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McGRAW HILL FINANCIAL

FTR underfunding affects hedging in PJM

By Juliana Brint
Published on - Fri, 16 Aug 2013 20:06:37 GMT

The persistent underfunding of financial transmission rights in the PJM Interconnection is affecting market participant behavior, with decreasing monthly FTR clearing prices on several major paths, and some companies saying that they are altering their hedging strategies.

FTRs are financial instruments that allow market participants to hedge day-ahead congestion risk between two points on PJM's grid. FTRs entitle their holders to a stream of revenue, or charges, based on the day-ahead price difference across a transmission path.

PJM FTRs paid out fully from June 2006 to February 2010, according to data from the grid operator. But since 2010, PJM FTRs have seen decreasing pay-out levels.

The monthly FTR pay-out levels averaged 85.7% in 2010, 79.5% in 2011 and 74.7% in 2012, according to data from PJM. For the first seven months of 2013, the monthly pay-out levels have averaged 68.2%, according to PJM data.

The underfunding has triggered a number PJM stakeholder proceedings and a series of complaints to the Federal Energy Regulatory Commission. In a June ruling rejecting a FirstEnergy complaint about FTR underfunding, FERC suggested that market participants should adapt their bidding behavior to reflect the expected value of FTRs (Docket No. EL13-47).

"The amount paid by FTR holders should reflect the expected value of a given FTR," FERC said. "Thus, if the value of FTRs is reduced by underfunding, then the FTR holders should pay less for these instruments, and will receive the value for which they have paid."

It seems that some market participants have been taking that advice to heart, putting less value on FTRs. "I think that the problem has been persistent for long enough, with no resolution in sight, that you would anticipate the market is discounting FTRs," said one market participant who wished to remain anonymous.

PJM's independent market monitor, Monitoring Analytics, said in a Thursday state of the market report that "the market response to the revenue adequacy issue has been to reduce bid prices and to increase bid volumes and offer volumes."

In the 2010 to 2011 planning period, "the clearing price for an FTR obligation was $0.71/MW, and in the 2013-2014 planning period, the clearing price was $0.30/MW, a 57.7% decrease," Monitoring Analytics said. "In the 2010 to 2011 planning period, the clearing price for FTR obligation sell offers was $0.22/MW, and in the 2013 to 2014 planning period it was $0.05/MW, a 340% decrease."

Platts has been compiling data from independent system operator FTR auctions since March 2011. Since then, several major paths in PJM have shown declining clearing prices in PJM's monthly FTR auctions.

In the nine months for which Platts has monthly on-peak FTR price data for the Western Hub to PPL Zone path in both 2011 and 2012, the 2012 clearing price was lower in every month. In those nine months, the 2012 prices were about 99% lower on average than they were in 2011.

In the first eight months of this year, only May saw higher monthly on-peak FTR prices in 2013 than in 2012 for the Western Hub to PPL Zone path. For the first eight months of 2013, monthly on-peak FTR prices on this path have been 266% lower, on average, than they were in the first eight months of 2012.

"We do factor in underfunding during any bidding we may do for FTRs," said PPL spokesman Ryan Hill.

Similar patterns were observed for paths from Western Hub to Atlantic Electric Power Zone, to Baltimore Gas and Electric Zone, to Dominion Zone, to PECO Zone and to Pepco Zone. For each of these paths, the clearing price for on-peak monthly FTRs has mostly decreased where year-over-year comparisons are possible, with a couple months, at most, showing year-over-year increases.

Other paths — such as the Western Hub to Jersey Central Power and Light Zone path and the Western Hub to Public Service Electric and Gas Zone — were more mixed, with a majority of on-peak monthly FTR prices decreasing year-over-year, but three to four months showing year-over-year increases.

"When folks bid on these FTRs, they've got to factor in a huge underfunding premium," said one consultant who represents a variety of PJM market participants and wished to remain anonymous.

Raymond DePillo, vice president for power operations and asset management at PSEG, said his company has been factoring in expectations for underfunding when bidding on FTRs. DePillo said he believes that this strategy is "becoming the norm" for PJM market participants.

Congestion as a complicating factor

PJM and market participants said it is difficult to know with certainty whether the changes in FTR path values are driven by underfunding or another factor, such as expectations of lower congestion.

"It is apparent that FTR revenues in the annual auctions have been down the past couple of years compared to historical values," said Stu Bresler, PJM's vice president of market operations and demand resources. "However, at the same time, we see the actual congestion has been lower. While it is very likely that participants are bidding less for FTRs because of the underfunding experienced over the last few years, it would be difficult to directly correlate the lower FTR auction revenues to FTR underfunding because participants are likely also bidding less for FTRs due to the expected lower congestion."

The 2013-2014 annual FTR auction generated about $558.4 million in net revenue, a roughly 7.4% decrease from the previous year's auction, according to Thursday's state of the market report. Day-ahead congestion costs in PJM in the first six months of 2013 totaled $389.6 million, a 35.3% increase over the first six months of 2012, according to the report.

By contrast, the 2009-2010 annual FTR auction generated about $1.330 billion in net revenue, and the first six months of 2010 saw about $734.2 million in total day-ahead congestion costs, according to previous state of the market reports.

While it is difficult to reconstruct what market participant expectations may have been for congestion going into the monthly FTR auctions, the paths that saw predominantly decreasing on-peak monthly FTR prices have had more mixed results in terms of on-peak day-ahead congestion costs.

PPL Zone, for instance, saw three months in 2012 in which average on-peak day-ahead congestion costs were higher than they were in 2011. Four of the first seven months of 2013 saw higher on-peak day-ahead congestion costs at PPL Zone compared with 2012 congestion costs.

The AECO, BG&E, Dominion, JCPL, PECO and Pepco zones each had year-over-year increases in average on-peak, day-ahead congestion costs in two to five months of 2012. In each of those zones, average on-peak, day-ahead congestion costs have been higher year-over-year in three to five of the first seven months of 2013. The PSEG zone has seen year-over-year increases in average on-peak, day-ahead congestion costs in every month since November.

"Every auction is different," said one market participant. The prices are "partly a function of if I think there will be less congestion next year and if there have been upgrades. But if everything were the same and there's more underfunding now that I know about … of course I would pay less for the instrument. Talking to traders, the general belief is that that has happened."

Physical participants changing hedging strategies

Some market observers said that while financial speculators may be willing to simply pay less for FTRs, companies looking to hedge physical positions may be more vulnerable to the variations in FTR funding levels. "If I was trying to use [FTRs] for hedging, it is a very risky proposition if they're going to be underfunded," said one market participant. "If instead I do what FERC is saying -- yeah, these things have become inferior, so pay less for them -- that business can continue fine for speculators. … If they are not going to work as hedges, that is going to have an impact and it can't be addressed by just saying, 'Just pay less for them.'"

"If you look at the whole spectrum of who this is going to hurt, it's not just the financial marketers," the consultant said. "For the most part, they are going to be smart enough to factor in huge risk premiums. … Although incrementally it has hurt some financial players, in the end it is going to end up hurting physical players who really need the hedge."

Some market participants and observers have also argued that if the amount paid for FTRs in the auctions is reduced, the burden will ultimately shift to load by reducing the money paid to the firm transmission service customers who hold auction revenue rights (ARR) entitlements.

"If [market participants] are only willing to bid 60% of the value [for FTRs], if I'm a load-serving entity, my ARR is now also only worth 60%," said DePillo of PSEG. "The ability to protect against congestion risk as a load-serving entity is greatly diminished. … If ARRs are worth less, which they are as a function of the FTR price, people bidding on loads are going to incorporate that into their bids, incorporate having to manage more of that basis risk in the competitive solicitation, [so it will be] reflected in prices load pay."

Some said physical market participants are seeking alternatives to FTRs, such as accepting more risk in the day-ahead market, buying and selling basis swaps on exchanges or using the FTR-like product offered by Nodal Exchange.

"You can keep reducing your bid, but you're still missing your mark [for hedging]," the consultant said. "You can continue to lower your bid, but you may not clear at all. In some cases, you're better off just taking the risk" in the day-ahead market.

In March 2012, Nodal Exchange began offering power contracts for energy plus congestion at various nodes in PJM. Settled against day-ahead prices published by PJM, these contracts are effectively equivalent to PJM FTRs, explained Paul Cusenza, CEO of Nodal Exchange.

"There are always benefits to trading our contracts," Cusenza said. "One additional benefit at the moment is the contracts do settle against the actual prices. … That degree of certainty and knowledge is certainly attractive."

Cusenza said Nodal Exchange has seen "a lot of growth broadly across all of our products," including its FTR-like products.

DePillo said PSEG is continuing its use of basis transactions and the Nodal Exchange product, but that liquidity can be a limiting factor in seeking hedging alternatives.

American Electric Power spokeswoman Tammy Ridout said her company has adjusted its hedging strategy in light of the ongoing underfunding issues. "AEP incorporates underfunding assumptions into the valuation of FTRs, thus reducing the expected value of FTR instruments," Ridout said. "AEP has engaged in transacting other products in substitution of FTRs."

Due to underfunding, Hill said PPL has "significantly reduced" its use of PJM FTRs for hedging.

"We participate in Nodal Exchange 'OTC' FTR auctions that don't have the same underfunding issues, and we sell basis as a hedge when prices are attractive," Hill said. "We are hopeful that PJM will come up with a suitable solution so that we can once again use PJM FTRs as an effective way to mitigate basis risk."