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Cross-border exchange and sharing of generation reserve capacity

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This paper develops a stylized model of cross-border balancing. We distinguish three degrees of cooperation: autarky, reserves exchange and reserves sharing. The model shows that TSO cooperation reduces costs. The gains of reserves exchange increase with cost asymmetry and the additional gains of reserves sharing decrease with correlation of real-time imbalances. The model also shows that voluntary cross-border cooperation could be hard to achieve, as TSOs do not necessarily have correct incentives.

Keywords: Cross-border balancing, generation reserves, multi-TSO interactions, electricity transmission reliability

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1 Introduction

Transmission System Operators (TSOs) are responsible for the security of their transmission system. They use upward and downward reserves to deal with imbalances, caused by unanticipated outages and forecast errors of demand and intermittent supply. Historically, each TSO procured and activated its reserves in its own zone. However – following cooperation in forward markets, the day-ahead market and the intraday market – some TSOs in Europe and the United States recently started cross-border cooperation of reserves. Current cooperation projects are voluntary but the European balancing guideline obliges European TSOs to cooperate on reserves procurement and activation within two to four years after its adoption (ENTSO-E, 2014). This obligation will increase the number of cross-border balancing projects.

The benefits of cross-border cooperation of reserves have already been studied in the literature. Most of the literature presents case study results. Vandezande et al. (2009) estimate that a Belgium-Netherlands balancing market would have decreased procurement and activation costs by 29-44% in 2008, depending on the availability of cross-border capacity. Likewise, Van Den Bergh et al. (2015) estimate the benefits of cross-border activation of reserves to be around €25 million a year for a case study of the 2013 Central Western European electricity system (Belgium, France, Germany and the Netherlands). However, they find lower benefits of cooperation if transmission constraints are neglected during cross-border procurement. Farahmand et al. (2012) study the integration of the balancing and procurement markets of Northern Europe, Germany and the Netherlands. They estimate savings of approximately €400 million per year. Gebrekiros et al. (2013) find only a reduction of 2% of procurement costs in a small numerical illustration. van der Weijde and Hobbs (2011) quantify the inter-market benefits using a stylised 4-node network. They find that the benefits of coordinating balancing markets generally

exceed unit commitment benefits. In a future with a 45% penetration of renewable generation, Mott MacDonald (2013) estimates operational cost savings of exchange and sharing of reserves on European scale in the order of €3 billion a year. They assume that the increased intermittent and unpredictable generation capacity results in increased volumes of imbalances.

The case study approach in the literature means that there is still a lack of understanding, whether and to what extent TSO cross-border cooperation is economically efficient for each TSO zone and for the region as a whole. The contribution of this paper is to present a general model that analyses three degrees of TSO cooperation in reserves provision. First, we examine autarkic TSO reserve provision - a non-cooperative TSO equilibrium. Next we study the supply efficiency of reserves exchange, where a TSO can acquire reserve capacity in the adjacent TSO area. The last case investigates reserves sharing. Reserves sharing leads to both supply efficiency and dimensioning efficiency. We show that each step in the integration of zones results in progressively lower expected socio-economic costs. We also present a numerical example in order to illustrate the three scenarios. Lastly, we show that the gains of cooperation are not equally distributed across TSOs. Some TSOs may even experience an increase of procurement costs, which makes voluntary cross-border cooperation harder to achieve. As the European balancing guideline does not specify the details of inter-TSO agreements, there is, however, room for bargaining.

The paper is organised as follows. The next section describes various concepts of electricity balancing, together with types and examples of cross-border balancing mechanisms. Section 3 introduces the model and analyses different degrees of cooperation of cross-border reserves procurement. Next, section 4 studies the implementation of cross-border reserves procurement. Section 5 concludes.

2 Electricity balancing

Electricity balancing is the continuous process, in all time horizons, through which TSOs ensure that a sufficient amount of upward and downward reserves are available to deal with real-time imbalances between supply and demand in their electricity transmission system. Imbalances occur due to forecast errors of demand and renewable supply and unforeseen events such as line failures and generation outages. If imbalances between supply and demand persist for a certain period of time, the electricity system could collapse, leading to a blackout.

Most transmission systems consist of different interconnected networks, which are each governed by one TSO. Since system frequency is shared on all voltage levels of a synchronous area, due to the technical characteristics of electricity, power system reliability is considered to be a common good. That is, a non-excludable but rival good. This means that a MW of power can only be used once and that it is technologically difficult to prevent interconnected TSOs from using more than they provide. Underprovision of reserves in one TSO zone could thus lead to a widespread blackout throughout the synchronous area. Therefore, to prevent this ‘Tragedy of the Commons’, all TSOs in a synchronous area are obliged to provide reserves.

Figure 1 shows the two stages of electricity balancing: procurement and activation. First, to ensure that sufficient reserves are available for real-time balancing, TSOs procure an amount of reserves – so-called reserve capacity or balancing capacity – in advance.¹ This reserve requirements, R , is stipulated by network codes and guidelines. To determine the least-cost procurement of reserve capacity to meet the reserve requirement, the TSO holds an open bidding process for each type of

¹Even network operators with a real-time balancing spot market, like CAISO and Transpower, still procure some reserve capacity in advance. CAISO procures in the day-ahead market and hour-ahead market (Zhou et al., 2016), while Transpower holds a yearly tender for long-term contracts (Transpower, 2013). According to Transpower (2013), the procurement costs are €46.7 million per year.

reserves² for a given future contracting period. Balancing service providers can submit reserve capacity bids, indicating the size [MW] and the price of the bid [€/MW/hour availability]. In the illustration of Figure 1, bid 1, bid 2 and part of bid 3 are accepted in the procurement phase to meet a reserve requirement R . Accepted bids are obliged to be available throughout the contracting period. Second, in each activation period³ of the contracting period the TSO holds another open bidding process where both the procured reserve capacity and available non-procured capacity submit balancing energy bids. Bids are accepted by financial merit order to meet the real-time imbalance or reserve need r_t of the system. Accepted positive bids increase their generation, while accepted negative bids decrease their generation. In return, they receive the activation price p_{act} . In the illustration of Figure 1, bid 2, part of bid 3 and an additional non-procured bid are accepted in the activation phase to meet the real-time imbalance r_t .⁴

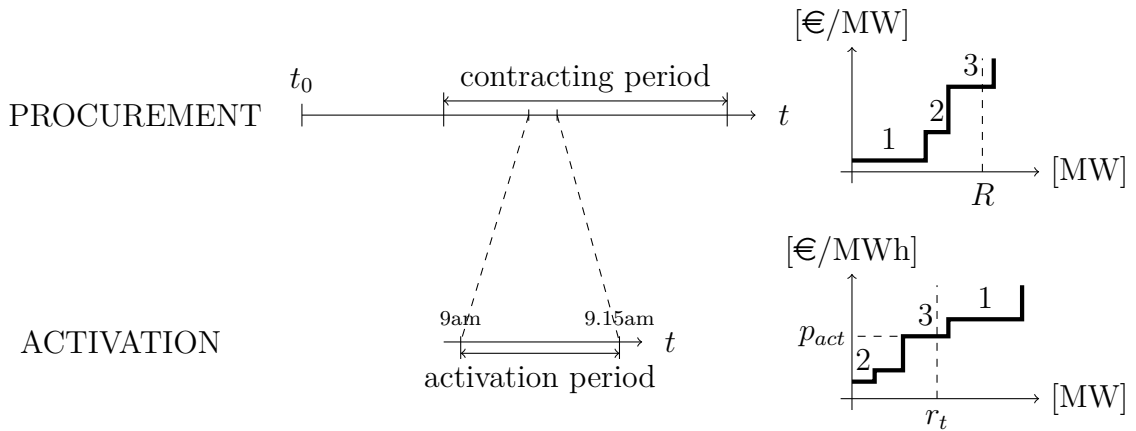


Figure 1: Procurement of reserve capacity and activation of balancing energy.

²In Europe, three main categories of reserves exist: (1) Frequency Containment Reserves (FCR), which is used for stabilising the frequency after a disturbance; (2) Automatic and Manual Frequency Restoration Reserves (aFRR and mFRR), which bring the frequency back to its setpoint value; and (3) Reserve Replacement (RR), which replace the active reserves such that they are available to react to new disturbances (ENTSO-E, 2014). These three types are called primary, secondary and tertiary reserves in North America (Ela et al., 2011).

³The activation period, also called settlement period, can be 15 mins, 30 mins or 1 hour depending on national market design characteristics. This should be standardized for cooperating TSO zones. According to Neuhoff and Richstein (2016), convergence to the largely used 15 min period is supported by most.

⁴An alternative to merit order activation is pro-rata activation. In that case all procured reserves are activated but in proportion to their relative procurement bid size.

In many TSO zones procurement and activation is more complex than the explanation above. For example, some TSOs co-optimize the market clearing of different types of reserves or assess the reserve capacity bid and the balancing energy bid jointly (50Hertz Transmission GmbH et al., 2014).

Both generation and demand could voluntarily participate in balancing markets, i.e. in both procurement of reserve capacity and activation of balancing energy. However, if the upward reserve need is so large that available reserves are insufficient, the TSO will involuntarily shed load as a last resort to avoid a blackout.

2.1 Cross-border balancing

Under the impulse of increasing renewable energy integration, supranational legislation (ENTSO-E, 2014), and a general drive for more cost efficiency and reliability, some TSOs have started to coordinate electricity balancing between neighbouring TSO zones. Often cited benefits of cross-border balancing include a more efficient use of electricity generation, including reduced renewable energy curtailment (Mott MacDonald, 2013); reduced reserve needs (NREL, 2011); a higher reliability level (Van Den Bergh et al., 2015); internalisation of external effects on neighbouring TSOs (Tangerås, 2012), a standardization of the rules and products, which creates a level-playing field (ENTSO-E, 2014); and improved market liquidity, which increases competition (Hobbs et al., 2005). In the end, all these benefits decrease the socio-economic cost of balancing. This paper focuses on the first two of the above-mentioned benefits:

- (A) **Supply efficiency:** balancing services, both procurement of reserve capacity to meet reserve requirements and activation of balancing energy to meet real-time imbalances, are supplied by the cheapest balancing service providers. That is, if the market is enlarged, expensive balancing services in one part of the market can be substituted for cheaper ones in a different part of the mar-

ket. The scope for supply efficiency depends on the difference of procurement and activation costs between cooperating TSO zones.

- (B) **Dimensioning efficiency:** less procurement of reserve capacity is needed if a TSO in need of capacity can use idle reserve capacity of adjacent TSO zones.

Cross-border cooperation yields benefits both in procurement of reserve capacity and activation of balancing energy. Table 1 shows the different degrees of cooperation that are possible in procurement and in activation.

Table 1: Degrees of cooperation in cross-border balancing between TSO zones.

PROCUREMENT of reserve capacity	ACTIVATION of balancing energy
To meet the reserve requirements resulting from reserve dimensioning	To meet real-time imbalances resulting from forecast errors and unforeseen events
Autarky: no cross-border cooperation Exchange: procure reserves in other zones Sharing: multiple zones take into account the same reserves	Autarky: no cross-border cooperation Imbalance netting: avoid counteracting activation Exchange: activate reserves in other zones

First, the three degrees of cooperation in procurement of reserve capacity are autarky, exchange and sharing. Reserves exchange makes it possible to procure part of the required level of reserves in adjacent TSO zones. These reserves are contractually obliged to be available for activation by the contracting TSO and they can only contribute to meeting this TSO's required level of reserves. Reserves exchange changes the geographical distribution of reserves. More reserves are procured in cheap TSO zones and less in expensive TSO zones. Reserves exchange increases supply efficiency by decreasing the procurement costs.

Reserves sharing allows multiple TSOs to take into account the same reserves to meet their reserve requirements resulting from reserve dimensioning.⁵ A TSO

⁵In practice, reserves exchange and sharing is not limitless. Baldursson et al. (2016) summarize the limits on reserves exchange and sharing, as imposed by the EU guideline on electricity transmission system operation (European Commission, 2016).

in need of balancing energy can use this shared capacity, if other TSOs do not. Reserves sharing leads to both supply efficiency and dimensioning efficiency.

Second, the three degrees of cooperation in activation of balancing energy are autarky, imbalance netting and exchange. Imbalance netting avoids counteracting activation of balancing energy in adjacent TSO zones. For example, activating upward reserves in response to a negative imbalance in one TSO zone, and separately activating downward reserves in response to a positive imbalance in another TSO zone, is inefficient since counteracting imbalances naturally net out on synchronous networks. A simple coordination of imbalances could avoid this inefficiency. Imbalance netting is a constrained version of exchange of balancing energy.

Exchange of balancing energy is a further degree of cooperation in activation of balancing capacity. It implies that cooperating TSOs construct a common merit order of balancing energy bids and select the least-cost activation that meets the net imbalance of the joint TSO zone.⁶ Imbalance netting and exchange of balancing capacity increase supply efficiency by decreasing the activation costs.

2.2 Examples of cross-border balancing

Balancing and reserve cooperation between TSOs is still in its infancy. However, a few examples of successful cooperation exist in Europe and the United States:

In Europe, ENTSO-E is reviewing a number of pilot projects with the aim to test the feasibility of a multi-TSO cooperation on the cross border procurement of reserve capacity and activation of balancing energy. First, the International Grid Control Cooperation (IGCC) is a project of imbalance netting of frequency restoration reserves (FRR) to avoid counteracting activation of balancing energy (Just, 2015). The IGCC was launched in 2012 and currently consists of TSOs from Austria, Belgium, Czech Republic, Denmark, France, Germany, the Nether-

⁶Other market arrangements, like BSP-TSO and an additional voluntary pool, are also possible (Doorman and Van der Veen, 2013).

lands and Switzerland. Second, a part of this group of countries (Austria, Belgium, Germany, the Netherlands and Switzerland) also jointly procure frequency containment reserves (FCR). Third, the Trans-European Replacement Reserves Exchange (TERRE) is established between UK, France, Great Britain, Greece, Italy, Spain, Portugal and Switzerland. The project aims to jointly activate replacement reserves (ENTSO-E, 2016; Neuhoff and Richstein, 2016). A fourth example of TSO cooperation is the Regulating Power Market (RPM), which was established in 2002 between Denmark, Finland, Norway and Sweden. The RPM is a common merit order of manual frequency restoration reserves (mFRR) activation. Since the Electricity Balancing guideline obligates European TSOs to cooperate on imbalance netting, exchange of balancing services and sharing of reserve capacity, within two to four years after its adoption (ENTSO-E, 2014, articles 13-20), the number of projects is expected to increase in the future.

In the United States, a cross-border energy imbalance market (EIM) was established between CAISO and PacifiCorp in November 2014. As of 2016 the cross-border EIM consists of five network operators and public utilities in eight states. According to CAISO (2016), the current benefits of the three main participants (CAISO, PacifiCorp and NV Energy) amounted to \$88.19 million between 2014Q4 and 2016Q2 and are expected to increase even more in the future with an increased share of renewable generation.

3 Benefits of cross-border reserves procurement

This section studies the benefits of cross-border procurement of reserve capacity. We derive analytical expressions for the optimal level of procured reserves and study the associated cost decreases. Each degree of cross-border cooperation is analysed: autarky, reserves exchange and reserves sharing.

3.1 Model

This model studies two TSO zones $i = 1, 2$ that can either not cooperate (autarky), exchange reserves or share reserves. The need for reserves in TSO zone i at a certain instant is denoted by a random variable r_i [MW]. This is the real-time imbalance between supply and demand due to a combination of forecast errors of demand and intermittent supply, and failures of generation capacity or transmission components. We denote the joint probability density function of the reserve needs by $f(r_1, r_2)$ and the marginal density functions of r_1 and r_2 by f_1 and f_2 respectively.⁷ The TSO's variable of choice is R_i [MW], the quantity of reserves procured for its own zone i . The contracting period for the procurement of reserve capacity could be e.g. an hour, a week, a month, or a year. In the model we only focus on procurement of upward reserves. Negative reserve procurement is the mirror analysis and its equations are similarly interpreted.

In this paper we are interested in efficiency gains from exchange or sharing of reserve procurement, not efficient activation as such. Hence, the model does not take reserves activation into consideration and we therefore take marginal generation costs to be equal to zero. Costs of procuring R_i of reserve capacity in TSO zone i , however, are not zero and are given by $\gamma_i(R_i)$, with γ_i increasing, smooth and convex.

Figure 2 summarizes the order of events. First the TSO at each node i chooses how much reserve capacity R_i to procure. In case of exchange or sharing of reserves, the procurement may entail payments between TSOs. Next, in real time, the actual need for reserves r_i is observed in each node i . The procured reserves will be used to accommodate the reserve needs. In case local reserves are insufficient, TSOs will use exchanged or shared reserves, or, as a last resort, carry out load shedding. Last, settlement payments - if any - are made.

⁷The joint probability density function $f(r_1, r_2)$ will in general depend on the procurement interval and the time to real-time operation.

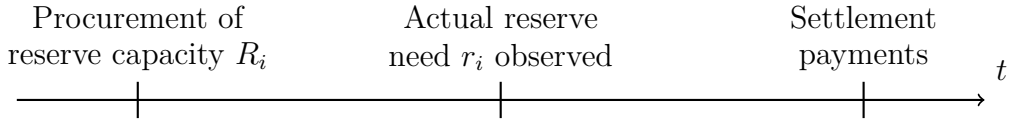


Figure 2: Order of events

3.2 Optimal autarkic TSO reserve provision

We first consider the case where there is no trade or exchange of reserves between zones. Thus, each TSO zone operates as an isolated “island”. In reality, network codes and guidelines stipulate the quantity of reserves each TSO zone is required to procure.⁸ However, here we pursue an alternative approach by considering the first-best outcome within this setting, i.e. where TSO i procures a quantity of reserves R_i such that expected social surplus in Zone i is maximized.⁹ We assume the value of lost load (VOLL - measured in €/MWh) is fixed at v and that electricity demand D_i is price inelastic and also valued at v . Hence, for a given level of reserve needs r_i and procured reserves R_i social surplus is given by consumer surplus net of costs of interruptions (due to unserved demand) and costs of procuring reserves,

$$S_i = vD_i - v[r_i - R_i]^+ - \gamma_i(R_i). \quad (1)$$

The TSO selects R_i to maximize $E[S_i]$ with respect to R_i

$$\max_{R_i} \left\{ vD_i - v \int_{R_i}^{\infty} [r_i - R_i] f_i(r_i) dr_i - \gamma_i(R_i) \right\} \quad (2)$$

Equivalently, since demand is inelastic, the TSO can minimize combined costs of interruptions and reserves, i.e.

$$\min_{R_i} \left\{ v \int_{R_i}^{\infty} [r_i - R_i] f_i(r_i) dr_i + \gamma_i(R_i) \right\}. \quad (3)$$

This is the approach we shall use henceforth.

⁸Such an exogenous requirement is also standard in reliability management of the day-ahead market, where the N-1 reliability criterion is used instead of balancing the costs of reliability and interruptions (Ovaere and Proost, 2016).

⁹If the reserve requirements of network codes diverge from this first-best optimum (e.g. due to imperfect information or socio-political constraints), costs are higher than in the first-best.

Differentiating (3) we derive the following first-order condition for the optimal quantity of reserves R_i^a in autarky:

$$v \Pr \{r_i > R_i^a\} = \gamma'_i(R_i^a). \quad (4)$$

The condition (4) is very intuitive: reserves should be procured up to the point where the marginal cost of procurement (right-hand side) is equal to the marginal cost of interruptions (left-hand side). The second-order condition for minimum is easily seen to be satisfied.

3.3 Reserves exchange

We now turn to the case of reserves exchange, which as explained earlier, makes it possible to procure part of the required level of reserves in adjacent TSO zones. We assume here that sufficient transmission capacity is available to accommodate the flows arising from use of reserve capacity in adjacent TSO zones and thus neglect any limits transmission capacity constraints would place on reserves exchange (Van Den Bergh et al., 2015). That is, there is only load-shedding if $r_i > R_i$, irrespective of where the reserve capacity is procured. To make the setting non-vacuous we assume that procurement costs are not symmetrical so there is a motive for reserves exchange.

This sections shows that exchange of reserves only leads to supply efficiency, not dimensioning efficiency. We study two variants of reserves exchange. First, that the required level of reserves in each TSO zone is the same as in autarky (regulated reserve levels); and second, that it is adjusted in accordance with procurement prices of reserves exchange (locally optimal reserve levels).

3.3.1 Regulated reserves levels

Here we assume, in accordance with the EU guideline on electricity transmission system operation (European Commission, 2016), that the required level of reserves

in each TSO zone is the same as in autarky, i.e. R_i^a .

In the first-best solution for this setting the two TSOs jointly minimise total costs of procurement, subject to the constraint on reserves. That is, the cheapest reserve capacity in the two TSO zones is procured first. This amounts to the following constrained cost minimization

$$\min_{R_1, R_2} \{\gamma_1(R_1) + \gamma_2(R_2)\} \text{ s.t. } R_1 + R_2 = R_1^a + R_2^a. \quad (5)$$

Note that R_i denotes the combined quantity of reserves procured in Zone i by the two TSOs. The side constraint simply says that the overall quantity of reserves procured has to equal the sum of the required reserve levels in the two zones. This minimization problem is easily seen to lead to the following set of equations:

$$\begin{cases} \gamma_1'(R_1) = \gamma_2'(R_2) \\ R_1 + R_2 = R_1^a + R_2^a. \end{cases} \quad (6)$$

That is, overall costs are lowest when the marginal cost of reserve procurement is equal in the two TSO zones. Fig. 3 shows this cost minimization graphically.

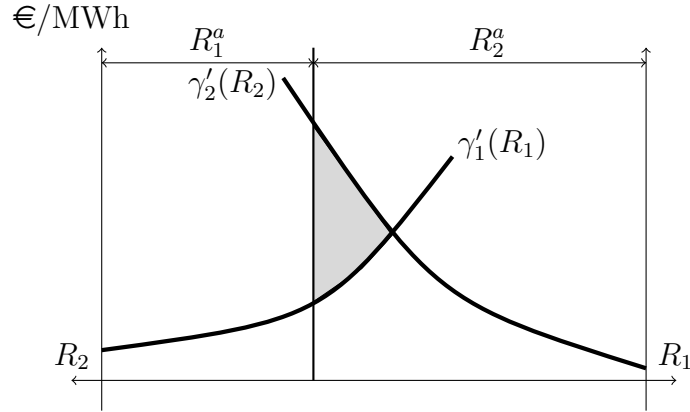


Figure 3: Cost minimization under reserves exchange between two TSO zones

The axis runs from left to right for TSO zone 1 and from right to left for TSO zone 2. The upward sloping lines are the marginal procurement costs in Zone 1 and 2. Clearly, if costs are symmetrical in the two zones, then there is no reason to exchange reserves and the optimal solution is for each TSO to procure reserves within his own

zone. If costs are asymmetrical, then there is a rationale for exchange. The grey area in the figure represents the reduction of procurement costs under the optimal procurement of reserves as compared to the costs in autarky where exchange is not possible and each zone supplies its own required reserves.

3.3.2 Locally optimal reserves levels

In the previous section we considered reserves exchange where required reserve levels were assumed to be given by regulation.¹⁰ Since the regulatory levels in our model were set so as to match marginal costs of interruptions and reserves, the resulting outcome after opening up for exchange is, however, no longer an optimum: marginal interruption costs no longer match marginal costs of procuring reserves; it will be tempting to lower required reserves in the cheaper zone, where marginal procurement costs have risen, and raise them in the more expensive zone, where they have fallen.

So another scenario is possible when TSOs are allowed to adjust their reserves levels in accordance with prices; this would seem likely to be the tendency over the longer run.

Again, we begin by considering the first-best solution for the present setting. This involves finding the jointly optimal reserve levels, viz. solving

$$\min_{R_1, R_2, R_1^e, R_2^e} \text{ s.t. } R_1 + R_2 = R_1^e + R_2^e \left\{ \sum_{i=1}^2 v \int_{R_i^e}^{\infty} [r_i - R_i^e] f_i(r_i) dr_i + \sum_{i=1}^2 \gamma_i(R_i) \right\} \quad (7)$$

where R_j is the amount of reserves procured in Zone j (as before) and R_i^e is the amount of reserves procured by TSO i .

It is readily seen that the optimal solution in this case is determined by the condition that all marginal costs be equal, both across zones and cost types. In

¹⁰We assumed the regulation to hold TSOs to autarkic levels, even after exchange is allowed, but in principle the regulation could be set at any arbitrary level.

other words,

$$\begin{cases} v \Pr \{r_1 > R_1^e\} = v \Pr \{r_2 > R_2^e\} = \gamma_1'(R_1) = \gamma_2'(R_2) \\ R_1 + R_2 = R_1^e + R_2^e. \end{cases} \quad (8)$$

3.4 Reserves sharing

Reserves sharing allows multiple TSOs to draw on the same reserves resources to meet their required level of reserves when it comes to operation. Recall that while exchange of reserves only leads to supply efficiency, reserves sharing leads to both supply efficiency and dimensioning efficiency. As before, we assume that transmission capacity is sufficient to always accommodate the flows arising from use of reserve capacity in adjacent TSO zones. That is, there is only load-shedding if $r_1 + r_2 > R_1 + R_2$.

In our model, reserves sharing amounts to maximizing the surplus of the two zones jointly, in effect uniting them.¹¹ As before, since we take demand to be inelastic, this is tantamount to minimizing expected costs of interruptions and procurement:

$$\min_{R_1^s, R_2^s} \left\{ v \int_0^\infty \int_{R_1^s + R_2^s}^\infty [r_1 + r_2 - R_1^s - R_2^s] f(r_1, r_2) dr_1 dr_2 - \gamma_1(R_1^s) - \gamma_2(R_2^s) \right\} \quad (9)$$

The optimal reserve capacities when reserves sharing is allowed, R_1^s and R_2^s , are determined from the following first-order conditions:

$$\begin{cases} v \Pr \{r_1 + r_2 > R_1^s + R_2^s\} = \gamma_1'(R_1^s) \\ v \Pr \{r_1 + r_2 > R_1^s + R_2^s\} = \gamma_2'(R_1^s) \end{cases} \quad (10)$$

which are derived by differentiation of (9) with respect to R_1^s and R_2^s , respectively. The first-order equations imply that marginal costs of reserves procurement are equal to VOLL times the loss of load probability in the two zones together. Clearly, this implies that marginal costs of procurement are equal at the optimal levels

¹¹As a simplification, we neglect any limits on reserves sharing, see Baldursson et al. (2016).

of procurement, $\gamma'_1(R_1^s) = \gamma'_2(R_2^s)$. Hence, the costs of reserves procurement are minimized as in reserves exchange, but for different levels of reserves and, hence, also reliability.

3.5 Efficiency of different degrees of cooperation

To compare the efficiency of the different degrees of cooperation, we need to compute the total costs c^j for each degree of cooperation $j \in \{a, e, l, s\}$. It leads to the following proposition.

Proposition 1. *Each step in the integration of zones results in progressively lower expected socio-economic costs, i.e. $c^a \geq c^e \geq c^l \geq c^s$.*

Proof. Recall that for each degree of cooperation $j \in \{a, e, l, s\}$, R_i^j is the optimal amount of reserves procured in Zone i and c^j is the sum of procurement costs and interruption costs in both TSO zones. By contrast, R_i is the amount of reserves procured by TSO i . Equation (11) is the sum of procurement costs and interruption costs with autarky. This minimization determines R_1^a and R_2^a . Adding an additional variable R_1^e leads to equal interruption costs and weakly lower procurement costs in equation (12). The inequality is strict if $R_1^e \neq R_1^a$ and $R_2^e \neq R_2^a$. Adding even more variables to allow a trade off between procurement costs and interruption costs causes equation (13) to be weakly lower than equation (12). Again the inequality is strict if $R_1^e \neq R_1^a$ and $R_2^e \neq R_2^a$. To proof the last inequality, notice that equation (13) equals equation (14) if the correlation of reserve needs is one. If the correlation

is lower than one, both procurement costs and interruption costs decrease.

$$c^a = \min_{R_1^a, R_2^a} \left\{ vE[r_1 - R_1^a]^+ + vE[r_2 - R_2^a]^+ + \gamma_1(R_1^a) + \gamma_2(R_2^a) \right\} \quad (11)$$

$$\geq c^e = \min_{R_1^e} \left\{ vE[r_1 - R_1^e]^+ + vE[r_2 - R_2^e]^+ + \gamma_1(R_1^e) + \gamma_2(R_1^e + R_2^e - R_1^e) \right\} \quad (12)$$

$$\geq c^l = \min_{R_1^l, R_1, R_2} \left\{ vE[r_1 - R_1]^+ + vE[r_2 - R_2]^+ + \gamma_1(R_1^l) + \gamma_2(R_1 + R_2 - R_1^l) \right\} \quad (13)$$

$$\text{with } R_1 + R_2 = R_1^l + R_2^l$$

$$\geq c^s = \min_{R_1^s, R_2^s} \left\{ vE[r_1 + r_2 - R_1^s - R_2^s]^+ + \gamma_1(R_1^s) + \gamma_2(R_2^s) \right\} \quad (14)$$

□

This can also be shown graphically. Figure 4 shows the socio-economic costs for each degree of cross-border cooperation. The increasing lines are the marginal procurement costs to reach a certain reliability level ρ .¹² As a result, the area below such a line is the total procurement cost to reach reliability level ρ (dark grey area) and interruption costs are $v(1 - \rho)$ (light grey area). In aggregate, a higher degree of cooperation leads to lower procurement costs to reach a certain reliability level, i.e. $\gamma^a(\bar{\rho}) > \gamma^e(\bar{\rho}) > \gamma^s(\bar{\rho})$. Figures 4a and 4b show that moving from autarky to exchange with regulated reserve levels leads to lower procurement costs but leaves interruption costs unchanged, because the reliability level is held fixed. Proceeding to exchange with locally optimal reserve levels (Figure 4c) increases procurement costs but less than the decreases of interruption costs. This analysis also shows that moving from autarky to locally optimal exchange has an ambiguous effect on procurement costs because the cost increase of a higher reliability level can exceed the cost decrease of reserves exchange. The cost decrease depends on the cost asymmetry between procurement costs in both TSO zones. Last, reserves sharing (Figure 4d) leads to an even higher reliability level and thus interruption costs decrease. As before, its effect on procurement costs is ambiguous and depends on

¹²Reliability $\rho \in [0, 1]$ can be defined in multiple ways. For example, $\rho = 1 - \text{LOLP}$, where the loss of load probability (LOLP) is the probability of being in a state of the world where some load shedding is needed; or $\rho = \text{fraction of total demanded load [MWh] that is supplied to consumers}$.

the correlation of reserve needs in TSO zones. The next section presents a numerical illustration of the benefits of cross-border cooperation and studies the comparative statics of the main parameters.

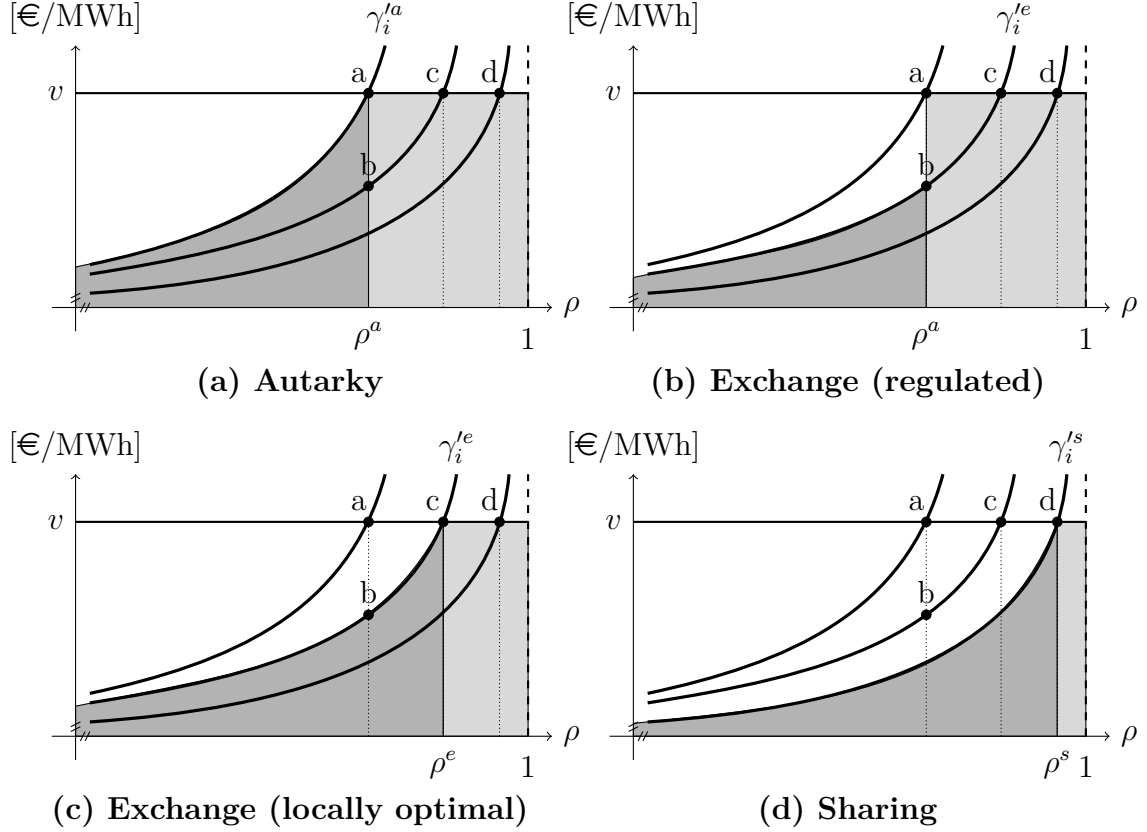


Figure 4: Degrees of cooperation: cost efficiency and reliability level.

3.6 Numerical illustration and comparative statics

The benefits of cross-border exchange and sharing of reserve capacity depend on two parameters: the difference in procurement cost in both TSO zones (c_1 and c_2) and the correlation of reserve needs between TSO zones ($\xi = \text{corr}(r_1, r_2)$). Supply efficiency increases if procurement costs are more asymmetric and dimensioning efficiency increases if reserve needs are less correlated. Figure 5 plots the sum of interruption costs and procurement costs with reserves exchange and sharing, relative to the costs in autarky, and shows that the benefits of exchange increase with

cost asymmetry (c_1/c_2) and that the benefits of sharing increase with decreasing reserve need correlation ξ .¹³

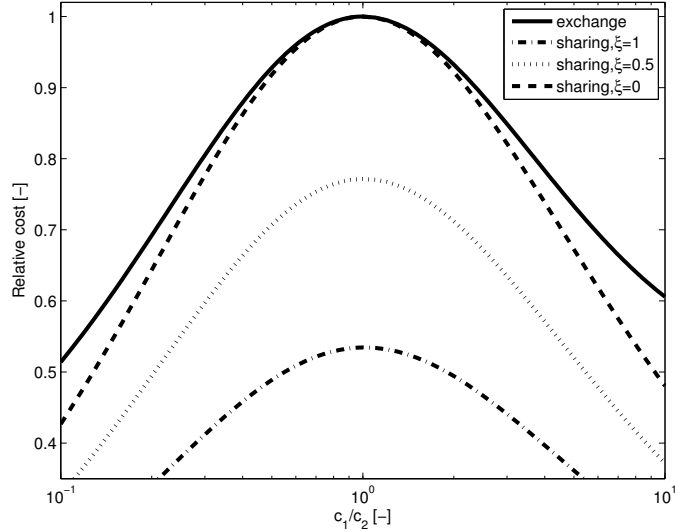


Figure 5: Relative cost of reserves exchange and reserves sharing, as a function of the cost asymmetry (c_1/c_2) and the reserve needs correlation (ξ).

Figure 5 illustrates several issues. First, when the two TSO zones have identical procurement costs, no cost arbitrage is possible and exchange of reserve does not yield any cost reduction. However, reserves sharing leads to a lower reserve need and thus a lower cost. Second, when the cost of reserve procurement differs between TSO zones, reserves exchange does yield a cost reduction. For example, when the cost of reserve procurement is higher in TSO zone 1, TSO 1 procures part of its reserve obligation with reserve capacity providers in TSO zone 2. Third, the cost reduction decreases when the reserve needs in the two TSO zones are more correlated. When the reserve needs are fully correlated, reserves sharing yields almost no additional cost reduction compared to reserves exchange.

Figure 5 also illustrates that the cost reduction increases when reserve procurement costs become more asymmetric and reserve needs are less correlated. With low cost asymmetry and low correlation, reserves sharing yields the major part of the

¹³The probability density functions of reserve needs are jointly normal with correlation ξ , each with a mean of 0 MW and a variance of 100 MW: $N(0,100)$. The cost of reserve procurement in Zone i is $\gamma_i(R_i) = c_i R_i^2$, with $c_1 = c_2 = 1$ at $c_1/c_2 = 1$. The VOLL is 10,000 €/MWh.

cost reduction, while with high cost asymmetry and a high correlation, reserves exchange yields the major part of the cost reduction. With symmetric costs and high correlation, cross-border cooperation in reserves yields very little cost reduction.

Table 2 analyses in detail the reserves, total procurement costs and total interruption costs for the values used in Figure 5, with $c_1 = 2$ and $c_2 = 1$. The table shows that sharing reduces the total amount of procured reserves and decreases interruption costs (increases the reliability level). Note that sharing with correlation $\xi = 1$ is equal to exchange with locally optimal reserves.

Table 2: Reserves and costs in Zone 1 and 2: $c_1 = 2, c_2 = 1$ (PC = procurement cost, IC = interruption cost).

	R_1	R_2	R_1+R_2	Relative reserves	PC	IC	Total costs	Relative costs
Autarky	23	26	49	100%	1763	479	2242	100%
Exchange	16	33	49	100%	1611	479	2090	93.2%
Sharing $\xi = 1$	17	33	50	100.8%	1638	429	2067	92.2%
Sharing $\xi = 0.5$	15	29	44	88.9%	1273	324	1597	71.2%
Sharing $\xi = 0$	12	24	36	74.4%	891	217	1108	49.4%

In addition to cost asymmetry and the reserve needs correlation, three other parameters influence relative costs of reserves exchange and sharing: VOLL (v), procurement costs, and the relative size of the TSO zones. Table 3 compares the relative cost of the base case with a case with higher VOLL, a case with higher procurement costs, and a case where countries differ in size. First, the relative gains of cooperation increase with increasing VOLL, since both the gains of decreased interruption costs and decreased procurement costs are higher. Second, higher procurement costs decrease the relative gains of cooperation. Third, if the TSO zones differ in size¹⁴ the relative gains of cooperation decrease.

¹⁴The relationship between the size of a TSO zone and its reserve need standard deviation σ is not linear because larger countries already internalize their imbalance variability. If the correlation of reserve needs between regions of a TSO zone 1 is ξ_1 and this zone is 2^n times larger than an adjacent TSO zone 2, then $\sigma_1 = (\sqrt{2(1+\xi)})^n \sigma_2$. If $\xi_1 = 0.65$, $\sigma_1 = 6\sigma_2$.

Table 3: Sensitivity of relative costs [%].

	BASE	$v = 10v_b$	$c_i = 10c_{i,b}$	$\sigma_2 = 6\sigma_b$
Exchange	93.2	92	95.5	96.7
Sharing $\xi = 1$	92.2	91.2	94.0	96.1
Sharing $\xi = 0.5$	71.2	69.9	73.9	85.4
Sharing $\xi = 0$	49.4	48.0	52.4	74.6

4 Implementation of cross-border reserves procurement

Whenever TSOs start exchanging and sharing reserves, there are gains and distributional effects. This section first analyses how the benefits of cooperation are distributed. Next, we study what institutions improve the incentive for cooperation.

We consider first the autarkic TSO case. In this case, each TSO can implement a market mechanism to minimize the procurement costs of the reserves required. Next we discuss the distributional effects of reserves exchange via a uniform-price auction. These effects can be negative for one of the parties so that compensation mechanisms need to be put in place to guarantee cooperation. We develop a Nash bargaining game to study the compensation necessary for TSOs to agree an exchange of reserves. This game can be defined for regulated reliability levels as well as for optimized reliability levels.

4.1 Optimal autarkic TSO reserve provision

The analysis of the previous section is based on the premise that the TSO (in lieu of a social planner) has direct control of the available reserves. In a market-based system this is not the case and the reserves have to be procured by some market mechanism. Here we assume a uniform-price auction with the resulting price p_i .¹⁵ The TSO now determines the level of reserves R_i that minimizes the

¹⁵Some TSO zones use pay-as-bid clearing but this is considered to be less preferable (Neuhoff and Richstein, 2016).

cost of procurement and the cost of interruptions:

$$\min_{R_i} \left\{ v \int_{R_i}^{\infty} [r_i - R_i] f_i(r_i) dr_i + p_i^a R_i \right\}, \quad (15)$$

This results in the first-order condition for the optimal level of reserves.

$$v \Pr \{r_i > R_i\} = p_i^a. \quad (16)$$

Generation firms supply the reserves. We assume they do not exercise market power and take prices as given, so generators will bid up to the point where marginal procurement costs equal the reserves price, i.e. where

$$\gamma'_i(R_i) = p_i^a. \quad (17)$$

The market equilibrium is determined by (16) and (17). Clearly, equation (4) follows from these two conditions so the market equilibrium coincides with the first-best level of reserves in autarky. In a market implementation the resulting reserves price is p_i^a .

4.2 Reserves exchange

4.2.1 Regulated reserves levels without inter-TSO compensation

Now suppose we are in a more realistic setting where, instead of a joint minimization of costs, each TSO minimizes its own costs, subject to the constraint that regulatory reserve levels must be met. As in the autarkic setting, we assume reserves in each TSO zone are procured by a uniform-price auction and, moreover, that these auctions are run simultaneously. Since exchange is unfettered, prices and marginal procurement costs will be equal in the two zones, i.e.

$$p^e = \gamma'_1(R_1) = \gamma'_2(R_2), \quad (18)$$

where p^e denotes the price of reserves in exchange, common to the two zones. Comparing (18) to (6), since each TSO will procure the level of reserves required

by regulation, it is clear that the market solution achieves the cost-minimizing outcome.

4.2.2 Inter-TSO transfers to guarantee cooperation

In a transition from autarky to exchange, the reserves price will rise in the cheap zone where marginal procurement costs are lower in autarky than in exchange, and fall in the expensive zone where these costs are higher. Hence, the TSO in the cheap zone will not have an incentive to participate in joint procurement auctions without compensation. Figure 6 shows this situation, with Zone 1 being the cheaper and Zone 2 the more expensive. The financial gain of TSO 2 corresponds to area C+D, whereas the loss of TSO 1 corresponds to area A. TSO 1 can compensate TSO 2 for his loss and retain some surplus provided $C + D > A$.

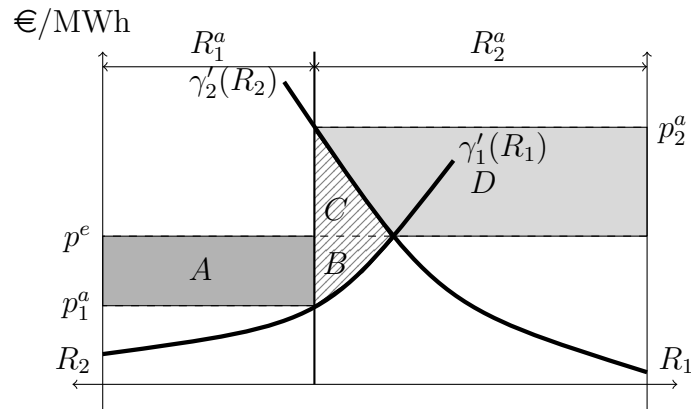


Figure 6: Cost minimization under reserves exchange between two TSO zones. Area A indicates the procurement cost increase of TSO 1; area C+D indicates the procurement cost decrease of TSO 2.

If the cross-border reserves procurement is organized via a uniform-price auction, we need transfers between the TSOs to guarantee cooperation. We will analyse the situation where there are lump-sum transfers.¹⁶ In principle, there are infinitely many solutions to the bargaining game between the two TSOs, as long as a bargaining solution is feasible. Here we use the approach of the Nash bargaining game (Nash,

¹⁶Another possibility is a distortionary tax on import or export.

1953; Binmore et al., 1986) and assume that the autarkic solution is the fallback for both TSOs. Assuming consumers are compensated for interruptions, total costs for TSO i in autarky are $C_i^a = p_i^a R_i^a + L_i$, where $L_i = v \int_{R_i}^{\infty} [r_i - R_i^a] f_i(r_i) dr_i$ are expected interruption costs.¹⁷ We denote the lump-sum side payment from TSO 2 to TSO 1 by x . Similar to (Kolstad, 2005), the side payment can be interpreted as a measure of difficulty to make an agreement.

With exchange the TSOs have the following costs:

$$C_1^e = p^e R_1^a + L_1 + x$$

$$C_2^e = p^e R_2^a + L_2 - x$$

Assuming equal bargaining power of the two TSOs the Nash product is given by

$$N = [(p_1^a - p^e) R_1^a + x] [(p_2^a - p^e) R_2^a - x] \quad (19)$$

and the first-order condition for maximum with respect to x turns out to be

$$x^* = \frac{1}{2} [((p_2^a - p^e) R_2^a - (p_1^a - p^e) R_1^a)]. \quad (20)$$

That is, the transfer is $0.5(A + C + D)$. The drop in costs for TSO i , going from autarky to exchange with bargaining and side payment is seen to be

$$C_i^a - C_i^e = \frac{1}{2} [((p_2^a - p^e) R_2^a - (p^e - p_1^a) R_1^a)] \quad (21)$$

The right-hand side of (21) is half the net financial surplus resulting from reserves exchange ($C + D - A$). If one TSO has a stronger bargaining position than the other this result would not be reached. In this case the stronger TSO would gain more of the surplus. The basic result that a positive financial surplus is necessary for a bargaining solution to be feasible would, however, clearly still hold.

The analysis above assumes that a TSO only cares about its procurement

¹⁷Since required reserve levels are the same as in autarky it is in fact irrelevant whether consumers receive compensation. This is no longer the case when reserve levels are allowed to adjust to changed marginal reserve procurement costs.

costs. In reality, however, a TSO is also concerned about social welfare in its zone. In part because increased costs of reserves procurement are charged to consumers through network tariffs, and therefore do not affect TSO profits. Including this welfare concern into the TSO utility function increases the willingness to cooperate. Suppose that a TSO has a preference $\alpha \in [0, 1]$ for social welfare (SW) and $(1 - \alpha)$ for a decrease of procurement costs (PC). It favours cooperation if:

$$\Delta U_i = \alpha \Delta SW_i - (1 - \alpha) \Delta PC_i \geq 0 \quad (22)$$

With a lump sum transfer y the TSOs have the following changes of utility:

$$\Delta U_1 = \alpha \Delta SW_1 + (1 - \alpha)(p_1^a - p^e)R_1^a + y \quad (23)$$

$$\Delta U_2 = \alpha \Delta SW_2 + (1 - \alpha)(p_2^a - p^e)R_2^a - y \quad (24)$$

where ΔSW_1 equals area B and ΔSW_2 equals area C in Figure 6. Assuming equal bargaining power of the two TSOs the Nash product is given by

$$N = [\alpha \Delta SW_1 + (1 - \alpha)(p_1^a - p^e)R_1^a + y] [\alpha \Delta SW_2 + (1 - \alpha)(p_2^a - p^e)R_2^a - y] \quad (25)$$

and the first-order condition for maximum with respect to y turns out to be

$$y^* = (1 - \alpha)x^* + \alpha \frac{\Delta SW_2 - \Delta SW_1}{2} \quad (26)$$

That is, if a TSO also cares about social welfare in its zone, the lump sum transfer is lower, which is an indication that voluntary cooperation is easier (Kolstad, 2005).

Proposition 2. *If a TSO, in addition to procurement costs, also cares about social welfare in its zone, the lump sum transfer needed for cooperation is lower: If $\alpha > 0$, $y^* < x^*$.*

Proof. If $\alpha > 0$, $y^* < x^* \Leftrightarrow \frac{\Delta SW_2 - \Delta SW_1}{2} < x^*$, where $\frac{\Delta SW_2 - \Delta SW_1}{2} = 0.5(C - B)$ and $x^* = 0.5 [((p_2^a - p^e)R_2^a - (p_1^a - p^e)R_1^a)] = 0.5(D + C + A)$. Therefore $y^* < x^* \Leftrightarrow A + B + D > 0$. Since areas A, B and D are positive, $y^* < x^*$. \square

In Europe, the Electricity Balancing guideline obligates TSOs to cooperate on balancing and reserves procurement. Therefore, TSOs will cooperate even without an incentive to do so. However, in regions without an obligation to cooperate, cost-reducing cross-border cooperation will only materialize if all TSOs reap the benefits of cooperation. This can be ensured with side payments, which can be both the explicit value of our analysis (as in the inter-TSO compensation mechanism) or more implicitly (e.g. distortionary import tariffs or transaction costs to join the cross-border cooperation platform).

4.2.3 Locally optimal reserves levels

In the case of locally optimal reserve levels, not only costs of reserves, but also expected consumer interruption costs will change. Hence, the feasibility of a bargaining solution and side payments will be affected. Basic insights, however, remain the same as in the previous case.

4.3 Reserves sharing

As in the case of reserves exchange there are, in general, distributional consequences of reserves sharing that may make one zone better off and the other worse off, both as regards procurement costs and expected interruptions.¹⁸ Similar to reserves exchange, for incentive compatibility of sharing there will be a minimal side payment from the zone that gains the most to the one that is worse off and a bargaining outcome can be predicted using the Nash bargaining solution. If there is sufficiently low correlation in reserve needs between the two zones, it is, however, possible that the gains from lower interruption costs due to integration outweigh any rise in reserves procurement costs. An extreme example of this is when the two zones have

¹⁸With reserves sharing, assigning procurement costs to TSOs is ambiguous since the decrease depends on the correlation of reserve needs between the TSO zones. In addition, expected interruption costs in each TSO zone depend on how interruptions are shared. For example, if interruptions are shared in equal proportions, the distribution of expected interruption cost is different than if the reserves-providing TSO has priority over the reserves-receiving TSO.

perfectly negatively correlated reserve needs. In this case reserve sharing eliminates any needs for reserve procurement! This is, however, unlikely to be the case in real situations.

5 Conclusions

This paper compares three degrees of TSO cooperation in generation reserves provision: autarky, reserves exchange and reserves sharing. We derive analytically the optimal procurement of reserves in each of the three cases and show that costs decrease with cooperation. The benefits of reserves exchange and reserves sharing depend on cost asymmetry and correlation of real-time imbalance variability between cooperating TSO zones. That is, when TSO zones have highly asymmetric reserve procurement costs but highly correlated reserve needs, reserves exchange already yields a high cost reduction. When TSO zones have fairly equal reserve procurement costs but a low degree of reserve needs correlation, reserves sharing is needed to reap the full benefits of TSO reserves cooperation.

Our model also shows that cross-border reserves cooperation has distributional effects on TSOs. Some TSOs may even experience an increase of procurement costs, so that voluntary cross-border cooperation requires transfers. We derive the side payments that are needed to induce cooperation and show that cooperation is easier when TSOs care not only about their own costs but also care about social welfare in their zone.

In this paper we focused on the changes of procurement and interruption costs generated by more efficient supply. The true benefits of cross-border cooperation can be higher than presented in our model because of improved market liquidity, internalisation of external effects, and increased market access through standardization of rules and products. In addition, TSOs that are first to cooperate can define the rules and standards of cooperation and have therefore lower transaction

and compliance costs.

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