



E.ON AG

Avenue de Cortenbergh, 60
B-1000 Bruxelles
www.eon.com

Contact:

Political Affairs and Corporate
Communications

Political & Regulatory
Affairs
Phone: +49-211-4579 4804
marketregulation@eon.com

E.ON Position on Forward Risk-Hedging Products and Harmonisation of Long-Term Capacity Allocation

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General Remarks

E.ON's view is that **long-term transmission** rights not only provide market participants with hedging opportunities, but **are important instruments for achieving cross-border competition in the forward market**. Transmission rights should therefore be allocated between all bidding zones. Market participants holding transmission rights can compete in a neighbouring forward market without taking price risk. Compared to the case of FTRs and PTRs transmission rights with UIOSI, hedging with CfDs (when one can sell on one side of the border and buy at the other side of the border) does not lead to any cross-border competition in the forward market. The only ones that can sell CfDs without taking a price risk are the local competitors. Therefore, either FTRs or PTRs with UIOSI shall be implemented in a consistent way between different price zones throughout the European Union.

In section 1.2 it is stated *"Options for enabling risk hedging for cross-border trading are FTRs or PTRs with UIOSI provisions, unless appropriate cross-border financial hedging is offered in liquid financial markets on both sides of an interconnector."* E.ON does not see that this exemption can be used anywhere in Europe. As an example it can in our opinion not be sufficiently justified that appropriate cross-border financial hedging is offered in liquid financial markets between SE4 and DK2, as the liquidity is low in CfDs for SE4 and DK2. The following statement in section 2.2 b is not fully correct. *"These payments can be used to pay the price differential to FTRs issued for the opposite direction ("netting"). This means that, provided FTRs obligations are requested by the market in both directions, FTR obligations can be allocated with no direct link to physical capacity, since the opposing payments could be netted."* It is true that netting can be done, but if TSOs would allocate more net capacity than is available, the TSO would bear the financial risk for the part that exceeds available capacity. However, market participants might be willing to sell additional FTRs.

Same with the statement in section 2.4 (under PTR with UIOSI), that is not fully correct: *"However it should be taken into account that the long-term capacity right which is nominated explicitly is not made available to the day-ahead market and thereby decreases its liquidity."* To give the full picture it should be added that a nominated long-term capacity right increases liquidity in the forward market time frame. Additionally - due to netting of nominated long-term capacity rights additional capacity is made available for the day-ahead market in the opposite direction.

Questions

1) Are there other products or options which are not considered in this document that would be worth investigating?



E.ON would like to see PTRs with UIOSI or FTRs options allocated between all bidding zones. However, an alternative option could be introduced in the Nordic market, which could find a broader acceptance in the Nordic market. This option constitutes a market with CfDs and system price derivatives incorporated with "synthetic" FTR obligations, equivalent to a combination of two CfDs, which are auctioned by the TSO. The hedge for the TSO would be realised slightly differently through the combination of CfDs with different locations compared to the FTRs directly connected to a particular bidding zone border but the end result would essentially be the same. Thus, CfDs are auctioned by the TSO who is also able to "repurchase" capacity on the auction or the secondary market under strict regulations. The TSO should issue CfD products in relation to expected available capacity. That is, auctioned financial capacity should reflect the underlying physical transmission capacity expected to be available in the day-ahead market. At the very least this solution should be tested between some Nordic bidding zones.

2) What will be the importance of the long-term Target Model and specifically the design of the forward market and the structure of long-term hedging products once the Day-Ahead and Intraday Target Models are implemented? Do you think your interest and demand for long-term hedging products will change (either increase or decrease) with the implementation of the Day-Ahead and Intraday Target Models? More specifically, what is your interest in cross-border/zone hedging?

Market coupling is the most appropriate model to determine the spread between markets that determines on its turn the "pay out" value of forward allocated transmission rights (either physically with UIOSI or financially). As such, market coupling leads to a more robust and stable day-ahead price. Trust into the day-ahead market outcome leads naturally to an increase in forward trading (bigger volumes traded around the curve, products traded further ahead in time) and possibly non-asset based traders will enter these markets. This leads to an increase in the need for forward hedging and the need to allocate more capacity to the forward time frame.

To be fully clear, market coupling as such is not enough for creating competition in forward markets, as a supplier who would only source himself on the spot market will need a higher risk premium to sell forward to customers in that market. The "need" for forward transmission rights does not essentially change because the target model for market coupling and intra-day is in place.

3) Would long-term hedging markets need to evolve (e.g. in terms of structure, products, liquidity, harmonisation, etc.) due to the implementation of: 1) the day-ahead market coupling,



2) day-ahead flow-based capacity calculation and 3) occasional redefinition of zones? If so, please describe how these changes would influence your hedging needs and strategy. If no evolution seems necessary, please elaborate why. Can you think of any striking change not considered here?

Flow-based capacity calculation would not change the hedging needs. With regard to market coupling see our answer under 2). Stated this, however, it is clear that splitting up existing bidding zones in smaller bidding zones makes hedging more difficult and lowers the competition in forward markets. One example is the splitting up of the former Swedish common bidding zone to four bidding zones. The fact that there are major differences in generation and demand in some bidding zones makes it difficult to use CfDs to hedge the local price. Introduction of transmission rights would increase competition in the forward market and make hedging easier.

4) What is for you the most suitable Long-Term Target Model (combination of energy forwards and transmission products) that would enable efficient and effective long term hedging? What would be the prerequisites (with respect to the e.g. regulatory, financial, technical, operational framework) to enable this market design in Europe? Which criteria would you use to assess the best market design to hedge long-term positions in the market (e.g. operability, implementation costs, liquidity, efficiency...)?

E.ON believes that the market should be able to influence the market design. Where PTR options exist, UIOSI should be introduced, if not already existing. Any change from PTRs to FTRs options should be consulted with market participants. Allocation of maximum capacity on a multi-year basis and appropriate regulatory incentives for TSOs would be important.

5) What techniques of market manipulation or "gaming" could be associated with the various market for hedging products? What measures could in your view help prevent such behaviour?

Regulators have several instruments in REMIT and MAR, so no specific measures should be needed from our perspective.

6) Would you like to change, add or delete points in this wish-list? If so, please indicate why and how.

In the General/Scope section, the last paragraph:



"The "European LT Rules" shall be implemented on all borders where PTRs or FTRs option are/will be implemented, i.e. at least on the borders of the Central-West, Central East, France-UK-Ireland and South-West regions, plus the Denmark-Germany interconnections and the interconnections between Hungary, Romania, Bulgaria and Greece and other Members States."

should be amended as follows:

*"The "European LT Rules" shall **ultimately be implemented on all borders.**"*

There is no valid reason for PTRs and FTRs not to be offered on other European borders (i.e. Nordic countries), in addition to or in replacement of the current system applied locally.

To be fully clear, the entry into force should be modified that the *"The European set of rules should enter into force **starting with the yearly allocation for 2014.**"*

The section "payment deposit" should include different types of collaterals that auction participants can chose from, at the minimum bank guarantee and cash deposit.

Further ACER asked explicitly for feedback on the question whether a 1/12th or 2/12th of the total amount should be provided when buying the yearly product. From our perspective this depends mainly on the timing of the payment for the monthly instalment of the yearly product and the timing given for reminders before executing the bank guarantee. 1/12th should be generally sufficient. In any case it must be ensured that unpaid yearly capacity is reallocated in the corresponding monthly auction to avoid any capacity blocking.

ACER states that nomination is not included in the harmonisation list, as the rules shall focus on capacity allocation and not the use of cross-border capacity. We are of the opinion that nomination rules are an integral part of the allocation rules and must be harmonised. Currently there exists a wide range of nomination rules and especially the point of them when to nominate. For a PTR with UIOSI it makes a difference if the final nomination must take place D-1 at 9:00 or D-2 at 14:00. This may change the value of such product as market spreads can change. Further at some borders we have to nominate only to one TSO, at others to both or the auction office. It will minimize our daily work if there was one nomination deadline and one principle to whom to submit the information.

7) Which aspects of auction rules would be most valuable to be harmonised? Can you provide some concrete examples (what, when, where) of how this could help your commercial operation (e.g. lowering the transaction costs)?



What really helps our commercial operation is one common allocation platform under one harmonised set of AR, one type of collateral and one figure for the bidding limit. Harmonising wording in auction rules without changing the IT platform does not help much as we have to train our staff on using many different systems, which is time consuming and from an operational perspective costly. In the end, as long as different AR exists there is never full harmonisation and in case of incidents the specific rules need to be consulted and followed.

8) Which elements of auction rules have regional, country specific aspects, which should not be harmonised?

We are not aware of any.

9) Which aspects should be harmonised in binding codes?

All aspects should be harmonised in the codes without any exceptions. However there may need to be different transition periods for Member States.

10) If you are to trade from the Iberian Peninsula to the Nordic region and there existed PTRs with UIOSI, FTR Options or Obligations and CfDs in different regions – what obstacles, if any, would you face? How would you deal with them?

We understand the question how competition can be achieved in the forward market by using transmission rights. This example shows that transmission rights are not only about hedging the price difference between the different price zones, but to compete cross-border in the forward market. If you just want to hedge the price difference between the different bidding zones you can buy in one bidding zone and sell in another bidding zone. If a Spanish supplier would like to supply a customer in the Swedish bidding zone 4 there are two alternatives. The Spanish generator can sell its generation in the Spanish market and buy a Nordic system price contract and a CfD for Sweden 4. This would mean that the Spanish supplier would compete with other Spanish generators in the Spanish forward market and in the same way compete with Swedish suppliers in the retail market for Sweden 4, but there will be no cross-border competition due to these transactions. The other alternative would be that the Spanish supplier buys transmission rights between all relevant bidding zones, which would be complicated for a single supply contract, but would give cross-border competition between all bidding zones.



11) Would allocating the products at the same time represent an improvement for market players? Why? Where, if not everywhere, and under which conditions?

Allocating the product at the same time is not seen as improvement, as this requires bidding preparation for more than 20 borders at the same time. We would prefer 2-3 different gate closures the same day with enough time between result publication of the previous auction and gate closure of the next one.

What indeed is important is that results are published shortly after the gate closure and not the next day as done at some borders today. Late publication affects forward power market prices as the price spread used for calculating the bid can change within a day or even a couple of hours.

12) How important is it that capacity calculation for the long-term timeframe is compatible and/or consistent with the short-term capacity calculation and that capacity is interdependent and optimised across different borders?

Compatibility of capacity calculation methods across various timeframes is important to ensure that maximum capacity is being allocated to the market and that all the capacity not used before the day-ahead timeframe is offered to the market.

13) Please indicate the importance of availability of different hedging products with respect to their delivery period (e.g. multi-year, year, semester, season) for efficient hedging against price differential between bidding zones. What do you think of multiple-year products in particular?

Multiple-year products would be an advantage to increase cross-border competition in the forward market.

Another valuable option is to allocate yearly capacity not only once a year but twice a year. We could envisage the first yearly auction in May/June and the second one in October/November.

14) What would be your preferred splitting of available interconnection capacity between the different timeframes of forward hedging products? Which criteria should drive the splitting between timeframes of forward hedging products?

Maximum available capacity should be allocated to the most long term product.

15) While products with planned unavailability cannot be standardised and harmonised throughout Europe, they enable TSOs to offer more long-term capacity on average than standardised and harmonised products would allow. Do you think these products should be kept in the future and, if so, how could they be improved?

Yes, it would be positive that TSOs can make use of products that maximise the allocated capacity. However, the amount of planned unavailability should be kept to a minimum, i.e. once for a monthly product and 2-3 times for a yearly product. A negative example is the monthly allocation at the Polish border where there are up to 10 different interruptions per month (see http://www.central-ao.com/images/stories/upload/Auctions2012/ATC/announcement_02_02_2012_march_to_be_published_adapted.pdf for an example).

16) Products for specific hours reflect market participants' needs. What should drive the decision to implement such products? How should the available capacity be split between such products and base load ones in the long-term timeframe?

The focus should be on allocating base products. We do not have any specific need for some sort of peak, of-peak product. However, this should not prevent TSOs to allocate additional capacity on top of this base product in case in some hours during the whole month such is available. We are aware that this is the case at some Austrian borders where there is during peak hours more transmission capacity available than during of-peak. This case might be a special case, but is a good example of maximising offered capacity to the market.

17) Should this possibility be investigated and why (please provide pros and cons)? In case you favour this possibility, how should this buyback be organised?

Maximisation of allocated capacity means that sometimes too much capacity has been allocated. TSOs should therefore buy back capacity when it is clear that too much capacity has been allocated. There should be clear rules for this. As soon as it is clear that too much capacity has been allocated, the TSOs should inform that market and thereafter arrange a transparent auction to buy back capacity.

18) With the potential evolution from PTRs with UIOSI to FTR options, does the removal of the nomination process constitute a problem for you? If so, why and on which borders, if not on all of them?



One issue with removing the physical nomination could be the sourcing of green energy as some systems require the proof of physical nomination (i.e. Italy).

19) How could the potential evolution from PTRs with UIOSI to FTRs on border(s) you are active impact your current long-term hedging strategy?

It depends on the status of the relevant markets. It would be a natural development to directly introduce FTRs options within the Nordic market, as the Nordic forward market is based on financial products. In any case we object the introduction of FTR obligations as this clearly minimizes our hedging opportunities.

20) If nomination possibility exists only on some borders (in case of wide FTRs implementation), is it worth for TSOs to work on harmonising the nomination rules and procedures? If so, should this harmonisation consider both the contractual and technical side? How important is such harmonisation for your commercial operation? Which aspects are the most crucial to be harmonised?

We clearly support a technical and contractual harmonisation of nomination rules. Currently we have to operate technically more than 20 different cross-border nomination systems. Most of them claim that they are according to the ESS format (ETSO Scheduling System) agreed between TSOs back in 2003 (!) and regularly updated since, however our practical experience when implementing a new border is that they are all diverging. Finally we do not expect that FTR options will be introduced in the near time such wide spread and therefore we definitely think that it is worthwhile to work on harmonisation of nomination.

21) Looking at the current features offered by the different auction platforms (e.g. CASC.EU, CAO, individual TSO systems) and financial market platforms in Europe, what are the main advantages and weaknesses of each of them?

Currently there are two platforms allocating PTRs for several borders, CASC.EU and CAO. Both have its cons and pros. We have a slight preference for the CASC platform but could live with the CAO one if this is chosen as the final European platform.

22) How do you think the single auction platform required by the CACM Framework Guidelines should be established and organised?



One of the existing regional platforms should be used as the European one, instead of inventing a fully new system. Such approach is pragmatic, cost efficient for both sides, TSOs and market participants.

o How do you see the management of a transitional phase from regional platforms to the single EU platform?

We don't expect any bigger problems and the shift of the Italian borders to CASC showed that such is possible within short time.

o Should current regional platforms merge via a voluntary process or should a procurement procedure be organised at European Union level (and by whom)?

We would prefer a voluntary process. ACER could arrange a voting of market participants on the preferred platform to give guidance.

o Should the Network Code on Forward Markets define a deadline for the establishment of the single European platform? If so, what would be a desirable and realistic date?

Yes, the NC should define a date. Our desirable date would be 2014, however realistic for the whole of Europe might be 2015.