POSITION

2-sided CfDs: The effects of the design options must be comprehensively examined

Position of EFET Deutschland - Verband Deutscher Energiehändler e.V. on the discussion about renewable energies financing in the future electricity market design

Berlin, March 2024

Two-sided contracts for differences (CfDs) can have a major impact on the functioning of the wholesale market. Their introduction must therefore be carefully weighed up from a trading perspective. Energy Traders Germany recognises that support and financing instruments can play an important role in achieving politically defined expansion targets for renewable energies if market-driven investments are not sufficient. However, care must be taken when designing these CfDs to ensure that they do not have a negative impact on liquidity in the wholesale market by removing incentives to hedge prices. When reforming the instruments for financing the expansion of renewable energy, a variant should therefore be chosen that minimises the negative effects on the long-term electricity trading market and does not distort the short-term dispatch price signal. In this paper, the traders' association makes suggestions as to what is important in detail.

What role do futures markets play today in reducing price risk for consumers and producers?

The conclusion of forward contracts for the sale of electricity is an effective means of increasing price transparency for energy consumers and energy producers. This process of **reducing the risk of future price fluctuations** is known as "hedging".

- The **futures market** is a key mechanism for protecting households, SMEs and industrial consumers from price fluctuations in the usual hedging window of 1-3 years. The energy price crisis in particular has shown how important the futures market is in **flattening price peaks** for end customers: because suppliers had generally hedged their prices on the futures market, jumps in prices for end customers were much more moderate than the short-term market would have suggested.

- Wholesale trading makes it possible to **hedge investments**, including in renewable and conventional electricity generation plants and other technologies that are important for the energy transition, **against** various **risks** (volume, price, counterparty and balancing risks).

- The **more liquid** the **futures market**, the better and more favourable the hedging for both producers and consumers. Liquidity is created when as many electricity

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suppliers and consumers as possible participate in this market. The German futures market is currently the most liquid futures market in Europe and plays a decisive role in the hedging and risk management strategies of a large number of market participants (both for the German electricity market and for the electricity markets of other member states).

- Energy markets are highly affected by the regulatory framework. Government measures or the announcement of government measures can have an impact on the futures market. This makes it even more important to choose a **CfD model with** the **least negative effects on long-term trading**.

What impact would the introduction of more 2-sided CfDs have?

Germany has set itself the target of generating at least 80 per cent of its gross electricity consumption from renewable energies by 2030. At the most recent COP28 in Dubai, it was decided, among other things, to triple the expansion of renewable energies by 2030. We recognise that funding and financing instruments can play an important role in achieving such politically defined expansion paths if market-driven investments are not sufficient to achieve the desired expansion volume.

2-sided CfDs, depending on their design, can shield producers from price risks, reducing the need to hedge on the wholesale market. **Two-sided CfDs can** therefore **strongly influence the functioning of the wholesale market**. The guaranteed remuneration for the producer associated with a 2-sided CfD and the socialisation of risks reduce incentives for long-term price hedging via the market. This reduces liquidity in the futures market, which in turn makes price hedging for electricity producers and consumers and possibly the market-based expansion of renewable electricity generation more difficult.

The reduced liquidity in the futures market means higher costs for hedging the portfolios of households, SMEs and industrial customers. There is a risk that the introduction of 2-sided CfDs will make the procurement of green electricity outside of this support system more expensive, for example for electrolysers or industrial consumers.

What kind of CfD design would avoid negative impacts on consumers?

While recognising the need to ensure investment security, it is of the utmost importance to minimise dependence on public support measures wherever possible. Private investment should be prioritised, and politics should only intervene if private financing proves insufficient. Even today, many wind and solar projects can be realised without state support and through investments by electricity generation companies due to their competitive technology costs. **Industrial electricity consumers, companies and producers of green hydrogen have specific requirements for renewable electricity procurement**, which can be easily covered by a Power Purchase Agreement (PPA).

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Prior to the introduction of 2-sided CfDs, actions should therefore be examined to **strengthen PPA-driven RE expansion**. This could include, for example, credit guarantees to cover payment defaults.

In the event of a possible introduction of 2-sided CfDs or similar instruments, we advocate a circumspect and comprehensive approach that emphasises a holistic view and a long-term perspective. Two-sided CfDs must not be considered in isolation but should be examined **considering the interactions with all existing electricity markets** (e.g. futures market, day-ahead market, intraday market) and subjected to a strict impact assessment. Hasty reforms pose a considerable risk to market stability and Germany's ability to achieve its renewable energy and climate targets.

Energy Traders Germany demands in detail:

- A CfD model with **the least negative effects on long-term trading** should be selected.
- **Incentives for system integration** of the renewable electricity generated must be maintained.
- **CfDs must remain voluntary,** and companies should be allowed to conclude long-term trading contracts (incl. PPAs).
- CfDs **should be used sparingly** and reserved for new low-carbon capacity where private investment is insufficient.
- The **reference period** of the CfDs should **be as long as possible** to encourage market rational optimisation of the assets during the year.
- We reject CfD models that incentivise price-independent electricity generation or that imply the physical purchase of electricity volumes from a central, state-supported facility. Instead, "Capability-based", "Deemed" and "Financial CfD" models should be analysed intensively, as they do **not distort the short-term dispatch price signal**, at least.

Possible parameters to reduce the negative effects of 2-sided CfDs

Various adjustments could help to reduce the undesirable effects and should therefore be investigated in more detail:

- Combination models of CfDs and PPAs,
- "Cap and floor" models, in which a corridor is set instead of a strike price, within which the project developer neither receives nor makes a payment,
- „Opt in“ or „Opt out“ options,
- Flexible contract terms for CfDs,
- "Merchant head" model, in which the installations are freely marketed for a certain number of years before the CfD term begins,
- Issue of guarantees of origin for installations in the 2-sided CfD, whereby it must be ensured that these guarantees of origin are clearly differentiated from unsubsidised guarantees of origin.

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In the context of the various design options, the effects of aggregated direct marketing should also be explicitly examined.

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