barriers to market access, so reducing market liquidity.

Finally, 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 markets for hedging products? What measures could in your view help prevent such behavior?

It should also be avoided that possible manipulative behaviors in the market for hedging products could have an impact on energy markets, notably on the outcome of day-ahead market coupling.

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 behavior.

It should finally be taken into consideration that 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 reflecting 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.

As regards the specific point raised in the Annex I of the consultation document (Recovery of Payment, pg. 16), we support the idea that a market participant can choose between different systems like: bank account deposits, bank guarantees, parent company, rating, etc.. However, it is of paramount importance that the requirements (e.g. rating grades etc.) concerning the issuers of bank guarantees be flexible enough to take into account the current financial turbulences in order to avoid sudden, costly and not adequately justified measures (e.g. the change of the issuer of a bank guarantee). If the transition towards bank guarantees implied more frequent installments (e.g. each D+2) to be invoiced to market participants, a clearing house service should be introduced in order to avoid imposing excessive administrative burdens to operators.

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 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.

Thus, we 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 more specific and operational rules should be taken out from the European codes since they may reflect local

specificities and/or contingencies and 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.

Thus, the lack of harmonization poses an obstacle to a further integration of European energy markets, imposing to market participants significant efforts in following 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. Indeed, simultaneous allocation could result difficult to manage under an operational point of view, whereas market participants wouldn't have the opportunity to adjust their bidding strategies on a specific border by taking into account the outcome of a previous auction on another border.

However, we believe that a certain harmonization of auction timing is useful in order for long term cross-border capacity auctions related to a specific timeframe (e.g. multi-yearly, 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 be 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 be maximized 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 have products which better fit their specific needs. In case of allocation of multiple-year products a well-balanced splitting of available interconnection capacity between different timeframes should be ensured.

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?

It would be good to make as much capacity as possible available to the long lead time products (e.g. yearly products). Subsequent timeframes should be used to adapt the total volume to the evolution of forecast.

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 in 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.

- **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 a 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 decreasing capacity holders exposure in case of a reduction of available capacity, allowing them to receive a compensation which better reflects 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?

The impact of this transition will strongly depend on the level of development and liquidity of day-ahead and intra-day markets once the European Target Model will be 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?

It is of utmost importance that nomination rules and procedures be harmonized across different borders, since the regulation 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.

Assoelettrica advocates for the harmonization of nomination timing, format and aggregation rules (i.e. the methods for the nomination of capacity allocated in different timeframes). 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 contribute 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 as a mean 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 market operations.

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). In the 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 specific deadline for the establishment of a single European platform in the European Network Code on forward market could represent an incentive toward this specific outcome, provided that this deadline allows to accommodate the gradual transition process described above.