

The importance of a secondary capacity market

Task Force Switzerland is a subsidiary of the EFET Electricity Committee. An ad-hoc working group of the Committee completed recently its view on a design for a new market in electricity transmission rights, to foster the development of a market in wholesale electricity (as a commodity) in continental Europe.

Our new position paper is entitled “*Key principles in the treatment of electricity transmission capacity rights and their linkage to day-ahead allocation mechanisms*”¹. We propose a series of principles or market and product design criteria, which could ensure the rapid introduction of markets in electricity transmission capacity rights.

Since we wrote the paper, Consentec issued a report for the European Commission, “*Towards a common co-ordinated regional congestion management method in Europe*”², which endorses the idea of a target model retaining a market in transmission rights in parallel with the creation of market coupling.

1. Why a secondary capacity market is urgently needed

Currently, in the absence of a secondary market for physical transmission rights market participants bear a substantial base risk. Primary transmission capacity is usually being allocated in the form of (one) annual and monthly auctions, thus there exists currently 13 times a year the opportunity to hedge the base risk between two price zones. Exposures being created from sales or trading activities will seldom coincide with the timing of the auctions. The timing of sales or trading activities is unfortunately most often not at the disposal of the sales agent/trader.

Even if the sales agent/trader accepts the inherent base risk due to the different timing of auction and sales/trading activities, he will be often left with too much or too little capacity. This is due to the character of the auction; a single sided and single round auction means for the trader a one off chance to acquire capacity in the auction. Due to the lack of a secondary market that may lead to an overbidding for capacity, leaving the auction participant with more transmission capacity than intended and may thus facilitate an unintended capacity hoarding.

Another important point to consider is the incentive for the TSO to guarantee the firmness of the physical capacity rights at least cost. The firmness of capacity is currently either not guaranteed (capacities are sold on a firm basis, but then are curtailed) or is achieved by means of redispatch/ countertrading. The potential buyback of capacity by the TSO shall offer a second measure to TSOs to bring the allocated capacity back in line with the physical available capacity thereby not jeopardizing operational security but also accepting the firmness of capacity originally allocated. Without secondary market there is no price signal for TSOs to decide whether a buy back is advantageous or not.³

¹ (June 2007). Available on <http://www.efet.org/default.asp?Menu=76>

² (September 2007) Available on http://ec.europa.eu/energy/electricity/florence/14_en.htm

³ See also EFET working paper: More transmission capacity for European cross border electricity transactions without building new infrastructure, May 2006, Appendix 5: Secondary transmission capacity rights market model.

The main reason for which trading in auctioned rights has not become liquid is the lack of contractual firmness of rights granted presently. Both compensation for curtailment and a TSO buy-back offer must at any point in time be referenced to the forward market spread between the pertinent areas.

2. Why a secondary capacity market has not developed yet – obstacles to trade

EFET spent some time and work in the development of an Annex to its EFET General Agreement Electricity⁴, however no secondary trade in physical transmission rights has yet been established. What are the obstacles to trade the capacity in a secondary market?

- A lack of standardization in the rules governing the auction and the use of the acquired capacities from these primary markets. Each set of auction rules has different definitions in terms of *force majeure*, performance assurance, payment schemes and the like. A lack of standardization means that a legal opinion in respect to every contract governing the primary allocation of transmission capacity needs to be performed. Given the limited size of primary transmission capacity markets if limited to one border, this may prove to be too costly.
- There is a lack of IT standardization. There are almost as many IT auctions and notification systems as auctions between two price zones. These systems use different data models and electronic transfer protocols. Given that most TSOs or Auction Offices had already invested in IT systems, these investments are sunk and irreversible. However, when there is a need to replace the systems in future a common approach should be made by European TSOs to make use of one system or at least with systems that are compatible to each other.
- TSO or auction office as a notified and not consenting party: the TSO issuing the physical transmission capacity has in almost all cases to consent the transfer of physical capacity from the primary buyer to the secondary one. This is due to the additional credit risk that the TSO (or auction office) may incur through the secondary buyer. Additionally the TSO wants to assure that the new owner will be able to move the power between the pricing zones coupled by the transmission rights having the necessary balance responsibility on both sides and having acceded to the rules governing the use of transmission capacity.

3. What can TSO and regulators in Italy (in Switzerland) learn from the situation elsewhere and how can they facilitate a secondary transmission capacity market?

1. A history of six to seven years of explicit auctions for physical transmission capacity exists in Europe. IT systems are available on a broad basis; general rules governing the allocation and use of transmission capacities have been in place for years. EFET suggests that TSO and regulators should make use of previous work of other TSO and regulators in terms of governing rules and systems in order to allow economies of scale on the side of TSOs and transmission capacity market participants.
2. TSO shall allow transfer of transmission capacities from a primary buyer to a secondary one as a notified and not as a consenting party. In order to facilitate this change TSO could prepare a "white list" with participants that fulfill the TSO requirements in respect to collaterals and balance responsibility. This would create legal certainty to the transmission capacity buyers as they would not have to await consent by the TSO for a transfer of transmission capacity.

⁴ General Agreement Concerning the Delivery and Acceptance of Electricity, Version 2.1/December 20, 2000

3. Guarantee financial firmness of awarded transmission capacities, i.e. compensate capacity holders in case of inevitable capacity curtailments due to operational reasons at the **full market spread** (the hour to hour price difference during the curtailment between the two price zones in question).

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