Strelia

Strelia Energy Newsflash (II)

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Emergency measures to mitigate high energy prices:

the EU Commission's proposal aiming at mitigating high electricity prices

1. *Introduction*

On Friday 9th September 2022, EU energy Ministers held an extraordinary meeting on the energy situation in the EU with two exchanges of views. The first discussion concerned Ministers' preferences on different policy options to alleviate the burden of high energy prices on citizens, public services, businesses and industry, which could be implemented at the EU-level in a short timeframe. During the second discussion, Ministers then presented the state of play of the preparedness of their country for this winter.

For the first exchange of views, the discussion was mainly based on (i) a presidency background paper highlighting several options for short-term actions that could bring relief to the energy situation and (ii) non-papers from the Commission providing a preliminary assessment of options for emergency measures to reign in soaring electricity and gas prices.

Following this discussion, the Commission was expected to act in four main areas: (i) capping the revenues of electricity producers that face low production costs; (ii) a possible price cap on gas; (iii) measures for a coordinated electricity demand reduction across the EU; and (iv) measures that would help solving the issue of decreased liquidity.

The Commission published on 14 September 2022 its proposal concerning measures (i) and (iii) above aiming at mitigating high electricity prices.

This Newsflash is an update of our previous Newsflash of 13 September 2022 which highlighted the main measures discussed last Friday and put them into perspective compared to (i) the REPowerEU Plan and the short-term emergency measures and options for long-term improvements of Energy Markets presented by the Commission in May 2022 (discussed in our previous Energy Newsflash here); and (ii) the relevant non-papers and other background information that circulated last week.

As a follow-up of our last publication, we provide in addition insights and a preliminary analysis on the Commission's proposal on measures (i) and (iii) above aiming at mitigating high electricity prices.

2. *Forthcoming Commission proposals*

Based on the Commission's own contribution and following their first discussion, Ministers invited the Commission to:

1) Propose measures aimed at **capping the revenues of inframarginal electricity producers with low costs of production** and at **introducing a solidarity contribution from fossil fuel companies** to be used to mitigate the impact of high energy prices on customers.
    - The Commission had already considered in May 2022 that, in line with the Communication "Security of supply and affordable energy prices: Options for immediate measures and preparing for next winter", taxation or regulatory measures which are aimed at removing inframarginal rents of certain baseload electricity generators could be justified as a short-term intervention measure (see here). The Commission already stated then that such a measure should be non-

discriminatory and designed in line with the guidance provided in Annex 2 to the REPowerEU Communication of March 2022 which specified, among others, that:
  - Such a measure should be limited and tied to a specific crisis situation.
  - The measure should not affect the formation of wholesale electricity prices based on marginal costs expressed by the merit curve, hence preserving the efficiency of price signals for short-term operational decisions. In case of any doubt, lower levels of excess gains should be clawed back to avoid impacts on price formation.
  - Long-term price trends resulting from structural market developments and the carbon price signal from the EU ETS should not be affected, so as not to interfere with long-term price signals.
  - The additional inframarginal rents should be clawed back only in the time periods when gas plants were marginal and to the extent that such additional inframarginal rents were effectively earned by inframarginal units.
  - The measure should not distinguish different generation technologies. It should include any inframarginal units operating in the hours of application of the tax, e.g., inframarginal rents from hard coal and lignite-fired generation, renewables (including hydropower) and nuclear.
- In its non-paper of September 2022, the Commission further explained that:
  - The implementation of such a measure could either be mandatory for all Member States or optional.
  - The cap could most easily be applied to the organised day-ahead market.
  - Member States would be obliged to share the resulting revenues with electricity consumers with a view to lowering their electricity bills. This measure could therefore be linked to the measure on demand reduction if Member States use the resulting revenues to incentivise consumers to do so.
  - The measure would have to be designed carefully so as to avoid capacity withholding by generators or blocking potential new entry technologies. The amount of the cap is particularly relevant in this respect.
  - Capping inframarginal prices can lead to a situation where investors do not believe in their ability to recoup investment costs in periods of high electricity prices. This can increase the need for public support. Risk can be mitigated by setting the cap at a level that still provide incentives to invest in decarbonised technologies.

➔ In its proposal, the Commission linked together three specific measures aiming at alleviating the retail price paid by the final customers (be it a household customer or a small and medium-sized enterprises (SMEs)): (i) mandatory cap on market revenues and distribution of surplus revenues to final customers in order to finance public intervention in retail electricity prices; (ii) (non-mandatory) temporary extension of public interventions in electricity price setting (even below cost); and (iii) mandatory solidarity contribution from surplus profits to finance support measures to help customers.
  - Mandatory cap on market revenues and distribution of surplus revenues:
    - The implementation of this measure will be applied in all timeframes (yearly, quarterly, monthly, day-ahead, intraday and balancing) and concern both OTC or transactions taking places on power exchanges.
    - The cap is set at 180 €/MWh given that, before February 2022, the average peak prices in the electricity wholesale market were significantly and consistently expected below 180 €/MWh across the EU in the last decade (Recital 22)).
    - Inframarginal technologies subject to the cap are wind, solar, nuclear, hydro, biomass, geothermal, waste, lignite and oil (crude oil and other oil products). The following

technologies are excluded from the cap: gas, coal, storage (such as battery and hydro pump-storage) and demand response. The reason advanced by the Commission for excluding these technologies is that they compete in terms of flexibility with gas technologies (Recital 34).
    - This measure shall apply from 1st December 2022 to 31 March 2023.
- <u>Temporary extension of public interventions in electricity price setting (not mandatory):</u>
    - Extension of public intervention in price setting for SMEs (energy poor and vulnerable customers):
        - should be limited to 80% of the beneficiary's highest annual consumption over the last 5 years and maintain incentives for demand reduction;
        - should comply with the conditions of Article 5(4) and 5(7) of the Electricity Directive 2019/944;
        - could be below cost.
    - Temporary possibility to set prices below cost:
        - should be limited to an amount of the beneficiary's consumption and maintain incentives for demand reduction;
        - should comply with the conditions of Article 5(6) of the Electricity Directive 2019/944;
        - suppliers are compensated for supplying below cost;
        - all suppliers are eligible to provide such offers below cost.
    - These extensions shall apply the following day of the publication of the adopted new EU regulation.
- <u>Mandatory solidarity contribution from surplus profits to finance support measures to help customers:</u>
    - This measure concerns companies active in the field of oil, gas, coal and refinery sectors, i.e. EU companies or permanent establishment generating at least 75% of their turnover in the field of extraction, mining, refining of petroleum or manufacture of coke oven products.
    - The contribution shall be calculated on taxable profits which are above a 20% increase of the average taxable profits of the three fiscal years starting on or after 1 January 2019.
    - The rate applicable for calculating the contribution will be at least 33% on the above base.
    - These extensions shall apply the following day of the publication of the adopted new EU regulation.
    - This mandatory contribution shall apply from 31 December 2022 at the latest and only to surplus profits generated in the fiscal year that started on or after 1 January 2022.

- While the two last measures seem to be reasonably straightforward to implement (except for determining what is "below cost"), our assessment will be limited to the mandatory cap on revenues and the distribution of surplus revenues:
    - In order to avoid a tax and an administrative burden, electricity producers could decide to sell volumes generated by the technologies subject to the cap at a price equal or below 180 €/MWh depending on their marginal costs (including their opportunity costs). However, there is no certainty that these producers will adopt such a behaviour.
    - The easiest place for applying such a cap would normally be the day-ahead power exchange. However, this could be challenging even for this marketplace. Indeed, a lot of volumes sold on this marketplace consist of (i) "incompressible" electricity production coming from

derivative products for which it could be almost impossible to identify the underlying production technology and (ii) flexible technologies such as gas and hydro pump-storage units which are not subject to the cap. On the other hand, "incompressible" production from nuclear units which has not already been sold on the forward markets (in order to hedge the production) could be identified.

- It is also questionable why flexible technologies such as oil units (like turbojets) are subject to the cap while the other flexible technologies are not.
- For longer timeframes transactions such as selling expected wind production from a PPA on a quarter-ahead or month-ahead basis, revenues could be higher than the cap. However, if the wind production is lower than expected (as it was the case this summer in Belgium), producers need to source the missing production on the spot day-ahead and intraday markets (when the real production is well-known) at price driven by more costly marginal technologies such as gas units. The same observation could be made with respect to nuclear production which becomes unavailable. Therefore, a (tax) recovery scheme should preferably be put in place by Member States for suppliers facing such a situation.
- It is not clear how the distribution will be implemented: are the Member States going to redistribute the surplus through a tax scheme or are they going to request electricity supplier to do it by themselves? In any event, a minimum tax scheme will be necessary to be put in place as not all electricity suppliers are making surplus (such as non-vertically integrated electricity suppliers or electricity suppliers significantly affected by the current crisis).

2) Propose **emergency and temporary intervention, including gas price cap**. Specific measures in this regard should also help limiting the impact of high gas prices on EU electricity markets and energy prices for customers. Such measures should aim at benefiting European consumers to alleviate social and economic consequences of the current high energy prices, and European companies in order not to endanger their competitiveness, while preserving the incentive to reduce gas and electricity consumption and the market signal for decarbonisation.
   - A gas price cap was also already envisaged by the Commission in May 2022 as a short-term intervention measure. The Commission explained that solidarity mechanisms in case of a national security of supply emergency may also trigger the need for an administrative price for gas to be established in parallel, such as a maximum regulated price for natural gas delivered to European consumers and companies (EU price cap) to cover the period of a declared Union emergency. This type of price intervention would be limited to the duration of the EU wide emergency situation. The Commission specified that one possibility would be to limit price formation during this disruption scenario by capping the price on European gas exchanges, but that such a price cap could in general be introduced in different ways and could intervene at different levels of the gas value chain (see here).
   - In its non-paper of September 2022, it is further explained that:
     - The Commission analysed two possible instruments of emergency wholesale price caps on gas. The first instrument would involve a price cap on imported gas from Russia and the second instrument would entail an administrative pricing during emergency in the particular European region most affected by the disruption of Russian supplies ('red zone') to prevent a spiralling of gas wholesale prices (and the contagion effect on wholesale electricity prices).
     - These instruments could be applied separately or cumulatively, as they are not dependent on each other and aim at different results.
     - As regards the first option (i.e., limiting the import price of Russian gas via a price cap):

  - Such a measure would involve the introduction of a price limit for imports of Russian gas and provide certainty on prices and volumes in the market (if the agreement is expressed both in terms of prices/volumes). Its main aim would be to limit the revenues Russia earns from selling gas to Europe. It would also make it less attractive for Russia to trigger price increases via partial disruptions or market manipulations which would help to limit volatility and uncertainty on the gas market once the Russian price cap would be settled.
  - Different options would be possible: (i) introduction of a legislation to set-up a maximum price cap on the gas bought by Russia (close to the sanctions model); or (ii) creation of a single buyer entity that would negotiate specific volumes against specific prices with Russia.
  - To be implemented in an efficient and meaningful way, this measure requires the fulfilment of certain conditions, to carefully consider the pros/cons, an in-depth analysis as to its level, to determine the specific timing for its implementation, etc.
  - In any event, this measure should only be considered if the EU is ready to accept a full disruption of Russian gas supplies. The added value of this measure is mainly on reducing Russian revenues and prices volatility rather than necessarily lowering EU gas prices (unless Russia would increase supplies) and should therefore been understood as a quasi-sanction measure against Russia.
- <u>As regard the second option</u> (i.e., applying administrative pricing in a region most affected by the disruption of Russian suppliers):
  - The disruption of Russian gas supplies impacts unevenly the security of supplies in different Member States. Consequently, different price implications in different regions are likely to occur.
  - Therefore, some Member States might temporarily cap the wholesale price of gas as an emergency measure, in order to avoid an unnecessary spiralling in wholesale prices in their regional zone that would not attract additional gas.
  - The Commission envisaged under this second option a mechanism where European regions could be labelled according to the severity of the impacts of the disruption with red (higher exposure to disruption) and green zones (lower exposure to disruption). The red zone would be made up of Member States where prices could strongly rise above the prices observed on the Title Transfer Facility (TTF) index (see also the non-paper on TTF) following a full disruption of Russian gas supplies and eventually entering into the emergency level. The introduction of an administrative price with a cap would occur in this whole red area. However, the decision of implementing the cap would require the agreement of all Member States in the area. For this scheme to have a chance of working, it would require that the bigger Member States in the red zone are part of the scheme.
  - The price cap on wholesale transactions in the red zone would be dynamic and be set in reference to the TTF price.
  - Different options were analysed by the Commission: (i) a uniform price cap within and between zones; or (ii) a uniform price cap between zones with possibility to trade. Both options face several challenges. They rely on the willingness and agreement of all Member States in the red zone to work. It would be critical to ensure a common understanding with Member States on pros and cons and the appropriate analytical basis.
  - Finally, the Commission also recalled that Member States can also apply price cap for retail consumers, as this is allowed in the Gas Directive, which was already used by

Member States pre-crisis and which is part of the existing toolbox at national level in the current crisis context. However, the Commission stated that a price cap remains an auxiliary measure and does not address costs of gas as input for the economy (and its inflationary effects) and electricity production and the fundamental questions raised in the context of the current crisis as highlighted in its non-paper. The Commission also stressed that the higher the wholesale price the bigger the costs to pay by the public budget or the supplier to finance such retail price cap.

3) Present a proposal **incentivising coordinated electricity demand reduction across the EU** in order to relieve pressure on electricity generation and address energy scarcity and high energy prices. In this respect, Ministers agreed that credible and coordinated demand-reduction initiatives are vital to improve the resilience of the EU economy ahead of the winter. Furthermore, Ministers took stock of the new legal tool to reduce gas use in the EU by 15 % until the next spring and measures taken by Member States in this respect.[1]
    - This measure is also in line with what was proposed in May 2022. Indeed, the Commission already stressed in May that Member States should incentivise demand reductions in line with the actions proposed in the EU 'Save Energy' plan (see here).
    - In its non-paper of September 2022, the Commission further clarified that:
        - The aim of a coordinated demand reduction would be to affect overall consumption of electricity and peak demand and hence to directly lower consumer prices.
        - If properly designed, a coordinated demand reduction in electricity should also lead to lower EU gas consumption for electricity generation. Smart demand-side flexibility technologies and services that lower demand in a time-dependent way when electricity is produced by gas, at peak times, will be incentivised.
        - These demand reduction measures can take different forms, such as (i) the introduction of tender schemes under which particular consumer categories offer to stop and/or shift consumption from moments of peak load, or (ii) the introduction of demand reduction objectives for certain consumer categories.
        - Financial incentives or compensations to affected market participants would be needed. The cost would depend on the design of the measure (number of participants, level of compensation).
        - National implementation would require introducing the necessary demand reduction schemes. Depending on design of the schemes, State aid clearance may be needed.

➔ In its proposal, the Commission further specified the details of the measures aiming at demand reduction:
- Member States should seek to reduce 10% of the total monthly gross electricity consumption compared with the average of gross monthly electricity consumption of the latest 5 years (i.e., starting in 2017).
- Member States shall reduce their gross electricity consumption by 5% during the peak hours corresponding to at least 10% of all hours of the month.
- Member States may choose appropriate measures to incentivise customers to reduce their demand. These measures, which might include tenders, should not be unduly limited to specific customer(s) (groups).
- Demand reduction shall apply from 1st December 2022 to 31 March 2023. Measures to incentivise demand reduction will apply as of 1st December 2022.

[1] Council Regulation (EU) 2022/1369 of 5 August 2022 on coordinated demand-reduction measures for gas, *OJ* L 206, 8.8.2022, p. 1–10.

4) Design **emergency liquidity instruments** that would ensure that **market participants have at their disposal a sufficient collateral to meet margin calls** and that would **address increased volatility in futures markets**, and consider reviewing relevant guidelines to integrate the rules on safeguards.
    - Such a measure was also envisaged in May 2022. The Commission already specified that if such emergency liquidity support measures contained State aid, those interventions needed to take place in full respect of the respective provisions. Moreover, the Commission stated that these measures needed to be limited, proportionate and transparent and must be targeted to avoid excessive distortions. The Temporary Crisis Framework for State Aid could be used by Member States for their targeted measures. Finally, Member States need to ensure that those measures would not undermine the sanctions regime imposed on Russia (see here).
    - In the presidency background paper of September 2022, Member States considered the possibility of:
        - An immediate credit line support for market participants experiencing very high margin calls, including the case for specific solution at European level, for instance through ECB.
        - Modifying the trading rules on energy exchanges, such as modifying temporarily the regulatory requirements for collateral in electricity trading including revisiting automatic price ceilings adjustments.
        - Temporary suspensions of European power derivatives markets or subject the trading of futures to specific bands.
    - In this respect, it has been recently estimated that Europe's power producers face at least EUR 1tn in margin calls.

3. Other key takeaways

In addition to the four main above-mentioned measures, Ministers also discussed the following points.

- Concerning the **medium/longer-term improvements to the market framework**, Ministers invited the Commission to swiftly pursue the ongoing work on the review of the electricity market and to **propose adjustments to the functioning of electricity markets supported by an impact assessment** as soon as possible.
- Ministers stressed the need to **accelerate the decarbonisation of the EU's energy system** and **reduce dependency on fossil fuels**, particularly from Russia.
- Ministers called on the Commission to present an **extended and broadened scope of the Temporary Crisis Framework** at least until 31 December 2023 for liquidity support measures, measures covering increased energy costs and for aid supporting the accelerated deployment of renewables and the decarbonisation of the industry. Investment and financing conditions need to be further improved and alleviated to allow for a comprehensive and swift roll-out of gas alternatives.
- Ministers took note of the Commission's update on the enhanced outreach to international partners and reliable suppliers to increase gas deliveries and agreed that coordinated EU action should be intensified. Ministers encouraged **further work on the voluntary EU Energy Platform on gas, LNG and hydrogen**, in order to secure the EU's energy supply at affordable prices. Ministers also encouraged **further work to develop LNG transhipment and the network of energy interconnectors**.
- While reiterating their commitments to cost-effectively meet our commonly agreed GHG emission-reduction targets, Ministers discussed **possible options how to make use of the EU ETS** in addressing current high electricity prices and noted the effort by the Presidency to swiftly advance the negotiations and find a solution on the Market Stability Reserve in the context of the REPowerEU initiative.
- Ministers also took stock of the **improved situation of gas storage and preparedness in Europe**. The EU has already reached a significant level of gas storage, **the capacities are now filled at 83 %**, which

should, together with the solidarity mechanism in place, and the recently adopted Regulation on Coordinated Gas Demand Reduction contribute to a safe winter and reduce the need for additional gas imports in the coming months.

4. *Next steps*

The Commission's proposal will require a qualified majority vote in the Council to be approved. In the light of the emergency situation, Member States have already expressed their intention to swiftly work on the Commission's proposal. The adoption of this first set of proposals is thus expected rather soon.

It must be kept in mind that the proposed measures are extraordinary in nature and thus limited in time. The Commission has committed to carry out a review of the electricity emergency tool by 28 February 2023, taking into account the electricity supply situation and electricity prices across the EU, and present a report on the main findings of that review to the Council. As regards the solidarity contributions of the fossil sector, the Commission will carry out a review by 15 October 2023, in view of the general situation of the fossil fuel sector and surplus profits generated and present a report on the main findings of that review to the Council.

As regards any gas price cap measure, the Commission indicated that it will deepen its discussion with Member States about the best ways to reduce gas prices, also analysing various ideas for price caps and enhancing the role of the EU Energy Platform in facilitating lower price agreements with suppliers through voluntary joint purchasing.

Finally, as regards the Commission's task to design emergency liquidity instruments that would ensure that market participants have at their disposal a sufficient collateral to meet margin calls and that would address increased volatility in futures markets, the Commission has stated that, in cooperation with the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA), it is already working on the above, as requested by the Council, as well as a range of options to ensure that the financial system supports actions to ease the current situation, while preserving financial stability. The Commission indicated that it may adopt further measures in the coming days and weeks with market regulators and that the ongoing work streams cover the following areas: derivatives, benchmarks and trading (see here).

For any additional information, please do not hesitate to contact us or your usual Strelia contact person.

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