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ALERT MEMORANDUM

European Council Regulation to Address High Energy Prices

On October 6, 2022 the European Council adopted Regulation (EU) 2022/1854 as an emergency intervention to address high energy prices in the European Union (the "Regulation").

The Regulation revolves around the key principles announced by European Commission President Von der Leyden during the State of the Union speech:

1. ***Electricity demand reduction***, particularly during peak hours, also with a view to lowering prices, at least when gas-fired power plants are not necessary to cover demand (Articles 3-5);

2. ***Mandatory cap on revenues of inframarginal electricity producers***: a cap on the market revenues of electricity produced through non gas-fired power plants, *i.e.*, a de facto decoupling of electricity prices of inframarginal producers from that of gas-fired power plant, albeit without dismantling the merit order regime[1] in place (Articles 6-8);

3. ***Use of the proceeds in excess of the cap to finance public support of end-customers (Article 10) and/or the direct intervention of Member States to set retail electricity prices*** (Articles 12-13);

4. ***A contribution from fossil fuels producers (oil, coal, gas, and refinery***), intended as an additional 33% tax to be levied by Member States on extra profits generated after January 2022 compared to the three previous fiscal years (Article 14-16). This tax on the extra profits will have to be employed to support other measures under the Regulation, or to foster technologies under the RePower EU, or even to support energy-intensive users (Article 17).

The legal basis for the Regulation is Article 122 TFEU, which allows the Council to adopt measures "*appropriate to the economic situation, in particular if severe*

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[1] For a description of the merit order regime see background box below.

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difficulties arise in the supply of certain products, notably in the area of energy", in the spirit of solidarity between Member States[2] .

While including specific rules (*e.g.*, the amount of the revenue cap and the percentage of the levy on extra profits), the Regulation requires the adoption of national implementing measures (notably of a fiscal nature).

The main principles followed by the Regulation are the following:

- ***Expedited timing***. The Regulation was adopted only three weeks after the Commission's proposal dated September 15, 2022.
- ***Temporary measures to face an emergency in the energy sector.*** The Regulation is intended to provide a temporary solution to an emergency situation in the energy sector (*i.e.*, the increase of electricity prices due to the war in Ukraine[3]) and will be in force until December 31, 2023[4]. Because of its temporary nature, the proposal is not intended to redesign the electricity market, but only to remedy the distortive effects the exceptionally high prices of gas, including the spill-over effects on the price of electricity.
- ***Solidarity principle***. These measures also reflect the principle of solidarity, both between the companies that are mostly benefiting from the gas price increase and those who are mostly affected by same (see Articles 9 and 16), and between EU Member States. In particular, the Regulation foresees bilateral solidarity agreements between Member States to share part of the inframarginal revenues[5] collected by Member States with high energy production for the benefit of end-users in Member States with low electricity generation (article 10)[6].

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[2] See judgement of 15.7.2021, Case C-848/19 P, *Germany vs. Poland*, where the ECJ clarifies that: "*the principle of solidarity underpins the entire legal system of the European Union*" (ECLI:EU:C:2021:598).

[3] See Recitals 1, 2, 10, 24, 28, 50, 54, and 8 ("*The disruption of the energy market, caused by one of the main market players which has artificially reduced the supply of gas in the context of Russia's war of aggression against Ukraine, and the hybrid war which is thereby being carried out, have created a crisis situation which requires the adoption of a set of urgent, temporary and exceptional measures of an economic nature to address the unbearable effects on consumers and companies. If not addressed rapidly, the crisis situation may have severe detrimental effects on inflation, on the liquidity of market operators and on the economy as a whole*") which was added by the Council in the approved text

[4] The Commission has committed to carry out a review and present a report on the main findings of that review to the Council: (a) of the electricity emergency tool by 28 February 2023, taking into account the electricity supply situation and electricity prices across the EU; and (ii) by 15 October 2023, in view of the general situation of the fossil fuel sector and surplus profits generated

[5] For an explanation of "inframarginal revenues" see background box below

[6] Solidarity agreements are generally encouraged on a voluntary basis, but may be mandatory as well in certain cases, to ensure cap on revenues will also benefit Member States without high energy production. In this respect, the Regulation requires solidarity agreements between Member States shall be entered into by December 1, 2022 where a Member State's net imports dependence is 100% (and the agreement will have to be entered "*between the importing Member State and the main exporting Member State*" in order to "*to share the surplus revenues*"). Net imports dependence is defined as "*the difference between the total electricity imports and total electricity exports as a percentage of the total gross production of electricity in a Member State*".

In line with the subsidiarity principle, the Regulation clarifies that a common approach to revenue limitations for inframarginal generators[7] is also necessary in order to preserve the functioning of the electricity system and cross-border trade and investments, and thus security of supply[8].

Background: Why does an increase in gas prices extend to, and overwhelms, of electricity prices?

An increase in the price of gas affects the overall electricity prices, not only the price of electricity produced by gas-fired power plants.[9]

This is easily explained by looking at how electricity price is set on the day-ahead market of the EU wholesale electricity markets.[10]

The day-ahead market is organized on an auction model, where transactions are concluded for the following day.

Electricity producers (from fossil fuel electricity producers to renewable energy producers) bid into the market for a price they establish based on their production costs (*e.g.*, renewables have very low marginal production costs and are therefore the cheapest). Electricity is then bought starting from the cheapest offers first, all the way to the most expensive ones. The most expensive technology needed to satisfy the demand is known as the "marginal generator"; the cheapest technologies that are called before the marginal unit to satisfy demand are known as the "inframarginal generators".

Once demand is satisfied, every producer (including the inframarginal generators) gets the price of the last producer from which electricity was bought (*i.e.*, the marginal generator), meaning that, in the end, all electricity generators (until demand is satisfied) get the same price for the power they are selling.

Such pricing system is referred to as a **marginal pricing** system, also known as a pay-as-clear market, because electricity prices are driven and set by the cost of marginal producers, *i.e.*, the most expensive producers to serve demand.

This mechanism is often illustrated with the "**merit order curve**", since power price is determined by a "merit order", *i.e.*, a sequence in which power producers offer power to the market following an order based on how much lower their offer is, and where the clearing

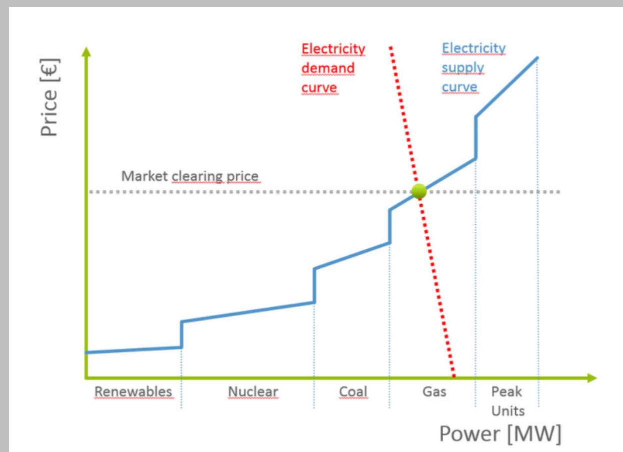
[7] For an explanation of inframarginal generators see background box below

[8] At the same time, Member States retain the right to introduce more ambitious measures both in terms of demand reduction and the limitation of revenues of electricity producers, as long as they are proportionate, do not distort the functioning of electricity wholesale markets, do not jeopardize investment signals and they are in line with Union Law

[9] See ACER's Final Assessment of the EU Wholesale Electricity Market Design April 2022.

[10] See Commission Regulation (EU) 2015/1222 of 24 July 2015 establishing a guideline on capacity allocation and congestion management; Directive (EU) 2019/944 of the European Parliament and of the Council of 5 June 2019 on common rules for the internal market for electricity and amending Directive 2012/27/EU (recast); Regulation (EU) 2019/943 of the European Parliament and of the Council of 5 June 2019 on the internal market for electricity (recast).

price and clearing volume are determined by the intersection of power demand and power supply.



Clearly, then, if the marginal production unit is that of a gas-fired power plant, the higher cost of gas impacts the cost of electricity as a whole and not only the electricity produced by gas-fired power plants, including also inframarginal generators (*e.g.*, renewables). Accordingly, inframarginal generators are benefiting from the higher cost of gas, without having to bear it. The "inframarginal revenues" can thus be very high.

Key pillars of the Regulation

1. Electricity demand reduction

Electricity demand reduction is set to bring down energy prices, by reducing the overall need for gas power plants to generate power in order to meet demand. In particular, targeting the most expensive hours is expected to lower electricity prices, as this is usually the time when electricity from expensive gas power plants is mostly used and becomes the marginal production unit.

The Regulation foresees two electricity demand-reduction targets.

The first is a reduction of total **monthly gross electricity consumption** by 10%, compared to the average consumption in the period from November 1 to March 31 of the past five years.

The second is a reduction of gross electricity consumption during **peak price hours**: Member States shall identify peak price hours corresponding to a minimum of 10 % of all hours of the period between December 1, 2022 and March 31, 2023, and the reduction achieved over the peak price hours shall be at least 5% on average per hour, compared with forecasted consumption.

However, Member States may target less than 10%, as long as:

- at least 3% of peak hours are covered, and
- energy saved during those peak hours is at least equal to the energy that would have been saved with the application of the above regular measures on electricity reduction during peak price hours.

Member States may choose appropriate measures in order to reduce monthly and peak price hours electricity consumption, provided that they are in line with the relevant EU competition and electricity market rules. In particular, the measures must respect the following conditions:

- where financial compensation is paid in addition to market revenues, the amount of that compensation shall be established through an open competitive process;
- measures must only involve financial compensation when such compensation is paid for additional electricity not consumed compared to the expected consumption in the hour concerned without the tender;
- measures must not unduly distort competition or the proper functioning of the internal market in electricity;
- measures must not be unduly limited to specific customers or customer groups, including independent aggregators, in accordance with Article 17 of Directive (EU) 2019/944[11]; and
- measures must not unduly prevent the process of replacing fossil fuel technologies with technologies using electricity.

2. Mandatory cap on the revenues of the inframarginal electricity producers

The Regulation imposes a cap of €180/MWh.

This is not a cap on the price of electricity sold on the wholesale energy market. Such prices will continue to be based on the outcome of the merit order procedure on the day-ahead market. Only the profits in excess of the cap will be affected ex-post. Clearly, the Commission is aware that, instead of benefiting consumers, the merit order rule is damaging end-customers. The measure is

[11] Directive (EU) 2019/944 of the European Parliament and of the Council of 5 June 2019 on common rules for the internal market for electricity allows final customers, including those offering demand response through aggregation, to participate alongside producers in a non-discriminatory manner in all electricity markets.

thus trying to rebalance the scenario, without dismantling the merit order regime.

A cap of €180/MWh targets all of the market revenues of inframarginal generators (as well as, where relevant, intermediaries participating in electricity wholesale markets on behalf of producers), and applies to electricity produced from the following sources:

- wind energy;
- solar energy (solar thermal and solar photovoltaic);
- geothermal energy;
- hydropower without reservoir;
- biomass fuel (solid or gaseous biomass fuels), excluding bio-methane;
- waste;
- nuclear energy;
- lignite;
- crude oil and other oil products; and
- peat.

Though the cap in principle applies to all revenues exceeding €180/MWh, Member States may decide to target only 90% of the market revenues exceeding the cap.

The cap on revenues does not apply to:

- **biomethane**, since the cap does not apply to those technologies using fuels that are substitute for natural gas, in order contribute to conversion of existing gas-fired power plants to decrease overall natural gas consumption;
- **demonstration projects**, to preserve incentives for the development of innovative technologies; and /or
- **producers whose revenues are already capped**, such as those of certain renewables, because they do not benefit from the recent skyrocketing of energy prices.

Member States may also decide the cap does not apply to electricity produced in:

- **plants with an installed capacity of up to 1 MW**, in the event that the cap would lead to a significant administrative burden; and
- **hybrid plants** which also use conventional energy sources, in the event that the cap would lead to a risk of increasing CO2 emissions and decreasing renewable energy generation.

The Regulation provides that Member States will put in place effective measures to prevent circumvention of obligations on producers, but does not provide for specific measures to achieve such result nor, generally, to collect revenues over the cap. However, the Commission will assist Member States in the implementation of the cap on revenues.

The cap on revenues of inframarginal electricity producers is expected to generate up to €117 billion on an annual basis.[12]

3. Use of the proceeds in excess of the cap to finance public intervention in support of end-customers or direct intervention of the State to

[12] The exact amount of revenues will vary for each Member State, depending on several factors, including, *inter alia*, (i) the amount of electricity generated from inframarginal technologies in the country, (ii)electricity prices during the time of application of the cap, (iii)energy mix characteristics, and (iv) design of support schemes for renewable energy.

set the price of electricity at the retail level (households and SMEs)

Surplus revenues resulting from the application of the cap must be passed on to final electricity customers, including mall and medium-sized enterprises ('SMEs') and energy intensive industries, while at the same time preserving the price signals on the markets across the Union and preserving cross-border trade,[13] through appropriate measure to mitigate the impact of exceptionally high electricity prices.

Measures may include, *inter alia*:

- financial compensation to final electricity customers for reducing their electricity consumption;
- direct transfers to final electricity customers, including through proportional reductions in the network tariffs;
- compensation to suppliers for supplying below cost;
- lowering the electricity purchase costs of final electricity customers, including for a limited volume of the electricity consumed;
- investments into decarbonisation technologies and renewables.

The measures might even include prices of electricity below costs for the benefit of household and SMEs.[14] The Regulation allows Member States to set prices of electricity for SMEs as an exception to the electricity directive, allowing tariff settings only to the benefit of vulnerable customers.

4. A contribution from fossil fuels producers (oil, coal, gas, and refinery) to support customers, including energy intensive users

In order to mitigate the impact of the energy crisis on households and companies across the EU, Member States are required to impose by December 31, 2022 a solidarity contribution to be paid by companies which are established in the EU and which produce or refine fossil fuels (oil, coal, gas).

The base will be calculated on the basis of the "excessive" taxable profits (as determined under national law) accrued in fiscal years 2022 or 2023. For the purpose of the Regulation any profit above 20% of the average taxable profits accrued in the four previous fiscal years starting on January 2018 or later will be deemed excessive.

The rate of the contribution will be at least 33% (Member States might decide to adopt a higher rate). The contribution shall be applied in addition to regular taxes and levied under applicable national law.

According to the Commission's estimate, the contribution will allow the collection of around €25 billion in public revenues.

The solidarity contribution is proposed as an exceptional measure, as it will only target surplus profits generated in fiscal years 2022 and 2023.

Proceeds from the solidarity contribution will have to be used for financial support measures aiming to:

- support end customers, and in particular vulnerable households;
- help (i) reducing energy consumption so as to lower the energy purchase costs of end customers, and (ii) promoting investments by end customers into renewables or other decarbonisation technologies;
- support companies in energy intensive industries provided that they will invest in

13 Recital 11 and 47.

14 Articles 12 and 13.

renewable energies or other decarbonisation technologies;

- develop energy autonomy.

In the spirit of solidarity, Member States may also assign a share of their proceeds from the solidarity contribution to the **common financing** of measures to reduce harmful effects of the energy crisis at the very EU level (*e.g.*, protecting employment, promoting investments in energy efficiency and renewable energy).

Some of the above measures will require the approval of the European Commission under State Aid rules (*i.e.*, financial support measures to support companies in energy intensive industries, which is already designed in the Regulation along the lines of the Temporary Framework).

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