

Energitilsynet consultation on the proposed decision of the Danish and Swedish NRAs on long-term hedging opportunities in Denmark and at its Northern borders



EFET reaction – 25 April 2017

The European Federation of Energy Traders (EFET) welcomes the opportunity to provide our reaction to the proposed decision of the Danish and Swedish energy regulators regarding the implementation of article 30 of the FCA Regulation on long-term hedging opportunities. However, we would like to remind the concerned NRAs that the question at stake, whether it concerns the internal Danish bidding zones or the bidding zone borders between Denmark, Sweden and Norway, impacts cross-border trade. Therefore, we would expect the whole discussion to take place openly and in English, so that market participants from the three countries and beyond be given the opportunity to contribute to the debate throughout the whole process.

1. Consultation of market participants and market evaluation

EFET notes with satisfaction that the regulators have so far respected the letter of article 30 of the FCA Regulation. Indeed, as the concerned TSOs do not offer transmission rights at the above-mentioned bidding zones borders, the regulators have conducted a consultation of market participants and an evaluation of the forward markets and forward hedging products according to article 30.3 and 30.4.

The evaluation entrusted to the independent consultant Houmoller Consulting¹ presents the following results:

¹ *Investigation of forward markets for hedging in the Danish electricity market*, report by Houmoller Consulting commissioned by the Danish NRA, dated 2 April 2017, available at: http://www.energitilsynet.dk/fileadmin/Filer/Hoeringer/EL/2017/Bilag_3_Investigation_of_Danish_power_hedging_ver_02_April_2017.pdf.

- **Consultation of market participants:**
 - All the respondents (100%) consider that the system price contracts do not give them a satisfactory hedge against spot prices in DK1 and DK2.
 - The vast majority of respondents (83%) consider the current products or combination of products on forward markets (system price + EPADs) as an insufficient hedge against the volatility of day-ahead prices in DK1 and DK2.
 - The vast majority of respondents (83%) are in favour of the introduction of PTRs/FTRs at the DK1-SE3, DK2-SE4 and DK1-NO2 borders.
- **Evaluation of the forward market and forward hedging products:**
 - Traded and cleared volumes of Nordic power derivatives has declined since the start of the economic crisis – while similar volumes for futures in continental Europe have increased over that period.
 - The liquidity of Danish EPAD contracts remains low, and the exchange turnover and open interest on Danish EPADs is declining.
 - The analysis does not indicate any harm done to the EPAD system by the PTR auctions for the Great Belt interconnector and the interconnectors linking Denmark and Germany.
- **Proposed remedies:**
 - Nordic TSOs could offer power derivatives. However, this would question the neutrality of the TSOs who would actively be engaged in commercial trading activities. This would also expose the TSOs to EMIR (EU 648/2012 Regulation on OTC derivatives, central counterparties and trade repositories) and MiFID (EU 2004/39 Markets in Financial Instruments Directive). As noted in the report, such an option was rejected by both the Swedish competition authority and the Swedish energy regulator.
 - Nordic TSOs could offer forward transmission rights, as a complement to the current EPADs. Forward transmission rights already exists between DK1 and DK2 and at their borders with Germany. The report shows that the introduction of PTR auctions at the DK1-DK2, DK1-DE and DK2-DE borders has not damaged the liquidity of EPAD contracts in Denmark, rather the contrary: a majority of the respondents to the consultation indicate that the PTR auctions provide liquidity to EPAD contracts.

While the report does not provide a recommendation as such, its results are clear: both the data and the experience of market participants show that the current setup of Nordic system price and EPADs does not always provide an efficient hedge in DK1 and DK2. The easiest remedy, which is supported by the majority of market participants who responded to the consultation and which has already proven its reliability in other parts of Europe, is the issuance of forward transmission rights by the TSOs as a complement to the existing EPADs.

2. Letter of intention of the Danish and Swedish regulators

In their letter of intention², the Danish and Swedish NRAs confirm the assessment that there are insufficient hedging opportunities in DK1 and DK2. However, for unclear reasons, they have decided not to request their TSOs to issue transmission rights according to article 30.5(a), but to request the TSOs to “make sure that other long-term cross-zonal hedging products are made available to support the functioning of wholesale electricity markets” according to article 30.5 (b). This letter of intention had us disappointed for the following reasons:

- The positive assessment of hedging opportunities in the Swedish zones SE3 and SE4 does not exonerate the regulators from finding remedies for hedging opportunities at the interconnectors between these zones and DK1 and DK2.
- Considering the elements of the report, we consider it unlikely that TSOs will find alternatives to the issuance of transmission rights without endangering the position of the TSOs as neutral market facilitators.
- The Danish and Swedish NRAs seem to dismiss the call of the majority of market participants for the issuance of transmission rights by the TSOs at the DK1-SE3, DK2-SE4 and DK1-NO2 borders.
- The use of article 30.5 (b) implies that the TSOs shall adopt the necessary arrangements within six months according to article 30.6. However, article 30.6 does not foresee any new consultation of market participants or public assessment of the remedy proposed by the TSOs.
- Finally, the consultation of market participants and the assessment performed by Houmoller Consulting also concerned the DK1-NO2 border. While we understand that the FCA Regulation does not yet apply to Norway and Norwegian borders, we believe it is important that the Norwegian regulator takes part in this debate. We hope to see a common decision of the Danish and Norwegian regulators soon on this subject, even if it happens outside the realm of the FCA Regulation for the moment.

3. EFET recommendations

The letter of intention of the Danish and Swedish regulators leaves us with the feeling that the regulators disregarded the assessment and consultation performed according to article 30.3 and 30.4 of the FCA Regulation for reasons we cannot quite understand. Without a clear justification on their part, it appears to us that the assessment and consultation may only have been completed to “tick the box” of the regulatory requirements, which is definitely not an attitude that either the Danish or the Swedish regulators have accustomed us to.

Article 30 of the FCA Regulation was one of the most debated elements of the Regulation during its drafting, and we believe an appropriate balance was reached in the end. Article 30 avoids unnecessary changes where hedging opportunities other than forward transmission rights exist, but it sets the issuance of forward

² Joint letter of intention of the Danish and Swedish energy regulators regarding hedging opportunities at the Danish-Swedish bidding zone borders, available at: http://www.energitilsynet.dk/fileadmin/Filer/Hoeringer/EL/2017/Bilag_2_Intentionsdokument_mellem_EI_og_SET.pdf.

transmission rights by the TSOs as the standard when the existing alternatives are insufficient. We do not believe that the intention of the legislator with article 30 was to create a caveat in the unbundling requirements that are an essential part of the architecture of the internal energy market.

Since the start of the liberalisation of EFET has supported the **issuance by TSOs of forward transmission rights at all bidding zone borders in Europe and in all directions, to the full amount that the underlying infrastructure can offer for each timeframe**. This activity is **an essential part of the TSOs' "public service" activities**, as regulated entities. The issuance of forward transmission rights at all borders in all directions allows to:

- guarantee that a certain minimum volume of products will always be available and offered on a transparent and non-discriminatory manner through organised auctions;
- provide substantial congestion income to TSOs by allowing them to extract the maximum value out of the network infrastructure they manage;
- provide better and more reliable visibility for market participants as to the total volumes of hedging products;
- ensure that the capacity that is offered to the market is maximised at all points in time and that any variations of these volumes is published in a timely and effective manner;
- provide valuable signals as to the structural value of cross border capacity, from a "congestion" point of view. This is useful for all market players and for TSOs and regulators, whereas the daily price signals are much more volatile. For example, forward allocation provides clear market-based price signals as to the need for additional infrastructure investments.

In the specific case of the Nordic market, with an existing – though insufficient – financial market for hedging, EPADs would be worth keeping **alongside forward transmission rights**, as they can complement each other in a number of ways:

- EPADs can complement forward transmission rights to hedge non-standard volumes (MW).
- EPADs can give market participants flexibility with regard to when and for which period hedging takes place, when forward transmission rights are auctioned at fixed dates for fixed delivery periods. Secondary markets for forward transmission rights however largely mitigate this lack of flexibility.

As highlighted in our paper of July 2014³, EFET is not aware of a successful stand-alone example of "appropriate cross-border financial hedging" being offered "in liquid financial markets on both side of an interconnector" in any part of Europe in any other way than through the issuance of forward transmission rights by TSOs. Indeed:

- Forward transmission rights issued by TSOs provide an open and non-discriminatory access to hedging solutions against congestion costs (and the day-ahead congestion pricing), with no additional transaction costs. On the contrary, two opposite EPADs are needed on each border for market participants to be able to hedge against congestion costs and pricing.
- Forward transmission rights allow all market participants to take part, without having to rely on the non-guaranteed liquidity of financial markets. This is essential for the development of any trading or retail activity for non-local participants and for market participants so that they can benefit from the liquidity (and coupling) of all EU markets on a forward basis. Non-availability of forward transmission rights may constrain competition even beyond the bidding zones where these rights are not available. **Competition in wholesale and retail markets ends up taking place in bidding zones, not in virtual hubs.** Only those market participants who are able to carry the (sometimes considerable) basis risks involved in the absence of access to transmission rights will enjoy the choice of cross-border market entry.

Therefore, **we call on the Danish and Swedish energy regulators to truly take into consideration both the assessment performed by Houmoller Consulting and the results of the market participant consultation in their decision. Both point to the issuance of transmission right by the TSOs at the DK1-SE3, DK2-SE4 and DK1-NO2 bidding zone borders, as a complement to the existing EPADs.** We also invite the Norwegian energy regulator to perform a similar exercise as a pre-implementation effort until the FCA Regulation is applicable to Norway.

³ For a detailed description, please refer to *The need for compulsory issuance by TSOs of forward transmission rights*, dated July 2014, available at:

http://www.efet.org/Cms_Data/Contents/EFET/Folders/Documents/EnergyMarkets/ElectPosPapers/~contents/K6HJBF2TN9CLEFLN/EFET_Compulsory-forward-TRs-22-Jul-14.pdf. See also our analysis of power derivatives and EPADs trading in the Nordics in our memo *A reality check on the market impact of splitting bidding zones*, dated June 2016 available at:
http://www.efet.org/Cms_Data/Contents/EFET/Folders/Documents/EnergyMarkets/ElectPosPapers/~contents/4L8JKNAX7C4W4YLS/EFET-memo_Swedish-zones-reform.pdf.