

## **NordREG consultation on "Measures to support the functioning of the Nordic financial electricity market"**

Energy Norway welcomes NordREGs consultation and thanks NordREG for providing us with this informative report as a basis for discussion and comments. We consider this as an important step in the wider assessment of the functioning of the Nordic financial markets, which also needs to address other questions, such as whether such a support is needed.

Amongst the measures described, Energy Norway's members currently prefer "support to the market maker function" i.e. model 1. In our view, the main advantages are the daily possibility to trade and the daily price transparency (or price spread transparency). In addition, the TSO "just" incurs fixed cost instead of having an open position on the financial markets, where the connected risk and cost would be passed on to tariff payers in the end. Amongst the other models, the auctioning of EPADs or EPAD combos i.e. models 3 and 4 seem to be acceptable alternatives under certain conditions, but there remain many open questions. Alternative 2 i.e. the TSO as a market maker should be excluded for the reasons described in the report, we do not want the TSO do be directly active on the financial market.

In Energy Norway's view, the report describes some interesting financial measures to improve the function of the EPAD marked. But it fails to address the current price area structure, that in some cases leads to the malfunctioning of the current EPAD marked and more fundamental measures to improve market functioning. We understand that this has not been in the scope of the report, but regulators should address these questions in consultation with the TSOs and stakeholders. A restructuring of the price areas could lead to improved EPAD markets without the need to employ additional financial measures simply by creating decent sized price areas containing a balanced mixed of production, load and flexibility.

We would further like to underline, that FTR options or obligations are not viable alternatives to EPADs for hedging electricity prices. LTTRs as described in the Guideline for Forward Capacity Allocation are not the products Norwegian producers or retailers need for their hedging of the electricity price. Norwegian companies want to profit from the liquidity of the system price and an EPAD takes them from their price area to the system price. An LTTR however would just replace their area price risk with the area price risk of the neighbouring price area. Since there are no liquid markets

in area price contracts, a LTTR would not help them hedge their position. In addition, LTTRs could reduce the liquidity of the system price futures. This weakens the main Nordic signal for future price development with negative consequences for investment and operational planning. LTTRs also have other disadvantages as mentioned in the report.<sup>1</sup>

Therefore, we do not discuss these options further in our consultation answer but rather concentrate our comments and remarks at what we consider the viable alternatives i.e. support of the market maker function for EPADs, or auctioning of EPADs/EPAD combos.

*First step: assess the need for support for the financial markets*

Any support measure by the TSOs to the market will have a cost, which will be carried by the tariff payers in the last consequence. Therefore, a market assessment should be carried out in consultation with the stakeholders. We agree with the consultants, that "a clear case of market failure should be identified before the TSO is instructed to intervene". Otherwise, the intervention will just cost without carrying benefits with it.

In addition, the cost of the intervention should be compared to the potential benefits. Is a potentially costly intervention for one EPAD necessary, or could another EPAD or the system price serve as acceptable hedging tools for a lesser cost?

Here are some questions that should be addressed in the assessment:

- Different demand for hedging: are there differences between price areas, producers' and consumer's needs? What needs do retailers have? Is there a high share of spot price contracts for example?
- How do producers and retailers hedge? Via EPAD, via EPAD of another price area, via system price, traded on the exchange or via a broker or a bilateral traded contract etc.? Are these options considered to be sufficient?
- Are all these market places together functioning and provide sufficient hedging opportunities? Size of the spread, depth, volume, liquidity, open interest and other factors should be addressed there
- Fundamental factors that influence the EPAD markets such as size of the bidding zone, dynamic bidding zone delimitation, unbalanced markets with more production or consumption within one bidding zone, the lack of flexibility within one bidding zone or fluctuation of grid capacity made available between bidding zones. The consequences of planned investment in transmission grid should also be assessed.
- A change from today's NTC coupling to flow based market coupling will also influence the price volatility of the area prices and their relationship to the system price.

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<sup>1</sup> However, in future cases where Norwegian producers need to prove access to transmission capacity in order to participate in neighbouring capacity markets or RES subsidies, it might be necessary for the TSOs to develop new instruments resembling transmission rights in some aspects to allow producers participation in these markets.

This exercise should help to identify exactly what the problem is and its' scale and thereby help identify the best way to address it.

*Fundamental measures to address market failure should be added to the tool box*

In our view, the bidding zone structure should be addressed as a fundamental measure in order to improve the function of the financial markets. While not all market failures are caused by fundamental factors due to the current bidding zone structure, some of the problems are certainly linked to it. In these cases, the above described measures to improve the function of the EPAD market would improve the symptom but not address the root cause of the problem.

If there were a strong fluctuation of available capacity between bidding zones, leading to unpredictable spreads between area prices, another way to address the problem would be for the TSO to guarantee a certain amount of available capacity in the price-coupling algorithm. That would reduce and stabilize the spread between price areas and make it more predictable for market parties. By reducing the risk that could also improve liquidity in the EPAD market.

In Energy Norway's view, guaranteed capacity in the algorithm, the bidding zone structure, the dynamic price areas and other fundamental measures should be addressed in a second hearing when the functioning of the financial market is assessed. That debate could develop new ways to manage bidding zones changes and/or their structure that could be more efficient to address illiquid EPAD markets and maybe less costly for the TSO than one of the above described market interventions.

*Benefits and cost of "Supporting a Market Maker" – the currently preferred option*

This is currently the preferred option amongst Energy Norway's member companies. In our view, a daily visible spread and the possibility to enter or exit positions daily are the biggest advantages of this model. Especially retailers point out, that it would become easier for them to offer tailor made products to their customers if EPAD price transparency existed.

In their view not only the allowed size of the spread but also a certain minimum volume is necessary, otherwise already small trades could move the price considerably, which would reduce the advantage of price transparency provided by the allowed maximum spread. Therefore, the question of the necessary maximum spread and minimum volume should be addressed in consultation with stakeholders, if that option is chosen, as suggested in the report.

As tariff payers, Energy Norway's members also appreciate that this option would only entail a known fixed cost for the TSO, consisting of the administrative cost and the compensation to the market maker, and not change the TSO's exposure to market price risks by an unknown size by adding direct exposure in the financial EPAD market.

Another advantage from our member's point of view is, that they could most probably use their existing connection to Nasdaq to trade EPADs. They would probably not need to establish a new connection to another exchange, if the TSO procures market making services from companies on the exchange already listing EPADs, where the majority of companies are members. Especially for

smaller companies a change of marketplace would effectively prevent them from profiting from market maker service, since the administrative cost of connecting to several exchanges might prove too high for them. This increased cost of potentially forcing market parties to connect to several platforms and the lack of opportunity for smaller companies to participate should be considered in any public procurement process that the TSOs eventually run. Therefore, the procurement process should focus on competition between companies offering market maker services but not on competition between exchanges. Instead, the TSO should use the exchange already listing EPADs and where the majority of the trades take place. There is maybe even a possibility to cooperate with the exchange as described in the report to further reduce cost for the TSO.

Under the criterion of good regulatory design, we also consider that market making is relatively easy to establish and to adjust, if the current exchange is used.

### *Benefits and cost of "Auctioning of EPADs" and "Auctioning of EPAD combos"*

The usefulness of these two models depends in the view of Energy Norway very much on the fact, that the auctioned product is identical to the currently exchange traded EPADs and not somehow different. If the product is identical, Nasdaq can be used for secondary trading and it won't make a difference if the product originated in the auction or is independently offered by a company afterwards. Given that the product should be identical to the traded EPAD it is also important to emphasize, that market parties bidding in an EPAD combo auction, must have the possibility to bid for just one EPAD of the EPADS combined in an EPAD combo. Most member companies are interested in an EPAD linking them directly to the liquid system price, not in an EPAD combo linking them to another price area. In the view of Energy Norway, it should make no difference to market parties if EPADs or EPAD combos are auctioned, since the product for them should be the same linking them from area price to system price. The difference is primarily for the TSO who has a different exposure to financial market risks if it auctions one EPAD or simultaneously two EPADs or an EPAD Combo. We will address that issue below.

Given that it is the same product auctioned as traded on the exchange, Energy Norway's members still prefer the market-making model. The main reason is that the auction will reveal a price only periodically and does not offer the daily transparency of a spread on the market place and the daily possibility to trade. In the case of EPAD combo auctions, the auction volume might in addition be limited by the fact that interested bids for both sides of the EPAD combo have to be found. In general, if one of the auctioning solutions is considered, the daily transparency and possibility to trade depends on the well-functioning trading and secondary trading on the market place. Some of these concerns might be alleviated by setting up an auctioning calendar and scheduling auctions in the right frequency. Therefore, if this model is considered, the questions on frequency, products, volume of the auctioned products and set-up of the auctions should be addressed in a separate consultation with market parties.

Again we want to emphasize that members would like to use their existing membership established at Nasdaq to bid in an EPAD or EPADs auction and not be forced to set up membership with a new exchange. This would make it difficult especially for smaller companies to profit from the increased liquidity in auctions since new IT links, agreements for collateral etc with a second exchange need to be set up.

As tariff payers, Energy Norway members are skeptical towards exposing the TSOs to financial market risk by forcing them to hold open EPAD positions. These risks will be passed on through the tariffs and could lead to tariff increases<sup>2</sup>. In addition, we disagree with theories, that imply that the TSOs have a need to or should hedge their exposure to market prices by becoming active in selling LTTRs or EPADs. TSOs already pass on their risk and costs to the tariff payers by having the right to impose tariffs on all grid customers. TSO hedging activity in financial markets has a cost and can lead to reduced congestion income, that loss of income will be passed on and the tariffs will increase as a consequence.

Therefore, concerning EPAD auctions or EPAD Combo auctions, Energy Norway emphasizes that there should be taken careful consideration of the financial market risks the TSO is exposed to and that the auction design should minimize those risk as far as possible. EPAD combo auctions or simultaneous and coordinated auctions of two EPADs seem to have an advantage over single EPAD auctions in that respect, as they can contribute to reduce the financial risk exposure of the TSOs. In addition, there should be an assessment of cost and benefits: is the gain of a more liquid EPAD market a higher benefit than the cost that the TSO is incurring and that will be passed on through tariffs.

Regarding good regulatory design, also auctions of EPADs or EPAD combos are relatively easy to set up if the existing exchange is used and relatively easy to adjust. Since the TSO is exposed to financial risks on behalf of the tariff payers, that solution requires extra transparency in our view. Not only right after the auction regarding sold volumes and price but also after the delivery period to determine how big the gain or loss of the TSO was on his EPAD position. That information is necessary to judge the efficiency of the auction solutions.

### *General remarks on the process to improve the functioning of the EPAD markets*

Energy Norway appreciates that the Nordic regulators have started this process and involve us from an early stage through consultations and workshops. In our view, this consultation on measures of how to support the EPAD market should be only the first in a row of Nordic stakeholder consultations.

As said above, a consultation on the functioning of the current financial market should follow, to identify the challenges and whether there is a need for intervention. This consultation (or a second consultation) should also address fundamental questions such as our current bidding zone structure and available capacity between price areas and potential measures to improve that. In addition, that consultation might reveal other reasons for reduced liquidity on financial markets such as the cancellation of the possibility to use commercial bank guarantees as collateral.

Once that process has finished and if it is established that there are problems on the EPAD market that need to be addressed and which could be solved through either market making or auctioning of EPADs and EPAD combos, there is the need for a third round of consultations. It should look into the specifics of the market making role (maximum allowed spread, minimum volume...) or the auctioning (products, schedule, volume...). That consultation should also give a first idea of what these different types of interventions will cost.

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<sup>2</sup> And as the hearing report correctly points out on page 24 and 25 – not allowing the TSO to pass the risk and associated cost 100% on to customers via the tariffs will give the TSOs wrong incentives to minimize their financial exposure by for example setting different ATC values. So the costs will have to be passed on 100%, all other solutions will give wrong incentives to the TSOs regarding capacity made available to the markets.

We agree with the report, that these consultations might reveal the need for a Nordic tool box rather than one single measure. The situations and challenges can be different from bidding zone to bidding zone and can necessitate different type of interventions.

Last but not least, we need transparency on cost and benefits of the different measures, once they are in place, so that they can be revised or adjusted in case they do not show their desired outcome or should the benefits of a more liquid EPAD marked not outweigh the cost.

Energy Norway thanks the regulators for this interesting report and the accompanying consultations and looks forward to continue that important debate at the workshop and other future occasions.

Best regards

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