

Hedging & Forward Markets in Europe

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My 3 key messages for today

1

Forward markets in Europe are functioning but can be improved

- Already today many options are available to market participants
- Need to balance between hedging efficiency and hedging cost
- There are many solutions to improve this balance and increase liquidity

2

However the solution proposed by EU policymakers would make things worse

- Virtual trading hubs (VTH) would lead to a liquidity split and make hedging less efficient
- The risk of price divergence between zones and a VTH would expose market participants or TSOs to high financial risks.

3

To increase liquidity there are three main things we can do

- Better designed financial rules
- Improve Longer Long Term Transmission Rights (LTTRs) functioning
- Avoid non-market friendly interventions

But first, an outline of what I will present today



Presentation Outline

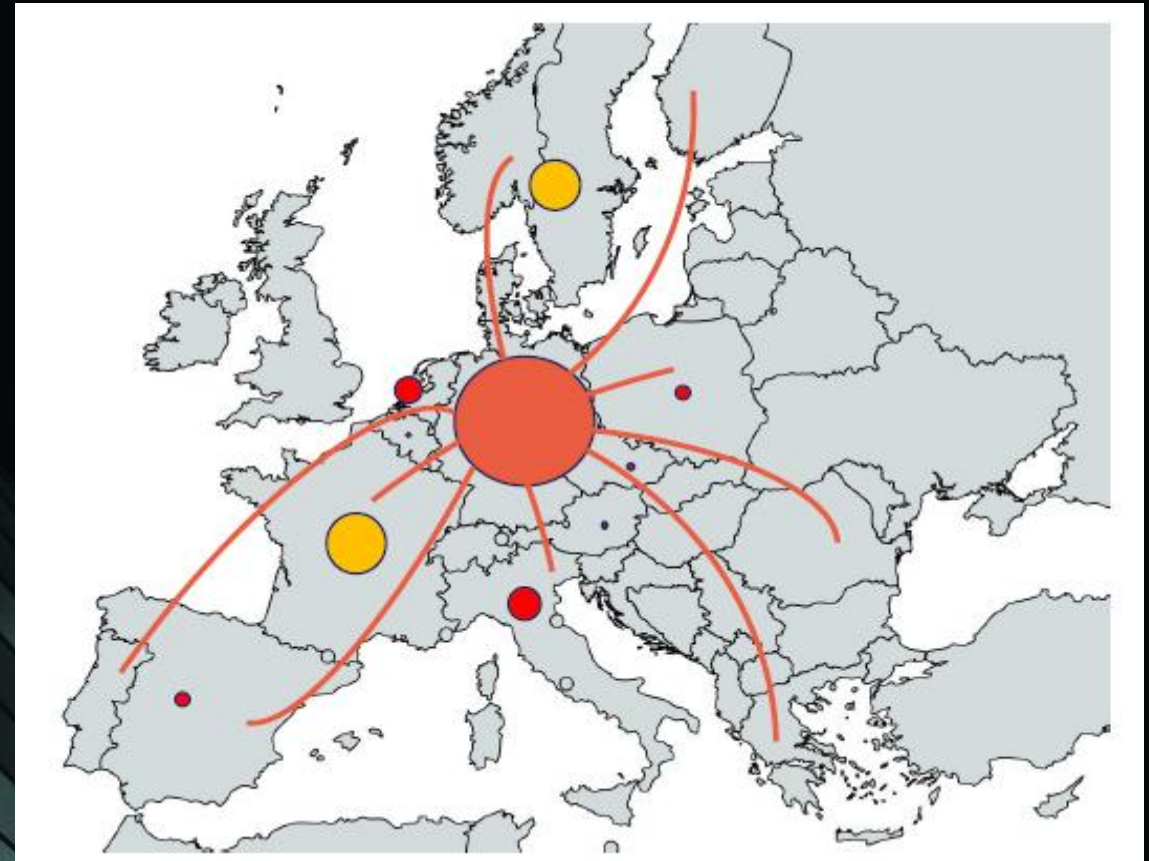
In the next 7 Mins, I will respond to the 3 guiding questions

1. What is the current state of forward market development across regions, and what practical steps could enhance their role in supporting investment and risk management?
2. How are long-term bilateral contracts, PPAs and CfDs influencing system operations and short-term market efficiency?
3. What investment support schemes are proving effective at attracting investments while minimising market distortions?



1. The current state of forward markets in Europe

- Liquidity varies by bidding zone. Market participants have many tools to create individual strategies: exchange-based, OTC, LTTR, spread-products.
- Germany is the largest pool of liquidity across Europe: used also by market participants outside Germany (proxy-hedging)
- In areas where forward markets are illiquid, alternative solutions, such as proxy hedging, exist.
- There are opportunities to increase liquidity



Why Germany?

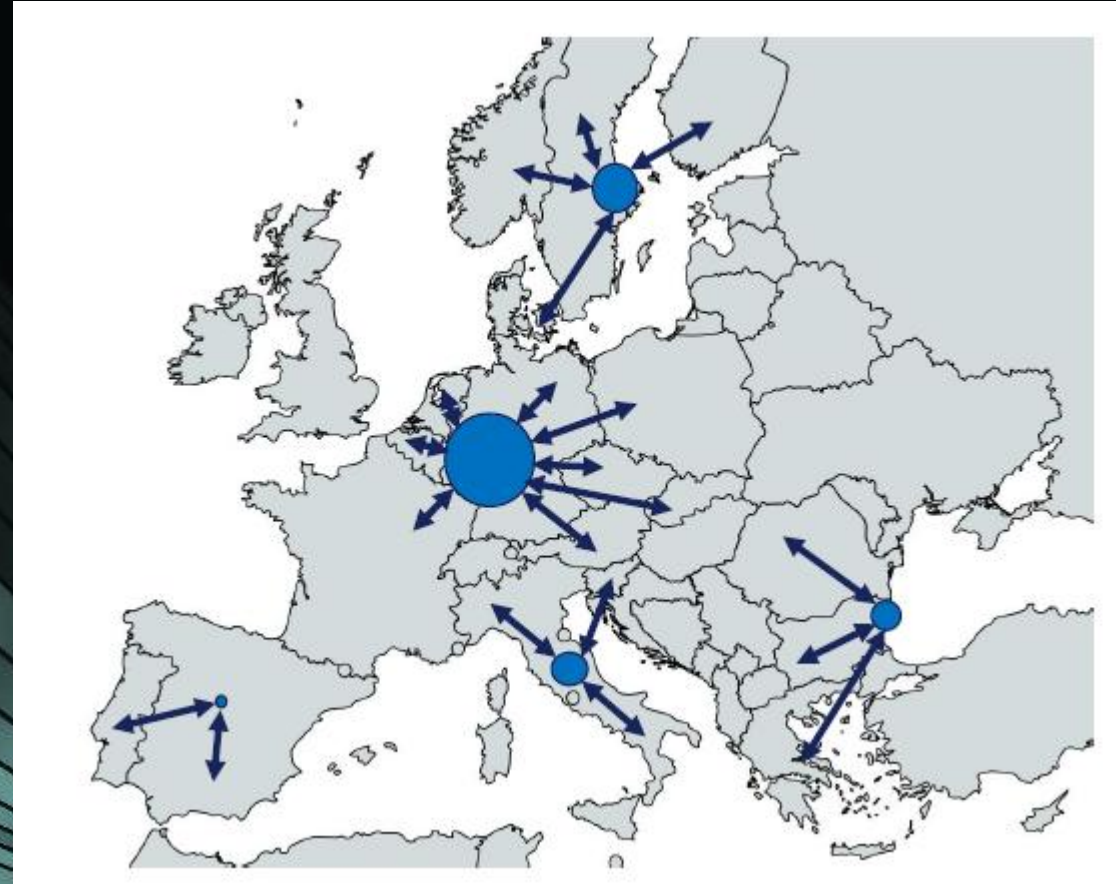
- **German hub liquidity builds on strong fundamentals and is self-reinforcing: high electricity demand, broad basis of market participant, highly interconnected.**
- **This cannot be created or transferred artificially**

The background of the image is a 3D wireframe cityscape. The buildings are represented by vertical rectangular prisms of varying heights and widths, all rendered in a teal or light blue color. The perspective is from a low angle, looking up at the buildings, which creates a sense of depth and scale. The overall aesthetic is modern and digital.

**What are policymakers
proposing?**

Virtual Trading Hubs

- i. EU policymakers are proposing the creation of regional “virtual trading hubs” independent of bidding zones (countries)
- ii. Imposed proxy hedging strategy – exposed to the prices of all underlying countries composing the hub – you don't have a choice
- iii. Issuance of zone-to-hub transmission rights by the TSOs: Exact definition and design still to be determined



Our concerns on Virtual Trading Hubs (VTH)

1. **Basis risk remains:** market parties are exposed to the price in their bidding zone
2. **VTH hedge efficiency is not better than current hedging strategies.** Instead it's better to leave market parties decide on proxy strategy
3. **No underlying physical transmission capacity** between hub and zone (compared to between zones)
4. **Risk of liquidity split** between (liquid) zones and hub, increasing transaction costs making it more difficult to find a counterparty
5. **No solution to share liquidity between hubs** – isolation of outer regions





**What should
policymakers be
doing?**

How to increase forward market liquidity

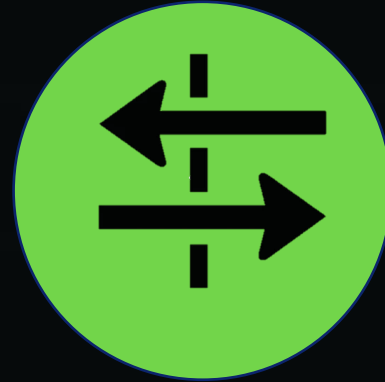
What can be done?



Better financial rules

Improve the clearing system and reduce the collateral burden

→ i.e. implement EMIR 3 rules regarding eligible collateral and margining transparency



Improved Long Term Transmission Rights

Longer maturity (3y instead of current 1), more frequent allocation, more volume.

→ Currently under consideration by the European Commission



Avoid disruptive spot market interventions

Forward markets depend on stable market rules. Interventions reduce incentives to hedge and therefore forwards liquidity

→ Avoid interventions like inframarginal caps

Implementing this



Increased liquidity



2. Long term contracts & short term market efficiency

- LT contracts complement existing ST markets to de-risk low carbon investments with high CAPEX.
- They help ensure bankability and, if needed, closing the financing gap.
- Several options exist: CfDs, PPA (market-based option), CRM (to guarantee SoS at a certain level).
- Today, I comment only on CfDs. For us, their design is key.



A well-designed CfD should:

1. **Provide price signals** for generators for system-friendly participation in wholesale markets (e.g. incorporate forward product prices in the reference index)
2. **Be compatible with other long term contracts.** For the same project, generators should be able to choose which volumes are covered by a CfD and cover the rest with with commercial hedging (forward products, PPAs)

More details in our recent report on CfDs:
<https://www.eurelectric.org/publications/unlocking-the-power-of-cfds-to-accelerate-the-energy-transition/>

3. What support schemes are effective at attracting investments while minimising market distortions?

- Well designed CfDs are effective at attracting LT investments while minimising market distortions (See previous slide).
- Specifically for PPAs, off-taker credit-risk guarantees can help many consumers. Welcome a greater role for EIB as guarantor of PPA.
- Looking ahead, the real challenge we see in attracting the necessary investment in:
 1. **New RES projects** – level of negative prices harm attractiveness of investments
 2. **Flexibility** – negative prices should incentivise this but it's not happening to the speed/capacity needed
 3. **Grids** – almost double from 38 to 67 billion eur/year
 4. **Demand** – stagnating in Europe at 23% for the last decade – supply/demand imbalance
 5. **Security of Supply and System Services** – create the necessary market for these ancillary services

Thank you for your attention

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Any questions ?

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