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Questionnaire on long-term hedging possibilities between the Nordic region and continental Europe

Dear Ms Bergstrom, dear Mr Selke,

European Energy Exchange AG (EEX) welcomes Energimarknads Inspektionen's and Bundesnetzagentur's initiative to consider market participant's view on long term hedging possibilities between the Nordic Region and Continental Europe and appreciates the opportunity to respond to the questionnaire on this topic.

As an exchange, EEX does not execute cross border trading activities itself. However, we possess expertise in organising markets and a number of our trading participant accomplish cross border trades. From our point of view, it is of the utmost importance that no existing market areas will be split up. EEX is one of the owners of European Market Coupling Company (EMCC) which provides important services for cross border trades between continental Europe and the Nordic countries.

By responding to the questionnaire we would like to share our above mentioned experience. Thus, we focus on those questions that concern us most and are happy to discuss them also on the workshop in Stockholm.

Kind regards

Daniel Wragge
Head of Political Communications

Miriam Mann
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Attachment: Response to "Questionnaire to market participants on long-term hedging possibilities between the Nordic Region and continental Europe"



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Responses of European Energy Exchange AG (EEX)

on

Questionnaire to market participants on long-term hedging possibilities between the Nordic Region and continental Europe

Leipzig, March 21 2012



Questionnaire to market participants on long-term hedging possibilities between the Nordic Region and continental Europe

Energy Regulators ask market participants to answer this questionnaire by email by the 21st of March 2012 and invite them to attend a workshop to discuss the issues on the 14th of March 2012 in Stockholm, Sweden.

Background

The Framework Guideline on Capacity Allocation and Congestion Management for Electricity (CACM) foresees the introduction of physical or financial long-term transmission rights (PTRs or FTRs), unless appropriate cross-border financial hedging is offered in liquid financial markets on both sides of an interconnector, at all borders in order to provide market participants with long-term hedging solutions against congestion costs and the day-ahead congestion pricing.

Currently, there are substantial differences regarding long-term hedging possibilities in continental Europe on the one side and the Nordic market on the other side. While PTRs are widely used in continental Europe for long-term cross-border hedging, the Nordic market does not use this instrument. Hedging in the Nordic market can be performed via Contracts for Differences (CfDs) between the respective price area and the system price.

The only border between the Nordic market and continental Europe that does currently offer long-term hedging possibilities is the border between Germany and Denmark West, where PTRs with “use-it-or-sell-it” are auctioned on a yearly and monthly basis.

In 2011 ACER asked Energy Regulators of the Northern Europe region to define common criteria to evaluate the different options available and decide how long-term hedging should be enabled on the respective borders/interconnectors between the Nordic market and the continent in the future. The affected interconnectors are the:

- NorNed Cable between Norway and the Netherlands;
- border between Denmark West and Germany;
- Kontek Cable between Denmark East and Germany;
- Baltic Cable between Sweden and Germany; and the
- SwePol Link between Sweden and Poland;



Furthermore, all future cables between the Nordic market and continental Europe will also be affected.

Further course of action

Currently, Energy Regulators from all involved countries are assessing the available options in this context and will inform ACER about their decisions by the end of Q2 2012.

As one of the steps towards making the necessary decisions the regulators will engage the market participants to help provide answers on the following topics:

1. What common criteria should be used to evaluate the possible options on each cable.
2. What is the need for hedging opportunities between the Nordic countries and continental Europe today and how do market participants anticipate this will change in the future.
3. How do the market participants view the existing possibilities of cross border financial hedging and what constitutes a liquid financial market.
4. What sort of hedging instruments should be used in order to promote an efficient market design and how should these products be designed.

In order to gain information and views from market participants and other stakeholders, Energy Regulators have compiled the questions below. Energy Regulators ask you to provide your answers to help them fully understand all aspects concerned. After assessing the preliminary answers, Energy Regulators would like to invite all interested market participants to further discuss the issues at a Workshop, which will take place in Stockholm, Sweden, on March 14th, 2012.

Please send your answers to this Questionnaire to: Margareta.Bergstrom@ei.se and Jan-Welf.Sellke@bnetza.de not later than March 21st, 2012.

Agenda and further details regarding the Workshop will be announced at a later stage. If possible, we would be grateful if preliminary answers to the questionnaire could be sent us by the 7th of March.

Questions



1. Opening questions

1.1 Who do you represent?

- a) A consumption company
- b) A production company
- c) A trader
- d) An interest group / An industry organisation
- e) A TSO
- f) Other

f) *Other: The European Energy Exchange (EEX) is an exchange. Our subsidiary European Power Derivatives (EPD) runs trading platforms for trading Futures, among others, Futures on power delivered in Germany and Austria and on power delivered in the French market area. We own 50% of EPEX Spot which provides a trading platform for the power Spot Markets in Austria, France, Germany and Switzerland. EPEX SPOT is part of the ITVC market coupling and runs the market in the CWE area. EEX is one of the owners of the auction office EMCC which provides congestion services for the implicit auction of capacities on the cables and borders: DK West-Germany, DK East-Germany, Baltic Cable and NorNed Cable.*

1.2 Where is your main office and/or your main activities located?

- a) Norway
- b) Sweden
- c) Finland
- d) Denmark
- e) Germany
- f) The Netherlands
- g) Poland

e) *Germany: Our headquarter is located in Leipzig, Germany. We have offices in Brussels, London and Paris.*

1.3 Could you please indicate the size of the company/organization you are responding on behalf of either in production volumes per year, consumption volumes per year, traded volumes per year or members?



In 2011 1043 TWh in power futures were traded on the trading platforms provided by EEX or registered for clearing following a trade in the OTC market. Thereof, financial power futures with delivery in the German/Austrian market area accounted for 986 TWh, power futures with delivery in the French market area accounted for around 57 TWh.

On EPEX SPOT's trading platforms 322 TWh were traded in 2011. The German/Austrian market area amounted to 224 TWh for Day Ahead-Auction and 23 TWh for the Intraday Market. In the French market area 60 TWh were traded in the frame of the Day Ahead-Auction and 3 TWh in the Intraday Market. In the Day Ahead-Auction for delivery in the Swiss market area 12 TWh were traded on the platforms of EPEX SPOT.

EEX has 165 members admitted for power future trading, EPEX SPOT has 210 members.

Nine of our trading participants are located in the Nordic market, but trade power futures with delivery in the German/Austrian market area. EPEX SPOT also has 9 trading participants who have their headquarters in Nordic countries. However, 5 trading participants at Nasdaq OMX Commodities are located in Germany. Summing up, there are a number of companies being active in both, the Nordic and the German market. Given Germany's geographical position, its size and the high liquidity of its future market, German futures are apparently also used for hedging price risk by non-German companies. This risk depends on the price difference between the German/Austrian and the local market of a non-German trading participant. In sum, there is a need for hedging cross border trading activities as these are common practice in European trading markets.

2. The need for hedging opportunities and changes in the future

2.1 How would you describe your companies need for hedging opportunities between the Nordic market and continental Europe today?

EEX itself does not have any need for hedging between the Nordic market and continental Europe.

2.2 Do you anticipate that your need will change in the future? If so, in what way would it change?

It is our view that the necessity for cross border trades and cross border hedging will persist also when a single European energy market will be realised. There will still be price differences between market areas because grid expansion tends to be a slow process. Given the high costs for grid expansion, it may not be desirable to push it in such way that price differences disappear completely. Effective hedging instruments for



remaining location risks may help to increase overall welfare and might be the preferred solution in order to maximise welfare. Moreover, the increase of renewable energy exploitation could bring about the need for more cross border trading to balance fluctuating electricity generation. Cross border trade thus could be a means for supporting the integration of renewable energy sources in those cases where market integration is difficult.

3. Existing possibilities of cross border financial hedging and liquidity of financial markets

3.1 How do you view the existing possibilities of cross border financial hedging?

Differing market characteristics in the Nordic and continental European markets might lead to difficulties in effectively hedging local prices. In the German/Austrian market area, futures are based on German/Austrian Day Ahead-prices in the respective delivery period. In the Nordic market, tradable forwards and futures are based on the generic System Price. Nordic trading participants have the opportunity to hedge local differences by the use of Contracts for Difference (CfD), but there is no such hedging opportunity between the Nordic market areas and continental European market areas. Hence, we welcome that trading participants will have the opportunity for effective cross border hedging once tradable PTRs with Use-It-Or-Sell-It and / or FTRs are in place.

3.2 In your opinion what constitutes a liquid financial market?

In a liquid financial market trading participants are able to sell and buy positions at any time without huge losses. Among others, this is reflected in tight bid-ask spreads.

In addition to liquidity, financial markets should provide opportunities to hedge risk effectively. A trading participant's needs for hedging might be very specific. However, liquidity requires standardisation in order to bundle it. Hence, there is a certain trade-off between standardisation and the individual hedging need of a trading participant.

3.3 Has your company performed transactions with counterparties in other than your home market? If so, between which countries / through which interconnectors and how often?

As an exchange, we do not trade ourselves. However, EEX is one of the owners of the auction office EMCC whose activities are executed on a daily basis.

3.4 Have you used the financial market in order to hedge your open positions for these transactions? If so, how often and to what extent?



See question 3.3.

- 3.5 In your opinion, are the respective (national/regional) financial markets sufficiently liquid in order to perform hedging between continental Europe and the Nordic Market?

We believe this question needs to be evaluated by active trading companies.

4. Product design to achieve an efficient market design

- 4.1 What sort of hedging instruments should be used in order to promote an efficient market design?

We believe that the Use-It-Or-Sell-It-criterion should count for any cross border hedging instrument. However, we believe that FTRs should be preferred to PTRs as for most trading participants access to FTRs is easier than to PTRs. In addition to an easy-to-use product design the use of such instruments should constitute incentives for TSOs to invest in additional transmission capacities.

In general, obligations and options are able to fulfil the above mentioned criteria.

- 4.2 How should these products be designed in order to promote an efficient market design?

From our point of view, it is of the utmost importance that no existing market areas will be split up as this would disturb the trading practice established over many years. Furthermore, it would contradict the overall goal of an Internal European Energy market. Liquidity of the existing markets as well as for PTR's/FTR's would be split up and the overall welfare would be strongly reduced.

Transmission rights should have the same maturities as the power contracts in the regions connected by the cross-border products. By that, hedging of cross border trading activities would be facilitated and hedging could be conducted at minimum costs.

- 4.3 To what extent would your company make use of long-term transmission rights if these were offered on interconnectors between the Nordic and Europe?

Not applicable



5. Firmness

Most interconnections between the Nordic market and continental Europe are subsea DC cables. There are some general differences between AC interconnections and subsea DC links. While terrestrial links are generally easier to repair, this might not always be the case with subsea cables. Repairs and maintenance can take several weeks or months when it comes to subsea cables. Furthermore when it comes to single interconnectors which are not TSOs, these interconnectors may be subject to restrictions in capacity which are out of control of the owners of these interconnectors.

Energy Regulators believe that these differences have to be taken into account when defining firmness rules. Otherwise financial firmness could lead to a dramatic increase in cost and easily exceed congestion revenues.

5.1 How do you see different firmness rules for AC interconnections and DC subsea links?

We do not consider it necessary to have different rules for AC interconnections and DC subsea cables in place.

5.2 Would firmness rules which limit firmness to for instance a few days before the operational day make a LT transmission right less attractive as a hedging product?

Such rules would clearly make long-term transmission rights less attractive as limits to the firmness of the product limit its ability to hedge existing positions as well.

5.3 How would different firmness rules affect the attractiveness of LT hedging products? Please elaborate.

Different firmness rules would in general lead to different products with different market prices. As a consequence liquidity in such products would be split up and hence costs related to hedging would increase. Therefore and in order to provide a market with maximum efficiency and social welfare, firmness rules should be standardized for all interconnections.

6. Common criteria to evaluate the possible options on each cable

6.1 What common criteria should be used to evaluate the possible options on each cable?

As a means to bundle liquidity we argue for as much standardisation in designing FTRs and/or PTRs as possible. Common criteria for all cables should be the same that are common practice in electricity trading markets in order to facilitate hedging with FTRs and/or PTRs. In this regard, issued maturities of PTRs and FTRs should be the same that are common in the electricity markets (monthly, quarterly, yearly products for at least the upcoming three years). From our point of view, FTRs should be preferred to PTRs as access to FTRs is easier, probably resulting in higher liquidity. We consider it



important to apply the same criteria to all cables in order to ensure the transmission rights' liquidity.

6.2 Why should these criteria be used?

See answer to question 6.1.

