

EFET observations on the draft forward capacity allocation network code as submitted by ENTSO-E to ACER on 1 October 2013



6 November 2013

EFET would like to share its views with respect to the draft network code on forward capacity allocation, which ENTSO-E submitted to ACER on 1 October 2013. It is clear from this document that considerable work from ACER will be required to complete the drafting of the network code and to ensure that the code complies with the Framework Guidelines.

We are ready to help with these tasks and have drafted some initial comments in the sections below. EFET already has some text proposals which were submitted to ENTSO-E during the consultation which we would be happy to discuss with ACER and/or NRA officials.

1. “Firmness”

The current draft of the network code does not comply with the firmness stipulations of the Framework Guidelines and *does not in fact provide for firm access to the grid beyond the day-ahead timeframe of the market at all.*

- a) The Framework Guidelines specify that TSOs may only curtail previously allocated transmission rights in cases of an emergency situation (ES) or *force majeure (FM)* [paragraph 3.3]. So does Regulation 2009/72 [Article 16]. Indeed curtailment may **only** be used where there is an emergency situation **and** other methods have been exhausted.

By contrast, the draft NC states that TSOs have the “entitlement” to curtail (unbounded) as well as in the event of an ES or for *FM*. Article 62 of the draft network code introduces a different regime for curtailment under conditions of emergency situation and force majeure. This is superfluous and misleading since it implies that “emergency situation” and “force majeure” are the same thing. Also a different definition of force majeure is used in the NC compared to the Framework Guidelines.

- b) In the event of curtailment, and in normal circumstances, the Framework Guidelines envisage compensation at market spread without any caps. And in order to implement a cap, TSOs require regulatory approval on a case-by-case basis [paragraph 6.4].

By contrast, the draft NC allows for both a generalised cap to the overall level of compensation (monthly) and a general price cap implemented by TSOs which seem to apply in all circumstances. We have already experienced such caps on various borders and the fact that they can be used as another form of protection of TSO's congestion income. Market participants would rather expect no limitations before the monthly caps are reached and some specific rules which would take into account the congestion income from other months of the year, when curtailments are such that this monthly cap is reached.

- c) The Framework Guidelines give preference to *physical* firmness after nomination and does not otherwise include a concept for different treatment before or after some arbitrarily defined deadline.

By contrast, the "long term firmness deadline" developed by ENTSO-E in the proposed NC will have the effect that transmission rights are, in fact, non-firm before nomination. And for FTRs, the definition of "long term" appears to be a period of up to 19 hours before gate closure. This would mean the exercise of this right can literally be changed by the issuing TSO every day.

- d) The Framework Guidelines do not make any particular provisions for DC interconnectors other than the provisions on force majeure.

By contrast, the NC [Article 60(3)] allows TSOs to develop a particular regime for interconnections consisting of a single line.

To summarise:

| | NC (ENTSO-E) | FG (ACER) | EFET position |
|---------------------------------------|--|-------------------------|---|
| Not an ES or FM situation | Entitled to curtail | No curtailment | No curtailment |
| Compensation before nomination | < capped market spread [monthly] /price caps | n.a. | n.a. |
| Compensation after nomination | Capped market spread [monthly] /price caps | n.a. | n.a. |
| ES is defined as... | Vague event | Undefined (?) | An operational security event. As defined in OS code. |
| In ES | May curtail (<i>inter alia</i>) | May curtail | May curtail |
| Compensation before nomination | Price paid | Capped market spread | Market spread |
| Compensation/ remedy after nomination | Price paid | Capped market spread | Physical firmness |
| FM defined ... | As in CACM code | As in FG (not the same) | As in FG |
| In FM | May curtail (<i>inter alia</i>) | May curtail | May curtail |
| Compensation before nomination | Price paid | Price paid | Price paid |
| Compensation/ remedy after nomination | Price paid | Price paid | Physical firmness |

2. Obligation to calculate and publish Available Capacity and for a TSO to issue forward transmission rights

We welcome the requirement that all TSOs must offer forward transmission rights unless the competent regulator has expressly approved that the TSO shall not issue such rights. However:

- This should be better reflected in the title of section 1, which should be called “Obligation to issue Forward Transmission Rights”,
- We disagree that a derogation to issue transmission rights would de facto constitute a derogation to calculate and to publish the available capacity on each border (cf. Art.12, which mentions that “*All Transmission System Operators of each Capacity Calculation Region shall ensure that Long Term Cross Zonal Capacity is calculated **for each Forward Capacity Allocation** and at least on annual and monthly timeframes*”). Cross zonal capacity is part of the fundamental transparency data that all TSOs should calculate and publish in an effective and timely manner for all bidding zone borders and directions, even in the absence of capacity allocation.

Concerning the obligation to issue transmission rights, it is important to recall that TSOs and HVDC cable owners bear special responsibilities as monopolistic providers of transmission services. EU legislation recognises them as owners of essential facilities. In this capacity they must, under proper regulatory supervision, grant individual market participants the transmission access products which they legitimately request, including in forward timeframes. In this context, market participants do not expect to be greeted with a refusal of third party access to network infrastructures in the forward timeframe.

As a general principle we consider that all TSOs should issue forward transmission rights on all bidding zone borders, independently of the existence (or not) of other local hedging instruments (such as price spreads or CfDs towards the concerned bidding zones). Indeed, forward transmission rights issued by TSOs provide an open and non-discriminatory access to hedging solutions against congestion costs (and the day-ahead congestion pricing), with no additional transaction costs. On the contrary, two opposite CfDs are needed on each border for market participants to be able to hedge against congestion costs and pricing. The issuance of forward transmission rights is therefore important for competition to develop in all bidding zones and not only in virtual zones. It is also essential for TSOs and/or cable owners to offer to the market all the available volumes of cross-border hedging instruments provided by AC or DC interconnection lines.

Any decision of regulators regarding restrictions to the obligation to issue cross border hedging instruments must, at the very least, be based on a very serious and up-to-date border per border analysis, based on a minimum number of rigorous criteria. Article 34.5 currently provides no requirements for justifications and should therefore refer to a minimum list of criteria to be checked.

It is also essential that each concerned regulators performs an initial assessment upon entry into force of the code (based on the new list of criteria) and repeat this analysis on an annual basis, due to the fast evolution of markets.

Our suggestions for such minimum requirements are listed in the Appendix to this letter. We also make recommendations as to how regulators should proceed when the liquidity of the market cannot be proven or when the issuance by TSOs of transmission rights would significantly increase the liquidity of existing hedging instruments.

The Appendix starts with an illustration of a situation that the network code should aim to improve, where no forward hedging instruments are currently available and where significant amounts of transmission rights could be issued by TSOs based on existing DC links.

3. Revenue Adequacy

We challenge the admissibility of this concept under applicable EU legislation, whether it is applied in the context of the degree of firmness of rights or with respect to UIOSI. TSOs should not be permitted to discriminate against cross border transactions in any market timeframe by invoking a different regulatory formula or a different firmness standard from those which would apply in the case of grid access granted to internal (national) transactions. The same goes for DC cable operators who should not withhold the payments made by Market Participants in order to protect their revenues, thus giving priority to their rights against the functioning of the internal market.

Therefore regulators must ensure that TSOs adhere through the FCA code to strict standards of firmness as a priority to cost recovery and should avoid isolating some particular element of the transmission network which would be granted special treatment or exemptions to EU regulation.

4. Non-compulsory buyback tool for TSOs

As drafted, there is scope for buyback to be initiated via a combination of Articles 47-48 in the draft network code. This combination would appear to make sense and allow TSOs to purchase previously allocated rights in the secondary market or in a bespoke buyback exercise. Under a market-based buyback regime, TSOs will always, by definition, be paying the market valuation of the capacity. This can then sensibly be assessed as an alternative to other firmness tools such as re-dispatch.

A buyback approach can replace the existing wide ranging curtailment possibilities under the “firmness” provisions in the current FCA draft and the scope for withholding of capacity by the TSO under the current draft balancing code. Such restrictions in the use of an essential facility are not consistent with the TSOs’ duties to provide third party access to networks.

5. Definitions

The draft text appears to suggest that the Commission will now take responsibility for an overarching “Definitions” network code under Article 6(11) of the Regulation. This would be a welcome development since it is anticipated that the network codes themselves will be binding EU Regulations and there is no room for inconsistency and ambiguity.

In our view the concept of “long term” should be removed from this network code and replaced by references to the forward market or “forward rights” as appropriate. The code is about the issuance and use of transmission rights of a duration between one day and 1-3 years. This is not a period usually recognised as “long term” in market parlance.

6. Regulatory Approvals

Most of the areas enumerated in Article 8(4) should be the subject of agreement at regional or European level. With the possible exception of paragraph 8(4)(g), it seems impossible to us that they should be left to purely national resolution.

7. Incentives

The capacity calculation methodology provides little incentive on TSOs to make available the maximum capacity, as requirement of Regulation 714/2009 [Article 16(3)] One of the elements that TSOs need to consider is the availability of remedial actions to ensure that firm capacity may be provided. There needs to be more details about the type of measures that TSO will be required\permitted to undertake in order to make forward capacity available.

8. Operational Security Limits

These are not needed and should be dealt in the TRM or FRM only. This would otherwise be a way for TSOs to override the capacity calculation methodology without any regulatory scrutiny. Article 16 of the draft code should be deleted.

APPENDIX

A majority of stakeholders converge on the need for firm forward hedging instruments.

It strikes us however that the proposed Network Code:

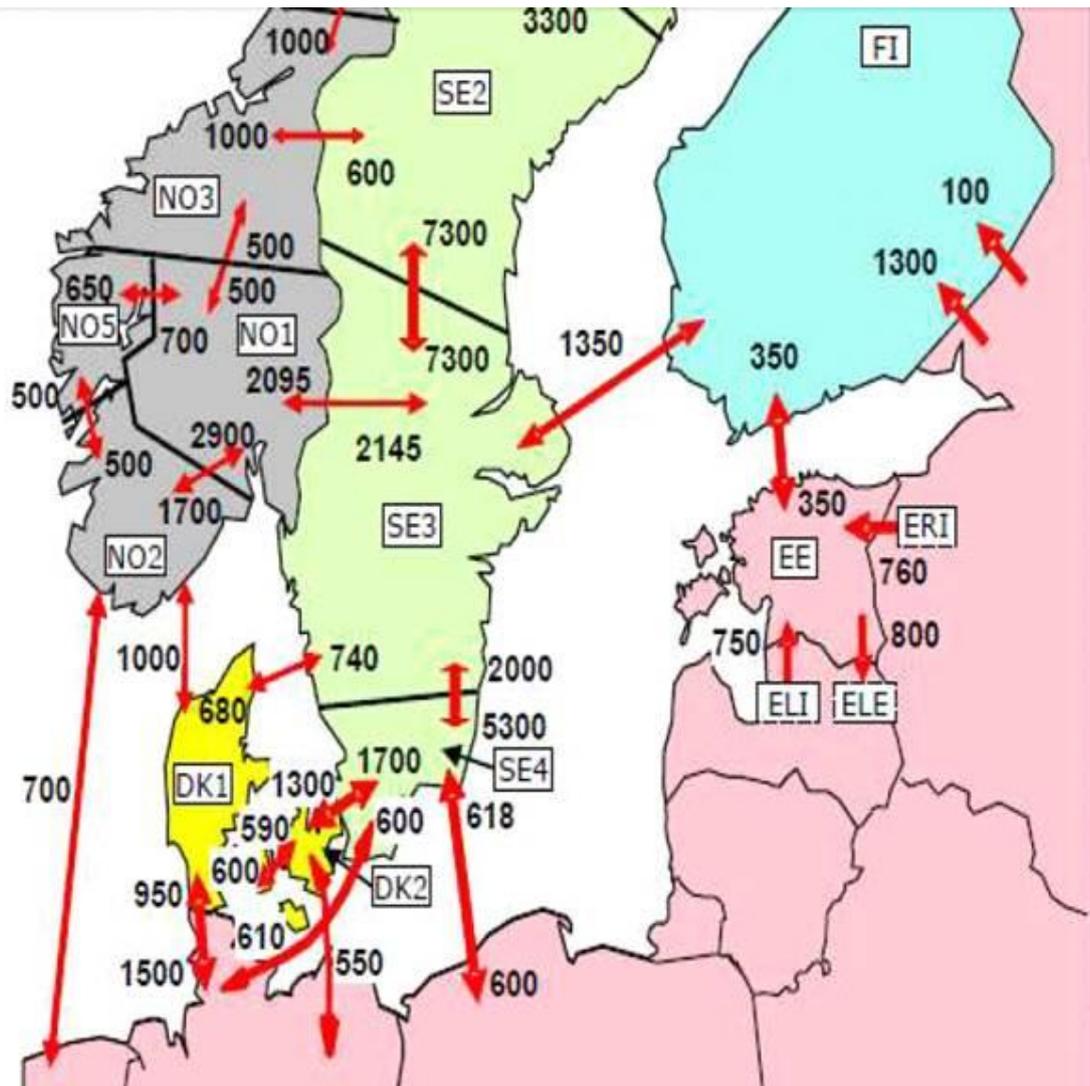
- Proposes to generalise non-firmness on all bidding zone borders (thus decreasing the level of firmness already available at some borders),
- Provides no guarantee that forward hedging instruments will be available for all bidding zones borders, in order to *“provide market participants with Long Term hedging solutions against congestion costs and the day-ahead congestion pricing, compatible with zone delimitation”*, as defined in the first paragraph of the Framework Guidelines, Art.4.1: *“objective of Long Term transmission rights, physical or financial”*.

EFET is highly dissatisfied that the final version of the network code could let situations persist, where no forward hedging instruments are available to the market, when TSOs and/or DC cable owners have access to substantial amounts transmission rights, which are left unoffered in the forward timeframe.

Illustration of the situations that the network code should aim to improve (due to the lack of hedging instruments in the NO2 area, Norway – see illustration on page 7):

- 700 MW NorNed cable **between NO2 and NL** without any forward hedging instruments available or a market (neither financial hedging instruments, nor any physical or financial transmission rights being issued by TSOs),
- 1050 MW Cross-Skagerrak cable **between NO2 and DK1** without forward hedging,
- also very limited CfD liquidity in DK1 and DK2, hence no hedging instruments against congestion costs and prices (there is a fair liquidity in SE3 and FI CfDs, other zones have poor to very poor CfD liquidity or CfDs do not even exist as products),

As a result, there are no hedging opportunities for market participants to hedge basis risk between the Nordic system price and the zone in question. This is a severe barrier to any type of cross-border contracting, whether this is a retail contract, or a transaction in the wholesale market providing additional forward liquidity in the local wholesale markets.



Source: Nordic Market report 2012 from NordReg (Nordic regulators)

Minimum requirements for TSOs/ regulators' study on the existence and the need for hedging instruments for Bidding Zones borders where TSOs do not issue PTRs or FTRs

The structure of such study must ensure that the adequate parameters are analysed and should be conducted in a way which enables to guarantee its objectivity. The study should be performed on a border per border analysis, keeping in mind the objective to “*provide market participants with Long Term hedging solutions against congestion costs and the day-ahead congestion pricing*”, as defined in the Framework Guidelines:

- Report on the annual and monthly available volume of existing financial hedging instruments for each direction and for each border,
- In case these hedging instruments are defined against a system price (or any other external price reference), the study should also calculate the equivalent volume of cross-zonal hedging instruments (available for hedging against the price spread between each pair of bidding zones).

In case of CfDs, this would require, for example, to calculate the volume of compatible CFDs which would allow forming a “synthetic FTR” between the two bidding zones.

- In case there is no financial hedging instrument available to the market on one side of the border (or a very limited volume), the study should conclude on the inappropriate availability of cross-border financial hedging being offered in liquid financial markets on both side of an interconnector for that bidding zone border (no long term hedging solutions against congestion costs and the day-ahead congestion pricing) and consequently on the benefit of making FTRs\PTRs available,
- Report and comparison with the **Annual and Monthly volume of available PTRs or FTRs that could be offered by TSOs as a result of the existing network infrastructures** (available structural hedging instruments in each direction and on each border which could be offered to the market),
- When the volume of hedging instrument offered to the market does not equal the volume of available FTRs or PTRs, the analysis should also conclude on the inappropriate availability of cross-border financial hedging being offered in liquid financial markets on both side of an interconnector for that bidding zone border and on the benefit of making FTRs\PTRs available,
- Equally when hedging instrument are being offered to the market, the study should compare the churn rate in CfDs with the churn rate in markets where hedging is done directly in the bidding zone, such as Germany and the UK, in order to draw conclusions on the appropriate availability of cross-border financial hedging being offered in liquid financial markets,
- Report on the **average liquidity of existing financial hedging instruments for each direction and for each border**: contrary to PTRs/FTRs auctions, volumes must be collected throughout the year in case of continuous trading. This is therefore not equivalent to offering all the available volume through an auction of PTRs/FTRs products,
- Report on **price spreads** and on the **volatility of this liquidity of existing financial hedging instruments across the year**.

To assess market needs:

- **Obligation to consult all market participants having an activity in the bidding zone of the concerned region** (not only those active on both sides of each border)
- Report on the **granularity of the existing financial hedging products**: in order to efficiently hedge cross border positions, market participants need some cross border hedging products which offer an **hourly hedge on market spreads, such as PTRs or FTRs**. This is usually not offered with financial products which are based on daily (or weekly, or monthly) average of market prices.

This is needed especially when Peak / Off Peak market spreads are inverted. For example, with a financial product based on daily market spreads – that is to say based on the “end of day price difference” - it would be **impossible to hedge against the strictly positive price difference** for all the hours of the day in a specific direction.

These minimum requirements should be included in the proposed FCA network code (this could easily be listed in an Annex). Previous studies which do not comply with these requirements should also be updated accordingly. When a lack of hedging product is identified on a specific border, action should be taken immediately to introduce forward transmission rights. There is no good reason for introducing in the network code that TSOs could wait two or five years before issuing PTRs or FTRs.