Advocacy Note on Forward Markets - Collateral

TSOs raise concerns over collateral consequences from trading financial derivatives

Key message: Potential costs of collateral requirements on TSO's trading financial derivatives are a concern for TSOs and need to be carefully considered in proposals for TSO involvement in the forward market design going forward.

ENTSO-E welcomes the mandate to the European Commission to launch an impact assessment of different potential solutions in the forward market before a final decision is taken according to Article 9 of the Electricity Regulation pursuant to the Electricity Market Design Reform.

Collateral concerns

TSOs made an evaluation and published a position note regarding the potential LT market models, where collaterals were pointed out as an important topic to be analysed. With the current financial regulation and the setup without a secondary market for Long Term Transmission Rights (LTTRs), TSOs are exempt from posting collateral. However, TSOs will be obliged to place collateral in a new Virtual Hub setup if a secondary market is part of the model for the market design. The amounts of collateral needed depends mainly on market conditions (price volatility) and the amount of capacity/volume TSOs offer of the contracts, but also other factors like product type and maturities.

Key aspects of concern:

- Based on internal stress tests using 2022 data, the order of magnitude of the collateral could reach several billion euros for some TSOs in case of stressed market conditions. ENTSO-E expects the margin calls to be smaller in normal market conditions.
- The potential daily volatility in margin calls requires TSOs to inject large amounts of cash at short notice.
- TSOs would need to secure liquidity via credit lines and/or partially via banks or public guarantees, potentially at a high cost for tariff payers. Most regulatory regimes do not currently include provisions for working capital facilities. Finally, large collateral could deteriorate TSOs credit rating, making it more costly and generally more difficult to acquire the needed working capital for grid investments and operations.

Need for cost benefit analysis

Given the high costs of collateral and the potential liquidity harm, ENTSO-E calls for a holistic cost-benefit analysis of market design scenarios also including the investigation of the change in collateral requirements for market participants, which should be included in the impact assessment of FCA 2.0.

Possible solutions

Based on the outcome of the cost-benefit analysis, ENTSO-E would recommend diving further into the following solutions if hedging products are to be provided by TSOs:

- Keep the current framework where TSOs don't have to deposit collaterals by staying in an option setup without secondary trading at JAO (the majority of TSOs are in favour of this solution). Alternatively, designing an obligation or financial product setup where collateral is not needed from TSOs, or the risk and cost of collateral is regulatory mitigated, could also be considered. To limit competition with commercial forward markets, market participants should not be allowed to take short positions at JAO. A third possibility is the TSOs procuring a national market maker in bidding zones where analysis shows it can improve liquidity significantly.
- In case of a setup with products requiring collateral (like in Svenska Kraftnät's and Statnett's EPAD auctions): it is necessary to minimize collateral (ex. by adapting volumes) for TSOs' trading LTTRs decoupled from physical flows. Access to significant TSO-credit lines needs to be provided in the regulation by Member States or central banks to cover the collateral of TSOs' trading. Without reassurances in the regulation there is unclarity about the responsible competent party to assure financial backing for TSOs. Ultimately, the cost for setting up credit lines will have to be paid by tariff payers.