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# ENTSO-E assessment of the feasibility of multi-yearly hedging products

December 2013

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## 1. Background

ACER conducted a public consultation in 2012 on Forward Risk Hedging Products. A majority of the respondents expressed their interest in the introduction of longer-term products since their perception is that they would increase cross-border competition and provide further risk-hedging opportunities. Their reasoning was that in order to better hedge production capacity, capacity should be available for as far in the future as there are liquid forward markets for electricity.

ACER has asked ENTSO-E to provide an initial feedback on the feasibility of multiannual products in order to help reaching a decision on whether these products should be introduced by TSOs.

Below, we analyse the manifold consequences and implications of introducing multi-yearly hedging products and the feasibility of these products.

## 2. Consequences and implications of introducing longer-term capacity products

### 2.1 Impact on competition

As we understand the proposal, as much capacity as possible should be allocated long term. This implies that potential new market entrants will be faced with the situation that, compared to the situation with only yearly products, merely a reduced amount of capacity is left at the time they want to enter the market.

Under this condition, multi-yearly products would not only provide an obstacle to new entrants, but also to smaller players: Obtaining multi-yearly long term transmission rights basically means the conclusion of a contract with a high amount of total liabilities and duties over a long period of time. Smaller market participants may not be able to enrol in such auctions because of the risks involved. It is therefore likely that only a few big players would compete for this share of capacity, thereby reducing competition.

Furthermore, if the introduction of multi-yearly products was to be considered, it would have to be ensured that this happens in a harmonised way. Otherwise, the goal of establishing a level playing field across Europe could be jeopardised, again resulting in distortions hampering the functioning of the internal market.

### 2.2 Impact on available capacity

The uncertainties in calculating and providing long term capacities will of course increase the longer in the future capacities should be calculated and allocated.

In order to calculate available capacities, maintenance planning is an important input. This maintenance planning involves a large number of TSOs, generation companies and service providers (i.e. companies delivering and providing components). Currently, yearly available capacities are calculated during autumn of Y-1. Important input factors are all projects (planned maintenance of both network and large generation units, new constructed lines or substations which have to be connected to the grid) which might affect the

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interconnector capacity. It is already very challenging to agree on dates for projects leading to lower capacities on an interconnector for yearly products. A coordinated and firm planning for more than one year ahead is hardly feasible under these circumstances – for this reason, the year ahead planning horizon is also determined by the NC Operational Planning and Scheduling. If the inputs try to reach too far into the future, they will be too estimative to provide a reliable capacity calculation.

If TSOs have to provide firm capacities and some circumstances respectively the timing of incidents (i.e. unplanned outages of big power plants and others) cannot be foreseen in spite of sophisticated planning tools, some flexibility and contingency for shorter term adjustments needs to be reserved. As a result, compared to a situation where capacity is allocated on a yearly or even shorter term basis, only a relatively small share of capacity can be provided for allocation in the very long term due to less information and higher uncertainty. We doubt that the benefit of offering such low capacities would outweigh the organisational difficulties associated with allocating multi-yearly products, especially those described below regarding auction rules, processes and systems.

Another effect of introducing multi-yearly products is the further fragmentation of capacity into more products – for each time frame, less capacity can be allocated due to reservations for the newly added timeframes. Some of these timeframes already count with limited capacity. Additionally, multi-yearly products which have been auctioned in preceding years have to be accumulated and considered when establishing other products<sup>1</sup>.

### 2.3 Impact on auction rules, processes and systems

Including multi-yearly products in auction rules may reduce the flexibility regarding the modification of auction rules. It will be more difficult to change auction rules from one year to the next as it is practiced today (only small/non-substantial changes might be possible). Substantial changes from year to year would become more cumbersome for this reason: the same link which today exists between yearly and monthly products (resale) would also be applicable for multi-yearly products. Discrimination has to be avoided, implying that the conditions for obtaining and using monthly capacities should not significantly differ from those for yearly capacities if both kinds of products are due at the same time. This would apply for multiannual products as well, i.e. conditions for yearly and monthly products should not differ significantly from those for multi-yearly products. However, any change in auction rules would imply that multiple contractual frameworks exist in parallel.

On top, market parties' preferences for product duration are related to market drivers and can change over time. With multi-yearly products in place, split rules could not be adjusted quickly in response to changed market needs.

Regarding the adjustments of processes and systems resulting from an introduction of multi-yearly products, with our current knowledge, we estimate that some modifications will be necessary. For example, the resale of multi-yearly products in the yearly auction would have to be enabled. Operational costs at the auction offices would increase accordingly. However, we do not consider the necessary adjustments and resulting costs as very significant.

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<sup>1</sup> Multi-yearly product 1 which is applicable for Y-2, Y-1 and Y, needs to be considered when fixing the capacity for multi-yearly product 2 applicable for Y-1, Y and Y+1; both products 1 and 2 need to be considered when defining multi-yearly product 3 applicable for Y, Y+1, Y+2.

## 2.4 Impact on TSO risk exposure

The non-payment risk for TSOs increases when long term transmission rights are allocated over a period of multiple years. In response, TSOs would need to assess more thoroughly market participant's credit worthiness. Furthermore, higher collaterals/securities should be required. Both these measures, of course, demand more human resources on behalf of TSOs and more financial resources on behalf of market participants.

## **3. Relation to Network Codes**

The Network Code on Forward Capacity Allocation developed by ENTSO-E and delivered to ACER on October 1<sup>st</sup> 2013 does neither preclude nor stipulate the introduction of multi-yearly capacity products.

However, the Framework Guideline on capacity allocation and congestion management and the respective Network Code require a regular assessment of the efficiency of bidding zones which can lead to an adjustment of these zones. Introducing new zone delimitations would be very demanding even with only year-ahead capacities being auctioned. Defining new zones when multi-yearly products are in place would increase the complexity further and increase the risks for traders: The NC establishes that "Where Bidding Zone Border(s) no longer exist, holders of Long Term Transmission Rights on those Bidding Zone Border(s) shall be entitled to reimbursement based on the initial price paid for the Long Term Transmission Rights". With annual products, this compensation/product interruption can be totally or partially avoided by optimally coordinating the Bidding Zone changes with the yearly auctions calendar. For multi-yearly products, this policy of avoiding disruptions becomes unfeasible.

As indicated above, the Network Code Operational Planning and Scheduling defines that the inputs for long term capacity calculation are provided on a yearly basis because forecasting further into the future provides too unreliable results.

## **4. Conclusion**

TSOs understand market participants' desire for possibilities to hedge their production for longer periods of time. However, allocating the majority of capacity via longer term products may constitute a considerable entry barrier for new actors and discourage the participation of smaller players. This could result in market distortions and reduced competition. It finds further that longer term capacity calculation is automatically subject to more uncertainties which lead to smaller amounts of capacity being available. A further consequence of multi-yearly products is that the capacity available per time frame will be reduced since it is split across a higher number of products. In case multi-yearly products were introduced, it would hardly be possible to adjust auction rules without discriminating market players and increasing complexity of contractual framework.

Though technically feasible, it requires a careful assessment by regulators if the benefits pointed out by market players in their responses to ACER's consultation on long term hedging products outweigh the above mentioned drawbacks.