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A reality check on the market impact of splitting bidding zones

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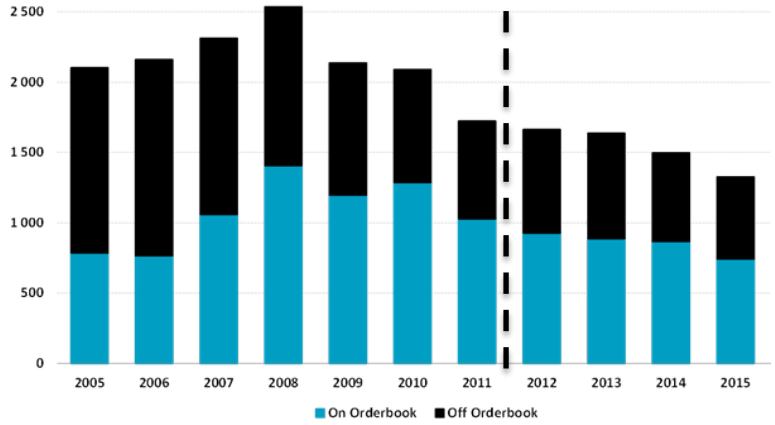
As the organisation representing the interests of over 100 energy trading companies in Europe, the European Federation of Energy Traders (EFET) very closely follows and participates to the ongoing debates concerning the review of bidding zones. EFET favours stability in the configuration of bidding zones along the lines of long-standing structural congestions. This certainty and continuity are essential to underpin liquidity, investments in generation and demand-response on the basis stable price signals stemming from fair competition between market participants in all segments of the market, including in the crucial forward timeframe, and signal the need for transmission infrastructure developments. Bidding zones delineation should also ensure supply competition, which provides customer choice, product innovation and variety, and improved efficiency. These are the reasons why we generally favour larger bidding zones, as they allow for more liquidity and competition – at wholesale and retail levels – over smaller, inevitably less liquid zones.

In this context, **we harbour concerns regarding some of the statements made by decision-makers and regulatory authorities with regard to the success of bidding zones splitting**. The example of the treatment of the bidding zone reform conducted in Sweden in 2011 is particularly telling: most commentaries have focused on the better management of internal congestion in Sweden, in particular a correction of the previous tendency for congestion to be artificially shifted to the national borders, following the switch from one to four zones – an assertion we do not contest. However, another part of the institutional narrative around the reform has been the claim that its impact on the market has been marginal[1]. In addition, the Swedish model as part of the Nordic system – small bidding zones combined with a system price – is taken as an example in the ACER Opinion on the future of the German-Austrian bidding zone to show how the market structure could be amended in central Europe to maintain appropriate liquidity and competition[2].

[1] See, e.g. the letter of the Swedish Energy Market Inspectorate *Energimarknadsinpektionen* (EI) dated 7 April 2016 based on a report of 2014, in which the EI claims that "*the bidding zone reform did not lead to any major negative consequences [in terms of forward market liquidity, wholesale market power and retail competition]*".
[2] See points 121-126 of ACER Opinion 09/2015 of 23 September 2015, which refers to the EI report of 2014 mentioned in footnote 1. In point 124, ACER notably "*invites the involved NRAs to analyse whether specific changes in the market design would be required to preserve and enhance the level of market liquidity and competition in the CEE region*".

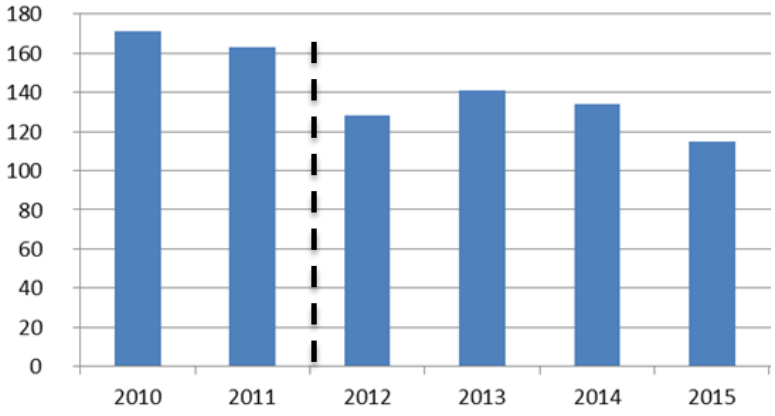
The perspective of market participants concerning the impact of the bidding zone split in Sweden is quite different. Our observation of the market on a daily basis induces EFET to set the record straight on this point: **the 2011 reform in Sweden has been associated with a negative trend in the liquidity of the forward market in power and the liquidity of the market in the contracts for difference (so-called Electricity Price Area Differentials or EPADs) used to hedge forward positions (thus price and volume risks) in particular bidding zones against the system price. The effect is significant**.

On a regional basis, the volumes of future contracts traded on Nasdaq-OMX has decreased by over 20% from 2011 to 2015:



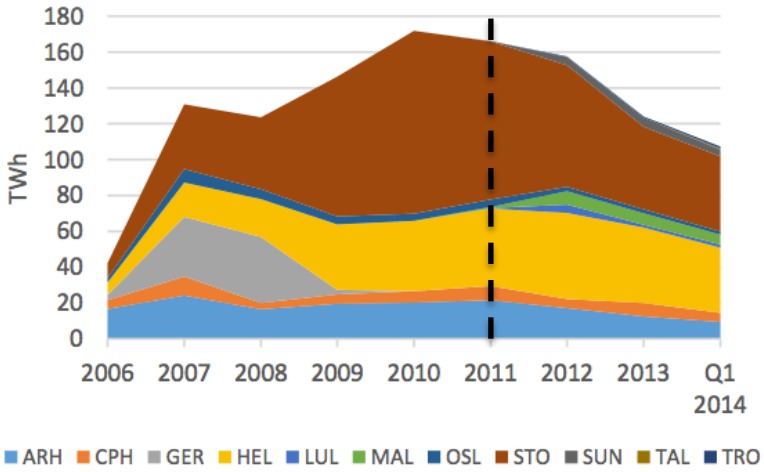
Nasdaq cleared futures aggregated (TWh)
Source: Nasdaq data

A similar trend can be observed in the liquidity of EPADs, which serve as hedging instruments in the price between each zone in the region and the system price. A cumulative drop of close to 30% can be observed across the region:



Nasdaq EPADs cleared and traded (TWh)
Source: Nasdaq data

The picture is yet more striking when breaking down the volumes of EPADs transacted per bidding zone, where a cumulative drop of over 40% can be observed in Sweden (note the sharp decrease in EPADs liquidity in the SE3 (STO) zone in brown below):



Nasdaq EPADs cleared and traded (TWh)
Source: ResearchGate

The table below further shows that the liquidity plunge of EPADs (-28% in the region; -42% in Sweden) far outweighs the slight drop in electricity consumption (-4% in the region; -5% in Sweden) in the period between 2010 and 2013. In parallel, churn rates have dropped by 39% in Sweden over that period (compared to a decrease of 17% in Denmark, and an increase of 11% in Finland):

	Area	2010	2011	2012	2013
*Electricity consumption (GWh)**	DK	35640	34458	34268	32350
	EE	8011	7827	8138	8049
	FI	87467	84244	85125	84044
	NO	129792	122020	127863	127843
	SE	147090	139222	141996	139576
*EPAD volume traded (GWh)***	DK	26634	29534	22325	20111
	EE				93
	FI	39259	43250	47942	42106
	NO	3930	4253	2981	2685
	SE	102055	89054	84293	58995
Churn rate	DK	0,75	0,86	0,65	0,62
	EE				0,01
	FI	0,45	0,51	0,56	0,50
	NO	0,03	0,03	0,02	0,02
	SE	0,69	0,64	0,59	0,42

Electricity consumption, EPADs and churn rate
Source: ResearchGate

These figures show that the reality is far from the picture depicted by the regulatory authorities. Against improvements accruing through the 2011 reform in the management of congestion in Sweden and in the allocation of transmission capacity at the Swedish national borders, following an investigation by DG COMP, has to be weighed the negative impact on the forward liquidity of the Nordic market.

It is clear that any review of bidding zones delineation ought to include a serious and thorough analysis of market efficiency in different bidding zone configuration scenarios. We insist the analysis of efficiency must extend to study of liquidity and competition effects. Crucially, forward liquidity in transactions in electricity and in transmission rights or contracts for difference has to be part of that. It is not enough that analysis focus on the optimisation of day-ahead congestion management, as is often the case in current debates.