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FORTUMS RESPONSE TO ACER CONSULTATION ON FORWARD RISK-HEDGING PRODUCTS AND HARMONISATION OF LONG-TERM CAPACITY ALLOCATION RULES

General comments

Fortum welcomes the consultation by ACER on Forward Risk-Hedging Products and Harmonization of Long-Term Capacity Allocation Rules.

Forward Hedging is an important part of the daily operations of both producers and consumers in the power markets. The market development can be measured by the liquidity of the market and amount of active consumers in the market. Market Coupling secures the optimal flows over the transmission lines. The involvement of the TSO is focused on maximizing the needed cross border capacities at all times through building of more transmission capacity and or counter trading.

Guidelines and Codes should support only market based solutions that provides liquid and transparent conditions for all market players. The current aim to force TSOs to issue PTRs or FTRs is based on physical market thinking and neglects the fact that financial markets are more efficient. This is also supported by EMIR and the goals of EU internal market.

The risk with introducing FTRs is that welfare will be moved from TSOs to the few market players that are interested in buying FTRs. To little/low interest will cause the auction price to be too low and TSOs will sell (hedge) their transmission income too cheaply. This is especially the case with FTR options. Market based CfDs issued by market players are more neutral and does not contain this problem.

Major steps should be taken in order to create a large and liquid Central European market. The German market has enough liquidity already today but the neighboring countries are still in a "start-up" face. The adjacent countries use the German market as proxy when hedging due to good liquidity. They could be joined by a system price (ELIX) and use CfDs to hedge the total risk. This would create the biggest and most liquid market.

Answer to the questions

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?

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Market coupling will improve the power flows and power will always move in the right direction. The need for cross-border hedging will diminish after artificial transmission restrictions (e.g. Physical Transmission Rights) are removed. In the Nordic market where the system price and combination of CfDs is the used and preferred model, the market coupling does not change the need or use of long-term hedging products system price and CfDs.

It is very important to hedge your production or consumption in the price-areas you operate. This is best done by a system price and CfD combination hedge. The need for cross-border hedging disappears through well-functioning market coupling and liquid markets on both sides of the border.

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 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?

Day ahead market coupling: see previous question. It should be the most important priority.

Flow-based capacity calculation: this will not fundamentally change the need for hedging purposes. The basic need to hedge volatile power prices will remain.

Redefinition of bidding zones: It is clear that splitting up existing bidding zones in smaller bidding zones would decrease liquidity in forward markets with existing product category and make hedging more difficult. A better approach to the fundamental challenge would be building more transmission capacity. Redefinition of zones should rather aim at merging price areas across national borders to create bigger and more liquid price zones.

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...)?

Financial forward markets are the best solution for long-term hedging. The markets/zones need to be as big as possible in order to have good liquidity and transparency. The bigger the markets/zones are to more liquidity they will attract and work for best possible solution. Then no transmission products are needed since the adjacent markets have enough liquidity and cross-border flow is taken care by the market coupling.

This could be used in the German market which already has enough liquidity and the neighboring markets use the German market as a proxy hedge. A system price and CfD approach would create the biggest market. Since products would be financial and traded over the exchange that would be supported by EMIR as well.

The use of PTRs or FTRs shows the weakness in the current model with national borders as price-area borders. TSOs should work closer together and build transmission capacity where needed. Also price-areas across national borders should be developed.

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The current use of PTRs(or FTR options) is mainly for proprietary trading not hedging purposes. Traders prefer the "option" type of contract with low fixed cost and high potential upside. Moving to FTR obligations is only supported by those who trade CfDs since they are a real hedging product with both linear payout you can both win and lose money. Traders have said they are not interested in FTR obligations since the payout can be both negative and positive, this in fact proves that speakers for FTRs are in reality only interested in the "quick wins" of the FTR option.

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 behavior?

With the use of PTRs or FTRs there is a problem since the amount of them is predefined according to the available transmission capacity. There can always be a possibility that the transmission ends up in the hands of too few players and distort the market. With CfDs that are issued by the market players not TSOs the amount of contracts can be as big as the total interest of the market. No TSO involvement is needed since that is taken care by the market players and the price level at all times.

With FTRs or PTRs with UIOSI the risk is more that there will be a limited number of market participants interested in these products and instead of being used for hedging, these products end up being for speculation. If the market is liquid, the FTRs may be used by TSOs to hedge congestion incomes. If the market proves to be illiquid, there's a risk that FTRs get underpriced, hence transfer welfare from TSOs to speculators.

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

See answers to questions 4 and 5.

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)?

The leading principle must be that forward XB products support power derivatives markets. All actions should make the trading easier and with as low barriers as possible to attract as many players as possible.

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

Once liquid derivatives market exists, rules with regard the products should not be regulated by Network Codes, but let the market deliver the desired products. In the Nordic market the CfD-market and products have entered market-based.

9) Which aspects should be harmonised in binding codes?

See answer to question 8.

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?

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Transmission rights are based on a rather old-fashioned thinking that one should be able to reserve transmission capacity for his own needs. Reserving this capacity with PTRs causes that this capacity is no longer available for the market. With liquid markets that benefit from implicit auction the need for separate transmission rights vanishes. Let's see two cases:

Case 1: Selling electricity from Iberian Peninsula to the Nordic region without hedging. A generator sells its production on spot-market in price area Spain. An electricity buyer buys the electricity from the spot market in respective price area in Nordic region.

Case 2: The same with hedging. In addition the generator sells a forward contract for price area Spain and hence hedges its sales with the forward's price. The buyer hedges similarly by buying a forward contract (or as in Nordic countries the main forward market is based on system price contracts, he buys a forward contract for system price and CfD-contract for the respective price area).

This example shows that there is not a need for transmission rights otherwise the example should tell how you would use them.

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

The Nordic Forward market is based on derivatives having system price as underlying and the CfD-contracts supporting the power derivatives market. The allocation of these products is market-based and the product structures evolved based on the market participants' needs.

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?

See answer to question 11.

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?

See answer to question 11.

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 11.

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 11.

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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 11.

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

See answer to question 11.

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?

See answer to question 11.

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?

In the North Western European market the need for PTRs or FTRs is questionable since market coupling will start next year. This can also be seen in the answer to question 10.

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?

No answer.

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?

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

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

o 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?

It is important that the auction office is available for all interested parties.

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