

Comment to the NordReg/Thema report: "Measures to support the functioning of the Nordic financial electricity market"

Introduction

The power intensive industries welcome NordReg's initiative to analyse and discuss ways to improve market functionality, hedging opportunities and liquidity in the Nordic area, and its possible alignment to FCA GL. The report is a useful contribution to the discussion surrounding financial hedging across bidding areas, but we find its scope and assessments too limited.

Power-intensive industries rely on secure and reliable supply of power at competitive prices for short-term survival. These industries are also capital-intensive with long payback periods, so a predictable power prices, including all charges and taxes, for the longer term is essential for investment decisions and long-term operation.

Power intensive industries usually hedge their power costs through long-term power contracts. In the Nordic market these contracts are either referred to the system price or to the area price in specific locations in the grid. Demand for price-area hedging through EPADs has been limited, either because the specific area price risk is seen as limited or because the cost of the relevant EPAD is considered too high compared to the area price risk. For such reasons, we strongly back the report's narrative on examining whether lack of EPAD liquidity is a market shortcoming before introducing new regulations.

In the coming dialogue with EU on the alignment with FCA GL it is important to start with an appropriate assessment of the need for market improvement in the Nordic area and of the compatibility of the proposed hedging solutions with the Nordic forward model. Of the alternatives described in the NordReg/Thema report, we prefer model 1, i.e. support to the market maker function. Auctioning options in the form of model 3 or model 4 could be acceptable in specific circumstances.

Improved forward market

The main objective of an improved forward market is to enable consumers and generators to reduce their exposure to wholesale market price risk. Hedging is mostly done using the system price and should be available within each day-ahead price zone through EPADs, while there is no sound reason for hedging to be based on cross-border instruments. Hedging should be available within each day-ahead price zone, and not be mainly based on cross-border instruments.

Lack of hedging opportunities could be a result of low demand, and not necessarily a sign of market imperfections. We would strongly oppose any new regulation unless the need for it is unquestionable. Should new regulation be required, the preferred actions to improve the hedging opportunities of the market participants in the Nordic forward market should be:

1. Improved bidding zone structure. Certain bidding zones lack relevant flexibility. In some other bidding zones, pricing is dominated by one producer. In this context, regular establishment of new zones harms liquidity.
2. Maximize available transmission capacity between zones. In some cases, weak forward liquidity is due to instability and unpredictability in the capacity that is available for the market. This is directly related to the way TSOs operate the grid. If TSOs were asked to guarantee a minimum capacity on critical cross-sections of the grid to be used in the day-ahead pricing algorithm, they would have an incentive to stabilise or maximize capacity.
3. Stronger market maker functions for EPAD contracts, preferably financed and handled by the market, and not TSOs.

Our conclusion regarding the models in the report are as follows:

1. Cross-border instruments will be irrelevant and redundant hedging instruments in the Nordics and should not be introduced.
2. Instructing TSOs to organise auctions of EPADs or cross-border instruments, or performing market maker duties is at odds with the role of TSOs as neutral market facilitators, emphasising the need to establish "Chinese walls" and to have these overseen by regulators.
3. TSO costs (deficits and risk related to auctions, support of the market maker function, etc.), will be socialised through grid tariffs leading to unwarranted redistribution of value from consumers and generators to traders.

The Nordic market does not need cross-border instruments Even though the Nordic market works reasonably well, new measures may improve the market functioning. Liquidity support should however focus on area prices versus the system price, i.e. EPADs. Introducing new cross-zonal products will split liquidity and might be harmful.

First, the present European target model for the forward market contains many features that are not very applicable in Nordic markets. . Imposing these regulatory changes on the Nordics thus risks adding unnecessary costs and uncertainty on an already well-functioning Nordic market. In a Nordic market setting, powerprices are hedged through the system forward price while EPADs hedge against area price deviation from system prices. These hedging instruments would make cross-border instruments superfluous and irrelevant, and could end up drawing liquidity away from the EPAD markets. Furthermore, we believe that introduction and increased trading of cross-border capacity products will undermine and reverse the process of fully integrating the Nordic national markets.

Second, the likely cross-border instruments are not appropriate for hedging purposes. FTR-Obligations could in principle be used to hedge cross-border trades, but they could expose TSOs to unlimited financial risk, and will hardly be introduced anywhere. FTR-Options are easier to manage for TSOs, and will thus be their preferred choice. FTR-Options are however not preferred hedging instruments for localisation spread.

The Nordic market needs reform

Whereas most aspects of the Nordic electricity market are the most advanced in Europe, progress in recent years has been minimal. In the forward market, the main issue is the link to the day-ahead market.

Certain bidding zones lack relevant, price-setting flexibility (SE4 etc.) and will most of the time have to “import” their day-ahead price from a number of different neighbouring zones, leading to unstable and unpredictable pricing. In some other bidding zones, pricing is dominated by one producer. In both these cases, establishing a liquid EPAD will be very costly, and EPAD pricing may be prone to manipulation. In these cases, rearranging day-ahead pricing structure, for instance through a merger with one or more neighbouring zones, would improve EPAD liquidity.

In some cases, the main issue for the market is lack of stability in the capacity that is available for the market. This is directly related to the way TSOs operate the grid. If TSOs were asked to guarantee a minimum capacity on critical cross-sections of the grid to be used in the day-ahead pricing algorithm, they would have an incentive to stabilise or maximize the capacity.

A new concept of “price zones” could be introduced. A price zone is a group of adjacent bidding zones (also including zones in different countries) where prices can be aligned through various mechanisms. A price zone may also include bidding zones from different countries. This will increase the chance that the market will solve the issue of EPAD liquidity without intervention.

EPADs should not be auctioned

The issuing cost of FTR-Options correlates well with congestion incomes. However, issuing cost of instruments that are suited for hedging purposes (EPADs and FTR-Obligations) does not correlate well with TSO income, and the risk will have to be hedged. Such risk is difficult to hedge for players that have no natural position in the relevant areas, and TSO will have to establish advanced trading operations to do it. This will jeopardise their impartiality and independence as market facilitators.

EPAD-Combos are designed to mimic FTR-Obligations. Hedging in the Nordic market is however based on the system price forward, and the market does not need such contracts. Introducing them will support the development of forwards for key price areas and split the forward liquidity. Splitting forward liquidity between two competing models may achieve the opposite of the intended effect. EPAD-Combos can only be split into two EPADs and used in combination with the system price if there is a liquid secondary market for EPADs in which the unused leg may be sold. At present, there is no liquid secondary market, and nor is there likely to be one: Those who want an EPAD, buy it and keep it as a basis for other hedging.

In a situation without a liquid secondary market, the buyer takes the pre-settlement risk. This introduces a risk premium that will be reflected in auction pricing. Experience in Europe has shown that prices in auctions of such instruments generally are lower than the realised payout from the price spread between zones. This loss will be absorbed by the TSOs, and passed on to consumers through grid tariffs.

EPAD liquidity should not be supported by TSOs

The FCA GL prescribes TSO involvement in cases where hedging opportunities are insufficient. If TSO involvement should be deemed necessary, care should be taken to avoid a situation where the market involvement of the TSOs jeopardises their role as neutral market facilitators. Implementing the proposed measures will increase administrative and financial costs for TSO, as well as their financial risk. In the end, the costs will be borne by grid customers, and the grid cost is already major cost risk for consumers.

Most traded markets of the bid-ask type have market makers that guarantee buy and sell bids with a minimum volume and maximum spread. This service is generally agreed with the market operator and paid for by the market participants through trading fees. This is in place in the EPAD market where EPADs are traded. The reason for no demand is in some cases that there is no need for them since the area price correlate strongly with the system price and since sometimes erratic area prices make EPADs a risky investment.

Some Nordic zones are either importing most or their consumption, or have a large share of exports. This translates to either a lack of sellers or buyers of EPADs. Zones with a more balanced supply-demand balance would incentivise more EPAD trade. The forward market should be a pure financial market, linked with the day-ahead market through a harmonised zone partition. The market should be self-financing and not subsidised by generators and consumers of electricity that do not use it.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Ole Børge Yttredal". The signature is fluid and cursive, written in a professional style.

Ole Børge Yttredal

Director Energy & EHS Department, Federation of Norwegian Industries