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CEPS EXPLAINER

COULD THE EU ELECTRICITY MARKET DESIGN REFORM SABOTAGE THE VERY INTERNAL ENERGY MARKET IT IS SUPPOSED TO UPHOLD?

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SUMMARY

The Council of the EU and the European Parliament are currently scrutinising and tabling amendments to the European Commission's proposal to reform EU electricity markets, of course coming in the aftermath of 2022's energy price crisis.

This short CEPS Explainer focuses on two highly controversial issues at the heart of the Council and Parliament's respective positions – namely suggested amendments to Article 66a concerning possible future electricity price crises, and the resort to inframarginal revenue caps. The authors fear that if these proposed amendments survive into the final negotiated text of the legislation, then the entire internal energy market could be seriously damaged as a result.

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Are a short-terminist European Parliament (EP) and an inward-looking Council about to seriously damage the internal energy market, a construct that took more than 20 years to build and has served Europe well? There is a significant risk that this question might receive a positive answer by the end of the year, if the current prevailing positions of the Council and EP on the European Commission's proposal to reform EU electricity markets were to be merged into a very unholy final agreement[1].

Two highly controversial issues are at the core of our assessment – the amendments to Article 66a concerning future electricity price crises and the resort to inframarginal revenue caps[2].

ARTICLE 66A AT THE CORE

In a new Article (66a) of its reform proposal, the Commission introduced a mechanism allowing it to declare a regional or EU-wide electricity price crisis, provided some stringent conditions resulting from wholesale and retail electricity price dynamics are met. During the crisis period – which can last up to one year – Member States are allowed to revert to regulated prices for small and medium sized enterprises (SMEs), though with some limitations[3]. The draft EP report extends the possible recipients of regulated prices to include households and – crucially – energy intensive industries.

In more detail, the conditions for the Commission to declare an electricity price crisis are:

a) very high prices in wholesale electricity markets at least two and a half times more than the average price during the previous five years which is expected to continue for at least six months;

b) sharp increases in electricity retail prices of at least 70 % which are expected to continue for at least six months; and

c) the wider economy is being negatively affected by the electricity price increases.

[1] At the time of writing, the Council and EP are yet to formalise their respective positions on the dossier, so this analysis could be partially or totally reviewed once the co-legislators adopt their stance. We do, however, believe that the main elements of our assessment will retain their validity. Since the Council is more advanced in its general approach to the dossier (at least on the articles relevant for this analysis) than the EP is in dealing with its own report, this CEPS Explainer mostly focuses on the Council.

[2] The inframarginal revenue cap is a measure introduced by Council Regulation (EU) 2022/1854 at the peak of the 2022 energy price crisis. Its aim is to limit the revenues that renewable and nuclear power plants earn compared with their costs. The cap was set at EUR 180/MWh, although Member States were able to decide on their own cap above or below this benchmark and allow for exemptions if necessary. This is what ultimately led to the extreme fragmentation and damage to the internal energy market.

[3] Notably, regulated prices cannot not be applied to more than 70 % of targeted electricity consumption and incentives to reduce electricity demand should be retained. Furthermore, were electricity prices to be 'exceptionally and temporarily' set below (production) costs, they would only apply to maximum 80 % of the (median) level of household consumption.

These conditions might be considered as somewhat vague and difficult to assess, therefore partially relying on the Commission's own discretion. Conditions *a)* and *b)* apply to, respectively, wholesale and retail markets. Moreover, they both incorporate price averages and price futures. The reference to 'wholesale prices' in condition *a*) might be seen as too general as wholesale prices are not properly defined. The reference to a future timespan of up to six months ahead in conditions *a*) and *b*) could certainly benefit from being further and more firmly specified. Finally, condition *c*) is highly discretionary and a vastly complex exercise to undertake.

The Council and the EP have up until now been separately amending the Commission proposal, and in spite of profound differences within and among themselves they both seem oriented towards a more treacherous version for the text. The two institutions are contemplating a series of very profound changes, notably to weaken the Commission's powers to declare an emergency (proposed by the Council) and extending the possibility for Member States to set regulated prices for all retail consumers (proposed by the EP). Both the Council and EP seem to have institutionalised the inframarginal revenue cap, although with differing intensities.

In detail, the Council revised the original criteria for a price-led crisis by:

1. Excluding 2022 from the calculation of the wholesale price over the previous five years;
2. Lowering the period of lasting sharp increases in the retail price from six months to three months; and
3. Giving the Council, by means of an implementing decision, the power to approve any Commission proposal to declare a crisis. On top of this, the Council can directly amend a Commission crisis proposal.

While the aim of reducing the reference period for future electricity prices seems rather self-explanatory, the exclusion of 2022 from the average of the wholesale prices merits a second look.

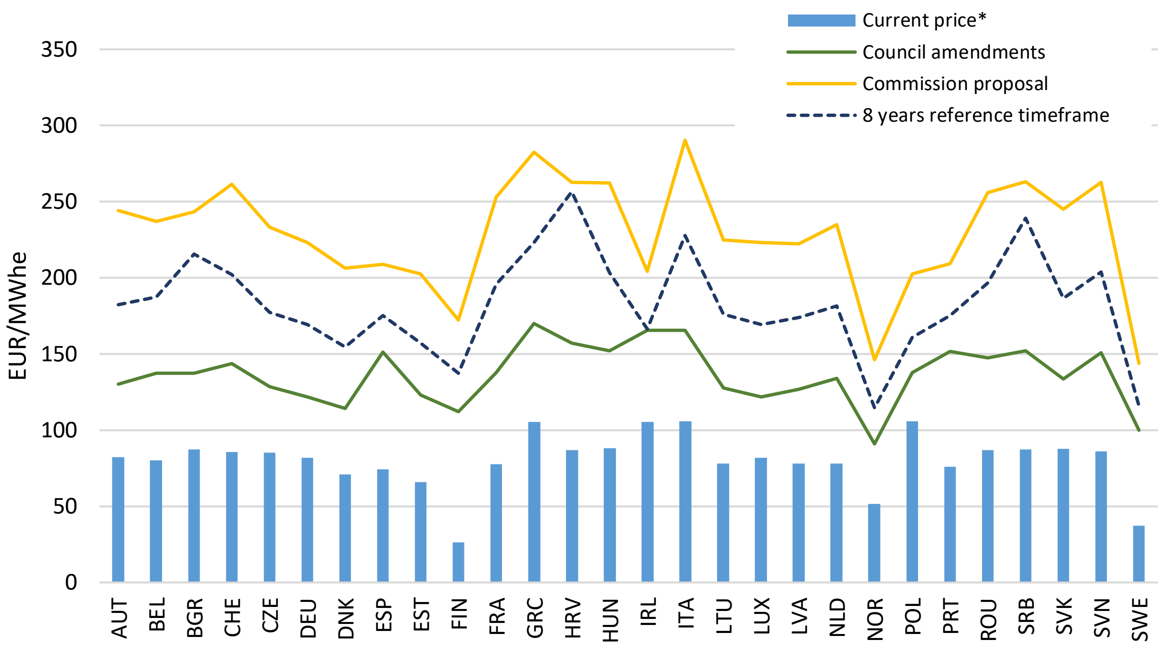
Based on our assessment, such an exclusion would decrease the crisis-triggering price of about EUR 90 per MW/h on average in the EU (i.e. from an average of EUR 230 MW/h to EUR 137 Mw/h). While large discrepancies do exist across Member States (see Figure 1 below), this represents a significant reduction that could mean emergencies are declared more frequently, that it would be easier to declare one, and there would be more favourable terms for Member States to adopt regulated prices.

Given the exceptional heights reached by electricity prices in 2022, the rationale of excluding that year from the reference average might seem, upon first glance, justifiable. However, one should account for the fact that future electricity price levels will likely remain higher – as a result of the persistent imbalances in the energy supply markets and increased tensions at international level – than in the pre-2022 period.

Therefore, a reference to pre-2022 prices only would also not properly reflect current and future market conditions. Added to this, high electricity prices in 2022 were ultimately the result of a scarcity situation which should be properly accounted for. 'Cherry-picking' the period of interest might fail to convey the right market signal to consumer and to incentivise demand reductions.

To mitigate the impact of high 2022 prices on the average while maintaining a more reliable framework, instead of excluding 2022, one option could be to just expand the timeframe of reference. Including two additional to additional years to the reference, for instance, would lower the average crisis-triggering price of about EUR 45 MW/h – that is, half of the reduction caused by the Council amendment (see Figure 1).

Figure 1. Crisis-triggering electricity prices, based on the original Commission proposal and subsequent Council amendments



Note: Current prices refer to 01/05/2023.

Source: Authors' elaboration based on EMBER data on wholesale day-ahead electricity prices.

Additionally, the EP proposes to extend the possibility for Member States to set regulated prices for all retail consumers, thereby enlarging the scope for them to regulate prices.

THE RETURN OF INFRAMARGINAL REVENUE CAPS

The amendments to Article 66a are not the only ones that risk harming the EU internal energy market.

The Council further amended the Commission's proposal by allowing Member States to apply inframarginal revenue caps until the end of June 2024. As explicitly noted by the Commission in a report released in June 2023, because of its very heterogeneous application across Member States, the cap has created *'significant regulatory uncertainty, thereby posing a risk for the development of new investment, particularly in renewable sources*'.

As such, in the same document, the Commission acknowledged how prolonging the inframarginal revenue cap would raise a significant burden for the uptake of long-term contracts, hindering one of the main objectives of the electricity market design reform proposal. On these grounds, the Commission did not propose to extend the inframarginal revenue cap beyond June 2023.

Some observers have raised the prospect that the cap extension proposed by the Council is relatively harmless, at least from a practical viewpoint. Since it is unlikely that the reform will formally enter into force before the beginning of 2024, its impact would in fact be rather limited. However, the severity of the political message the Council is signalling to the market should not be underestimated – Member States' commitment to regulatory stability as a precondition for investments will remain intact so long as they do not need to make decisions on agitated price dynamics. While the possibility to reintroduce inframarginal revenue caps was also called for – and with even greater emphasis – by the preliminary EP report mentioned above, a more advanced EP position is required for a proper assessment.

LIKELY IMPLICATIONS

The EU has often been accused of being distanced from the reality on the ground. But the internal electricity market is a very concrete, down-to-earth matter. The functioning of the internal energy market allowed Member States to successfully confront the energy crisis that was a direct consequence of the Russian invasion of Ukraine. For example, the internal market has allowed the EU (or at least north west Europe) to accommodate a situation where France could become a net importer for electricity in less than three months, having been for a long time a net exporter. Furthermore, it's the only theoretical premise and the only effective theatre to ensure the EU's ambitious decarbonisation strategy happens and is ultimately successful.

The internal energy market is, therefore, an unquestionable EU success. However, the above changes to the Commission's electricity market reform proposal ultimately risk eroding it to the point where it will no longer function as it should.

Inframarginal revenue caps and price-led emergencies are intimately intertwined because they represent the essence of the question over how long Member States can derogate from internal energy market principles, among others, to subsidise or finance national priorities.

The same arguments we hear around article 66a and inframarginal revenue caps resonate – and not by coincidence – in the Council discussions around another key political element of the proposed reform: the criteria according to which Member States shall utilise the revenues generated by the two-way so-called Contract for Differences (CfDs)[4].

The clash here seems to be between Member States advocating for effective conditionalities and those in favour of a far more relaxed set of conditions. It is pretty much evident that relaxed criteria support the discretionary use of those revenues that, in the absence of a common framework, could further contribute to eroding the internal market. Finally, the exact same considerations could be applicable to the uneasy discussions around the (relative) relaxation of the State Aid Framework as a result of the US Inflation Reduction Act.

All these, yet disparate, issues share an alarming common trait – namely the tendency to try and solve today's problems with yesterday's mindset, by re-nationalising competencies over issues that no Member State can deal with alone. A subsidy race is a contagious fever that seems to have infected Member States.

After relaxing the State Aid framework and finding any possible way to accommodate Member States' increasingly arbitrary requests at EU level, it is hard not to see how such developments risk eroding the Union from within. Furthermore, it is equally hard to imagine how any Member State can legitimately think to engage with either the US or China while weakening the most strategic asset the EU still has – its internal market.

Member States' short-sightedness is the equivalent of sawing off the branch we all are sitting on.

It would be interesting to know what the 'Guardian of the Treaties' thinks about all this and what – in case they find the time, motivation and motive – they have to say about it.

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[4] A two-way contract for difference under the Commission's proposal is the only tool that Member States can use to support low-carbon electricity generation such as renewables. This is relatively uncontroversial. It represents a contract signed between an electricity generator and a public entity, which sets a strike price, usually by a competitive tender. The generator sells the electricity in the market but then settles the difference between the market price and the strike price with the public entity. If the market price is higher than the strike price, then the generator will need to pay the difference to the public entity, which will then generate revenue.

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