CEER Call for Evidence on

Generation Adequacy Treatment in Electricity (C09-ESS-05-03)

FORTUM Response – 27/04/2010

- Fortum regards the generation adequacy outlook in Europe good
- Fortum views that existing market framework is capable of delivering efficiency, security of supply and environmental targets in a balanced manner
- Fortum considers decisions on any additional capacity remuneration mechanisms at this point in time unnecessary and harmful for the development and functioning of the European power market

FORTUM welcomes CEER's Call for Evidence on how current and future electricity markets can provide the necessary level of "generation adequacy", as well as of demand response, to ensure functionality of European electricity markets.

FORTUM believes that generation adequacy (and security of supply in general) should be primarily sought by letting the market work and find its equilibrium; focus should be on market efficiency and market integration. While market integration proceeds, policies must become more coherent and eventually harmonised. This applies also to all kinds of subsidies, which, for example, would disintegrate renewable power generation and peak capacity from the remaining power market.

There is also an increasing risk for diverging national policies due to mainly national renewable support schemes (structural) and cyclical market conditions caused by recession (temporary). There should be a distinction between different drivers and corresponding policy approach.

Electricity sector should not become subsidy based but remain market oriented in order not to burden society with inefficient capital allocation and related costs due to biased incentives.

In light of these general remarks, FORTUM would like to present its position to the three questions by the CEER:

1) What are the key elements for ensuring generation adequacy in the competitive electricity market in EU MS and the EU as a whole?

- In general, we regard generation adequacy outlook good in the near future due to past and ongoing generation investments and temporary decrease of demand caused by recession.
- In the long run grid investments and market integration contribute to generation adequacy where local fluctuations in supply and demand even out over aggregated larger market and price areas. Not only generation but also retail business serving the customers will benefit from stronger infrastructure.

- We believe that efficiently functioning electricity markets would deliver an appropriate level of generation adequacy through a balanced generation mix and market-based demand response, including smart grid development.
- In market based environment price spikes are needed to cover costs of back up capacity and to give incentive to demand response and storage capability.
- Other distortions, such as price caps/floors in wholesale markets, also alter the generation mix by artificially limiting price signals for investments. These distortions should be removed.
- Support levels for renewable electricity must be valued in competition. Support mechanisms for renewable energy should be market based and harmonized Europe-wide. Support schemes should be clear and transparent leaving no room for hidden subsidies.
- Given the development of the internal electricity market, the Commission should study the possibilities for a legislative proposal for revaluating future needs and harmonisation of renewable support schemes, and opening up trade for green values in Europe in the context of the review of the RES Directive in 2014 at the latest.
- Market rules (e.g. balancing responsibility) should be harmonised among the different Member States and technologies.

2) Do you observe any barriers for investing in new generation capacity? If yes, please list and explain them

- In general, we regard framework conditions for generation investments in Europe rather good although there are natural uncertainties related to expectations of financial returns on invested capital.
- Lack of grid investments which can result in developing smaller price areas will increase barriers for generation investment. The smaller the price area is, the more difficult it is to make market based investments. If plenty of subsidized capacity is built in a small price area, it will be partly at the expense of market based capacity. Larger price areas have better capability to absorb new investments into generation. Entry barriers caused by weak grid should be removed by grid investments and counter-trade financed via grid tariffs.
- Large penetration of politically driven RES, combined with mandatory priority of dispatch, alters the generation mix and the market equilibrium, making investments in conventional technologies riskier and less attractive. Furthermore, national capacity payments or RES subsidies in one country may hinder new investment in neighbouring country which has less generous subsidy scheme in place.
- Possible non-market based subsidy competition between countries creates uncertainty. Unpredictable subsidy policies may result in speculation and de facto entry barriers for new investments. If market based renewable subsidy systems were harmonised, subsidy levels of member states would find equilibrium and investments would be made efficiently in places where the natural conditions are most favourable.
- The increasing share of intermittent RES generation is likely to lead to more frequent price spikes. Price spikes are needed to signal need for peak and reserve power plants, activation of demand response and storage capability.
- Differences in environmental regulation requirements, as well as power plants and grid authorisation procedures and delays in licensing procedure create distortions and barrier to investments.
- Further barriers are caused by delays in grid connection and high capacity-based grid tariffs for generation.
- Inadequate competition in gas supply and in gas market flexibility

3) In case of additional measures for ensuring generation adequacy, what would be the key issues to take into account?

First we would like to highlight the fact that current market models in Europe have shown capability to deliver high security of supply and generation adequacy despite strained conditions. We doubt whether society and citizens in general have serious concerns relating to their everyday electricity supply in terms of generation adequacy.

There is no system which could guarantee 100% security of supply and generation adequacy under all circumstances and all additional mechanisms have a cost through lower economic efficiency.

However, following additional measures can work positively towards ensuring generation adequacy in the common electricity market:

- Removal of existing wholesale price caps and regulated end-user prices
- R&D support for demand response, power storage technologies, smart grids, super-grids etc.
- Rapid implementation of the existing grid investment plans in Europe and call for the development of a top-down grid plan for 2020 - 2030 period
- Rapid EU-wide market coupling of spot markets and integration of intra-day and balancing markets
- Adequate operational system reserves to be always contracted by the TSOs, taking into account the increasing volumes of intermittent generation
- Licensing of power plants and grid investments should be accelerated
- Flexibility mechanisms should be allowed in Industrial Emissions Directive in relation to reserve power plants

FORTUM has strong reservations for making decisions on capacity payments or capacity markets at this point in time. They lead to additional subsidy needs for other types of generation and thereby distort the energy market in the long-run. Capacity remuneration removes incentive to develop demand response and energy storage which are cost efficient tools to safeguard system stability. Potential benefits of additional, subsidy-based generation capacities will soon be exhausted by additional power demand.

If such arrangements are implemented with short notice, they will most likely be national creating spreading disturbance to neighbouring countries over time. Also, in capacity payment based system the national regulator decides how much capacity must be in place (base load, mid-merit, peak-load and reserve capacity) instead of the market. This would be counter-productive for the common European electricity market development. Capacity subsidies create a never ending loop and will not contribute towards balanced result between efficiency, security of supply and environment in the European target model for power market.