BECH-BRUUN

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Per Hemmer
Partner

T +45 72 27 35 50
phe@bechbruun.com

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Memo on TSO use of financial instruments in support of financial electricity markets

1. Introduction

The Danish TSO for electricity, Energinet, and the Swedish TSO for electricity, Svenska Kraftnät, have been asked by the Danish Energy Regulatory Authority ("DERA") and the Swedish Energy Market Inspectorate ("Ei") to ensure that there are sufficient cross-zonal hedging instruments available for the Danish bidding zones DK1 and DK2. DK1 is connected to the Swedish bidding zone SE3 via the Konti-Skan interconnector, and DK2 to the Swedish bidding zone SE4 via the Öresund interconnector.

The request from the authorities is based on the FCA Regulation (as defined below), and triggered by DERA's assessment that the Danish market for hedging instruments is not sufficiently liquid.

Energinet is therefore currently investigating different options for supporting the liquidity of the Danish market for cross-zonal hedging instruments. Almost all of the options currently on the table, however, require Energinet to trade in financial instruments.

Energinet has requested us to examine whether the Market Directive allows Energinet, as TSO, to carry out such activities, see section 4 below. As our assessment will be based on community law, it will be applicable to other EU TSOs as well, subject to any special national legislation. We will however generally only refer to Energinet in the following.

Energinet will be exposed to an increased financial risk if it issues or trades financial instruments. The TSOs' economic conditions are subject to regulation as well as review and approval from national regulatory authorities. We will therefore also examine whether it is possible under the Market Directive and Electricity Regulation (as defined below) to use TSO revenue such as congestion income or network tariffs to cover costs arising from the new activities, see section 5 below.

Further, financial instruments and the trading thereof are generally subject to intensive regulation. Energinet has therefore also asked us to examine whether Energinet is exempt from MIFID II (as defined below), if the envisioned measures are carried out, see section 6 below.

2. Executive summary

2.1 Regulation of the TSOs' activities

The tasks of the TSO are generally described in the Market Directive, but are not exhaustive. Under the Market Directive, the TSOs play an important role in achieving the directive's goal of moving towards a fully liberalised internal market in electricity.

From the wording of the Market Directive it is clear that issuing or trading financial instruments in support of the financial electricity markets is not a core task of the TSOs. However, this does not necessarily mean that TSOs are prevented from carrying out such activities.

Subject to the fundamental principles and limitations being complied with, member states and TSOs thus enjoy wide scope for implementing the tasks in practice.

The most important limitation to the TSOs' activities is the unbundling requirement. Hence, TSOs are not able to carry out activities which constitute production or supply of electricity.

The EPAD contract is an instrument which may support the business of electricity supply as a hedging opportunity, and which is often sold by electricity producers. However, in our understanding this does not imply that the activity of selling (or buying) EPADs falls under the definitions of production or supply in the sense of the Market Directive.

It is therefore our assessment that the Market Directive does not prevent TSOs from carrying out activities involving EPADs, provided the aim of the measure is connected to the TSO's general role and tasks, and that it is otherwise consistent with the fundamental principles of the directive. This is also supported by the Market Directive assuming that "electricity derivatives" may be traded between TSOs and electricity supply undertakings.

TSOs are expected to contribute to the facilitation of a genuine internal market in electricity. The decisions by DERA and Ei are triggered by an analysis showing that the markets for hedging instruments in DK1 and DK2 is not sufficiently liquid, which is an obstacle to the internal market.

The purpose of the measures being considered by Energinet is therefore to facilitate the internal market, which is part of the TSOs' general role.

This context becomes even clearer when the FCA Regulation is taken into account. The purpose of the regulation is to provide market participants with efficient hedging opportunities against price differences between bidding zones. As operators of the interconnections, the TSOs hold a key role in this regard.

The FCA Regulation's art. 30 is an exemption to the main rule of introducing long-term transmission rights on interconnections, which may be used if the aim of the regulation is in practice ensured otherwise. It is thus a condition for the exemption that the markets for the alternative hedging instruments are sufficiently liquid.

The task of ensuring liquidity is thereby in natural extension of the TSOs' general obligation to introduce long-term transmission rights, and is effectively an alternative to the full-fledged long-term transmission rights provided for by the regulation.

Further, from the process of the adoption of the FCA Regulation, it is clear that the TSOs' issuing of e.g. EPADs to support market liquidity is not considered contrary to the regulation. The purpose of the measures is also ultimately tied to the facilitation of the internal market in electricity as this is also the underlying aim of the measures of the FCA Regulation.

It is therefore our assessment that the measures are not in conflict with the Market Directive, as the activities are connected to the TSOs' obligations under the directive, as well as in accordance with its overall purpose, and provided it is designed to comply with the unbundling requirement. As the trade of financial instruments is not specifically stated in the Market Directive as a task of the TSOs, and as the member states and National Regulatory Authorities (NRAs) have a wide discretion in setting out the tasks of the TSOs, we recommend that it is discussed with the relevant NRA (DERA).

2.2 Economic conditions (coverage of costs)

There are generally two ways for TSOs to cover the costs which may arise due to the measures for supporting liquidity of the financial market under article 30 of the FCA Regulation: through either (1) congestion income; or (2) network tariffs.

The TSOs' use of congestion income is regulated in the Electricity Regulation art. 16, subparagraph 6.

Pursuant to this provision, the TSOs can only cover costs related to measures under FCA Regulation Article 30 from the congestion income, if the cost recovery is for the purpose of i) guaranteeing the actual availability of the allocated capacity; ii) maintaining or increasing

interconnection capacities through network investments, or iii) if approved by the NRAs up to a maximum amount.

Concerning i) it is not described further what is meant by "*guaranteeing the actual availability of the allocated capacity*". In practice, ensuring the availability of the capacity of the interconnectors is handled in different ways by using operational measures to relieve congestion in interconnectors (and thereby ensure availability of the capacity), such as countertrading and redispatching.

Further, firmness costs are considered to be recoverable using congestion income under this part of the provision. It also seems to be assumed under the FCA Regulation that costs related to firmness under the regulation are recoverable by congestion income.

As the contemplated measures are analogue to long-term transmission rights, somewhat comparable to the firmness regime and the underlying purpose (removal of barriers to the internal market in electricity) is also the same, it may be argued that the costs should also be recoverable using congestion income.

However, the long-term transmission rights are tied to the capacity of the interconnector in question, while the hedging products to be supported are in principle independent of the underlying capacity. And as the wording of the provision of the Electricity Regulation specifically mentions the capacity of the interconnector, it is therefore our overall assessment that it is most likely not possible for TSOs to use congestion income to cover the costs of measures for supporting financial markets pursuant to the FCA Regulation art. 30, unless directly connected to the capacity of interconnectors, which in our understanding is not the case for the contemplated measures.

Concerning ii) it is our assessment that the measures also fall outside the scope of this part of the provision, as the measures and the costs incurred are not taken for the purpose of "*maintaining or increasing interconnection capacities*".

Under iii), DERA may allow congestion income to be included in the calculation of network tariffs to the extent it cannot be efficiently used for the purposes mentioned under i) and ii). Consequently, the use of congestion income is in any case subject to DERA's indirect approval. The comparability between the measures and long-term transmission rights and firmness may be used as an argument in this regard.

It is finally noted that there does not seem to be a clear or consistent practice in the EU NRAs' handling of costs in relation to the use of congestion income.

The legal framework for the use of network tariffs is less specific. The Market Directive sets out general principles of the NRAs approval of costs to be included in the calculation.

Further, the FCA Regulation's art. 58 sets out that costs incurred by the TSOs arising from obligations under the regulation are to be recovered through network tariffs, to the extent they are assessed as reasonable, efficient and proportionate by the NRAs, in line with the general principles of the Market Directive.

DERA and Ei's request of the TSOs is directly based on the FCA Regulation's art. 30. It is therefore our assessment that the associated costs for Energinet may be said to arise from the FCA Regulation, and are thus recoverable through the network tariffs pursuant to the FCA Regulation art. 58, provided that the general principles are complied with.

The compliance with the general principles is subject to an individual assessment of specific costs by DERA.

In the first instance it will therefore be up to DERA in coordination with Ei to decide if the measures are acceptable, and afterwards to form an opinion of whether the associated costs comply with the general principles set out by the Market Directive and FCA Regulation.

2.3 Financial regulation

Energinet will support the liquidity in the Danish EPADs market by entering into EPAD contracts directly with counterparties on its own account. This kind of trading activity is considered an investment service or investment activity according to MiFID II, provided that the activity is carried out with financial instruments comprised by MiFID II.

It is our assessment that EPADs constitute commodity derivatives contracts which are comprised by MiFID II.

As a result, Energinet will, *prima facie*, become subject to MiFID II. However, it is our assessment that Energinet will most likely be able to rely on the TSO exemption in article 2(1)(n) of MiFID II.

For Energinet to be able to rely on the TSO exemption, three conditions must be satisfied.

The first condition is that Energinet is pursuing its tasks under the Market Directive in relation to the trading activity comprised by MiFID II. It is our assessment that this condition is satisfied as supporting the liquidity of the Danish EPADs markets is a task that would be able to fall within the tasks of Energinet according to the Market Directive.

The second condition is that Energinet's MiFID II trading activity is only carried out in respect of commodity derivatives. This condition is also satisfied since, in our assessment, EPADs qualify as commodity derivatives contracts comprised by MiFID II.

The third condition is that Energinet does not operate a secondary market, hereunder a platform for secondary trading with financial transmission rights. Operation of a secondary market is not defined in MiFID II and there is no official guidance on this area. This results in some uncertainty as to what constitutes the operation of a secondary market.

Different auctioning-models have been put on the table by Energinet. Based on our understanding of the auctioning-model currently being considered by Energinet it is our assessment that this would likely not suffice to constitute the operation of a secondary market. However, since a number of factors may influence this assessment we note that our assessment is associated with some uncertainty.

Provided that the auctioning-model does not constitute the operation of a secondary market, the third condition of the TSO exemption in article 2(1)(n) is also satisfied.

As a result, it is our assessment that Energinet will most likely be able to rely on the TSO exemption in article 2(1)(n) and as a consequence does not become subject to the provision of MiFID II in relation to the contemplated trading activity with EPADs.

3. Basis for conclusions

Our assessment of the matter will be limited to the following sources of law:

- EU legal framework on regulation of TSOs:
    - Directive 2009/72/EC concerning common rules for the internal market in electricity, (the "**Market Directive**")
    - Regulation no 714/2009 on conditions for access to the network for cross-border exchanges in electricity (the "**Electricity Regulation**"), and
    - Regulation 2016/1719 establishing a guideline on forward capacity allocation (the "**FCA Regulation**")

- EU legal framework on the financial markets:
    - Directive 2014/65/EU on markets in financial instruments (MiFID II)

We have agreed with Energinet that we will not look into any other sources of law than mentioned above, as our assessment should be limited to the activities' compatibility with

the Market Directive. Our assessment will therefore not include other sources of law which could be relevant to forward capacity allocation[1], or regulation of financial markets other than mentioned.[2]

The Electricity Regulation and FCA Regulation are included with the purpose of providing context and to make a more specific conclusion on the compatibility of the activities.

We are aware that legislative proposals for a recast directive on the internal market for electricity[3] and the Electricity Regulation[4] have been presented by the European Commission. The proposal for new Electricity Regulation includes an amendment of the rules for use of congestion income. As the processing of the proposals to our knowledge has not been concluded, we have not taken the proposals into account in our investigations and assessment. It should however be emphasised that the Market Directive and Electricity Regulation, which forms a significant part of the legal basis for our assessment, may be subject to change.

Finally, our assessments are based on the sources referenced to in the text or footnotes of the memo, which constitutes the information available to us. We are not aware of other official contributions for interpretation of the relevant sources of law than applied here.

4. Regulation of the TSOs' activities

4.1 Legal framework

4.1.1 General principles

The Market Directive sets out common rules for the internal market in electricity, with the aim of achieving efficiency gains, price reductions, higher standards of service and increased competitiveness, to the benefit of the consumers.

[1] Such as regulation 2015/1222 establishing a guideline on capacity allocation and congestion management, network codes and guidelines

[2] Such as concerning market integrity and market abuse, including Regulation 2012/648/EU on OTC derivatives, central counterparties and trade repositories (EMiR), Regulation 2014/596/EU on market abuse (MAR), Regulation 2011/1227/EU on wholesale energy markets integrity and transparency (REMIT), and Directive 2015/849/EU on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (AMLD IV)

[3] http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/595924/EPRS_BRI(2017)595924_EN.pdf

[4] http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/595925/EPRS_BRI(2017)595925_EN.pdf

Pursuant to the directive, the member states are to promote regional cooperation between TSOs, as a first step towards the creation of a fully liberalised internal market and to accelerate the market integration. The cooperation between TSOs shall include "*cross-border issues, with the aim of creating a competitive internal market in electricity, [and] foster the consistency of their legal, regulatory and technical framework (...)*"[5].

The Market Directive also requires the member states to ensure that TSOs and other electricity undertakings are operated with a view of ensuring the principles of the directive, including effective competition and facilitating the internal market:

> *"Member States shall ensure* (...) *that* (...) *electricity undertakings are operated in accordance with the principles of this Directive with a view to achieving a competitive, secure and environmentally sustainable market in electricity, and shall not discriminate between those undertakings as regards either rights or obligations."*[6]

In the TSOs' cooperation at European level, the objectives of the internal market also play an important role. The Electricity Regulation establishes ENTSO-E, and sets out that the purpose of the cooperation network is to "*promote the completion and functioning of the internal market in electricity and cross-border trade and to ensure the optimal management, coordinated operation and sound technical evolution of the European electricity transmission network*"[7].

The TSOs should therefore generally be expected to contribute to the overall aim of moving towards an integrated and genuine internal market in electricity, in accordance with the Market Directive.

4.1.2 Unbundling requirements

In order to move towards the overall aim of creating an internal market in electricity, one of the most fundamental parts of the Market Directive is the requirement for effective unbundling:

> *"Without effective separation of networks from activities of generation and supply (effective unbundling), there is an inherent risk of discrimination not only in the operation of the network but also in the incentives for vertically integrated undertakings to invest adequately in their networks",* therefore

[5] The Market Directive art. 6, subparagraph 1

[6] The Market Directive art. 3, subparagraph 1

[7] The Electricity Regulation art. 4. The TSOs are explicitly obligated to take this objective into account when drafting the network codes, cf. the Electricity Regulation art. 8, subparagraph 1

> *"Fully effective separation of network activities from supply and generation activities should apply throughout the Community to both Community and non-Community undertakings. To ensure that network activities and supply and generation activities throughout the Community remain independent from each other, regulatory authorities should be empowered to refuse certification to transmission system operators that do not comply with the unbundling rules* (...)"[8]

The TSO must therefore be separated from activities of electricity generation and supply[9], and independent of all such production and supply interests, cf. the Market Directive art. 9.

Pursuant to the preamble as quoted above, the purpose of the unbundling requirement is to mitigate the risk of discrimination. Further, it follows from the Market Directive art. 31 (concerning unbundling of accounts) and art. 37 (concerning the duties and powers of the NRAs) that unbundling shall ensure that cross-subsidisation between transmission and supply activities do not take place.

As it appears from the above quote, unbundling is also a prerequisite for TSOs being certified under the Market Directive art. 10.[10] Energinet is certified by decision from DERA, as approved by the EU Commission.[11]

However, if full separation is not possible, subject to certain conditions, a "*vertically integrated undertaking*" may be allowed. Such undertakings are subject to special requirements to ensure as much practical separation as possible, in order to reduce the risks (e.g. discrimination) which the unbundling requirement aims to prevent.[12]

The unbundling requirement thus constitutes a general limitation on the activities of the TSO.

4.1.3 Tasks of the NRAs and TSOs

The Market Directive includes specific provisions on the tasks of both the TSOs and the NRAs.

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[8] The Market Directive preamble items 9 and 24

[9] The term "supply" is defined in the Market Directive art. 2, subparagraph 19, as "the sale, including resale, of electricity to customers"

[10] We have not assessed the possible consequences for Energinet's certification (or of the certification's implications for the envisioned set-up) of the possible measures

[11] See DERA "Certificering af Energinet.dk som transmissionssystemoperatør for el" dated 30 October 2011 (preliminary) and 28 February 2012 (final)

[12] See particularly the Market Directive arts. 13 – 14

The NRAs are generally responsible for ensuring that the TSOs comply with the requirements under national as well as community law, including concerning cross-border issues.[13]

The NRAs are further to be granted powers to carry out investigations into the functioning of the electricity markets and to "*decide upon and impose any necessary and proportionate measures to promote effective competition and to ensure the proper functioning of the market*"[14].

The NRAs are thus given a vital role in ensuring that all players live up to their obligations and that the market functions properly.

The TSOs' tasks and conditions are particularly set out in articles 12 and 17, and vary depending on whether the TSO is part of a vertically integrated undertaking or not.

The primary responsibility of the TSOs is set out in art. 12, point (a):

> *"Each transmission system operator shall be responsible for:*
> *(a) ensuring the long-term ability of the system to meet reasonable demands for the transmission of electricity, operating, maintaining and developing under economic conditions secure, reliable and efficient transmission systems with due regard to the environment"*

Further, pursuant to art. 12 the TSO shall contribute to the "*security of supply through adequate transmission capacity and system reliability*" (point (c)), and is in that regard also responsible for:

> *"(d) managing electricity flows on the system, taking into account exchanges with other interconnected systems. To that end, the transmission system operator shall be responsible for ensuring a secure, reliable and efficient electricity system and, in that context, for ensuring the availability of all necessary ancillary services, including those provided by demand response, insofar as such availability is independent from any other transmission system with which its system is interconnected"*

The TSO also has a number of more specific tasks related to the interconnection with other transmission systems, including providing necessary information to the operators of other

[13] The Market Directive art. 37, subparagraph 1, point (b)

[14] The Market Directive art. 37, subparagraph 4, point (b)

transmission systems[15] and granting and managing third-party access in order to facilitate market integration.[16]

During the preparation of the Market Directive, the following was stated concerning interconnections:

> *"... it must be ensured that procedures for managing interconnections are really transparent, based on market systems, and thus maximise trade."*[17]

It is further specified in art. 17, subparagraph 2, that the activity of electricity transmission includes the following tasks:

> *"*(...)
> *(c) granting and managing third-party access on a non-discriminatory basis between system users or classes of system users;*
> (...)
> *(f) investment planning ensuring the long-term ability of the system to meet reasonable demand and guaranteeing security of supply;*
>
> *(g) the setting up of appropriate joint ventures, including with one or more transmission system operators, power exchanges, and the other relevant actors pursuing the objectives to develop the creation of regional markets or to facilitate the liberalisation process;* (...)"

The wording of the Market Directive does not indicate that the listed tasks of the TSOs in arts. 12 and 17 are exhaustive.

Therefore, the activities of the TSOs are not necessarily limited to the listed tasks, as long as the general framework – including its limitations – in the Market Directive is complied with.

Activities specifically involving financial instruments are neither specifically mentioned as part of the TSO's tasks, nor do they play an important part in the Market Directive.

[15] The Market Directive art. 12, point (e)

[16] The Market Directive art. 12, point (h)

[17] Opinion of the European Economic and Social Committee on the i.a. 'Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/54/EC concerning common rules for the internal market in electricity', section 1.2.6.1

However, "*electricity derivative*" is included as a separate term, and is defined as a financial instrument as comprised by the MiFID-directive[18], which is related to electricity.[19] Specific examples of what may constitute an electricity derivative are not set out.

The term is further not used extensively in the Market Directive, and only appears in a few specific provisions.

First, it is explicitly set out that electricity supply contracts do not include electricity derivatives.[20]

In addition, under art. 40, member states must require supply undertakings to keep records related to i.a. "*all transactions in electricity supply contracts and electricity derivatives with wholesale customers and transmission system operators*".

4.2 Market Directive assessment

4.2.1 Wording of the directive

The Market Directive does not explicitly allocate issuing or trading in financial instruments in support of the financial electricity markets as a task of the TSO.

It is thus clear that issuing or trading financial instruments in support of the financial markets is not a core task of the TSOs under the Market Directive. However, this does not necessarily mean that the TSOs are prevented from carrying out such activities.

Although activities specifically involving financial instruments are not specifically mentioned as part of the TSO's tasks, "*Electricity derivatives*" are set out as a defined term in the Market Directive as a financial instrument as comprised by the MiFID-directive[21] which is related to electricity. Pursuant to art. 40, supply undertakings must keep records of transactions involving electricity derivatives with i.a. TSOs.

Thus, it is implicitly presumed that supply undertakings may have transactions involving electricity derivatives (i.e. buying or selling such contracts) with TSOs.

EPADs are formerly known as Contracts for Difference ("CfDs"), as they cover the difference between the price in a specific bidding zone and the Nordic system price. If used in combination between areas – as an "EPAD Combo" – they may provide a hedge for the risk

[18] Directive 2004/39/EC on markets in financial instruments

[19] The Market Directive, art. 2, subparagraph 33

[20] The Market Directive, art. 2, subparagraph 32

[21] Directive 2004/39/EC on markets in financial instruments

of price differences between bidding zones.[22] As EPADs are set against the system price, they are not directly associated with interconnections, and thus not limited to e.g. the capacity of an interconnector, as transmission rights (including financial transmission rights ("FTR")) are.[23] EPADs are to be considered financial instruments under MIFID II, see section 5.2 below.

In general, the tasks of the TSO are not set out exhaustively or in detail in the Market Directive. It is therefore up to the national legislators to complete the regulation of its TSO within the overall framework set out by the directive, including the restrictions provided by i.a. the unbundling requirement.

As the Market Framework thus only provides the overall framework, the member states – and to some extent the TSOs themselves – enjoy wide scope for deciding how and with what methods the tasks are implemented in practice, as long as the general principles are upheld.

It is therefore our assessment that the wording of the Market Directive does not immediately prohibit TSOs using financial instruments such as EPADs, provided the purpose of the Market Directive (see section 4.2.2 immediately below) and limitations therein (such as the unbundling requirement, see section 4.2.3) are complied with.

4.2.2 Purpose and underlying principles of the Market Directive

The activities of a TSO should in any case always fall within the legal framework set out by the Market Directive.

Whether Energinet is able to carry out the activities involving the financial instruments currently envisioned therefore also depends on a specific assessment of the activities in relation to the general role and tasks of the TSO as accounted for in 4.1 above.

It follows from the legal framework that the TSOs are to contribute to the facilitation of a genuine internal market in electricity. The overall purpose of the Market Directive is to move towards an internal market in electricity, and the activities of the TSOs under the directive should naturally be seen in this light.

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[22] An EPAD Combo consists of a buy position of EPAD contracts in one bidding zone and a sell position of EPAD contracts in another bidding zone. The holder of the contracts will receive payment where a bidding zone price is lower than the system price, corresponding to the difference, and is on the other hand obligated to pay the amount of the difference, if the bidding zone price is higher than the system price. The combination thus provides a hedge of the risk of a price difference between the two bidding zones

[23] The characteristics of EPADs as financial instruments and measures being considered are further described in section 5.2 below

A measure which is connected to the TSOs' overall tasks and role, and which is deemed necessary to move towards a genuine internal market will therefore not be in conflict with the Market Directive as a starting point.

The key question is hereafter if the trading of financial instruments in the specific case also can be said to be related to the TSOs' general role and responsibilities and consistent with the general legal framework of the Market Directive.

In this case, the basis for the measures being considered is the decisions issued by DERA and Ei.

Pursuant to the Market Directive, the NRAs are entitled to ensure the proper functioning of the electricity markets by imposing measures to support this goal. It is not stated directly who the measures may be imposed upon. But as NRAs are generally responsible for monitoring the TSOs, it seems reasonable to assume that the TSOs may be the subject of such an order.

The decisions by DERA and Ei are ultimately triggered by an analysis showing that the market for hedging instruments in DK 1 and DK2 is not sufficiently liquid. This is considered an obstacle to the internal market in electricity.

The purpose of the measures to be introduced is therefore to facilitate the internal market in electricity, which is also the general objective of the Market Directive and thus part of the TSOs' role.

The measures Energinet has been asked to consider, using financial instruments or otherwise, are thus overall consistent with the Market Directive, as the aim is to move towards a fully integrated market, by removing the barrier created by the lack of hedging opportunities in DK1 and DK2.

This line of reasoning may be further substantiated by taking into account the FCA Regulation, which forms the legal basis of DERA and Ei's decisions, and provides further context, including on the relation to the TSOs' core task of operating interconnections. See section 4.3 below.

Further, it follows from the Market Directive that operation, maintenance, provision of access and other tasks concerning interconnections are allocated to the TSOs. The interconnections are vital to the facilitation of the internal market in electricity.The issue of price differences between bidding zones is part of the same context, as price differences occur where the interconnection capacity is insufficient.

The new element compared to LTTRs – to our understanding – would be that EPADs are not linked to or limited by the capacity of an interconnector and thus this activity is a financial activity rather than an activity related to the transmission system as such.

4.2.3 Unbundling requirement

Pursuant to the unbundling requirement of the Market Directive, TSOs must be separate and independent from production and supply of electricity, in order to prevent unfair treatment of other parties using e.g. interconnectors.

"Production" is not separately defined in the Market Directive, but is used synonymously with generation of electricity.[24]

Producers or generators of electricity are well-positioned to offer e.g. EPADs, as their production activities provide a natural hedge for the financial risks involved.[25]

A TSO which sells EPADs may therefore become a competitor of entities which generate electricity. However, it is clear that this does not mean that selling EPADs will in itself constitute production in the Market Directive's sense of the term.

"Supply" is defined as the "sale, including resale, of electricity to customers", where "customer" may be both a wholesale or final customer.[26]

In our understanding, suppliers of electricity are natural buyers of EPADs, as EPADs provide a hedge against the risk of price differences from the spot price. Such hedging opportunities are necessary for the supplier to enter into agreements involving e.g. a fixed price with customers. However, an EPAD does not involve any actual sale of electricity, but is rather a financial product linked to the price of electricity, which may be used by electricity suppliers in support of their business.

In DERA's decision on certification of Energinet[27] it is emphasised that it may be problematic if a company which has activities of production or supply of electricity receives exclusive information from the TSO through e.g. a contract for a service, as this may provide the company with an unfair advantage over other market participants and entail a risk of market abuse. This is however subject to a specific assessment and should be discussed with the relevant NRA (DERA).

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[24] See e.g. the Market Directive art. 2, subparagraphs 1-2

[25] See Nordic TSO Market Steering Group: "Examination of possible other long-term cross-zonal hedging products", footnote 10

[26] See the Market Directive art. 2, subparagraphs 19 and 7

[27] See footnote 11 above

We further understand that holding a financial position in the market may entail a risk of conflicts of interests for TSOs, as it may provide an economic incentive which is contrary to e.g. ensuring sufficient capacity of interconnections.[28]

While this is an issue which will be a concern of the relevant NRA (DERA) and which must naturally be handled when designing the measures, it is not in our assessment comparable to taking up activities of production or supply of electricity.[29]

In addition, the financial position may entail a loss for the TSO, which must ultimately be covered by consumers.[30] However, this does not necessarily mean that funds from transmission activities are diverted to production or supply activities, which would be in conflict with the prohibition of cross-subsidisation, which forms part of the unbundling requirement. For our assessment of whether the losses may be covered by the congestion income or the network tariff, see section 5 below.

It is therefore our assessment that the envisioned measures are not in themselves contrary to the unbundling requirements of the Market Directive. However, the measures should be discussed with the relevant NRA (DERA) and designed to ensure that it complies with the unbundling requirements of the Market Directive.

4.3 The FCA Regulation and the role of the TSOs in relation to long-term cross-zonal capacity products

The FCA Regulation applies to all transmission systems and interconnectors in the EU and "lays down detailed rules on cross-zonal capacity allocation in the forward markets".[31]

Pursuant to the regulation, long-term transmission rights must, as a rule, be available on all interconnectors. As TSOs operate the interconnections, they play an important role in relation to the allocation of the long-term transmission rights in practice, and the specific tasks in this regard, as further set out by the FCA Regulation.

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[28] As payment pursuant to EPADs corresponds to price differences, which are affected by the available capacity

[29] Mitigating the risk of conflicts of interests could of course still be decisive in the process of obtaining DERA's approval of the design or organisation of the measures. Pursuant to agreement with Energinet, we have however limited our assessment to whether the activities are outright prohibited by the Market Directive or Electricity Regulation. Elements such as the structural consequences of holding a financial position in the market and potential (unfair) competition with existing market participants may however still be important when deciding how the measures are to be implemented in practice

[30] Recovery of costs (including financial losses) will be subject to a separate assessment

[31] The FCA Regulation art. 1

The FCA Regulation is based on the Electricity Regulation and refers to a general objective of moving towards a fully functioning and interconnected internal energy market.

The overall purpose of the FCA Regulation is thus to contribute to the facilitation of a genuinely integrated market, by providing market participants with LTTRs as an opportunity for a long-term hedge of their positions against the risk of price differences between bidding zones due to e.g. congestion. The objective is thereby – in accordance with the Market Directive – to reduce the obstacles (in this case the risk of price differences) to the development of the genuine internal market.[32]

In this regard, the preamble sets out the following concerning the necessity of hedging opportunities:

> *"In order to move towards a genuinely integrated electricity market,* ***efficient hedging opportunities*** *should be developed for generators, consumers and retailers to mitigate future price risk in the area where they operate (…)."*[33] (emphasis added here)

The FCA rules are further described by ENTSO-E as "*a vital building block … to provide risk hedging opportunities to the market*" and "*to create a single, competitive forwards market across the continent*".[34]

This is also seen by the long-term transmission rights not being limited to *physical* rights, but also *financial* rights ("FTRs").

Subject to NRA decision, it is however possible under art. 30 of the FCA Regulation, for the TSOs to opt-out of the requirements under the regulation for introduction of long-term transmission rights (whether physical or financial), but only if there exists other long-term hedging opportunities for the market participants, fulfilling the aim of the FCA Regulation. These opportunities must be available in practice to market participants, i.e. the market for the hedging instruments must also be liquid.

With the FCA Regulation's art. 30, this responsibility of ensuring other long-term hedging opportunities being available if the TSO wishes to opt-out is also allocated to the TSOs.

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[32] We are aware, that ENTSO-E and ACER disagreed on the general purpose of the long-term transmission rights during the preparation process. However, it appears from the preamble that the matter was settled by the purpose explicitly being the provision of financial hedging opportunities

[33] The preamble of the FCA Regulation item 3

[34] See ENTSO-E: " Network Code on Forward Capacity Allocation – Explanatory Document", October 2013, p. 7

The task of ensuring liquidity can thereby be said to lie in natural extension of the TSOs' general obligation to introduce long-term transmission rights for the sake of market participants, as art. 30 is an exemption to the main rule in favour of TSOs which do not find the introduction of full-fledged long-term transmission rights necessary.[35]

It is however not immediately clear if this also means that TSOs are directly expected to auction or buy EPADs, as the measures for ensuring liquidity of the market for hedging instruments are not further specified in the FCA Regulation.

However, in the discussions leading up to the FCA Regulation, "synthetic FTRs" were discussed as an alternative to the regular FTRs, with particular relevance to the Nordic market.[36] It appears that an EPAD Combo would constitute a synthetic FTR.[37]

Synthetic FTRs were not adopted as part of the FCA Regulation. In its decision on the matter, ENTSO-E added that "[t]*here is no restriction on the introduction of synthetic FTRs where this is considered appropriate by the relevant NRAs"*[38].

It was therefore ultimately concluded that TSOs are allowed – but not required – to enter financial markets under the FCA Regulation and network code.[39]

On this basis it is our assessment that the use of EPADs to support market liquidity under art. 30 is not contrary to the FCA Regulation.[40]

Further, EPADs are comparable to FTRs, which are part of the TSOs' obligations under the general rules of the FCA Regulation.

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[35] It should however be noted that the measures to support the liquidity of the markets are of interim nature, as the adequacy of the market for risk hedging products is to be reassessed at least every four years, cf. the FCA Regulation art. 30, subparagraph 8

[36] ENTSO-E, minutes of Stakeholder Advisory Group meeting 26 November 2012, p. 3. It further seems that the exemption in the FCA Regulation art. 30 is mainly to accommodate the wishes of the Nordic TSOs, who preferred keeping the Nordic market model as it was, including the use of EPADs instead of long-term transmission rights

[37] Spodniak, Petr: "Long-term Transmissions Rights in the Nordic Electricity Markets: an Emprical Appraisal of Transmission Risk Management and Hedging", 2017, p. 57, where the following is set out: "…synthetic FTRs (EPAD Combo) on hedgers … two EPAD contracts in an opposite direction (EPAD Combo) between interconnected bidding areas, which replicates the hedging effect of FTRs"

[38] ENTSO-E: "Network Code on Forward Capacity Allocation – Explanatory Document", October 2013, p. 32

[39] See ENTSO-E's presentation given at the Stakeholder Advisory Group Meeting 18 June 2013: https://www.entsoe.eu/fileadmin/user_upload/_library/resources/FCA_NC/130618_NC_FCA_SAG_Presentations.zip

[40] This is also consistent with what have been communicated to us by Energinet

In addition, the measures being considered by Energinet are narrowly tied to fulfilling the purpose of the FCA Regulation, as they originate from DERA's and Ei's coordinated decisions under the exemption in art. 30.

Energinet's possible use of financial instruments to support the liquidity of DK1 and DK2 is thus an alternative to the hedging possibilities provided by the long-term transmission rights, as a way to ensure that the condition for exemption of the general requirements of the FCA Regulation is in fact fulfilled.

The purpose of the measures can therefore be said to be the facilitation of the internal market in electricity in accordance with the Market Directive, as this is the general purpose of the FCA Regulation.

Thus, the context of the measures, namely the FCA Regulation and its art. 30, in our view indicates that the measures are not inconsistent with the Market Directive, provided the general rules of the framework are complied with in practice.

4.4 Our assessment

While it is clear that it is not a core task of the TSOs, in our assessment the Market Directive does not explicitly prohibit TSOs from carrying out activities involving financial instruments. It is further assumed in the directive that TSOs may have transactions with "electricity derivatives".

With regard to the specific case, the aim of the measures is further ultimately to remove an obstacle to the internal market in electricity to the benefit of market participants and consumers, and thereby in accordance with the general purpose of the Market Directive.

In addition, it is our assessment that the measures being considered by Energinet are not contrary to the unbundling requirement of the Market Directive, as they do not constitute either production or supply of electricity, despite the fact that both producers and suppliers may buy and sell similar instruments as part of their businesses. The risks for conflicts of interest etc. should of course still be handled when designing and implementing the measures.

The consistency of the measures with the Market Directive can also be inferred from the context provided by the FCA Regulation. The measures being considered are essentially a condition for using the exemption set out in the FCA Regulation's art. 30.

Thus, the measures are based on the FCA Regulation, which allocates specific tasks to the TSOs as operators of interconnections, with the aim of ensuring sufficient hedging

opportunities against price risk. The hedging opportunities are needed to facilitate cross-zonal trade of electricity.

A line may therefore be drawn from the TSOs' core task of operating and maintaining interconnections, to supporting an illiquid market for hedging opportunities, in order to move towards a fully integrated internal market in electricity.[41]

In conclusion, it is therefore our assessment that the measures being considered by Energinet are generally not in conflict with the Market Directive, as the activities are connected to the TSOs' obligations under the directive, as well as in accordance with its overall purpose, and provided it is designed to comply with the unbundling requirement. As the trade of financial instruments is not specifically stated in the Market Directive as a task of the TSOs, and as the member states and NRAs have a wide discretion in setting out the tasks of the TSOs, we recommend that it is discussed with the relevant NRA (DERA).

5. Economic conditions (coverage of costs)

5.1 General

Taking the Market Directive, the Electricity Regulation and the FCA Regulation into account, there are generally two ways for TSOs to cover the costs which may arise due to the measures for supporting liquidity of the financial market under article 30 of the FCA Regulation: through either (1) congestion income; or (2) network tariffs.

In the following we will assess whether the costs may be covered by using congestion income or network tariffs.

This will not include how the recovery of costs is to be carried out in practice, and we will therefore not address issues, such as separation of accounts and prevention of cross-subsidisation. Such issues may, however, still be important when designing the actual model.

We further note that per agreement with Energinet we have not taken national law into account which may be decisive with respect to whether the costs can be recovered.

[41] This applies to the contemplated measures in general. However, we have not made a specific assessment of each contemplated measure in relation to the TSOs' core task of operating interconnections.

5.2 Congestion income

5.2.1 Legal framework

The rules on the TSOs' use of congestion income are set out in the Electricity Regulation art. 16, subparagraph 6:

> *"Any revenues resulting from the allocation of interconnection shall be used for the following purposes:*
>
> *(a) guaranteeing the actual availability of the allocated capacity; and/or*
>
> *(b) maintaining or increasing interconnection capacities through network investments, in particular in new interconnectors.*
>
> *If the revenues cannot be efficiently used for the purposes set out in points (a) and/or (b) of the first subparagraph, they may be used, subject to approval by the regulatory authorities of the Member States concerned, up to a maximum amount to be decided by those regulatory authorities, as income to be taken into account by the regulatory authorities when approving the methodology for calculating network tariffs and/or fixing network tariffs."*

More details are set out in in Annex 1 to the Electricity Regulation. Pursuant to section 6.4 hereof, the NRA is ultimately responsible for ensuring that the congestion income is used in accordance with the regulation's provisions:

> *"TSOs shall clearly establish beforehand the use they will make of any congestion income they may obtain and report on the actual use of that income. Regulatory authorities shall verify that such use complies with this Regulation and those Guidelines and that the total amount of congestion income resulting from the allocation of interconnection capacity is devoted to one or more of the three purposes set out in Article 16(6) of this Regulation."*

As the Electricity Regulation thus sets out the limits on the use of congestion income, the question of whether costs related to measures taken in support of financial markets pursuant to the FCA Regulation's art. 30 (e.g. losses on financial instruments such as EPADs or related to support a market maker) may be covered using congestion income is to be answered based on these provisions.

Based on the above, the TSOs can only cover costs related to measures under FCA Regulation Article 30 from the congestion income, if the cost recovery is for the purpose of i) guaranteeing the actual availability of the allocated capacity; ii) maintaining or increasing

interconnection capacities through network investments, or iii) if approved by the NRAs up to a maximum amount.

Costs pursuant to point (a) includes in particular expenditures to cover the costs of redispatching, counter trading and other operational measures, while point (b) covers all expenditures needed to maintain or increase the interconnection capacity, including investments in new links and upgrading of existing links.[42]

5.2.2 Assessment

Concerning the Electricity Regulation's art. 16, subparagraph 6, point (a), it is not described further what is meant by "guaranteeing the actual availability of the allocated capacity". Therefore, it is not immediately clear if the contemplated measures may fall under this purpose.

In practice, ensuring the availability of the capacity of the interconnectors is handled in different ways by using operational measures to relieve congestion in interconnectors (and thereby ensure availability of the capacity), such as countertrading and redispatching. As noted above in 5.2.1, it is assumed that congestion income may be used for these measures pursuant to point (a).

In general, firmness costs are further considered to be recoverable using congestion income under point (a).[43] In this context it seems to be assumed under the FCA Regulation that costs related to firmness under the regulation are recoverable by congestion income, cf. the FCA Regulation's arts. 53-54 and 61. The conclusion on recovery of firmness costs under the FCA Regulation is not clear, however, and to our knowledge has not been tested in practice.[44]

It could be argued that long-term transmission rights and measures to guarantee these rights under the FCA Regulation fall under the purpose of point (a), as the aim is to ensure the allocated capacity.

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[42] European Commission: "Study Supporting the Impact Assessment concerning Transmission Tariffs and Congestion Income Policies", May 2017, p. 85. We are not aware of any other official contributions for interpretation of art. 16(6) and the use of congestion income.

[43] European Commission: "Study Supporting the Impact Assessment concerning Transmission Tariffs and Congestion Income Policies", May 2017, p. 86

[44] It is stated in the referenced provisions that the "cost of ensuring firmness" shall be borne by the TSOs "to the extent possible with Article 16(6)(a)" of the Electricity Regulation. Further, it is set out that a cap on firmness costs may be introduced, which cannot exceed the congestion income collected. It thus seems assumed that the firmness costs may be recovered through congestion income, in line with the general rule.

The key difference between long-term transmission rights, including FTRs, and the measures to support the market for (other) cross-zonal hedging products now being considered by Energinet is, however, that the long-term transmission rights are tied to the capacity of the interconnector in question, while the other hedging products are in principle independent of the underlying capacity.

Therefore, the costs will as a starting point fall outside the scope of art. 16(6)(a), as the wording specifically concerns the "*actual availability of allocated capacity*".

It may on the other hand be argued that it should be possible to recover the costs associated with the financial instruments using congestion income pursuant to art. 16(6)(a), as the instruments are in this case analogue to long-term transmission rights, and the underlying purpose – removal of barriers to the internal market in electricity – is also the same.

In our view, the purpose of the measures being considered by Energinet is indeed comparable to the firmness regime, as the purpose of the measures considered is to provide an effective possibility for hedging the risk of price differences between bidding zones, which will arise if there is congestion in the interconnector between the two areas.

The firmness regime is further similar to e.g. EPAD Combos, as the entitled party in both cases may receive compensation corresponding to the market spread.[45]

Thus, it may be possible to compare the contemplated measures to the firmness compensation mechanisms, and therefore also argue that the associated costs should fall under art. 16(6)(a).

However, the wording of art. 16(6)(a) still specifically mentions the capacity of the interconnector. While the costs of the firmness mechanisms under the FCA Regulation do seem to be recoverable using congestion income, the main rule is for the TSO's costs arising from the FCA Regulation to be covered through network tariffs cf. art. 58 of the FCA Regulation (see further immediately below).

It is therefore our overall assessment that it is most likely not possible for TSOs to use congestion income to cover the costs of measures for supporting financial markets

[45] Pursuant to the firmness provisions, the holder of a long term transmission right which is curtailed due to a limitation of the capacity of an interconnector, is to be compensated corresponding to the market spread between the two bidding zones. The purpose of e.g. EPAD Combos is also for the market participant to cover the market spread between two areas

pursuant to the FCA Regulation art. 30, unless directly connected to the capacity of interconnectors pursuant to art. 16(6)(a), which in our understanding is not the case for the contemplated measures.

Further, the measures under FCA Regulation Article 30 do not fall within the scope of the Electricity Regulation's art. 16, subparagraph 6, point (b), as the measures and the costs incurred are not taken for the purpose of "*maintaining or increasing interconnection capacities*". Thus, it is our assessment that the TSOs cannot recover the costs under art. 16, subparagraph 6, point (b), either.

If DERA finds that the costs fall outside art. 16(6)(a), it may however still indirectly approve the use of congestion income for the new costs, through the residual part of art. 16(6), which allows the income to be included in the calculation of network tariffs to the extent it cannot be efficiently used for the purposes set out in points (a) and (b) of the provision. The comparability between the contemplated measures and e.g. firmness may be used as an argument with DERA to approve the use of congestion income to ultimately cover the costs of the measures through this part of the provision.

Consequently, the use of congestion income is in any case subject to DERA's indirect approval, cf. Annex 1 of the Electricity Regulation as quoted above.

However, it is finally noted that there does not seem to be a clear or consistent practice in the EU NRAs' handling of costs in relation to the use of congestion income.[46] It is therefore not possible to foresee if the NRAs will accept the use of congestion income for the costs of the alternative measures under the FCA Regulation art. 30 under either parts of art. 16(6) of the Electricity Regulation.

5.3 Network tariffs

5.3.1 Legal framework

Under the Market Directive, it is up to the NRAs to make an assessment of whether the specific costs are proportionate and based on transparent and non-discriminatory criteria, and may thus be included in the network tariff calculation.[47] The Market Directive sets out that one of the main tasks of the NRAs is to fix or approve "*in accordance with transparent criteria, transmission or distribution tariffs or their methodologies*"[48].

[46] European Commission: "Study Supporting the Impact Assessment concerning Transmission Tariffs and Congestion Income Policies", May 2017, p. 97

[47] The Market Directive art. 37, subparagraph 10

[48] The Market Directive art. 37, subparagraph 1, point (a)

Further, the FCA Regulation includes a provision on the use of network tariffs for specific TSO costs in art. 58:

> *"1. Costs incurred by TSOs arising from obligations in this Regulation shall be assessed by all regulatory authorities.*
>
> *2. Costs assessed as* ***reasonable, efficient and proportionate shall be recovered in a timely manner through network tariffs or other appropriate mechanisms as determined by the competent regulatory authorities****. (…)"*[49] (emphasis added here)

Per default, the costs incurred by the TSOs under the FCA Regulation are therefore to be recovered through the network tariffs, to the extent the mentioned principles are met in the NRAs' assessment.[50]

5.3.2 Assessment

According to the FCA Regulation, the TSOs' costs arising from obligations under the regulation, may be covered by network tariffs if they are assessed as reasonable, efficient and proportionate by the NRA.

This is further supported by the Market Directive, under which the NRAs must ensure that the costs included in the calculation of the network tariffs are proportionate and fixed using transparent criteria.

First of all, pursuant to the FCA Regulation, the costs of the measures ultimately implemented by Energinet must therefore be said to arise from "*an obligation*" under the FCA Regulation to be recoverable through the network tariffs under art. 58. In this regard,

Energinet has been requested by DERA "*to ensure that other long-term hedging products concerning transmission capacities are available to support the functioning of the wholesale electricity markets*"[51] pursuant to the FCA Regulation art. 30, subparagraph 5, point (b).

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[49] The FCA Regulation art. 58

[50] We note that the wording of art. 58, subparagraph 1, specifically stipulates that this assessment of costs shall be made by "all regulatory authorities". It is our understanding that all EU NRAs are to make a coordinated assessment of what is considered "reasonable, efficient and proportionate" costs of the TSOs under the provision. To our knowledge, no such decision has yet been made, but we have not looked further into the matter at this point. This may be looked further into if required.

[51] DERA Decision On Cross-Zonal Hedging Opportunities In The Danish Electricity Market, 17 May 2017, English summary section 17

The task imposed on the TSOs by DERA and Ei thus follows from the FCA Regulation, as a natural consequence of the specific assessment of the efficiency of the existing forward market in DK1 and DK2.

For the costs to be recoverable in practice they must however further comply with the principles set out in art. 58, subparagraph 2, and by the Market Directive. The costs must thus be assessed to be "*reasonable, efficient and proportionate*" and based on transparent criteria.

Provided that these conditions are complied with, it is our assessment that the costs are recoverable through the network tariffs pursuant to the FCA Regulation art. 58. This will in our assessment include costs for taking up the activities including bringing in new personnel and other directly operating expenses.

It is not clear from the wording of art. 58 if losses on the financial positions may also be considered "costs". In ENTSO-E's report on transmission tariffs in Europe[52], TSO costs recoverable through network tariffs include costs related to compensation of energy losses in the transmission system.

It is therefore our overall assessment that it is therefore up to DERA to assess whether a loss on financial instruments may be included in the calculation of the network tariffs, also under national legislation, or if another instrument should be used. However, in our view, "costs" does not necessarily exclude such a loss, provided the risk is limited enough to also fulfil the principles of being "*reasonable, efficient and proportionate*".

In the first instance it will be up to DERA in coordination with Ei to decide if the measures are acceptable, and afterwards to form an opinion of whether the associated costs comply with the general principles set out by the Market Directive and FCA Regulation.

[52] "ENTSO-E Overview of Transmission Tariffs in Europe: Synthesis 2015", June 2016

6. Financial regulation

6.1 Introductory remarks

MiFID II will replace MiFID I as of 3 January 2018. Consequently, to ensure that our assessment of Energinet's contemplated trading activities is not outdated after 3 January 2018 we have carried out our assessment under MiFID II rather than under MiFID I.

6.2 General description of Energinet's contemplated trading activities

Energinet is exploring the possibility of supporting the liquidity in the Danish market for EPADs by means of buying or selling EPADs depending on the supply and demand for hedging opportunities in the bidding zones. Accordingly, Energinet contemplates to sell EPADs if supply is low and to buy EPADs if demand is low.

Energinet will enter into EPAD contracts on Energinet's own account directly with counterparties and the actual trading is expected to be carried out through auctions. We have described our understanding of the auctioning-model that Energinet currently contemplates in section 6.6.3 below.

However, it is our understanding that the exact auctioning-model and how the auctions are performed have yet to be finally decided. Different models have been put to the table, including the possibility of Energinet conducting the auctions itself and the possibility of having third-parties conducting the auctions, such as the Joint Allocation Office or existing forward exchanges, e.g. Nasdaq Commodities.

6.3 Assessment of MIFID II's application on the contemplated trading activities

We have been asked to assess whether Energinet will be able to rely on the exemption in article 2(1)(n) of MiFID II regarding activities carried out by TSOs ("**the TSO exemption**").

It is only relevant to assess whether Energinet will be able to rely on the TSO exemption if Energinet's trading activities are within the scope of MiFID II. Consequently, it will initially be established whether Energinet's contemplated trading activity will, *prima facie*, fall within the scope of MiFID II.

6.4 The scope of MiFID II

It follows from article 1(1) of MiFID II that it applies to investment firms, market operators, data reporting services providers, and third-country firms providing investment services or performing investment activities through the establishment of a branch in the Union.

Article 4(1)(1) defines an investment firm as

> *"any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis."*

Article 4(1)(2) defines investment services and investment activities as

> *"any of the services and activities listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I."*

According to point 3 in Section A of Annex 1, dealing on own account is an investment activity if the activity is carried out with instruments comprised by Section C of Annex 1, i.e. financial instruments.

Energinet has informed that they will be dealing on own account in EPADs. Accordingly, Energinet will become subject to MiFID II, if EPADs qualify as financial instruments.

6.5 EPADs

The list of financial instruments that are comprised by MiFID II follows from Annex 1, Section C of MiFID II.

As described in section 4.1.3, the Market Directive explicitly refers to electricity derivatives as financial instruments as listed in Annex 1, Section C, point 5, 6 and 7 of MiFID. Financial instruments comprised by point 5, 6 or 7 are sub-categorised as commodity derivative contracts.

EPADs are forward contracts with reference to the difference between the electricity price in a given bidding zone (area price) and the Nord Pool Nordic Spot system price. Accordingly, EPADs derive their value from the difference in the price of electricity. Additionally, there are no rights to physical delivery attached to EPADs why these contracts are only settled in cash. As such, EPADs are financial derivatives contracts (financial forward contracts).

Accordingly, it must be examined whether EPADs satisfy the definition of commodity derivatives contracts comprised by Annex 1, Section C of MiFID II. As mentioned in section 6.1 this assessment is only conducted in respect of MiFID II.

The characteristics of commodity derivatives contracts follows from Annex 1, Section C, point 5, 6, 7 and 10 of MiFID II.

Pursuant to Annex 1, Section C, point 5, commodity derivative contracts are:

> *"Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event".*

As described above EPADs are financial forward derivatives contracts that derive their value from the difference in the price of electricity. As such, EPADs satisfy the definition of a commodity derivative contract as set out in point 5 of Section C in Annex 1 of MiFID II, provided electricity is defined as a commodity in MiFID II.

It follows from article 2(6) in the Commission's delegated regulation 2017/565/EU that electricity is a commodity in respect of MiFID II. This means that a derivative contract deriving its value from the price of electricity is a commodity derivative within MiFID II.

Based on the above it is our assessment that EPADs are commodity derivatives contracts qualifying as a financial instrument comprised by Annex 1, Section C of MiFID II. This means that Energinet will become subject to MiFID II in relation to the contemplated trading activities with EPADs.

6.6 The TSO exemption

The TSO exemption in article 2(1)(n) of MiFID II has the following wording:

> *"[This Directive shall not apply to:]*
>
> *Transmission system operators as defined in Article 2(4) of Directive 2009/72/EC or Article 2(4) of Directive 2009/73/EC when carrying out their tasks under those Directives, under Regulation (EC) No 714/2009, under Regulation (EC) No 715/2009 or under network codes or guidelines adopted pursuant to those Regulations, any persons acting as service providers on their behalf to carry out their task under those legislative acts or under network codes or guidelines adopted pursuant to those Regulations, and any operator or administrator of an energy balancing mechanism, pipeline network or system to keep in balance the supplies and uses of energy when carrying out such tasks.*
>
> *That exemption shall apply to persons engaged in the activities set out in this point only where they perform investment activities or provide investment services relating to commodity derivatives in order to carry out those activities. That exemption shall not apply with regard to the operation of a secondary market, including a platform for secondary trading in financial transmission rights;".*

To rely on the TSO exemption Energinet must be able to demonstrate that it is:

1) carrying out its tasks under the relevant legislation as mentioned in the article 2(1)(n), and
2) that it is only performing investment activities or investment services with commodity derivatives, and
3) that it is not operating a secondary market, including a platform for secondary trading in financial transmission rights.

Consequently, it is assessed below whether Energinet is capable of satisfying the conditions set out in no. 1-3 in order to rely on the TSO exemption.

6.6.1 Re. 1 – Carrying out its tasks under the relevant legislation as mentioned in article 2(1)(n)

Pursuant to the TSO exemption, Energinet is only allowed to perform investment services and investment activities if these are carried out as part of the performance of Energinet's task in accordance with the Market Directive.

As described in section 6.5, it is our assessment that trading in financial instruments in support of the financial electricity markets is a task that would be able to fall within the tasks of Energinet according to the Market Directive. Accordingly, Energinet satisfies this condition.

6.6.2 Re. 2 – The investment activities or investment services are only performed with commodity derivatives

As described under section6.5, it is our assessment that EPADs qualify as commodity derivatives pursuant to Annex 1, Section C, point 5 of MiFID II.

It is furthermore our understanding that Energinet will only carry out the investment services and investment activities with EPADs. Based on this it is our assessment that Energinet also satisfies this condition.

6.6.3 Re. 3 – Operation of a secondary market for secondary trading, including a platform for secondary trading in financial transmission rights

The TSO exemption does not apply if the investment services and investment activities are carried out in connection with the operation of a secondary market.

As described in section 6.2 Energinet contemplates to carry out the trading activities through auctions in which Energinet contemplates to enter into EPADs contracts directly with counterparties.

However, the notion of "operation of a secondary market" is not defined in MiFID II and there is no official guidance as to how this is to be interpreted. This results in a level of uncertainty regarding whether the contemplated activity of auctioning EPADs would constitute the operation of a secondary market.

We have briefly outlined some of the arguments that may be put forward in the assessment of whether or not Energinet's contemplated trading activity would constitute the operation of a secondary market.

On the one hand it is a common denominator of the different types of MiFID II trading venues, i.e. a regulated market, a multilateral trading facility ("**MTF**") and an organised trading facility ("**OTF**"), that these by definition, cf. article 4(1)(21)-(23) of MiFID II, brings together third-party buying and selling interests in multilateral systems.

In contrast to these trading venues, it is our understanding that the auctioning-model that Energinet contemplates does not entail a multilateral system that brings together third-party buying and selling interests. Instead, the model allows market participants to notify Energinet of a certain level of demand or supply in respect of EPADs. Based on the prices and volumes notified by market participants, Energinet will then be able to fix a price and allocate EPADs pro rata to the market participants participating in the auction.

Accordingly, the auctioning-model lacks the common denominator of MiFID II trading venues, which indicates that the auctioning-model does not constitute the operation of a secondary market.

However, trading activities with some similarities to the contemplated activity of Energinet are regulated in MiFID II under the systematic internaliser regime. A systematic internaliser ("**SI**") is defined as an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system.

SIs must adhere to specific rules laid down in MiFID II, including rules on pre- and post-trade transparency. Hereby the SI-regime seems to indicate that there is a wish from the EU regulator to regulate this kind of systematic trading on own account.

Since there is no definition of what constitutes the "operation of a secondary market" there will be a margin of discretion left for the national competent authorities (in Denmark the Danish Financial Supervisory Authority, "Finanstilsynet") to operate within.

Based on the information received on the contemplated auctioning-model it is our assessment that this would probably not suffice to constitute the operation of a secondary market. Assuming that Energinet will not be operating a secondary market by auctioning EPADs, the three conditions to rely on the TSO exemption in article 2(1)(n) are satisfied.

Accordingly, Energinet would be exempted from the scope of MiFID II in respect of the trading activities with EPADs in accordance with article 2(1)(n) of MiFID II.

However, factors such as the frequency of the auctions, the volumes traded on the auctions and the question of outsourcing could influence the assessment of whether the auctions would constitute operation of a secondary market.

6.7 Conclusive remarks on the financial regulation

Due to the above mentioned uncertainty it is our recommendation that we open a line of communication with Finanstilsynet with a view to discuss the understanding of "operation of a secondary market" when Energinet has decided on the exact auctioning-model, hereunder whether this is outsourced to a third-party provider.

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Copenhagen, 13 November 2017

Per Hemmer and David Moalem