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Response to DG Energy's public consultation on the governance framework for the European day-ahead market coupling

This document contains the combined response of FIEC and CEFIC to the public consultation described in DG Energy's paper D(2011) 1176339 dated 28 November 2011.

In the text below, the term "paper" refers to DG Energy's paper D(2011) 1176339.

First, we have some general comments on the different issues mentioned in the paper. Responses to the questions then follow and then there are comments on the paper's Annex 2 "*Options paper for day-ahead electricity market governance guideline*".

1. General comments

a. If market coupling goals are laudable, coupling must target price competitiveness

Market coupling goals are laudable but the design must target price competitiveness. If not properly designed market coupling may, depending on the bidding / pricing zones architecture, lead to price increases. This would be inconsistent with the goal of long term global competitiveness for industrial consumers, which must remain a core principle throughout the development process.

b. The role of regulators regarding spot exchanges is crucial

The position of spot exchanges is fundamental in the market system. The control by the regulators of their operations should be enhanced and tools for regulatory oversight should be strengthened.

2. Market coupling makes the operation of spot exchange a monopoly

The operation of a spot exchange becomes a monopoly, when market coupling is introduced as the day-ahead congestion management system: for each price zone, market coupling requires a single spot price per hour. Only with this unique spot price is it possible to determine whether the market coupling plans must ship the energy into or out from the price zone during the hour in question.

This necessity of a single spot price makes competition between spot exchanges unfeasible. For a given price zone, two potentially competing spot exchanges would need to co-operate to create a single spot price per hour (i.e. they would have to pool their bids into one settlement system and one price calculation¹). In effect, this would leave the spot exchanges competing only for the collection of the spot bids – a competition needless in the age of the internet, where the players can send their bids directly to the common spot price calculation system.

This is confirmed by the fact that there is only one participating spot exchange per price zone in the current market coupling: the Central Western Europe-Estonian-Nordic area.

¹ Note that the two "competing" spot exchanges need to establish a common clearing & settlement. As an extreme case for a price zone: assume all the buyers send their purchase bids to spot exchange PX₁ and all the sellers send their sale offers to spot exchange PX₂. Obviously, neither of the two can do the clearing & settlement alone: PX₁ would have to collect the money from the buyers and PX₂ would have to pay these money to the sellers.

The upshot of this monopoly role is twofold:

- A. The spot exchanges must unbundle. The spot exchanges and the clearing houses carrying out the clearing & settlement of the spot trading cannot be engaged in other activities. For example, they cannot be engaged in intra-day trading/clearing, trading/clearing other commodities or trading/clearing financial contracts. Inevitably, engagement in other activities would give rise to cross-subsidizing.
- B. The spot exchanges must become regulated entities (analogous to the transmission system operators).

Besides good governance also the appropriate accompanying measures and regulators' watch (cf. REMIT) are indispensable for a reliable price signal from day-ahead market coupling. One of such accompanying measures, for example, relates to ensuring that all available interconnection capacity is effectively offered at day-ahead market coupling.

3. A level playing field for the competition on the electricity market requires harmonisation

The products offered by EU spot exchanges must be harmonised. This is part of the creation of a level playing field for the competition on the whole-sale electricity market. Therefore, regional differences must be eliminated.

4. Answers to the questions in the public consultation

In the following text, the term "QX" refers to the questions in the paper. The term "AX" is the corresponding answer.

Q1 *Is the problem definition correct?*

A1 Yes, basically the problem definition is correct. However, on the paper's page 5, there is a discussion of competition between spot exchanges. As mentioned above, market coupling makes competition between spot exchanges unfeasible. Further, on the paper's page 6, there is a discussion of how to establish market coupling, if a given area has no spot exchange. However, as explained below, a single spot price calculation makes the expansion of the market coupling extremely simple, rendering this discussion superfluous.

Q2 *Do you agree that governance of market coupling shall be addressed in a legally binding guide?*

A2 Yes, certainly. As noted above, market coupling makes the operation of a spot exchange a monopoly. Naturally, this monopoly must be regulated – and the regulation must have a clear legal foundation. This is a basic part of being societies governed by the rule of law.

Q3 *Which is your preferred option? Why?*

A3 The paper's option 4 is the preferred option. This is due consideration of cost, quality and influence for the stakeholders. A single price calculation carried out by a single, tightly regulated entity provides a simple, efficient and transparent solution, as is argued below.

The paper's chapter four provides seven preliminary criteria for choosing between governance options. In the following, the seven criteria are examined and it's argued, why option 4 is the best for Europe.

The first criterion is the **quality of the market coupling**. As a case: for the Nordic area, there has been price coupling between four countries for more than 10 years. This has been carried out by one entity with one staffed primary calculation site and one unstaffed disaster site (there is **not** a calculation company and a calculation site per Nordic country). This has worked well: when this system has produced unreliable spot prices, it has been solely due to a bad coupling system to

Continental Europe (after market coupling to Continental Europe had been established, the local Nordic re-calculation of the spot prices should have been avoided).

The second criterion is **efficient change management**. Obviously, with a single entity maintaining and operating the market coupling software, changes in the specifications and/or the daily operation procedure is simple. This is also confirmed by the Nordic case.

The third criterion is **speed, ease and cost of implementation**. The frequent bickering among the spot exchanges illustrate how slow and complicated the process will be, unless we in EU establish a single, well-regulated and well-governed entity, which carries out the market coupling. Clearly, a single entity is also the low-cost option: there is no need of the costly and risky redundancy implied in the spot exchanges' PCR proposal.

The fourth criterion is **tools for regulatory oversight**. Naturally, regulating a single entity is the simple option. For a NRA, just regulating a local representative (local spot exchange) only would be pointless: the decisions made in the neighbouring countries will heavily effect the cross-border energy flows – and therefore the local spot prices. Also, with a common algorithm for the market coupling a common, multinational regulation is needed either way.

The fifth criterion is **interference with national rules**. This favours the single entity also. As mentioned above, a common, multinational regulation is needed either way. With a single entity carrying out the market coupling, this multinational co-operation on regulation will be established, and the various issues, the NRAs need to agree on, will automatically surface. Also, as mentioned above, harmonisation is an end in itself in order to create a level playing field for the competition on the electricity market. This harmonisation is furthered when we establish a single entity.

The sixth criterion is **operating cost efficiency**. It is self-evident that this is best achieved by a single entity.

The seventh criterion is **extendibility**. This is best achieved by a single entity: a new country joining the market coupling need not establish a local price calculation. In relation to the entity carrying out the market coupling, the new entrant simply gets the same rights and obligations as the current participants (ownership share, influence, etc.).

Q4 What are in your view the main impacts of different options? Can you provide elements for assessment of impacts of the different options?

A4 In addition to the issues mentioned above, **transparency, intelligibility and influence for the stakeholders** are very important issues.

With option no. 4, we avoid an extremely complicated and opaque web of contracts between different calculation sites. Instead, we get transparency, intelligibility and a clear route to influence for the market coupling's stakeholders. As mentioned below, clear and formalised influence for the stakeholders is imperative because the market coupling moves vast amounts of money between players and between countries.

Also, the **operational safety** is by far the best with option 4. As a general safety rule: for a system, which needs to run reliably every day, you must not have a number of semi-autonomous entities trying to carry out the task simultaneously. The inherent dangers of the multi-calculation approach was clearly illustrated, when the spot prices for 10 November 2009 were calculated: in Paris, EPEX Spot failed to stay with the agreements and proceeded with the German spot price calculation on its own without waiting for the market coupling calculation. As a result, an economic loss was inflicted on the market players, who were left with unreliable spot prices.

Q5 Are the criteria for a good solution as presented in the list right? Do you have other criteria to add?

A5 The paper's criteria are sensible. In addition, IFIEC and CEFIC want to add the criteria mentioned above: **operational safety, transparency, intelligibility and influence for the stakeholders**.

Q6 Is the proposed timeline for the network codes and guidelines as presented in Annex 1 sufficient?

A6 No comment..

Q7 *If you think that governance of market shall be addressed in a legally binding guideline, is the relation between this guideline to the related network code as presented in this paper correct?*

A7 No comment.

Q8 *What should be the cost sharing solutions of market coupling between countries and between TSOs and power exchanges, both regarding the initial investment costs and the operational costs?*

A8 Market coupling moves vast amounts of money between countries. Also, market coupling is socio-economic efficient, as this congestion management system produces good day-ahead plans for the energy flows.

In order to ensure national influence and democratic oversight, each country participating in the coupling must own a share in the company carrying out the market coupling. For example, the shares (and thereby the national influence) can be allocated in accordance with the Lisbon Treaty's voting rights. Each national government will decide who will represent the country in the market coupler's board (subsidiarity principle). By investing in the market coupler, the participating countries will pay for the initial investment in the market coupling. Again, each country will itself decide, which national entity will pay for this (subsidiarity principle).

The operational costs of market coupling must be financed by the capacity owners. For most links, the capacity owners will be TSOs. However, in case of merchant links, the commercial owner of the link will also pay his part of the operational costs. The capacity owners must pay for the operation, as the market coupler is providing a service for the capacity owners: on the capacity owners' links, the market coupler carries out the day-ahead congestion management.

Q9 *Which aspects of market coupling do need specific regulatory oversight?*

A9 All aspects: the specifications of the market coupling software, the daily operational procedures, the distribution of the congestion revenues and the fees charged by the market coupler and by spot exchanges participating in market coupling.

Q10 *What differences do you see between the need of governance arrangements for organizing intra-day trade compared to the day-ahead market coupling? Should a legally binding guideline on governance also cover the intraday timeframe?*

A10 As noted above, market coupling makes spot exchanges monopolies. In contrast: at the outset, the operation of an intra-day trading system is not a monopoly. If the TSOs set up a European capacity platform, any exchange can set up a multinational intra-day trading system utilizing the information from the TSO platform. However, the capacity platform should be prevented from providing capacity to OTC transactions.

In fact, the intra-day liquidity is very, very low. Due to the low liquidity, we must expect there is at most room for only one multinational, European intra-day trading system. Indeed, with the low intra-day liquidity, the current intra-day trading systems would probably not survive without cross-subsidization from the spot trading. Hence, in practice the low liquidity makes the operation of an intra-day trading system a monopoly. The important point is to avoid cross-subsidization in the future. Therefore, the intra-day trading must be separated from the spot trading (and from other activities). As the intra-day trading system in practice will be a monopoly, it must be separately regulated the same way as spot exchanges participating in market coupling.

5. Comments on the paper's Annex 2 “Options paper for day-ahead electricity market governance guideline”

5.1 Options for relation between TSOs and Power exchanges

As for the price calculation, there must be one company owned by the nations participating in the coupling, as argued above. This market coupler must have agreements with all participating capacity owners – for example, the market coupler must have agreements with the participating TSOs.

The market coupler will use the local spot exchanges as the local information hubs: towards local market players and other local stakeholders, the local spot exchange office will be the representative for the market coupler (as a case: compare the role played by the local spot exchange offices in Denmark, Estonia, Finland, Germany and Sweden). The market coupler needs corresponding contracts with each local spot exchange.

Also, as long as the spot settlement is not consolidated into one spot clearing house, the market coupler must have agreements with the local spot clearing houses carrying out the spot settlement: each spot clearing house must be informed about the local spot trading done by each market player.

As can be seen, there may not be need of contracts between the TSOs and the spot exchanges. However, there is a need for contracts between the market coupler and each capacity owner and there is a need for contracts between the market coupler and each local spot exchange.

5.2 Options for participation of PXs in the market coupling

As indicated by the text above, it is recommended that member states nominate who will participate.

5.3 Options on how single matching will be organized

As indicated by the text above, IFIEC recommends a new, single matching entity. European Market Coupling Company (EMCC) already exists. With a re-organized ownership and a market council, EMCC can be the single matching entity.

5.4 Options for stakeholder involvement

A council must be set up with representatives from the stakeholders. For example, IFIEC must be represented in the council. Note that the council must have formal influence – it's **not** just an advisory body.

This is because market coupling is a monopoly activity. The stakeholders cannot opt out of this system. Via their trading fees and grid fees, the end users and producers are paying for the market coupling. In return, they must have formal influence.

To some degree, this formal influence for the council may be similar to the influence granted to a German exchange market council (*Börsenrat*).

All important aspects of the software specification and of the daily operation routines must be approved in the council. If the council and the market coupler's board cannot agree on an issue, the decision rests with the regulators. This ensures a clear and efficient governance structure for the market coupling.

5.5 The market coupling software must be public open source code

This is in accordance with the transparency criterion mentioned above. As market coupling is a monopoly task, the stakeholders are all paying for the software. In return, they must have insight.

Indeed, it's hard to see the arguments for keeping the source code secret. The experience with open source code shows, this system provides for the most reliable software, as all aspects of the code can be scrutinized by any interested party. For the search for errors in the software, this means we use crowdsourcing – thereby ensuring high reliability for this very important software.