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Mr Andrus Ansip
Minister
Ministry of Economic Affairs and
Communications
11 Harju Street
EE - 15072 Tallin

SUBJECT: EXEMPTION DECISION NO. E/2005/001, ESTLINK PROJECT

Dear Mrs. Asta Sihvonon-Punkka,

Dear Mr. Andrus Ansip,

I am writing with reference to your decision to exempt the above mentioned project from certain provisions of the Regulation on cross-border exchanges in electricity (EC) No 1228/2003 and of the Electricity directive 2003/54/EC, notified to the Commission on 23 February 2005.

The relevant Commission services have analysed the decision and supporting material.

I hereby inform you the Commission has not decided to request the Estonian Ministry of Economic Affairs and Communications nor the Finnish Energy Market Authority to amend or withdraw its decision.

Nevertheless, the Commission services have the following observations regarding the Estlink project.

In its analyses, the Commission has paid attention, in particular, to the arrangements as to the capacity reservations for electricity supply towards the Baltic States. Competitive conditions in the Baltic electricity market(s) remain to be desired. Under the agreements, all capacity towards the Baltic States is reserved for Esti Energia, Latvenergo and Lietuvos Energija ('the Baltic incumbents'). Consequently, the Commission considered whether the exclusive reservation of capacity for the Baltic incumbents would prevent entry into the Baltic market(s) by suppliers that intend to compete with them by importing electricity from Finland via Estlink and, consequently, whether the agreements would meet the condition of Art 7(b) of Regulation (EC) No 1228/2003.

The Commission reached the conclusion that its concerns did not justify an amendment or withdrawal of the exception decision on the following grounds:

1. The generation assets currently owned by the respective Baltic incumbents are distributed in a manner that the Baltic incumbents cannot really supply customers independently from each other. Estlink will however allow the Baltic incumbents to shape their supply more independently and, therefore, create an increased scope for competition.
2. The business rational for the Estlink investors and the way the agreements have been conceived is to exploit the currently existing price differential between Finland and the Baltic states to import cheap electricity from the Baltic States, which currently have substantial overcapacity. This price differential is expected to disappear between 2009 and 2013 and revenues from exports are likely to decline if not disappear. The exemption will expire in 2013 or at the sale of Estlink to the TSOs, whatever comes earlier.
3. Therefore, it is unlikely that the interconnector, during the period for which exemption has been requested, will be used to import substantial amounts of electricity into the Baltics. Imports are likely limited to the occasions when the spot prices and intra-day prices on Elspot and Elbas markets are lower than Baltic production costs.
4. Once price differentials converge, the Estlink will be sold to the TSOs and the exemption of third party access will expire. Consequently, when importing electricity into the Baltics becomes a viable business opportunity, incumbents relinquish their exclusive rights to the capacity which will then come available to any third party.
5. The Estlink arrangements foresee a capacity fee of [...] ¹ €/MWh, regardless as to whether any of this capacity is used or not. This amount represents approx. [...] % of the current price for base load in the Baltics and, thus, a significant disincentive exists for capacity hoarding. The same costs will incite the current owners to sell the Estlink cable to the TSOs as they will no longer be counter balanced by revenues once export opportunities disappear.

¹ [...] indicates confidential information which has been deleted for publication.

6. In addition, the incentive for hoarding is reduced by the fact that capacity into the Baltics is held by three different parties. The losses in terms of more competitive prices and lost customers from selling capacity to an entrant will be spread among all Baltic incumbents. Not selling capacity will imply foregone revenues but nonetheless the risk of being confronted with the losses related to entry because another Baltic incumbent sells the capacity instead.
7. Consequently, hoarding capacity by withholding this from the secondary market or by delaying the sale of Estlink the TSOs is not a very likely scenario. A collective refusal to sell capacity on the secondary market would moreover require acts on the part of the Baltic incumbents that fall outside the scope of the present exception and are most likely contrary to Articles 81 and/or 82 of the EC Treaty, which continue to apply.

Nonetheless, an incentive to hoard capacity either by delaying selling the Estlink to the TSOs until the last moment and/or by not selling unused capacity on a secondary market cannot be fully excluded.

In order to reduce the risks of capacity hoarding, we would take into consideration that the Estonian and Finish regulatory authorities ensure that strict transparency rules as to the usage of reserved capacity apply. The fact that the Finnish TSO will approve the auction design for capacity in a separate, later decision may provide a convenient opportunity for the incorporation of this additional requirement in the Estlink arrangements.

In particular, we recommend that, regardless of the outcome of the current discussion on the revised Congestion Management Guidelines (which are being prepared in the framework of Florence Forum) the relevant TSO ensure that:

- The Estlink operator (hereafter “the operator”) publishes all relevant data concerning cross-border trade according to the best possible forecast. This includes the procedures for allocating capacity, including the time and procedure for applying for capacity, a description of the products being offered and the obligations and rights of both the operator and the party obtaining the capacity.
- All relevant information is available for the market in due time for the negotiation of all transactions.
- All information published by the operator is made freely available in an easy way. All data should also be accessible in an adequate and standardised means of information exchange, to be defined in close co-operation with other market parties. This includes information on past time periods so that new market entrants also have access to this data.
- When forecasts are published, the *ex-post* realised values of the forecast information shall also be published, in the time period following that to which the forecast applies.

- The actual flows at the interconnector are published accordingly, (e.g. on the website) by the operator in an appropriately timely manner.

Evidently, should revised guidelines ultimately impose stricter rules, the latter should apply.

Yours sincerely,

signed

François Lamoureux

EXPLANATORY NOTE

Background

- 1 Article 7 of the Regulation on cross-border exchanges in electricity (1228/2003) allows for national regulators or Ministries to exempt certain major new infrastructure projects from certain provisions of the Regulation on cross-border exchanges in electricity (EC) No 1228/2003 and of the Electricity directive 2003/54/EC provided that they meet certain criteria. The granting of such exemptions is the task of the relevant Regulators or Member State authorities. However such decisions are subject to review by the European Commission. Specifically, the Regulation states that the Commission may request that the regulatory authority or the Member State concerned amend or withdraw the decision within two months.
2. On 23 February 2005, the Estonian Ministry of Economic Affairs and Communications and the Finnish Energy Market Authority notified the decisions to exempt the Estlink project from third party access requirements under the procedure set out in the Regulation. Under these decisions, the exemption period will end on the date when the interconnector will become part of the national transmission systems of Estonia and Finland, and in any case, not later than 31 December 2013. Within two months of receiving the notification, i.e. by 23 April 2005, the Commission may request that the Estonian Ministry of Economic Affairs and Communications or the Finnish Energy Market Authority amend or withdraw its decision.

The interested parties and their roles

3. The developer of the project is As Nordic Energy Link (NEL). The object is that Estlink Project would be executed by NEL, who would own directly half of the submarine cable and the property in Estonia. The property in Finland and half of the submarine cable would be owned by the Finnish subsidiary of NEL. NEL is the sole shareholder of the said subsidiary. The power traders will enter into the capacity purchase agreements directly with NEL.

NEL is owned by the Project Parties from Finland and the Baltic states as follows:

- As Eesti Energia (Estonia), ownership 39.9 %
- State JSC Latvenergo (Latvia), ownership 25 %
- AB Lietuvos Energija (Lithuania), ownership 25 %
- Finestlink Oy (Finland), ownership 10.1 %

As Eesti Energia is a company wholly owned by the State of Estonia. Eesti Energia is the main producer, supplier and distributor of electricity in Estonia. The transmission system operator OÜ Põhivõrk is a fully owned daughter company in Estonia.

State JSC Latvenergo is a company wholly owned by the State of Latvia. Latvenergo is the main producer, supplier and distributor of electricity in Latvia. The transmission system operator is in the process of being legally separated from Latvenergo.

AB Lietuvos Energija is a company wholly owned by the State of Lithuania. Lietuvos Energija is the Transmission System Operator of Lithuania.

Finestlink Oy is owned to 60% by Powest Oy, wholly owned by Pohjolan Voima Oy and to 40% by Helsingin Energia. Pohjolan Voima Oy is a power producer and supply company, Helsingin Energia is vertically integrated municipal energy company for power and heat.

Assumptions regarding the project

4. The purpose of the Estlink Project is to construct a DC line from the Harku 330 kV substation in Estonia to the Espoo 400 kV substation in Finland and later to control and use it. The interconnection is built with a 70 km submarine cable with a transmission capacity of 350 MW and with a 9 km ground cable in Estonia and 20 km ground cable in Finland. The investment in Estlink Project is about €110 million. The objective is that the interconnection will be ready on 30 November 2006. Power transmission is planned to start on 1 December 2006.

During the exemption period, the transmission capacity will be divided, by contractual arrangement, between Pohjolan Voima Oy, Helsingin Energia, AS Eesti Energia, State JSC Latvenergo and AB Lietuvos Energija (hereinafter these parties receiving capacity will be called project parties). This capacity allocation will be subject to the use-it-or-lose-it principle.

During the period 2009 – 2013, depending on the completion of Fennoskan 2 – project between Finland and Sweden, the ownership of the interconnection will be transferred to Fingrid Oy and the transmission system operators in the Baltic States. This transfer will take place by 31 December 2013 at the latest. The transmission capacity will then be opened to third parties without a preference clause relating to the capacity.

Review of Criteria

5. The cost of development of the Estlink project is expected to be €110 million and the project was not operational in any sense at the date when the Directive entered into force. The project therefore falls under the category of a “major, new project” in the sense of the Directive.

6. In relation to the specific criteria set out in the Regulation Article 7(1) a-f,

a) the investment must enhance competition in electricity supply;

The project will enhance competition by bringing an interconnection between the Nordic and the Baltic electricity market.

The fact that the project will be exempt from TPA does not affect this judgement. Even if it is argued that the whole capacity of the project will be controlled by the

investing parties, this will not have a negative impact on competition in the Nordic and in the Baltic electricity market.

Competition is enhanced in the Nordic electricity market because the new players from Estonia (111 MW), Latvia (69.5 MW) and Lithuania (69.5 MW) bring new capacity to be traded in the market. Similarly new players from Finland (100 MW) may be able to bring new capacity to be traded in the Baltic market.

Even if the cable is supposed to transport electricity mainly from the Baltic market to the Nordic market, the back-flow possibility will in practise bring a price signal to the Baltic market. This can contribute to creating a liquid wholesale power market to the Baltic States.

- b) *the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted;*

The financial risk associated with the project relates primarily to the fluctuation of the electricity prices in the Nordic electricity market. When the Nordic and Baltic prices come close, for example following a good water year, the electricity trade from the Baltic to the Nordic countries could become unprofitable. The parties may lose substantial part of their income or even suffer big losses. The expected rate of return for the parties is [...] ² % on the invested own capital.

Without the exemption, the investors will not be sure that they have priority access to the cable in order to ensure that they will get the difference of their production costs and the market prices for a sufficient volume. The profits for investors are expected to rise from the income from the trading of electricity. The transfer costs payable to the applicant are only intended to cover the project expenses.

- c) *the interconnector must be owned by a natural or legal person which is separate, at least in terms of its legal form, from the system operators in whose systems that infrastructure will be built;*

The project will be developed by NEL that is separate from the Estonian system operator OÜ Põhivõrk and the Finnish system operator Fingrid Oyj. OÜ Põhivõrk is fully owned subsidiary of AS Eesti Energia, shareholder of NEL, but legally a separate company. Pohjolan Voima Oy, another shareholder of NEL through Powest Oy and Finnestlink Oy, owns 25.1 % of Fingrid Oyj shares and has 33.4 % of the voting rights.

- d) *charges are levied on the users of that interconnector;*

The charges from the interconnector are levied on its users. [There is a capacity fee of [...] €/MWh regardless of the actual use of the capacity.]

- e) *Since the partial market opening no part of the capital or operating costs of the interconnector has been recovered from any component of charges made for the use of transmission or distribution systems linked by the interconnection;*

² [...] indicates confidential information which has been deleted for publication.

No part of the capital costs invested has been recovered, since this is a new project.

- f) *the exemption is not to the detriment of competition or the effective functioning of the internal electricity market, or the efficient functioning of the regulated system to which the infrastructure is linked.*

No factors according to which the exemption would be detrimental to the effective functioning of the internal electricity markets have been detected.³

According to the statement of Fingrid Oyj the connecting of the cable to the national grid does not harm the effective functioning of Fingrid Oyj's grid, provided that the use and operational responsibilities and pricing is agreed upon on the bases of the principles presented by Fingrid Oyj.

Process

7. The application was the subject of informal discussions between DG TREN, the Estonian Ministry of Economic Affairs and Communications and the Finnish Energy Market Authority during early 2005.

Conclusions

8. The decision to exempt the project from third party access for a period up to 31 December 2013 is acceptable. It implies that Article 6(6) of the Regulation (EC) No. 1228/2003 and the Articles 20, 23 (2)(3)(4) of the Directive 2003/54/EC will not be applied in this case.
9. The attached letter notifies the regulator concerned that the Commission has not decided to request the regulator to amend or withdraw its decision on this project.

³ [See the measures described in the cover letter of this decision and in the national exemption decisions to ensure competition and the effective functioning of the internal market.]