

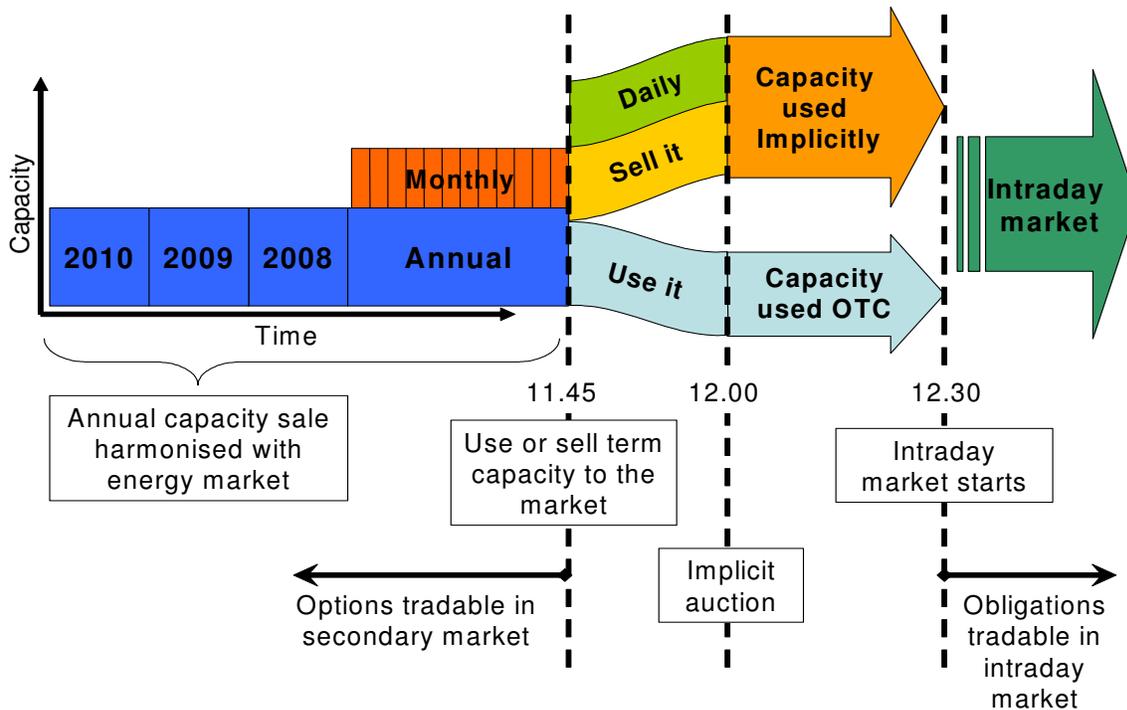
Notes for Transmission System Operators and Regulators on an EFET draft Appendix, to the EFET Standard Master Power Contract (for the wholesale trading of electricity), facilitating a secondary market in Transmission Capacity Rights

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1. Introduction

Legislative background

The EU Congestion Management Guidelines, forming part of the EU Regulation on cross border exchanges of electricity (Regulation 2003/1228, referred to in more detail in section 6 below), describe clearly how the primary allocation of cross border transmission capacity should be achieved. There is now a broadly common understanding how long term allocation via explicit auctions can work smoothly together with the short-term allocation via implicit auctions. This is represented in a timeline diagram set out below.



The Congestion Management Guidelines also recognise the need for intra-day allocations, although the principles behind how this should work at the EU level still being analysed¹.

The Guidelines additionally contain a number of rules designed to ensure that TSOs offer a maximum of capacity to the market, rather than some lesser, arbitrary or over-conservative amount. However they are less clear about the firmness of the allocated capacity rights and how TSOs should ensure this firmness. The essence of a major EFET proposal published in May this year² consists in the development of a model, which entails Regulators giving TSOs incentives to optimise, also to their own benefit if they succeed, the balance between both objectives.

Why a secondary market?

One of the elements in our suggested incentive scheme is that TSOs should be allowed to buy back in the market any part of the capacity rights they turn out to have oversold in advance, or indeed to buy back (in the manner of what is currently called curtailment) also whenever this is necessary for them to manage unexpected (but at short notice evident) operational circumstances such as physical plant outages, physical line failures or unplanned loop surges. (Of course, the availability to them of this buy-back option would not exclude the alternative methods of co-ordinated re-dispatch of generating plant and cross-border counter-trading.) However, until a liquid secondary market in transmission capacity rights develops, TSOs will not easily be poised to take the role of “re-purchasers”.

This is not the only reason why secondary markets are necessary. Wholesale market players have evolving traded electricity portfolios to manage. Sometimes they buy capacity rights on a yearly basis, which they do not need during certain seasons. At other times they only need the capacity rights they buy daily or monthly during peak hours; thus they may like to sell on their rights in a deep and liquid market during certain off-peak periods. Meanwhile other players, with

¹ EFET here strongly supports the cross border intraday opinion proposed in the DTe-CREG-CRE roadmap in which the following features are stated :

1. It [the cross border intraday trade] should enable both revision of day-ahead positions in case of physical disturbance and price arbitrage.
2. No particular restrictions will be imposed in terms of nomination.
3. As a first step, and for obvious operational reasons, the intraday allocation mechanism should be kept as simple as possible (example: a “first-come/first served” or a “pro-rata” method) with discrete gate closure times.
4. Capacity rights allocated in the intraday framework will be considered for mandatory use/nomination of the equivalent energy rather than offered as an option.

² EFET Position Paper “More transmission capacity for European cross border electricity transactions without building new infrastructure: Improving firmness of capacity rights and maximising capacity allocation using new Regulatory incentives for transmission system operators”, with Annexes; the Appendix 5 deals with the “Secondary transmission capacity rights market model”. The paper is available on www.efet.org

contrasting portfolios of power sales and purchases, may find themselves naturally on the buying side in some of those same seasons or off-peak periods, in their own efforts to optimise those portfolios.

EFET is aware that the EU Congestion Management Guidelines only currently envisage explicitly a “use it or sell it” principle somewhere near to the D-1 gate closure, allowing transmission capacity holders to sell on (or back) their unused (i.e. not nominated) capacity rights at the daily auction spot price. This feature is supported by EFET, although it is actually only a kind of last resort market for not used capacity. A secondary market allowing the sale and purchase of capacity rights at any moment in time, functioning in a complementary fashion to the regular advance (yearly/ monthly) primary allocations, is the missing link, which wholesale market players need to optimise their portfolio in capacity rights, according to their commodity portfolio on both sides of a particular border. And to aid that optimisation further, they need also the possibility - as mentioned above - to sell or buy in such a secondary market whatever quantity and duration of rights (as “strips”) will fit their portfolio need from time to time.

In the meantime, it has become clear to traders, that the precise extent of obligations and rights respectively of seller and buyer and original grantor (i.e. the TSO) in any such secondary must be rendered more certain, than presently results from the combined, but completely disjointed, effects of auction rules, unilaterally imposed by TSOs, on the one hand, and traders’ prevailing contractual practices on the other. *Hence our EFET Legal and Electricity Committees have undertaken an initiative to conceive and elaborate an Appendix, to the EFET Standard Master Power Contract (for the wholesale trading of electricity), covering the putative trading of Transmission Capacity Rights.*

In the foregoing context, the notes set out in sections 2 – 7 below address the key principles behind this draft Appendix, recommended by EFET to assist the creation of a liquid secondary (i.e. traded) market for transmission capacity rights.

2. Nature and scope of a transmission capacity right

To endow it with sufficient certain characteristics to build confidence in its true tradability, we know from experience (e.g. in writing a master contract text to cover the trading of greenhouse gas emission certificates) that the term “[transmission] capacity right” must be carefully defined in the contractual context. EFET has thus reached the conclusion that this right will need to be essentially *unconditionally* exercisable (subject to qualifications concerning primary market rules – see below), exercisable upon demand to those TSOs who granted and sold (auctioned) the right and non-subordinated to any operational or third party (competing) rights. We further concluded that the right must be characterized as a right to use a specified part of a transmission system, or a

specified inter-connector between two transmission systems, which is maintained and operated (solely or jointly with other TSO[s]) by the granting TSOs, for a specific duration (determined by reference to hours, days, months or years),

Now dealing with the more difficult elements of the suggested definition of the scope and nature of a capacity right in the standard terms for assignment, the following clarifications may be added:

- As to “unconditional”: The transferee will necessarily be bound by all relevant TSO rules, notably those imposed by way of the primary capacity auction and those in the applicable grid code[s]
- As to “non-subordinated”: Those outside the banking business may not readily understand this expression; certainly TSOs should not understand by our use of the expression, that traders question their right to curtail in physical emergencies nor their right to reclaim capacity for emergency reserve or emergency balancing (subject to compensation); we understand that for the secure operation of the high voltage network and for the smooth maintenance of reliable end-user supply, TSO discretion in these respects must not be compromised; for further explanation concerning what actually is non-subordination, please refer to explanatory point (b) in this section, below
- As to “right to ... use... exercisable upon demand” Here we mean an option to schedule, by due nomination to the granting TSOs, at the relevant point on the transmission system, in the relevant direction and for the relevant period, a maximum quantity of power, in a specified direction and up to a specified quantity; the discretion not so to nominate being conditional upon whatever use-it-or-sell-it (or additionally use-it-or-lose-it) provisions may govern the relevant primary capacity auction (subject to regulatory approval) and/or may be imposed upon market participants by competent regulators themselves

To allow a secondary market to function in such a way that assigned transmission capacity rights do *actually* carry the entitlements described above *in law*, the TSO primary capacity auction rules, and other TSO operating practices and standards, must be designed to ensure that a capacity right will not be subject to:

- (a) Any arbitrary or discretionary curtailment of access, without due compensation, by a TSO - i.e. no such curtailment could be justified by anything other than a true *force majeure* event (see section 6 below), nor to
- (b) The exercise of any *pari passu* or senior ranking right held by a third party or by a granting TSO, purporting to give that party any preference in respect of the use of, or income from, the same capacity.

We should however add that, alongside a new secondary market in firm transmission capacity rights, we imagine eventually markets in interruptible rights, and even in capacity utilization obligations, coming into existence. In these

cases the suppositions made in the foregoing bullet points and at conditions (a) and (b) above would be up for re-evaluation.

Finally (for this section), one accounting issue has so far been identified: To facilitate liquidity and tradability, capacity rights in any event need to be defined in the Appendix in such a way that they do not take on the characteristics of intangible assets for accounting purposes. (It seems that if the main characteristic of the right entails just the possibility of using, or more realistically nominating power in relation to, an indefinite set of transmission assets, such characteristics will indeed be avoided.)

3. Form of Capacity Right; Extent of Transfer of Rights and Obligations

We believe the capacity right should take the form of a fully transferable claim to nominate power against the transmission capacity identified in the original primary auction, transferable by assignment from seller to buyer, without the prior consent of the TSO. This absence of need for consent could, if so arranged without impediment to fungibility, be rendered subject to the discretion on the part of the TSO to establish (with regulatory approval) in advance a “white list” of eligible counter-parties, who have already proved their competence to submit nominations and to comply with TSO rules. We also believe that assignment should take place without any undue formalities, provided the national law concerning a transfer of capacity rights so permits.

Current rules governing auctions of capacity, which require that the TSO give its consent to every single transfer agreed between two capacity traders must thus be amended accordingly. The transfer of the capacity right should especially not be subject to the requirement that a handling fee or performance bond has been paid by the buyer or seller in the secondary market to the TSO. (Some auction rules, which envisage such payments, in this respect too will need to be amended and harmonized accordingly.)

We strongly recommend that an acquirer of a capacity right will not assume any payment obligation vis-à-vis the granting TSOs. As a facet of the enhancement of certainty and for simplicity of transacting in the secondary market, it is preferable that the granting TSOs should not be exposed to the credit risk of the purchaser in the secondary market. We see no other way in which to attain the crucial objective that capacity rights become more easily transferable than is currently the case in most jurisdictions.

It follows that capacity rights should be “fully paid” by the original successful auction bidder prior to transfer, even if the period during which the right may be exercised has not yet commenced and remains some months (or more) in the future at the date of transfer.

4. Notification of Transfer to TSOs

Any seller of a capacity right should notify the fact of transfer to the granting TSOs, as the TSOs have a pre-existing contractual relationship with the seller, in respect of the capacity rights sold. We suggest the buyer should also have a right to notify the TSOs of the transfer on behalf of the seller. As noted in section 3 above, however, neither acknowledgment nor confirmation from the TSO of the notification should be necessary for the transfer to occur and be valid (as long as the transferee is on any regulator-approved "white list" of eligible counter-parties competent to submit nominations and comply with TSO rules).

The objective is once again to achieve optimal "free transferability" of the capacity rights and optimal eligibility of trades for book treatment, while at the same time ensuring that TSOs are able to identify who will, or may, be offering nominations against the specified capacity after a transfer has been executed.

5. Timing of Transfer

The timing of the transfer will be dependent on the law governing the transfer of the capacity right. In the likely affected jurisdictions notification to a potential debtor (meaning the granting TSOs in a capacity rights transaction) is not necessary for a transfer of such a right to be effective.

The transfer of a capacity right could thus be deemed to occur contractually as soon as:

- (i) a verbal agreement between traders is reached (meaning that the transfer time need not await notification to the TSOs, or (if the jurisdiction does so dictate)
- (ii) at the latest, the point in time of notification of the transfer to the granting TSOs.

To the extent notification to the TSO is necessary under the governing law for the perfection of transfer, traders should be able to provide notification electronically or, if a register is maintained, notification should be deemed to be given upon the seller's request to the TSO transfer capacity rights to the buyer's account.

6. Evidence of Ownership

Ownership of the capacity right could be evidenced in a register administered by the relevant TSO (possibly kept electronically online, and in real-time, as is the case with the emissions allowance register). The register should disclose the capacity available on the relevant inter-connector or TSO (per connector, per direction and per time-slot), the capacity that has been allocated by auction in the primary market and the capacity not yet allocated. The register should disclose the names of the companies that maintain accounts with the TSO, but not their individual holdings.

7. Firmness, curtailment and *force majeure*

TSOs do not currently guarantee (in legal terms) firmness of the capacity rights they sell (though auctioned capacity often turns out to be firm in practice.) Nonetheless the TSO could buy back capacity from the secondary market in cases where they deem this necessary to manage the types of unexpected operational circumstances mentioned in section 1 above (the introduction to these Notes). The EFET interpretation of “fully firm” for this purpose entails the provision of compensation at the full cross border market spread, if a TSO has allocated capacity and subsequently withdraws it for any reason (other than narrowly defined “acts of God” – see discussion of *force majeure* below). Clearly, in relation to a secondary market, where a transferor has already fully discharged his payment obligations to the TSO, and correspondingly sold the capacity right for full value to the transferee, if any unforeseen curtailments by the allocating TSOs prove necessary, the attribution of resulting compensation should flow back to the transferee (i.e. the purchaser or secondary owner) of the capacity rights. Some governing law systems will contain rules as to the duty of the deprived capacity right holder in circumstances of withdrawal to mitigate his loss.

These improvements to firmness are fundamental to the promotion of more cross border competition in European power markets, because:

- **It is essential that wholesale market participants can hedge** not only their commodity price positions, but also their transmission cost risks, over various time periods and across borders. This becomes particularly important if a market participant is not vertically integrated in a particular national territory. Compensation capped at or based on the original auction price paid for capacity, and subject to very wide *force majeure* contingencies, offers an incomplete hedge as in practice do contracts for differences calculated solely around the commodity price risk;
- **TSOs are natural sellers of transmission capacity rights** and are the *only* power industry players in a position to offer the required firm transmission hedges to the market. Indeed, TSOs are the only market players that own transmission capacity. Furthermore, TSOs have alternative ways of managing the risks involved. For example by re-dispatching generation plant, declaring congestion internally on their domestic grid, counter-trading, or building new lines

It follows that curtailment of access to a transmission system for a holder of a capacity right by a TSO without full compensation should be limited to defined events of *force majeure*.

Despite the complaints and concerns across the industry following July 2006 uncompensated curtailments at the borders of Poland with Slovakia, Czech Republic and Germany, no changes have been made in 2007 auction rules to increase the firmness of auctioned capacity rights. Some new rules for annual

auctions 2007 indeed purport to increase the discretion of TSOs to curtail without compensation. For example, in the CEE “co-ordinated auction” rules, a new and very broadly defined term, “Emergency Situation”, is misguidedly used to give the TSOs the supposed right to invoke simply their own judgment or opinion about any technical eventuality to justify uncompensated curtailments on grounds of *force majeure*. This supposition is clearly not in line with EU Regulation 1228/2003 (L 176/4, 15.7.2003, Official Journal of the European Union EN). According to this EU cross border transmission access Regulation, and Congestion Management Guidelines attached to it, curtailment is permitted only in emergencies, but must still normally be compensated. Specifically Article 6 (6) a) requires indeed that TSOs guarantee any prior allocation of available capacity using auction revenues. Compensation for curtailment in legitimate emergency situations is ruled out under the Regulation, solely when a TSO can additionally prove a *force majeure* event.

Article 6 (1) of the Regulation provides that:

"Transaction curtailment procedures shall only be used in emergency situations where the transmission system operator must act in an expeditious manner and re-dispatching or counter-trading is not possible. Any such procedure shall be applied in a non-discriminatory manner. Except in cases of 'force-majeure', market participants who have been allocated capacity shall be compensated for any curtailment."

Because of misunderstandings and inconsistencies across the UCTE area in Europe regarding the justifiable scope of *force majeure* for the purpose of cross-border transmission access, it may prove advisable to elaborate some examples of what should and should not *objectively* be considered “Act of God”, in the context of denial of use of firm transmission capacity rights. This elaboration might be undertaken by a working group of TSOs, Regulators and wholesale market participants drawn from the constituencies represented in the ERGEG workshop about “firmness”, convened on 20 November 2006. For traders it is already clear that to maintain objectivity, *force majeure* must be restricted to circumstances and events rather than eventualities, and must especially exclude any actions or decisions, which are attributable simply to the opinions or judgments of TSOs.

8. Harmonization of Auction Rules

The description and definition of a transmission capacity right should be standardized as far as possible across Europe. This will ensue naturally with use of the standard Appendix for trading transmission capacity rights in a growing number of countries. But the secondary market contract can only achieve such standardization up to a limited point: If the rules, which govern the primary auctioning by TSOs of transmission capacity, cross-border throughout Europe are not also harmonized, legal and even practical uncertainty may ensue, about

what a transferee has actually bought and to whom he may look for recompense in the event his power or gas is not ultimately scheduled on the basis of the firm right he assumed he had purchased. In addition, the IT systems which deal with such transfers should be capable of inter-communication, in order to increase efficiency in the primary and secondary markets. This should be achievable based on EFET approved common IT standards for transactional data exchange (as used within EFETnet) and the compatible ebXML codes promoted by the ECAN group of ETSO.

EFET here strongly supports the cross border intraday opinion proposed in the DTe-CREG-CRE roadmap in which the following features are stated:

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4. Capacity rights allocated in the intraday framework will be considered for mandatory use/nomination of the equivalent energy rather than offered as an option.

This vision is reflected in the EFET position paper on intra-day, which has now been published.

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