Europex calls for TSOs to support existing market-based hedging instruments rather than regulatory-driven regional virtual trading hubs

– Position Paper –

Executive summary

Brussels, 25 July 2024 | From our point of view, obstacles impeding further growth in some European forward markets are foremost related to the underlying physical market structure, misguided policy interventions and stringent requirements stemming from financial regulation. **While TSOs may play a positive role in improving hedging opportunities, we recommend that the European Commission assesses the forward market liquidity situation per bidding zone, and on a regional basis where relevant, and considers possible improvements beyond the role of TSOs.**

By offering liquidity to the forward market, TSOs effectively hedge parts of their congestion income without a financial need to do so. **To ensure that the financial risk TSOs are exposed to is proportionate to the hedging needs they may satisfy, we outline five principles to be considered:**

1. An objective liquidity assessment method by the relevant NRAs is needed to confirm whether TSOs' support to hedging opportunities is necessary.
2. TSOs should not be forced to support hedging instruments that do not stem from market demand. On the contrary, TSOs' involvement should focus on enhancing already existing market-based hedging instruments facilitating market participants' hedging needs over different bidding zones or regions.
3. TSOs should enjoy large discretion on how to support forward markets.
4. JAO should not have an exclusive monopoly role.
5. TSOs should use an efficient methodology to determine the volumes they bring to the market.

We caution against the creation of a regulatory-driven regional virtual trading hub concept as it does not stem from market demand, leaves no discretion for TSOs and requires an exclusive monopoly for JAO. Instead, we should aim for efficient support of existing market-based hedging instruments, rather than a structural revolution of EU forward markets towards an untested regulatory-driven model.

Introduction

Article 9 of Regulation (EU) 2024/1747 mandates the European Commission to assess within 18 months from entry into force different options to improve the liquidity of EU forward markets. In light of the

upcoming impact assessment, this paper provides the European electricity exchanges' perspective on the FCA Regulation[1] and the best way forward for TSOs to support forward markets.

Well-functioning forward markets are the backbone of efficient hedging strategies

Forward markets have been instrumental to allow market participants to hedge their price/volume risks in large parts of continental Europe for about 15 years and in the Nordics since the mid-1990s. Especially during the energy crisis, well-functioning, liquid and transparent forward markets have proven to be vital to manage the high price volatility on European spot markets. Nonetheless, traded volumes were down due to the increased cost of collateral. Fortunately, there are clear signs of recovery. **On an overall basis, volumes across many European forward markets have been at record levels since mid-2023 and in other national/regional markets they are clearly higher than in the preceding two to three years.** From our point of view, obstacles impeding further growth in some European forward markets are foremost related to the underlying physical market structure, misguided policy interventions and stringent requirements stemming from financial regulation. As exchanges, we fully support the ambition to have more liquid, well-functioning forward markets in Europe. Against this background and in light of the upcoming impact assessment of the European Commission, we would like to focus this paper on the role of TSOs in forward markets.

Setting the scene: LTTRs act as a support to market-based hedging instruments at best

Long-Term Transmission Rights (LTTRs) are instruments issued by TSOs which market participants may use to complement their hedging strategy. To hedge against spot price fluctuations, market participants can enter long-term contracts with other market participants. **In order to find good buy/sell offers, market participants may choose a proxy-hedge.** In this case, they enter a long-term contract with an underlying that refers to the spot price of a different but closely correlated bidding zone rather than to the bidding zone where the hedging need exists. For example, a Dutch power producer may enter a German power future as a "proxy" for Dutch power if both day-ahead prices are well correlated.

Also a regional reference price which bundles several bidding zones together in an index can act as a proxy hedge. This is the case of the Nordic System Price, which represents a virtual spot market equilibrium index covering all spot market orders in the Nordic bidding zones and calculated based on the assumption of unlimited cross-zonal capacity between internal Nordic bidding zones. Similarly, the PUN is a virtual trading index covering the Italian bidding zones. More in detail, the PUN index is calculated as the average of the zonal prices in the day-ahead market weighted for the consumption volumes traded in each Italian bidding zone. While today the PUN is both the price paid by the demand side in the Italian day-ahead market and the index used for hedging forward contracts, starting from 2025 it will continue to serve only as the index for the Italian forward market.

[1] Regulation (EU) 2016/1719 establishing a guideline on Forward Capacity Allocation, hereafter the FCA Regulation.

In all of the above-described cases, market participants are left with a basis risk, i.e., the risk that the hedged price does not perfectly correlate with the local bidding zone spot price to which they are physically exposed. **To mitigate this risk, the market has come forward with different hedging instruments**. In the Nordics, the basis risk related to the Nordic System Price Futures can be mitigated by complementary trading in Electricity Price Area Differentials (**EPADs**), which allows market participants to hedge the price spread between the bidding zone where the physical exposure is and the regional reference price. In Italy, the basis risk can be managed by trading transport capacity fee hedges (**CCCs**) which allows market participants on the supply side to hedge the price spread between a specific Italian bidding zone and the PUN index.

Across most parts of continental Europe where bidding zone futures are used for proxy hedging, the basis risk (in this case, a "cross-border risk") can be mitigated in two different ways. Closer to delivery, when the forward market of the bidding zone where the physical exposure is becomes more liquid, market participants may enter a **locational spread contract** with another market participant. This locational spread contract is not an outright contract but a combination of two bidding zone futures, meaning that the market participant locks in the spread between the two bidding zones' day-ahead prices, thus, effectively unwinding its proxy hedge and entering into a direct hedge. Until their expiry date, the future positions can be managed individually, allowing a maximum of flexibility in case portfolio adjustments are necessary (i.e., additional/less capacity as initially planned). Alternatively, market participants can buy a **zone-to-zone LTTR issued by the TSO** which equally provides the market participant with a spread between two bidding zones' day-ahead prices. However, in this case, the main difference with the above-mentioned methodologies is the fact that the TSO is the counterparty, rather than another market participant, and that the amount of contracts being issued by the TSO is limited. Differently from market-based hedging instruments which can be traded unlimitedly as long as there is trading interest from market participants, LTTRs are issued by TSOs only up to a portion of the calculated maximum cross zonal capacity. Even if they were offered up to 100% of Net Transfer Capacity, which is very unusual based on the record that has been offered to date, they would not constitute more than on average somewhere between 20% and 40% of overall EU physical supply/demand per country.

All in all, zone-to-zone LTTRs are useful only as a cross-border hedging instrument, thereby complementing market-based hedging instruments.

An economically efficient TSOs involvement in forward markets

By offering liquidity to the market, TSOs effectively hedge parts of their congestion income without a financial need to do so. To ensure that the financial risk TSOs are exposed to is proportionate to the hedging needs they may satisfy, we outline five principles to be considered.

1. An objective liquidity assessment method by the relevant NRAs is needed to confirm whether TSOs' support to hedging opportunities is necessary.

Putting a requirement on TSOs to provide support to forward markets should only be a fallback option if the relevant NRAs assess that the existing hedging instruments traded in the forward market are not

deemed sufficiently liquid. This is in accordance with point (b) of Article 30(5) of the FCA Regulation. In this context, we believe that **the liquidity assessment by the relevant NRAs is needed to confirm whether TSOs' support is necessary to improve the hedging opportunities within given bidding zones and across specific borders and within given regions**. These assessments should take into account the political and regulatory environment as well as the structure of the underlying market to ensure no logical obstacles to forward market liquidity are overlooked. Also, they should be performed on a regular basis (2-3 years) to ensure that they provide an up-to-date picture of the state of the market which may motivate a change of the need for relevant TSOs' to nationally or regionally support hedging opportunities.

2. TSOs should not be forced to support hedging instruments that do not stem from market demand. On the contrary, TSOs' involvement should focus on enhancing already existing market-based hedging instruments facilitating market participants' hedging needs over different bidding zones or regions.

Once the assessment conducted by the relevant NRAs shows that there is a need to enhance liquidity in forward hedging, TSOs become involved in the forward market. This involvement should take place in the products deemed most useful from a hedging perspective in the given country or region. **As the market comes forward with hedging instruments most useful for market participants to fulfil their hedging needs, TSOs' involvement should always support existing market-based instruments**. **Supporting new models established by regulation rather than market demand contradicts the complementary role TSOs have in forward markets**. More concretely, the proposed regulatory introduction of zone-to-hub LTTRs with the hub defined as so-called regional virtual trading hub could fragment liquidity rather than help to improve it.

3. TSOs should enjoy large discretion on how to support forward markets.

In line with the FCA Regulation, TSOs should have large discretion on how to support forward markets.

While TSOs' support can take the form of auctioning zone-to-zone LTTR options/obligations, we firmly believe that also other forms of support such as auctioning EPADs or other existing market-based hedging instruments should remain possible. In case there are several types of hedging products available on the market, TSOs should assess each instrument's usefulness to secure hedging needs and consequently choose the way of support which would be the most economically efficient. Importantly, this assessment should take into account the market fundamentals of the region, the liquidity of these instruments and the ease to perform secondary trading in these instruments. Moreover, in case TSOs trade contracts in which they face a counterparty risk, they may want to trade at a market place which offers clearing.

Furthermore, we believe that instead of using service provider to auction hedging products, TSOs should have the discretion to use service providers to trade directly on exchanges. As TSOs are ultimately having a spread position, they could hedge this position through simultaneously buying and selling EPADs or bidding zone futures on exchanges. This way, market prices can be best assured.

4. JAO should not have an exclusive monopoly role.

There are clear existing and historic examples of TSOs efficiently providing additional forward hedging opportunities via market-based products without any need for centralisation of this offering via a pan-EU platform. Although we understand the theoretical attractiveness of centralisation, **TSOs should have discretion to tender the auctioning of LTTRs, EPADs or equivalent measures, thus, allowing any matching platform, broker or exchange to bid for the service**. Furthermore, any platform organising secondary trading of LTTRs or other market-based hedging instruments should properly adhere to the rules established under EU financial services legislation, including the Markets in Financial Instruments Directive (MiFIDII), the Market Abuse Regulation (MAR) and the European Market Infrastructure Regulation (EMIR), in order to ensure safe and efficient trading of these products.

5. TSOs should use an efficient methodology to determine the volumes they bring to the market.

The linear Net Transfer Capacities (NTC) approach, the flow-based capacity allocation and the expected net traded energy are all possible ways to determine the volumes TSOs should bring to the forward market. While a more price-sensitive methodology than the NTC approach is recommended, **we are seriously concerned about the introduction of Long-Term Flow Based Allocation (LTFBA) since it is immensely complex and questionable whether it will be beneficial for market participants and TSOs**. While in spot markets it is logical to allocate capacity to where it is valued most, in forward markets capacity allocation should ideally follow hedging needs. It is wrong to assume that hedging needs grow when the price spread is higher. Hedging needs might be high between well-interconnected zones with only a small price spread, especially if this price spread is quite volatile. Furthermore, it is highly unclear whether the allocated capacities under LTFBA will be larger than the current NTC methodology, as initially intended by ACER. In any case, significantly simpler measures are available in order to increase the volume of LTTRs. Simplicity regarding the methodology is recommended also from a market integrity perspective.

Finally, while we understand the thinking behind using expected net traded energy, it implies the assumption that forward markets should be balanced and that TSO volumes are missing from the market. While this idea seems sensible in markets that experience a significant demand and supply imbalance, it does not fit outside of this context. Hence, this volume determination criterion should be applied only if it is decided that TSOs' support is needed and under strict conditions related to the bidding zone size and its market structure.

Our advice for the European Commission impact assessment

We invite the European Commission to analyse the current status of the EU forward markets and consider possible improvements beyond the role of TSOs. While TSOs may play a complementary role to market-based hedging instruments, **the impact assessment should first look at the impediments to further growth of liquidity on a bidding zone per bidding zone and relevant regional basis to ensure no obvious obstacles are overlooked**. It is also important to take into account that, given the standard practice of proxy hedging, low liquidity in a bidding zone is not a problem per se.

When exploring possible improvements to the long-term transmission rights framework, the Commission should provide an **historic assessment of the use of LTTRs**, including several aspects: the purpose for which LTTRs have been traded, an analysis of how LTTRs fit into market participants' hedging strategies and interact with the forward market (OTC and exchange traded) and the extent to which LTTRs have supported market-based driven growth of forward markets. Regarding possible improvements, we recommend a detailed assessment of the costs and benefits of moving from options to obligations, especially considering the clearing structure required for issuing obligations. Furthermore, we suggest a broad analysis of different options to determine the volumes TSOs should provide to the market.

Finally, **when it comes to a possible introduction of zone-to-hub LTTRs as the standard choice for TSOs' support, we expect a detailed assessment in terms of increased hedging opportunities for market participants as well as all related costs for TSOs**.

About

Europex is a not-for-profit association of European energy exchanges with 33 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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