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## **Forward Risk-Hedging Products – PC\_2012\_E\_13**

The Finnish Energy Industries (EC Register ID number 68861821910-84) is a trade organisation for producers, suppliers, transmission, distributors and sales of electricity, for district heating and district cooling, and for design, implementation, operation, maintenance and construction of networks and power plants.

### **General comments**

The Finnish Energy Industries (ET) welcomes the consultation on Forward Risk-Hedging Products and Harmonization of Long-Term Capacity Allocation Rules.

Generally the basic need is to hedge power prices. An efficient market design is best supported with a liquid power derivatives market and with products supporting the power derivatives market. Currently, within the Nordic system, the system price in combination with CfDs serves well the Nordic market, where price areas are relatively small.

Forward market that is based on financially settled products is open to all interested parties, also market participants that have no physical position in the market area. Nordic market is a good example of this. The power derivatives market is highly competitive and has as members also a number of financial actors, in addition to European energy companies.

None of the Nordic day-ahead price zones are large and representative enough to replace the system price as the basis for a liquid forward market, and without the system price, forward liquidity would collapse. Introducing FTRs directly between Nordic price zones is not feasible with the number of zones in the Nordic market. Linking buyers and sellers through long chains of FTRs would not work in practice.

On the CWE side market coupling has improved the efficiency of the spot markets. System price type neutral contract structure could be a good addition in CWE areas product category, especially if it proves impossible to maintain current price areas without severely affecting XB transmission.

The future of needed XB hedging products depends on how power derivatives markets develop, will they remain separate as today or will they form one market as the Nordic market. FTR products ease to interconnect market areas. Within one market area, such as Nordic market, CfD contracts function better. In fact there are very few market participants in the Nordic market that have shown interest towards FTRs. Generators, retailers and power consumers need CfDs.

The forward XB products have to fit to the two local markets that are to be connected. Thus, there is no generic solution that is the “best one” for all interconnections. There should however be the leading principle, that forward XB products support hedging against volatile electricity wholesale prices and that the XB products don't hinder the use of transmission capacity. When liquid day-ahead and derivatives markets are functioning on both sides of an interconnector, financial XB products are to be preferred for ensuring efficient use of the interconnector, where such products are considered needed. Products enabling physical

reservation of transmission capacity should be abandoned once efficient day-ahead markets exist. The type and need of cross-border products depend what are the needs of market participants on the both sides of the interconnector. In the Nordic market long-term hedging is done with derivatives that have system price as the reference. CfD-products support this market. Nordic and Baltic markets are highly integrated.

### **Answer to the questions**

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

Yes. In regions where market participants find transmission capacity products guaranteed by TSOs useful, one option might be seen as a hybrid of two models. This constitutes a market with CfDs and system price derivatives incorporated with "synthetic" FTR obligations, equivalent to a combination of two CfDs, which are auctioned by the TSO.

#### **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 market coupling is likely to give more liquidity for the markets and eventually push OTC-trading increasingly to market places thus improving efficiency. After artificial transmission restrictions (e.g. Physical Transmission Rights) are removed, the need for XB-hedging is likely to decrease, since the XB capacity will be freely available for everyone in the market.

The increasing amount of renewable electricity production is likely to increase the volatility on spot-markets and hence the need for electricity forwards. If liquidity for some areas derivatives market is low, one should consider whether to start offering index-price based derivatives contracts.

#### **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. If the grid development lags increasingly the transmission needs there may be a growing need for index price power derivatives and correspondent CfD-type products. These products will however enter the market market-based as proven in the Nordic market. 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...)?**

The leading principle must be, that forward XB products support hedging against volatile electricity wholesale prices and that the possible XB products don't hinder the use of transmission capacity. There is no generic solution that is the "best one" for all markets and interconnections. When an efficient day-ahead market (DAM) is lacking, the preferred solution would be a PTR UIoLI. When an efficient DAM is introduced, market players can no more trade directly across the borders since capacity is made available to the whole market and optimised in the implicit auction. But other needs and opportunities for forward XB trading may arise.

First, if the owners of the interconnector want to hedge their congestion rent, they could sell FTR-obligations – some would prefer to call them a PTR UIoSI, but also this contract would act as a financial derivative since the holder will always have the incentive to give all capacity to the DAM. Generators and consumers cannot use only FTRs to hedge their fundamental risk since they are not exposed to volatile congestion rents.

Second, generators and consumers may have a need for swaps. If there is a system price in a given region (like in the Nordic), market players may need to swaps a forward on the system price to their local area price – to this end they need CfDs. If there is no system price available, market players may need a swap between two local area prices. This will make them able to use the adjacent forward market for hedging purposes, improving competition and market efficiency. These contracts could be called FTR-obligations or CfDs. TSOs cannot use these contracts to hedge congestion rent since it just swaps one price for another.

Finally, if two areas have liquid forward markets towards their local area price there is no need for a FXBM. Cross border risk could then be managed by buying one forward and selling the other.

**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?**

When Physical Transmission Rights exist there is a risk that one party may reserve transmission capacity in order to hinder transmission. 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.**

The organization of secondary "FTR/PTR" trading is neither a task for TSOs nor for the auction office.

**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. When considering what elements can and should be harmonised, the effects on the power derivatives markets must be evaluated.

FTR type contract don't suite the Nordic market structure, and would most probably have a negative effect on the well-functioning Nordic derivatives market.

**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?**

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).

**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.

**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?**

It depends on the status of the relevant markets. It would be a natural development to directly introduce FTRs within a market which is part of NWE-price coupling and where demand for transmission rights already exists. In markets with less liquid spot-market a monitoring of how PTRs are actually used over time will give insight into the moment at which it will be most appropriate to step down from PTRs. In view of significant advantages of FTRs (no nomination deadline reducing also operational risks and costs, no "netting" needed between TSOs for the nominated rights, etc.), further usage of PTRs will have to be justified by a cost-benefit analysis and subject to ACER's decision after consultation.

For Nordic market FTRs are not suitable. Market actors need system price –based derivatives and CfD-products.

**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.

Further information:

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