

EFET POSITION PAPER

Experiences from the Dutch Market Place Lessons Learnt in Winter 1999-2000

Introduction

The European Federation of Energy Traders (EFET) strongly supports the rapid development of a single European energy market.

Non-discriminatory and transparent access for all market participants to transmission capacity, including the inter-connectors, is vital to the development of an efficient and highly liquid electricity market with minimum barriers to trading across boundaries.

A clear example of what can happen during a transition from a monopolistic to a liberalised market place in an environment that is discriminatory and not transparent is the wave of price volatility and chaos that hit the Dutch market place during the winter period of 1999-2000.

The Dutch Market

In late 1999/early 2000 the Dutch market was characterised by having two disparate systems (the so-called "Protocol" and the free market) in operation side by side. This represented a serious challenge to both the market players including new entrants, and the regulator.

In particular, stranded costs burdened power purchases from the Protocol led market participants to try to avoid contracting under the relatively expensive Protocol.

Looking back to the autumn of 1999, the shorts in the market had three possible sources of power available to them for the year 2000. They could buy at the APX (a total of up to 900 MW import capacity had been allocated to APX), import through long term import contracts (a total of 800 MW had been allocated for this purpose), or buy from "the Protocol" at relatively inflated prices and with significant penalties for drawing more capacity during the year than ordered in autumn 1999.

With perfect hindsight it is evident that a fundamental problem arose when the shorts had to order Protocol capacity by November 1, 1999, and hence prior to knowing their import allocations (which were allocated only in December 1999) or their APX allocations, which naturally vary on a daily basis. This situation led many to speculate that they could purchase significant amounts in the free markets (imports or APX) and hence to contract as little as possible from the Protocol.

Import allocation process 1999 (for 2000)

Various options to allocate the import capacity for the year 2000 were discussed both formally and informally between the various players (producers / distributors / traders etc.) and the regulator. Such consultations provided the regulator with a view of the perceptions and interests of the various parties, but obtaining a consensus amongst the market players proved impossible given the disparate self-interests of the market parties involved. When defining a fair allocation mechanism the regulator (Dte) apparently underestimated the incentive for gaming, and persistently ignored advice from market players to this effect.

Definition of Legal Entities and Subsequent Gaming

The Dutch law (Electriciteitswet) prohibited making advance reservation for cross border transmission capacity through, for example, an auction mechanism, which forced the regulator to exercise its discretionary power. However, in probably unintentionally less well-defined wording the regulator allowed "legal entities" to apply for import capacity, thus failing once again to address the concerns expressed by market participants about the likelihood of gaming. Most players in the Dutch market recognised the possibility for gaming by using separate entities within their holding companies by applying for same import capacity many times through different subsidiaries. Even if a player had no real inclination to game, the gaming or fear of gaming of other players forced it to act similarly as a kind of pre-emptive countermeasure. This led to requests for import capacity totalling the power consumed in the whole of North West Europe!

According to the Netcode approved by the Dte, the only condition to participate in the reservation process, apart from stipulations regarding reciprocity, was that in order to prevent speculative reservation of capacity, any entity applying for capacity had to demonstrate that it had entered into "underlying supply contracts." Dte repeatedly refused to clarify what exactly this meant in practice. As a consequence, TenneT (the TSO) interpreted the condition as meaning "supply contracts with end users." The interpretation was implemented and endorsed by the Dte, *despite the fact that TenneT had earlier in the year published explicit guidelines to the contrary i.e. had stated that proof of end user contracts would NOT be required.*

The outcome of TenneT's allocation process was such that the capacity was de-facto allocated to incumbent players on the basis of market share (70% of which was captive supply). As a consequence, new entrants didn't achieve access to such capacity. Together with the existence of the exclusive Protocol contract, this in effect denied new entrants any prospect of securing the competitive supply necessary to engage in trading and/or supply businesses in the Dutch market.

In the end the regulator was forced to interfere and to exercise its discretionary powers in allocating cross border capacity proportionally to the estimated total amount of power delivered to the end users by the various players in the year 2000. It rapidly became clear that the Dte didn't want to use their statutory powers to intervene in the event of misapplication of the Netcode by TenneT. The only recourse of market parties being, appeals against the decision of the Dte in approving the Netcode and/or legal action against TenneT in respect of its application of the Netcode.

Timing of Allocation Process Results in Significant Market Imbalance

As described above, timing for reservations in the different markets played a crucial role also. Distributors had to first book the capacity under the Protocol. This happened per November 1 and was binding since the allocation of Protocol-volumes could only be changed by common accord of all Protocol participants. Only later, in early December were the actual import allocations published. Given the high cost of Protocol power and the necessity to order on November 1, some players speculated on high import allocations (known to be 800 MW on bilateral contracts and up to 900 MW through APX) and contracted too little under the Protocol. When the actual import allocations were published these players found themselves with substantial short positions which they could only cover through APX or by buying penalty power from the Protocol. It is estimated that the total short of the market was around 500-600 MW. It is also important to note that new entrants did not have the opportunity to contract under the Protocol as this agreement was restricted to the incumbent distribution companies and direct contracting with Dutch production companies was not possible due to these exclusive arrangements.

Of course the “long” players, having used different assumptions with respect to the cross border allocation for the calculation of the amounts to be contracted under the Protocol, had only disincentives to co-operate with their “short” competitors. That left these “short” players with litigation as the only option for forcing the other Protocol partners to re-open the volume allocation under the Protocol. (As said above, re-opening the Protocol was only allowed with consensus of all parties involved, i.e. also of the “longs”). Again the litigation was only open to Protocol parties as the disagreement on contracting levels was, in the first instance, a contract dispute between Protocol parties. New entrants were thus left entirely dependent on the outcome of litigation and a subsequent “closed shop” re-contracting process that they could do nothing to influence.

However, there was another consequence of the change in allocation of cross-border capacity allocation, forced by the above market situation. Day ahead prices at the APX soared to up to 500 €/MWh, just slightly below the price of penalty power under the Protocol, and this in spite of relatively cheap capacity not being dispatched inside the Netherlands. In more general terms the Dutch market had developed into a market where spot-prices were a multiple of that in the neighbouring countries.

Literally, within days whole annual profits exchanged hands, and this was exacerbated for companies that had traded swaps and whose expected physical hedges had evaporated when the capacity allocation remained below expectations.

Finally, a compromise was achieved by the end of January allowing additional volumes to be contracted under the Protocol on the 4th of February 2000 against a penalty on the capacity costs though, thus reducing the market’s short position. Prices dropped to a more acceptable level straight thereafter. Prompt prices remained very volatile and were driven strongly by the daily allocated import capacity to the APX – which remains subject to lack of transparency in TenneT’s capacity forecasts and sensitive to the priority allocation of 1500 MW of cross-border interconnection capacity to SEP.

Additional Effects compounding the lack of transparency

The whole situation became even more unclear after (unproven) suggestions that some counterparties traded amongst themselves at very high prices in order to earn on swaps that they had with third parties, and by allegations that TenneT did not always allow for optimal import capacity and seemed to cut import capacity at no notice and/or without apparent reasons. For example, at the beginning of the year, TenneT did not allow imports until January 4th, 00 hours. Also, they frequently cut import capacity at night times, each time resulting in high price spikes at the APX. It was alleged that TenneT reacted like this in order to protect its former sister company SEP, the single seller under the Protocol.

Allocation of Import Capacity to SEP

Despite a lack of clear statutory basis or approval from the European Commission due to the significance for cross border trade, the Dte followed the wishes of the Dutch government in allocating priority in reservation of cross border capacity to SEP in respect of its 1500 MW of long term import contracts. However, the Dte expressly and clearly limited the priority to SEP's obligation to "Take or Pay" for electricity under these contracts. It is known that SEP's Take or Pay obligation for electricity is no more than 561 MW and, furthermore, that due to the economic protection afforded to it under the Protocol for 2000 that SEP would suffer no harm if it had not received any capacity at all during 2000. Nevertheless, TenneT allocated the full 1500 MW to SEP.

Results

As a result, both the players' perception of stability (essential to the development of that still evolving "free" market) and the reputation of the regulator sustained (quite) some damage. Liquidity in, for example, the swap market immediately evaporated, making hedging and risk transfer impossible. Regulatory risk had already been recognised as a major factor during the transition, but now most certainly got the attention of all the players involved.

Import allocation process 2000 (for 2001)

As the Protocol contract expires at the end of 2000, the timing problem between contracting under the Protocol and allocation of import capacity will no longer apply. Players preparing for that much more dynamic year 2001 will require up front regulatory certainty, facilitating smaller and new entrant players to enter the market place confidently. Market players should be able to rely on transmission in order to secure their position in the market and risk manage their exposure. The situation where transmission capacity is non-firm and subject to non-transparent changes in availability leaves market participants in a very insecure position. The import allocation process should be defined and made known as early as possible. In particular, SEP should not have a priority treatment as enjoyed in the past. Clearly, the allocation procedure for the year 2001 should fit into a longer term solution.

Recommendation

For the year 2001, capacity auctioning as a potential short-term solution to congestion

management is recommended, if accompanied by the "use it or lose it" philosophy, but only on an interim basis.

Non-transaction-based methods, such as counter-trading, market-splitting and re-dispatch, should provide the long term solution to congestion problems and should therefore be developed by the TSOs for the year 2002 – beyond. The market-splitting approach, which should facilitate market liquidity whilst providing TSOs with the right incentives to optimise and allocate transfer capacity in a fair and efficient way, is particularly advocated.

There is a concern with respect to the full unbundling of TSOs and the implementation of full legal separation as that is the only means of guaranteeing real independence of a network operator. The TSOs must embrace the new requirements of a liberalised market, which demand separate generation and power marketing affiliates. Failure to do so will considerably restrict the opportunities of new participants, particularly wholesale intermediaries, and will prevent the full benefits of liberalisation from being achieved by all energy consumers.

To ensure fair and efficient allocation of cross-border capacity TSOs should be properly incentivised to co-ordinate among themselves. We would therefore like to emphasise here the importance of a speedy progress in the negotiations currently taking place within the framework of the Florence Regulatory Forum, which should lay basis for efficient and non-discriminatory allocation of cross-border power transmission capacity in the European Union.

Regulatory authorities have a crucial role to play in developing appropriate market structures to deliver the benefits of wholesale transactions through the development of competition. To ensure transparency and stability for the market participants, the following requirements are crucial:

- the need for clear and consistent rules to be established in advance
- the need for a consistent and equitable approach to the implementation of the rules as established (i.e. when the rules are right don't change them)
- the need for regulators to be fully independent of the political interference, something which has been questioned.
- the need for quick and decisive action to deal with abuse of dominant positions; not just in respect of cross border transmission but also in relation to the domestic market in electricity production.

In the absence of these elements, market confidence will be severely damaged and new entrants will be unable to compete on an equal basis (as a result of real and/or perceived barriers and risks to entry). Accordingly, effective competition cannot develop and the potential benefits of liberalisation will not be realised by final customers and wholesale parties alike.

It should be noted that the market remains in transition hence this paper is intended as a clarification and as a "lessons learnt." All parties did behave rationally in light of their situation. However, this case study clearly shows how unclear regulation, combined with monopolistic or oligopolistic inertia, can and frequently does lead to market distortions and inefficiencies.