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PUBLIC CONSULTATION IN RELATION TO THE COMMISSION COMMUNICATION "MAKING THE INTERNAL ENERGY MARKET WORK" (COM(2012) 663)

FORTUM'S REPLY

General remarks

We broadly agree with the general findings of the EC Communication on internal energy market and the consultation document. National and inward looking energy policies can jeopardize the implementation of the European internal energy market and therefore a European level framework and coherent energy policies are required to enhance the internal energy market. We welcome the consultation on generation adequacy, capacity mechanisms and the internal energy market and find the consultation document and the set of questions very relevant and topical.

However, the communication and the consultation document lack a deeper analysis of the reasons behind the current situation. The current situation is taken as given, while it would be useful to analyze the background in more detail and assess whether there is anything else that could be done in order to alleviate the situation - except implement capacity mechanisms. Several multiple and overlapping energy political priorities, uncoordinated national renewable subsidy schemes, priority treatment of renewable energy in the electricity system, national CO2 taxes, regulated end user prices and other incentives and restrictions are the root cause for current market failures. There need to be a clear commitment to start working on those issues. Trying to cure regulatory failures with a new set of regulation will not cure the original disease.

From the internal market point of view it is detrimental to design capacity mechanisms or other incentives solely from the point of view of one member state. Even if the outcome for each country separately would be optimal, it does not follow that such a system would be optimal for the whole system - from the internal energy market point of view. Our assessment is that the EU internal energy market is now genuinely at the cross-roads - either the EU rapidly changes the course and starts putting member states back on track regarding national measures and start to align the overlapping support instruments and policy targets. Otherwise we will very soon see a rapid deterioration of the basis for the common EU energy market.

We call for a pragmatic approach in going forward with the internal energy market. First, we need to push for full implementation of the internal energy market by 2014, in line with the European Council request. Secondly, the EC needs to establish a common EU approach and legislative base for the Capacity Remuneration Mechanism discussion. Finally, we need to agree on the post 2020 energy policy framework in line with the overall 2050 decarbonisation target, in order to decrease

the investment uncertainty which the energy industry is facing today due to unclear regulatory priorities. An important issue in this regard is to eliminate uncoordinated and overlapping targets and measures.

CONSULTATION QUESTIONS

1. Do you consider that the current market prices prevent investments in needed generation capacity?

The full costs of new generation capacity are in many cases higher than the current market prices, which, in a well-functioning market, should indicate that there is at present no need for additional new investments.

However, this statement is only partly true. Today's low market prices are caused by increasing subsidized and prioritized RES-E generation and deteriorating power demand. Meanwhile, the investment climate, combined with increasing political risks, is not promoting new investments, which are likely to be needed in order to replace end of lifetime capacity and to balance the growing RES generation. Only a minor share of new investments today are market based, most are based on subsidies. Market prices cannot deliver required incentives to investing in an overly complex environment with multiple overlapping policies and steering mechanisms.

In efficient power markets, prices are based on the supply-demand balance for the short-term trading and on market parties' expectations and hedging needs in the forward trading for some years ahead. For investment decisions the investors need to have their own price assumptions, as investments cannot be based on short-term or mid-term market prices. In a market-based environment investor will invest when they expect the future market prices (and the contract prices for balancing reserves) to cover the full costs of new capacity. Investments in modernisation and environmental improvements of existing capacity are similarly based on market-price expectations (including price volatility for flexible generation) for the future years after the investments are completed.

2. Do you consider that support (e.g. direct financial support, priority dispatch or special network fees) for specific energy sources (renewables, coal, nuclear) undermines investments needed to ensure generation adequacy? If yes, how and to what extent?

Yes. Supports for specific energy sources do undermine the role of the market price as an incentive and a basis for new investments , and should therefore be phased out. If only some generation forms get specific support, it will distort the competition in the market. Some support forms, like priority dispatch and full feed-in tariffs, also prevent the supported generators from reacting to short-term market prices, which can result in both surplus and deficit situations endangering the power system stability. Such support forms, like priority dispatch for renewable electricity displaces market-based forms of generation. Subsidies obviously encourage investments in subsidized

generation and discourage investments in other forms of generation and undermine the role of the market prices. It should be seriously considered whether it is justified to maintain the current privileges (no balancing responsibility etc.) for renewable electricity in the future.

3. Do you consider that work on the establishment of cross-border day ahead, intraday and balancing markets will contribute to ensuring security of supply? Within what timeframe do you see this happening?

Yes. The market integration on all timeframes considerably improves security of supply, as resources from the whole area can be automatically used to cover sudden deficit in other areas. Nordic power market is a good example of a well-functioning cross-border regional power market. In line with the European Council target, the EU power markets should be integrated by 2014.

Physical cross-border capacities still continue to restrict cross-border flows, and further grid investments are thus needed, as well as the development of smart metering to fully utilize the demand response resources in the whole European market. In the internal market security of supply should be considered in regional terms rather than from a point of view of one country only.

4. What additional steps, if any, should be taken at European level to ensure that internal market rules fully contribute to ensuring generation adequacy and security of supply?

European Commission should clearly support market-based mechanisms, including more market based RES subsidies, equal level-playing field for all generation and demand response resources. The development of cross-border grid infrastructure and full market integration should be strongly promoted. Security of supply should always be assessed in broader terms than from a point of view of one country only. As for the possible capacity mechanisms, member states should provide clear arguments and proof of the need for such a measure and the Commission should make also its own assessment on the situation. There should be a set of common EU criteria both for assessing the need for CRMs (capacity remuneration mechanisms) and for the design of such a mechanisms.

5. What additional steps could Member States take to support the effectiveness of the internal market in delivering generation adequacy?

Making the internal market work (infrastructure development, market coupling, regional cooperation etc.) is to the large extent a question of political will and commitment. Power generation is today burdened with many additional costs, like national taxes and regulatory costs, which should be removed. Smart meters, enabling wider demand response, should be introduced in all Member States. Regulated prices and price caps should be removed. RES subsidy schemes should be developed so that they better reflect the market price i.e. they should more market based. Existing

capacity remuneration mechanisms should also be phased out through more reliance on cross-border trade and on market-based demand response, as uncoordinated implementation of capacity mechanisms can distort markets and endanger generation adequacy for neighboring Member States. Speeding up the permission process for both generation and transmission would also be beneficial for generation adequacy.

6. How should public authorities reflect the preferences of consumers in relation to security of supply? How can they reflect preferences for lower standards on the part of some consumers?

Security of supply is naturally important for the consumers, as well as affordable electricity costs. Therefore it is important that security of supply is guaranteed in the most cost-efficient way.

Consumers want to have an impact on their cost of supply and environmental footprint. Smart metering, appliances for demand response and local small scale production, in connection with enhanced pricing, products and services, provide tools for consumers to make choices that affect also the supply to their homes. The awareness of the functioning of the electricity market in general and of the dependency between costs and supply will increase. Thus, there is a segment of consumers that are willing to contribute to security of supply e.g. by steering devices according to price signals or by accepting restrictions in their electricity use during certain periods, naturally in return of a financial compensation.

7. Do you consider that there is a need for review of how generation adequacy assessments are carried out in the internal market? In particular, is there a need for more in depth generation adequacy reviews at:

a. National level

Yes. National adequacy assessments should fully take into account the contribution from cross-border resources, not only from the neighboring countries but from the whole European market. Through the coupling of day-ahead, intraday and balancing markets this contribution is becoming much more reliable and should thus be fully acknowledged also in national generation adequacy assessments.

b. Regional Level

Yes. Regional assessments should similarly fully include the contributions from the other regions through market coupling.

c. European Level

Yes. Generation adequacy assessments at European level should take into account the possible capacity closures also due to disadvantageous competitive position (market based vis-à-vis support based generation) and not only based on technical lifetime. On the other hand, the contribution from demand response resources should be more clearly included. With increasing demand response, the total generation capacity level

will be a result of economic optimization by the market actors between the supply and demand-side resources.

8. Looking forward, is the generation adequacy outlook produced by ENTSO-E sufficiently detailed? In particular,

a. Is there a need for a regional or European assessment of the availability of flexible capacity?

Not on general flexible capacity, as flexibility can be provided by most power plants and the capacity structure is in principle a result of an economic optimisation. More transparency is however needed on how much balancing reserves are contracted by the TSOs and on how these resources are used.

b. Are there other areas where this generation adequacy assessment should be made more detailed?

The present level is basically enough, as the European power system should not be based on an idea of central planning. However, it would be necessary to have common rules and methodology for member states to do their assessments. Import possibilities from neighboring countries should be taken into account in such assessment. The generation adequacy can be based on commercial market-based decisions, and the adequacy assessments should mainly serve as information and as pointing out possible market distortions that need to be removed.

9. Do you consider the Electricity Security of Supply Directive to be adequate? If it should be revised, on which points?

Electricity Security of Supply Directive (2005/89/EEC) contains many important elements and principles, some of which are now taken forward for example in the context of 3rd package implementation (TSO cooperation, network code on capacity calculation and allocation etc.). However, the Directive predates the EU energy and climate package and it should be updated to take into account the present situation where the security of the whole electricity system is being seriously challenged by rapidly increasing, subsidy driven intermittent renewable energy. Also, it should be assessed whether this Directive could provide a suitable legal framework for laying down common EU wide compatibility criteria/standards for the use of non-discriminatory capacity mechanism in certain cases of proven security of supply risk in one or several member states.

10. Would you support the introduction of mandatory risk assessments or generation adequacy plans at national and regional level similar to those required under the Gas Security of Supply Regulation?

The value added of any kind of new regulation should be seriously considered. The emphasis should be in improving market functioning, not in creating new mechanisms or administrative procedures. As part of the capacity mechanism criteria, there should

be an obligation for the country planning to implement a CRM to produce a clear evidence on the justification of such mechanism and a risk assessment (which must take into account cross-border trade and availability of generation capacity and demand response in neighboring countries) should be part of that.

11. Should generation adequacy standards be harmonised across the EU? What should be that standard or how could it be developed taking into account potentially diverging preference regarding security of supply?

It is not necessary to harmonise generation adequate standards across the EU, they will evolve following the development in the market situation and import/export balance. However, such standards should be based on common EU rules and methodology. It is important that cross-border trade, especially the possibility to import electricity is fully taken into account when assessing generation adequacy. The whole idea of the internal market is that security of supply can be understood in a broader sense, i.e. regional or European, not only a national security of supply. Therefore no member state at least in the central Europe should have a reason to aim for full self-sufficiency in all situations.

12. Do you consider that capacity mechanisms should be introduced only if and when steps to improve market functioning are clearly insufficient?

Yes. Introducing capacity mechanisms should clearly be the last resort option after all necessary actions to improve market functioning have failed or proved to be insufficient to guarantee security of supply in the given member state. A detailed justification should be required from the member state planning to introduce a CRM, and this justification should be done prior to implementing any measures. Member state introducing a CRM should describe clearly what kind of actions has been done and why these actions have not been sufficient, especially why it has not been possible to rely on cross-border electricity import or demand response methods. Contribution of RES subsidy scheme development for the market functioning should be part of that assessment, too.

13. Under what circumstances would you consider market functioning to be insufficient:

a. to ensure that new flexible resources are delivered?

In most European power markets there is presently enough generation capacity, as well as emerging demand response, to provide adequate flexibility, together with existing and widening interconnections. Possible capacity mechanisms should address only the security of supply issue, as including other targets would easily lead to premature closures of existing market-based firm generation capacity. Power system flexibility should be provided through free market-based pricing (including market coupling) in the day-ahead and intraday markets, as well as through adequate balancing reserves contracted by the TSO, and market-based balancing energy prices.

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If these prerequisites are established, new flexible resources will emerge both from the supply and demand when needed by the market. If there are still major lacks in this respect, the market functioning can be insufficient in guaranteeing required flexibility.

b. to ensure sufficient capacity is available to meet demand on the system at times of highest system stress?

In competitive power markets the peak-load balance can always be reached through the matching of price-dependent supply and demand bids. With adequate demand-side flexibility (also from other markets through market coupling) demand-side bids will ultimately ensure that day-ahead and intraday markets can always clear without any need for bid curtailments (market failure). After the intraday market gate closure, the TSOs guarantee the supply-demand balance during the operational hour by the balancing reserves that should be contracted at the latest before the day-ahead market gate closure. If there are low price caps or other restrictions on market-based bidding in the day-ahead and intraday markets or if the TSOs do not contract balancing reserves in advance or if the present situation with priority access will remain, sufficient resources for system adequacy could be at risk.

14. In relation to strategic reserves:

a. Do you consider that the introduction of a strategic reserve can support the transition from a fossil fuel based electricity system or during a nuclear phase out?

Ideally, incentives for phasing out from carbon intensive generation should be provided by the market, driven by CO2 reduction policy and market based emissions trading. Similarly, this policy should provide adequate incentives for new low-carbon generation investments, including balancing and reserve capacity. Unfortunately, and for different reasons, the system does not presently fully work as it should. Strategic reserves are not an optimal solution, but they are better than some other options, especially when they are temporary with clear phasing-out criteria. Strategic reserves should also be outside the normal market to minimize the market distortions, and the capacity selection should be based on open competition. Strategic reserves should be used only for preventing market failures, i.e. only after all other resources in the market are used, and they should not create any price ceilings for the market. Price caps are not needed but if technical price ceilings anyway exist, these should be at high enough level. Also with technical price ceilings a common EU approach is needed. Different national or regional approaches can have negative impact on incentives for infrastructure development, market coupling and demand response development.

b. What risks, if any, to effective competition and the functioning of the internal market do you consider being associated with the introduction of strategic reserves?

Risks with strategic reserves are rather limited. The main risk for effective competition is if strategic reserves will be taken into use already before the price

ceiling has been reached. Peak prices should be allowed to occur in order to allow market based generation capacity to recover their costs and to get all demand response resources activated. The more this can take place in the market, the less there are needs for regulated mechanisms, such as strategic reserves. It should also be taken into account that if strategic reserves are too big, there is a risk that generation that would otherwise operate in the market is taken away and only used in the strategic reserve. Thus only plants that would otherwise have been taken out of operation, should be contracted as strategic reserve.

15. In relation to capacity markets and/or payments:

a. Which models of capacity market and /or payments do you consider to be most and least distortionary and most compatible with the effective competition and the functioning of the internal market, and why?

If capacity mechanisms are implemented, they should be clearly targeted towards solving the security of supply problem (i.e. capacity mechanisms should not be used for solving other policy objectives) and they should treat all capacity (irrespective of technology or age) similarly. Key criteria/principles of any capacity mechanisms should be harmonized at the EU level and they should preferably be of regional character. In principle, capacity markets and payments always cause distortions in the power market because of their regulated nature and if they are designed from a national point of view.

For wider capacity mechanisms, fixed payments can easily cause excessive costs to consumers, while capacity markets can lead to surplus capacity and suppress dynamic market-based demand response. Targeted capacity mechanisms on only some generation forms can lead to premature closures of other generation. With non-discriminatory coverage (equal treatment of all generation and demand-side resources, i.e. no discrimination between technologies and equal treatment of new and old generation) and free pricing (enabling capacity prices to go to zero with increasing demand response), the distortions can be kept lowest.

b. Which models of capacity market and /or payments do you consider to be most compatible with ensuring flexibility in a low carbon electricity system?

The ETS, when allowed to function properly (i.e. without overlapping steering mechanism), takes care of the emissions. Flexibility can best be ensured through equal market-based participation for both supply and demand in the day-ahead, intraday and balancing markets, as well as in balancing reserves. Possible capacity markets or payments should serve only security of supply, as flexibility can be adequately rewarded through the energy price volatility and the balancing reserve payments. Possible capacity mechanisms should thus allow free market-based pricing in the day-ahead, intraday and balancing markets without any price caps. For strategic reserves, a requirement of balancing market capability during operation can be one feature in enhancing flexibility for extreme situations. Key criteria/principles of any capacity mechanisms should be harmonised at EU level.

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c. Are there any models of capacity mechanism the introduction of which would be irreversible, or reversible only with great difficulty?

Capacity markets and payments always cause regulatory uncertainty for market actors, distorting decision-making already during discussions about possible mechanisms. With a clearly defined time period and with the possibility of the prices/payments going to zero, the phase-out of capacity mechanisms can be best enabled. Strategic reserves can be phased out more easily than other mechanisms, as strategic reserves do not have impacts on the normal market operation and as generation units contracted as strategic reserve would otherwise have been closed down and can thus be retired when the strategic reserve is phased out.

16. Which models of capacity mechanisms do you consider to have the have the least impact on costs for final consumers?

All capacity mechanisms increase costs for final consumers as they reduce market efficiency and increase system costs. Least impacts would be caused by market-based systems with non-discriminatory participation and a regional dimension instead of national systems. Transitional mechanisms, like limited strategic reserves, can also keep the consumer costs lower than full-scale capacity mechanisms.

17. To what extent do you consider capacity mechanisms could build on balancing market regimes to encourage flexibility in all its forms?

Capacity mechanisms as such should not be introduced for encouraging flexibility. The existing balancing mechanisms, with the on-going European balancing market integration, should instead be used and developed so that adequate balancing reserves are contracted by the TSOs (taking also into account the increasing balancing needs due to the growth of wind and solar generation) and that the balancing energy market is based on marginal pricing and free participation from both supply and demand resources, which will encourage increased flexibility based on the market needs.

18. Should the Commission set out to provide the blueprint for an EU-wide capacity mechanism?

The EU should define clear compatibility criteria for the use of capacity mechanisms but there is no need to establish a European-wide capacity mechanism. The priority should still be in completing the internal energy market, including technical market rules, market coupling and infrastructure development and making the energy only market model (with adequate balancing reserves) deliver.

19. Do you consider that the European Commission should develop detailed criteria to assess the compatibility of capacity mechanisms with the internal energy market?

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Yes. Such criteria should definitely be developed. Capacity mechanism development is clearly a European issue because it will potentially lead to irreversible change in the present energy only market design, on which the whole internal market legislation is based. The EU Commission as the "owner" of the internal energy market project should take the lead in the process of establishing a clear and effective framework for the use and non-use of capacity mechanisms, including exit criteria. Implementation of a national capacity mechanism should be conditional on prior notification and approval of the European Commission.

The criteria should require at least a) a clear evidence based justification for the implementation of a capacity mechanism, b) time-limited application including a regular assessment of the situation and whether the conditions for capacity mechanism are still justified, and c) clear phasing-out plan including setting the conditions when the capacity mechanism can no longer be justified.

20. Do you consider the detailed criteria set out above (p. 12 - 14) to be appropriate?

a. Should any criteria be added to this list?

b. Which, if any, criteria should be given most weight?

For criteria (1) a new sub point should be added to point a. and two additional other points should be added:

a.

- European integration of day-ahead, intraday and balancing markets (incl. balancing reserves)

d. adequate balancing reserves contracted by the TSO

e. functioning intraday market established

Energy-efficiency solutions (criteria 1b. and 6b) are important for reducing energy demand, but they are not possible to be included as capacity resources, as they are not resources that are bid in the electricity markets.

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