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Stromnetz Berlin GmbH
Puschkinallee 52
12435 Berlin

Consultation2014O01@acer.europa.eu

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Response to the ACER public consultation:

“European Energy Regulation – A bridge to 2025“

Vattenfall welcomes the opportunity to provide our views on areas that should be given the highest priority developing the single EU Energy Market.

Introduction

The main objectives of a regulatory framework are to facilitate cost efficient use of resources and provide signals for long term investments. Market price signals can provide all this and may at the same time offer end-users real control of their energy costs.

To ensure that the regulatory framework supports the market efficiently, it should be transparent and must be as predictable as possible. The framework should be designed in a way that poses the smallest disruption to past investments.

Regions in Europe face similar, but not identical, challenges. We propose to review the feasibility of regional solutions and explicitly focus on trade to further develop the internal market as the tool to deal with these challenges. The proposed market approach will encourage convergence and harmonization of rules and regulatory frameworks between regions. Vattenfall would like to see a regulatory framework that supports:

- the role of cross border trade on day ahead, intraday and real time is recognised as a tool to balance and encourage convergence and harmonization of rules and regulatory frameworks;
- a review of the feasibility of regional solutions. Regional specificities should not hinder further development of regional entities and the integration of regions;
- that all market actors, on a level playing field, are provided with options to adjust their positions close to real time;
- that all price caps on commodity are removed;
- that all demand is provided with the option to be active in the market;
- a development of smart grids and meters in the direction to support the option of individual supply adequacy;

- that the targeted supply adequacy level is properly defined¹;
- market coupled merchant interconnectors as a driving force for cross border capacity development in the best interest of European end-users.
- the roll out Smart Meters and standardisation of data formats and access to smart meter data is prioritized as the main enabler for development of products and services in the market;
- that harmonised structures for retail market set-ups on a European level are hard complex and time consuming processes. ACER's regulatory efforts should primarily focus on harmonising the formats of meter data and harmonising the interfaces of (transparent) access to this data. This is possible and would have a tremendous impact on the market development.

A. Electricity wholesale markets

1. Have we identified correctly the issues and trends within each area of the energy sector?

Vattenfall strongly supports the general approach of ACER, i.e. the need for a strong push for full implementation of network codes and in specifically coordinated cross-zonal capacity calculation and market coupling across all time frames and borders (including balancing market integration as a significant part).

In real time aggregated supply and demand should continuously match. To make that as efficient as possible, the supporting market arrangements for intraday, day ahead and forward should reflect the physical reality of real time as much as possible. Thus, Vattenfall agrees with ACER that market designs should enable pricing that rewards elasticity both on supply and the demand side providing a level playing field where the willingness to increase/decrease generation/consumption on a short notice is incentivized. (section 2.9)

Every step towards developing CRMs needs to be clearly justified and carefully evaluated on a cost efficiency basis. As long as supply adequacy is regarded a public good, the evaluation of supply adequacy should be guided by a targeted supply adequacy level so that costly over capacities are avoided. Where the assessment shows that additional capacity is needed to maintain the targeted supply adequacy level, a proper competitive environment for such mechanisms needs to be guaranteed. The impact on cross border exchange from different national measures both what regards design and time constitutes the biggest threat to the internal market.

Having said that, Vattenfall misses a dimension separating trends of national fragmentation from trends related to the energy transition as such. Where the latter require detailed regulatory response included in the document, implications from the former will require more political actions, for example a new set of instructions to national regulators.

¹ Until this requirement is fulfilled, a strategic reserve is the measure that involves the least risk for costly overcapacity.

2. Have we identified an appropriate regulatory response?

Vattenfall strongly supports message of section 3.1 *that*

“European-wide implementation of fully coordinated short-term trading, through liquid intraday and balancing markets, will create routes to signal the value that markets place on flexibility, as well as offering a greater range of balancing tools that can provide market-based solutions to the RES challenges.”

Significant potential for further refinements remains in areas of how existing assets and infrastructure are used across borders (e.g. *grid congestions and coordinated cross-zonal capacity calculation*)

Thus, Vattenfall wish also to give full support to the communication of section 2.2

“coordinated cross-zonal capacity calculation, forward-capacity allocation, day-ahead and intra-day market coupling, and integrated cross-border balancing will ensure that the existing assets and infrastructure are used in more efficient way to deliver electricity to consumers at the cheapest possible price”.

In relation to what is expressed in section 2.5 on the *appropriate tools for market participants and system operators to manage close-to-real-time changes*, Vattenfall would like to point out that **the key to properly address and allow the market to express value of flexibility is reached through a timely and gradual adaptation of the market framework e.g. gate closure, or shorter market settlement periods rather than separate and/or new products.** The development of products should be on a voluntary basis.

Vattenfall proposes to complement the list of regulatory responses with:

- A review of regulatory framework to facilitate regional market integration as a way to further the development of cross border co-operation building on the already achieved integration on a European scale.
- The development of a roadmap for gradual development of the market framework including but not limited to shorter imbalance settlement periods and a development of gate closer to accommodate full market integration of variable energy sources. This road map would counteract the need of market intervention.
- A review of potential supplementary measure to develop the intraday market and end the intraday market timeframe with an implicit auction² and at the same time provide TSOs with an incentive to update their capacity calculation intraday.
- Activities set to define a targeted supply adequacy levels that should be maintained by the responsible entity.

² I.e. a hybrid solution including both continues trading and an ending auction.

3. Which regulatory actions are most important and should be prioritised?

Firstly, the single most important action is to provide a regulatory response to off-set the negative impact on incentives for cross border trade following the plans to introduce of capacity remuneration schemes. From the list “Summary of possible regulatory actions” in the annex, Vattenfall would like to give the highest priority to the following actions:

- *the need for the rapid implementation of the present electricity Target Model across all geographies and market timeframes and commit to review the need for any changes;*
- *proactively advise on the design of interventions so that the goals of security of supply and competitive markets are met as far as possible;*
- *review the process for the development, modification and enforcement of network codes to ensure that it is effective and that the present governance arrangements are robust to the future pace of change.*

A premature decision to apply additional regulatory intervention will work as a vicious circle, dampen the market based incentives and increase the costs of subsidies even further.

Secondly, Vattenfall strongly agrees with what is referred to in paragraph 2.8, i.e. that current concerns regarding the generation adequacy are directly related to the increasing need to manage greater and more sudden fluctuations in the supply system. The current lack of profitability of certain generation plants is the expected and correct price signals from an oversupplied market.

To meet this, the regulatory framework should seek to avoid and remove distortions to the energy price formation and activate the demand side. The regulatory framework shall provide consumers and producers with market based incentives for them to adopt to price signals rather than adding unnecessary regulatory intervention. From the list in the annex Vattenfall recommends that the following action is prioritised:

- *further analysis to develop and improve the common European balancing target model defined in the Network Code.*

Thirdly, Vattenfall strongly shares ACER's view that the governance arrangements of ENTSO-E need to be adjusted to better support a cross border perspective. A strong regulatory framework that requires TSOs to allocate their full grid capacity across all time frames and all locations is the single most important regulatory measure to counter the trend of national fragmentation. A strong implementation of the Capacity Allocation and Congestion Management Network Code is the key to take the internal market to the next level. From the list in the annex, Vattenfall recommends that the following action is prioritised:

- *assess the appropriate level of regulatory oversight for power exchanges and other market coupling operators, and trading and capacity allocation platforms;*
- *assess whether bodies performing pan-European functions are regulated adequately and proportionately;*

4. Are there other areas where we should focus?

Furthermore Vattenfall would like to complement the regulatory action list with:

- Activities to support a development where intraday, day ahead and forward should reflect the physical reality of real time so that aggregated supply and demand are continuously matched, including areas such as:
 - o development of gate closure times;
 - o developments towards shorter imbalance settlement periods and shorter imbalance periods (towards 15 minute) that further reveals flexibility on supply and demand side;
 - o implementing pay as clear principle in all balancing markets;
 - o harmonize imbalance settlement prices as the marginal price used for up- or downward regulation. In case no regulation has been done imbalances should be settled with the day-ahead price established in a defined market place,
 - o ensure that all market actors are responsible for their imbalances;
- the development of a regulatory framework that opens up for regional development as a driver for increased cross border integration, complementary to, not replacing, the EU-wide development up to date;
- activities on transmission tariff harmonisation;
- activities to monitor and counteract unintended negative consequences for the EU-ETS from the increasing amount of subsidies and calls for additional CRMs for other capacities. An energy only approach is also the design option that has the best preconditions to deliver a cost efficient fulfilment of any CO2 reduction target.

B. Gas wholesale markets

2. Have we identified an appropriate regulatory response?

We support the statement that markets are becoming more integrated. . We believe the integration that can be seen in the current market results from the 2nd and 3rd energy packages and started to happen (slowly) from the moment the liberalisation of the gas markets in Europe started. . In addition, we believe the European gas Network Codes, that will be implemented in the coming years, will further contribute greatly to the market integration in the EU.

Vattenfall strongly supports the work that has been done with the realisation of the European Network Codes up to now, especially concerning the CAM and Balancing codes. We believe that the application of these codes in the European markets will certainly have a continued and increasing positive effect on market integration in gas.

With regards to possible elements of the gas sector that may limit market integration, we do not believe that supply and demand uncertainty is the only important issue. Vattenfall, together with all other European market parties, specialise in the assessment and prediction of supply and demand. We believe that there are many factors that are currently, and in the future, changing the supply–demand situation, such as the economic crisis, the situation in the Ukraine, shale gas development in the US as well as in Europe. However, it should be made clear that supply and demand changes are not the same as supply – demand change **uncertainty**. However, we support the belief that decreasing demand and supply (rather than

a fluctuating demand and supply) is likely to have negative effects on transmission tariffs and market liquidity.

In addition to the mentioned difficulties regarding decreased supply and demand, Vattenfall believes that gas market integration and further development suffers from some other problems, of which regulatory uncertainty is the most important and least predictable one. Political and regulatory decisions with regards to the market design and transmission situation often have a direct effect on the functioning of this market. These market developments are much more difficult to predict than supply – demand changes. For these, we are fully dependent on transparency of the regulation and policy makers, as well as timely publication and clarification. Considering that many investments in the gas market, such as storage and power production facilities, are made with a very long time horizon (often several decades), timely publication of regulatory changes is not even sufficient, if they take place after the investment decision has already been taken and construction has started or is already completed. In such cases, a market environment with frequent changes in market design – such as the current European gas markets – discourages long term investments and planning by market parties. We believe this could limit the further integration of markets and should be prevented.

Finally, Vattenfall agrees with ACER that cross-border cooperation has significantly improved over the last years. However, we would also like to point out that all European gas network codes strongly depend on this cross-border cooperation, but currently do not foresee in mandatory regulatory compatibility. The Network Codes leave some room for national markets to select from different options, when implementing these codes. Although we realise this may sometimes be appropriate in case of physical market differences, we believe it is very important that neighbouring markets align their choices and provide the market with an assessment of the possible impact of the use of different models and mechanisms on two sides of a border. We believe that currently, bordering regulators and TSOs are only obliged to coordinate their decisions. However, this does not oblige them to ensure that a workable solution is realised (through market consultation). We understand, both from regulators and TSOs that they themselves also sometimes struggle with this lack of steering, as they talk to each other, but do not have a mechanism to ensure they come to a solution together.

Vattenfall believe gas market integration would greatly benefit from extra attention to the compatibility of cross-border national decisions, following from the implementation of the network codes. This does not imply a full harmonisation at all border points. It does, however, require an assessment of the possible effects of different choices on each side of an IP, and a market consultation on the best solution for possible problems.

With regards to ACER's statements on the gas market's role in providing flexibility, we can mention that we are very pleased to find that ACER recognises the changing role of gas fired power plants in a market with increased RES power production. We support the statement that arrangements must be made to facilitate this changed role in the future.

3. Which regulatory actions are most important and should be prioritised?

Vattenfall can relate to ACER's stakeholder summary, regarding the need to hold off on new regulation until the current large amount of new European rules is implemented and had a chance to show its effects. We believe that the implementation of additional regulation on an EU level that may interact with the rules of the Network Codes will, at the least, make it impossible to assess which rule has which effect. In the worst case, additional (possibly market disrupting) rules are implemented to fix a problem that would already be solved by another – earlier - piece of regulation. For this reason, we fully support ACER's plan to

prioritise the effective implementation of the 3rd energy package. In addition, we also support the intended efforts towards the removal of regulation regarding end-user commodity prices.

ACER statement: "We will review the Gas Target Model to ensure that it remains a flexible regulatory framework for gas wholesale markets, identifying the most appropriate measures to develop liquidity in all markets and timeframes including possible tools of market integration."

Vattenfall recognises ACERs wish to increase market liquidity and as a company that trades gas in Europe, we support this aim. However, we believe there are other elements than the size of a market that limit its liquidity. We strongly believe that markets can act together as a single bigger market, without the requirement of integrating these markets on a physical level. Increasing the size of a market, in the first place, only increases the number of end-users within such a market, not necessarily the number of counterparts that could increase competition. In addition, (physically) merging two or more markets decreases the number of entry and exit points at borders. However, the underlying system costs remain the same (or even increase). This means that the tariff for entry and exit points in this new bigger market will have to go up. This in turn can act as a barrier for market parties to enter this market. This effect is strengthened due to the requirement for inter-market grid investments to enable the TSO to manage his bigger grid.

Vattenfall strongly believes that ACER could help facilitate market liquidity by removing remaining barriers to enter markets, such as storage obligations or restrictions concerning end-user supply, regulation and TSO terms & conditions published only in the local language and certain rules to obtain shippers or trading licences. We believe that solving these barriers will allow European market parties to become more active in all EU markets and will increase possibilities for new entrants to contribute to market competition and liquidity, as a properly implemented entry-exit system with a virtual hub and transparent information regarding system and portfolio balance will in fact allow trading and the flow of gas between markets as if they were a single market. These improvements, in our view, will follow largely from the implementation of the European Network Codes. Only with regards to the specific barriers mentioned above, additional action could be required and should be consulted upon.

ACER statement: "Uncertainty about future European gas supply and demand requires a flexible framework that allows market participants and system operators to react efficiently in changing circumstances."

Vattenfall strongly supports the above ACER statement. In addition to the mentioned benefits, a system that is flexible enough to withstand a strongly changing market can provide more stability and limit regulatory risk for market parties. This stability is a very important factor to provide a stable investment climate and to ensure market parties venture into currently illiquid markets.

As indicated above, we strongly support the regional approach to cooperation, as mentioned in paragraph 3.16 of the ACER document. We recognise the problems following from the voluntary nature of the GRIs. However, we also wish to call for caution regarding the development of regional regulation, as this could decrease transparency. For Gas we believe that a stricter monitoring and enforcement of the EU Network Codes could already increase regional issues, as they call for regional coordination already. We believe the biggest question in this respect is which institute could monitor and effectuate this task, as this cannot be a national body and must be able to address coordination issues between both TSOs and NRAs.

Considering the flexible electricity production mentioned in paragraphs 3.19 and 3.20, we support ACERs recognition of the possible role of gas fired power plants in the future production mix. We fully agree with the proposal to address the differences between the gas

and power market design to analyse possible efficiencies that can be gained. Naturally, the gas-fired power plants are currently suffering from decreased demand and an unfavourable fuel price situation. If, on top of that, running hours will continue to decrease – as is envisaged with an increasing share of renewable production, the financial situation could become critical. Vattenfall proposes to, in addition to the efficiency that could be gained in aligning the gas and power market design, ACER should also consider the gas market design in general. Gas market rules that match the historic (high amount of running hours) utilisation of the plants, could become less sensible within a system where the number of running hours decreases. For example, the CAM and Tariff Network Codes envisage a shift from long to short term actions at cross-border points. For this reason, capacity products and prices are thought to be adjusted to allow a more flexible capacity booking in line with actual requirements. However, at exit points of power plants, this flexibility is not necessarily guaranteed or arranged at a European level. This leads to an increase in capacity cost per running hour, which has a negative effect on the merit order position of gas-fired power plants. Specific attention to the cost allocation within the Tariff Network Code and subsequent national implementation is advisable.

C. Infrastructure investments

1. Have we identified correctly the issues and trends within each area of the energy sector?

Vattenfall shares ACER's view that the rapid growth of renewable energy generation capacity, increases the importance of a strengthened transmission grid and that this grid must be governed by a European perspective. An enforced cross border infrastructure enables sharing of generation capacity and resources, leading to lower costs for consumers.

As important as developing new connections is that existing transmission capacities are operated in the most efficient way. In the light of a persistent surplus capacity Vattenfall favours a market driven consolidation that would financially help all remaining capacities. In case policy does not trust the market alone or accepts the claims for subsidies, a "Strategic" or "System" Reserve would fit best.

2. Have we identified an appropriate regulatory response?

Insufficient development of transmission capacity is one of the main obstacles for the internal market. Vattenfall therefore encourages ACER and NRAs to look for measures to speed up the processes not only for projects of common interest, but for all transmission development related initiatives and projects. One way to guarantee some level of development across borders would be to open up for 3rd party interconnector projects, conditioned on that the full capacity is handed over to the market coupling operator and the operation to the system operator. Thus, Vattenfall proposes to complement the list of regulatory responses with:

- **An initiative to evaluate the potential contribution from market coupled third party projects (merchant links) as a complementary driver for TSO-driven cross border capacity development.** Currently, the exemption in article 17 of the IEM-regulation is not applied in a consistent and foreseeable way³. Being a natural monopoly the optimal quantity of transmission grid needs to be realised through a

³ See EUI Policy Brief "EU Electricity Interconnector Policy: Shedding Some Light on the European Commission's Approach to Exemptions" ISSUE 2012/06 • June 2012

regulated tariff. However, a third party project, subject to a fair regulatory approval and conditioned to use the market coupling mechanism would drive the desired interconnector development when the regulated TSO fail to generate progress within the regulated approach.

4. Are there other areas where we should focus?

Vattenfall would like to complement the regulatory action list with:

- Activities aimed at incentivise that cross border capacity is developed according to socioeconomic levels identified in the TYNDP closing the gap between socioeconomic potential and real development, here a combination of regulatory measures may be applied, among those a revised and harmonised application of the merchant links exemption.
- Adopt regulatory framework to incentivise the use of new technologies facilitating public acceptance (e.g. through reduced environmental impact).
- Evaluate under what conditions merchant links effectively may complement the TSO driven development. (see above)
- Focus on distortive negative externalities of CRMs on cross border development (see response on section A wholesale market for electricity)
- The regulatory framework must support a cross border governance structure that does not disqualify future organisational forms.
- One potential way to speed up the cross border co-operation of transmission system operation would be to launch a pilot project where system and market operation are optimized cross border and the potential for cost savings for society may be properly evaluated based on empirical data. Such an entity could also perform part or all of the activities referred to in the first bullet above.

D. Consumers, retail and the role of DSOs

1. Have we identified correctly the issues and trends within each area of the energy sector?

ACER's description provides a good overview of the main drivers that will drive the development on the consumer side of the market. In general, the (smart) developments on the electricity side revolve around better access to data and lowering market barriers so that all market actors can participate in the market when wanted. Improving access to data should be one of the main tasks for DSOs/ TSOs, while regulators should focus on lowering market participation barriers.

In line with ACER's analysis we expect much bigger changes on the electricity- than on the gas side. Changing gas qualities is a thing to keep a close eye on however. Increased feed-in of locally produced green-gas, will put additional requirements on DSOs to maintain the desired gas quality as the producers will probably not be able to match the existing standards.

2. Have we identified an appropriate regulatory response?

According to Vattenfall, one of the main reasons that there have been relatively limited developments in the area of Demand Side Response (DSR) and Energy Efficiency services is that the business case in many cases is just lacking. In principal smart metering is necessary

to trigger DSR. For energy efficiency the high upfront investments are an important barrier for customers (even though the business case is often positive), while for DSR services the current price differentials do not give sufficient (price) incentives to customers to engage in DSR. With standardized interfaces for collecting data from electricity meters and standardized formats for centralized meter data management, the cost for supplying DSR will decrease significantly. Easy access to real-time and historic data will be the basis for further development of products and services in the market.

Overall, Vattenfall argues that it is the task of the national regulators to define the minimum standard of the data that a DSOs should provide to its customers. Data demanded by customers that exceed the basic data can be offered by the DSOs as an extra service and should fall outside the scope of the regulation.

The relevance and beneficial contribution from Demand Side Response will increase with the level of RES penetration. By the time that higher RES levels make market prices more volatile (and not just lower), and customers are increasingly exposed to these market prices on a real time basis Demand Side Response measures will become attractive. For this to happen market actors should become increasingly responsible for their own imbalances as also is envisioned in the revised State Aid Guidelines. This, in combination with easier market access should help to develop DSR to the needed level.

Especially on the retail market level, ACER should acknowledge regional differences. Harmonization of retail markets in Europe should not be a goal in itself, but be carried out where necessary to create a level playing field and accurate price signals. Unlike on a wholesale market level, the benefits of full harmonization in retail markets are much smaller, while it remains a very costly exercise. Harmonization should mainly focus on improving price signals.

The DSO should be responsible for the management of data and making it available to the market in a non-discriminatory way. DSOs should not become more active in the ESCO area, but focus on smart metering and smart grids. Because these developments require big investments, the regulatory framework for DSO's should be structured in such a way that DSO's are able to make the necessary investments.

3. Which regulatory actions are most important and should be prioritised?

We want to support ACER's approach that primary focus should be on fully implementing the Third Package. This is particularly important for those elements of the Third Package that help to improve the accuracy of price signals (e.g. the 'market' Network Codes) and which should have absolute priority, before ACER's focus shifts to developing new regulation.

The focus of DSO unbundling should further be to fulfil the Third Energy package and the Energy Efficiency Directive (2012/27), and mitigate the existing exemptions that prohibit the development of a level playing field. These unbundling rules will also ensure that smart meter data is used and delivered in a non-discriminatory manner. At this point, we do not believe that ownership unbundling will help making the energy system 'future proof'. Access to data and data transparency is not improved by ownership unbundling of DSOs.

In the case of an output-oriented incentive regulation, the "outputs" (output parameters indicating the productivity of the DSO) shall be chosen such that they reflect the tasks of the DSO with their cost drivers in a way that expected and real financial remuneration enable the DSO to cover all costs of capital including risks, and give an incentive to carry out the tasks.

Since grid structures differ among DSOs, one set of “outputs” may not be applicable to all DSOs. Additionally in most cases the chosen output parameters are not measurable and also not influenceable by DSOs.

Besides, the DSO’s tasks may change over time, reflecting changing political goals (e.g. connection of distributed generation units or preparation of smart grids). With these cost drivers varying over time, the “outputs” which shall reflect the costs have to be adapted as well.

Further regulatory intervention should primarily focus on getting price signals right. Price caps in wholesale markets need to be removed, regulated prices in retail markets need to be abandoned and DSOs need to incentivise “smart” technology where suitable

4. Are there other areas where we should focus?

Consumers should increasingly be provided with the possibility to decide if they want to be exposed to real time prices or want complete price certainty. Real time balancing information (and prices) will therefore increasingly be needed from specific customers. Similarly, it should also be up to consumers to determine if they want full supply adequacy contracts or contracts with possible load reductions.

Furthermore - as all demand is provided with the option to be active in the market, the activity of aggregation of demand response must be properly defined and regulated. All market actors should be increasingly responsible for their own imbalances, thus retailers should not be responsible for the imbalances of other parties (e.g. third parties that are offering DSR solutions to our customers i.e. Aggregators).

Judging from the Nordic experience integrating retail markets is a very complex process going beyond changes in market model (“Target model”, balancing services, supplier of Last Resort, regulated pricing) into areas such as harmonisation of for example consumer rights, tax structure and distributed generation rules. Altogether, this makes retail market integration slow and hard to achieve. On the other hand, it has become clear that standardisation of meter data formats and access to meter data can be achieved, although the systems are slightly different and the set-up of the markets vary. Together with promising signs that there is a standardised plug-in for connecting to smart meters under way, the outlook for the development of a Nordic market for DSR service and meter data based products looks promising. Thus, the integration of Nordic energy services based on smart meters is likely to emerge long before the full integration of the Nordic Retail markets. The same probably goes for Europe as a whole. Thus, in order to reap the socioeconomic benefits of a harmonized European market for energy services and DSR services ACER’s regulatory efforts should primarily focus on harmonising the formats of meter data and harmonising the interfaces of (transparent) access to this data. This is possible and would have a tremendous impact on the market development



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