



– Consultation response –

Europex response to ACER-CEER draft policy paper on the further development of the EU electricity forward market

1. Executive summary

Europex welcomes ACER's recognition of the importance of long-term forward hedging and efficient, liquid, and transparent forward markets as central features of the Internal Electricity Market – both of which contribute significantly to the overall welfare benefits of the integrated European electricity market. However, we remain critical of how this draft policy paper addresses and assesses the overall functioning of the electricity forward market and the proposals put forth to approach the identified shortcomings.

While the aim of this paper is to review the Forward Capacity Allocation Guideline (FCA GL) model in the EU, its scope seemingly extends far beyond this narrow mission to also review the forward power markets, including MIFIDII/MIFIR/EMIR regulated financial markets. In addition to the concerns expressed throughout the rest of this response, we urge ACER to carefully consider what this process seeks to accomplish and the overarching effects such a broad review could have.

Below we list several key concerns:

- The policy paper is not clear about whether it aims to be a targeted review of the Forward Capacity Allocation Guideline¹, which seemed to be the initial intent, or a fully-fledged overhaul of the European electricity wholesale forward market design. The latter would require a much broader and more comprehensive analytical approach of the global power market design (including the financial markets regulatory framework), the FCA GL being just one of its components and not the main driver;²
- The exact link to ACER's Final Assessment of the EU Wholesale Electricity Market Design is missing and the paper seems to be a standalone process amid a parallel and much larger debate about possible forward and overall market design improvements against the

¹ Commission Regulation (EU) 2016/1719 of 26 September 2016 establishing a guideline on forward capacity allocation

² The FCA GL only addresses a rather limited portion of the overall power forward market needs. While LTRs are limited to a portion of NTC Cross Zonal Capacity, the power forward market enables bilateral, OTC and on-exchange hedging and trading needs against spot market BZ price fluctuations for the total expected *energy* trading positions, production, and consumption, on a BZ and regional level for several years forward in time.

background of the present energy crisis and in view of the EU's mid- and long-term decarbonisation agenda;

- The analysis focuses too heavily on relatively limited cross-border hedging needs, while failing to address the big picture need for hedging of *energy* positions on bidding zone/regional level, and thus failing to address the multi-faceted complexities of forward market liquidity overall in a comprehensive way;
- The policy paper does not provide sufficient evidence of the problems identified. Overall, the problems themselves are vaguely defined and too general to tackle in a complete and cohesive manner. In particular, the report does not define the BZs/regions where liquidity is deemed insufficient nor the main reasons for it;
- Market participants have not been adequately consulted within this process which we see as a critical first step to a full understanding of the situation;
- Regarding potential market coupling with energy futures, some exchanges already offer products in the form of power future spreads for a combination of different locations (E.g., BZ A vs. BZ B or BZ A vs. regional spot index X) which can be traded several years in advance as well as in months and quarters. Such market-based products should also be considered and the feasibility of their widespread introduction across the Internal Electricity Market should be further evaluated;
- A detailed impact assessment on the bidding zone specific factors hampering liquidity should be carried out and more fully take into consideration the experiences of market participants;
- Derivative markets are a derivative of the physical short-term market and have no impact on physical flows – their only purpose is to re-allocate risks and, therefore, to organise future cash-flows. Consequently, the physical network constraints and allocation models should not be the ones to determine the forward power market model;
- Using interconnection capacity as a tool for enhancing liquidity as proposed in some of the document models may not be effective. The interconnection capacity between EU countries/bidding zones is not homogeneous, being much lower than the demand in some cases, leading to impacts much lower than an underlying overall production/consumption churn rate of 1;
- The possible impacts on derivatives markets under MIFIDII/MIFIR/EMIR have not been identified, analysed, or assessed.

2. Introduction

In the policy paper, ACER and CEER note that the analysis “*does not aim to objectively quantify and back up all the positions expressed by regulators*”. We find this remark to be at odds with the intention of this paper as each proposal must be carefully and objectively quantified given

their disruptive nature, as well as the current delicate geo-political situation. Further, the alternative proposals must demonstrate, preferably through a detailed cost-benefit analysis, that they would improve the efficient functioning of the electricity forward market.

Reviewing the appropriateness of the LTTR framework should also compromise the option to abandon this activity and to rely on the markets instead, as some exchanges already offer today instruments for handling “basis risks” (E.g., the difference between a single BZ price and a regional/or hub reference price) and for hedging cross-border risk in the form of spread (swap) products.

Although improving liquidity in less liquid markets is desirable, most of the options presented in this policy paper, and in particular that of forward market coupling, would lead to far-reaching, technically challenging, time consuming and costly market design changes. Further, the document fails to demonstrate that this model would increase forward liquidity. Such proposals also fall far beyond the scope of a FCA Guideline review and disregard the interaction with financial regulation which applies to most organised forward markets, posing different regulatory hurdles which require thorough analysis, discussion and decisions on a higher level of legislation. In addition, most of the options would also require significant transition processes, which would translate into lengthy implementation phases of several years. All in all, the exceedingly disruptive nature of such a design merits a more thorough assessment, with a proper cost/benefit analysis and further clarity on how such a model would work in practice, before the proposal can be properly considered.

4. Literature review

In its policy paper, ACER frequently references literature regarding locational marginal pricing (aka “nodal pricing”) which largely differs from the European market system as well as its regulatory framework and agreed target model. A nodal approach would have significant drawbacks as already explained in detail at previous occasions and would certainly not help to improve the functioning of electricity forward markets.

Further, several of the publications referred to are significantly outdated, impacting their relevance against the current situation. For example, the study of the Economic Consulting Associates referred to in this literature review is already seven years old and no longer adequately reflects the application of transmission rights or CfDs. Additionally, the 2021 study referred to as being *of* the European Commission is a study that has been conducted *for* the European Commission and does therefore not necessarily reflect the Commission’s official views.

5. Terminology and problem definition

We would like to restate our concern that the inefficiencies laid out in the introduction are not supported by adequate evidence in this paper. Although the problems mentioned are mostly relevant, the often complex reasons behind lacking liquidity in some bidding zones deserve further attention. There should also be a more thorough assessment of the causes of this lack of liquidity in order to conclude which type of intervention would be most adequate

– thereby not only focussing on what tools of intervention ACER has but on what tools would be most beneficial.

Problem 1:

- The causes of liquidity issues can differ largely in the different bidding zones (BZs). A generalisation of problems in the forward market across BZs does not reflect this complexity in an adequate manner.
- National interventions hindering the build-up of liquidity in certain BZs, such as subsidies on fossil, renewable and nuclear investments, legal/regulatory interventions or regulated tariffs, should be tackled with priority.

Problem 3:

- In the absence of a well-functioning and liquid secondary market for LTTRs, some exchanges already offer spread products that can be traded in a continuous fashion and complement the continuous nature of electricity trading.

Problem 4:

- We strongly disagree with the problem definition as it is a reversal of causality. Forward market liquidity, or the lack thereof, is not a barrier to reconfiguration of bidding zones but is a criterion to carefully consider when studying bidding zone reconfiguration.

Problem 5:

- In the absence of a well-functioning and liquid secondary market for LTTRs, spread products offered by some exchanges already cover the relevant maturities.

Problem 6:

- In the absence of a well-functioning and liquid secondary market for LTTRs, spread products offered at some exchanges correspond to FTR obligations. Both directions are traded together in the same order book, thus bundling liquidity.

Problem 7:

- We would appreciate if ACER could clarify which data regarding spreads and which studies they are referring to in this section.

Problem 8:

- We would encourage the development of transparent and clear criteria to assess the liquidity in the different BZs, adequately considering the different specificities.

6.1 Basic policy changes - no regret improvements

We question the notion that a flow-based mechanism should be applied to the forward market timeframe as a no regret option. To date, no evidence has shown how such a method would contribute to enhancing hedging opportunities and market efficiency in the overall long-term forward market, or even limited to volumes offered and free to utilise for hedging of individual BZ to BZ price differentials. In more simple terms it seems relevant to limit the possible application of a Flow Based CCM to the market timeframes when the market results trigger a need to schedule production, consumption and trading positions subject to physical

Balancing Responsibility. This should include cross zonal flows (i.e., as the case for SDAC and SIDC) but not products traded in the long term forward time frame on a common European scale.

6.3.5 Type of intervention - Option 4: Forward market coupling with CfDs

There is no evident benefit of forward market coupling. Such a redesign would most certainly be immensely disruptive and disproportionately costly. While the paper suggests that implicit allocation of long-term capacities might in theory add liquidity for smaller and less liquid markets under certain circumstances, there is no guarantee of such benefits but there are clear drawbacks. (See our response to Section 2).

Forward markets already exist to allow market participants to hedge their exposure in their bidding zone. Their objective is not to compute an ex-ante equilibrium point between the bidding zones in the future.

We encourage ACER and CEER to continue their appreciated efforts to assist in fully optimising the integration of the spot market. As the spot market is representing the underlying, this would consequently further improve the forward market. Further, the aspects related to the intervention into financial markets have not been considered at all in this paper. Finally, a cost-benefit analysis of any such proposal done in close dialogue with market stakeholders would need to be preliminarily carried out.

6.3.6 Type of intervention - Option 5: Forward market coupling with Futures

Regarding forward market coupling with futures (Option 5) the draft policy paper states that this option shall allow the existing forward markets and futures products to be coupled with long term cross zonal capacities. However, such a proposal does not take into account that in some Member States future energy products are traded by a financial exchange, conversely to physical forward markets that are locally operated by the PX with delivery and withdrawal obligations. This is a major concern since it is not at all clear who would be the regulating entity of this exchange (financial authority/energy authority); which would be the applicable law (MIFID/FCA/EMIR, if anything else); and what would be the role of the exchange (PX/financial exchange) under this specific circumstance. Furthermore, if feasible, it remains unclear how lengthy and costly the regulatory processes and operational adoptions would be. In general, and as already stated under 6.3.5, we are concerned with ACER and CEER trying to address matters regarding the forward market with solutions that are applicable to the spot market.

8. Recommendations and proposed actions

The options preferred by ACER would require extensive legislative changes on both financial and energy regulatory frameworks. For this reason, and in light of the current strain on the EU electricity wholesale market and the high cost of hedging, we suggest that ACER focuses on less complex, short-term policy recommendations to competent authorities which can improve liquidity, thereby taking into account the forward market as a whole. This should

include a review of the requirements on the side of financial regulation, particularly regarding clearing. Moreover, no disruptive solutions should be implemented without first taking into account the much larger debate currently ongoing about possible market design improvements against the background of the present energy crisis and in view of the EU's mid- and long-term decarbonisation agenda.

About

Europex is a not-for-profit association of European energy exchanges with 30 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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