

Legal Update – April 2023

EU reform of electricity market



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On 14 March 2023 the European Commission proposed to reform the EU's electricity market in two different angles: (i) the reform of the energy market design and (ii) the reform of the wholesale energy market integrity and transparency (REMIT) Regulation.

In this alert, we will refer to the proposal for the reform of the energy market design (the “Proposal”), which is aimed at accelerating a surge in renewables and the phase-out of gas, make consumer bills less dependent on volatile fossil fuel prices, better protect consumers from future price spikes and potential market manipulation, and make the EU's industry clean and more competitive.

This Proposal follows the wide range of short-term measures already adopted by the EU to mitigate the impact of the unprecedented high and volatile wholesale energy prices on households and economy, especially following Russia's invasion of Ukraine and the European Commission President announcement in the 2022 State of the Union Address of the need for a fundamental reform of the electricity market design.

In this alert, we analyze the purpose of the Proposal, its main features and EY's assessment of the Proposal.

Objectives of the proposal

The Proposal addresses consumer, industry and investors' concerns over exposure to volatile short-term prices, driven by high prices of fossil fuels. This is done by incentivizing long-term instruments to complement the short-term markets.

More precisely, the Proposal is aimed at three main objectives:

- ▶ Protection of consumers from volatile prices: to this end, the Proposal improves the contractual rights of consumers to fixed price contracts, dynamic price contracts and multiple contracts. Additionally, it also improves existing protection for energy poor and vulnerable consumers by providing access to regulated retail prices for households and SME consumers in the event of a crisis. The proposal also creates the right of consumers to share renewable energy directly, without the need to create energy communities.
- ▶ Stability and predictability of the cost of energy: this is done by enhancing market access to more longer-term contracts and markets. Credit risk is a strong barrier to access to the PPA market, which the proposal tries to mitigate through different mechanisms to be implemented by Member States such as guarantee schemes and the introduction of certain evaluation criteria in the public support tenders. Two-way contracts for difference and forwards contracts shall also be encouraged.
- ▶ Boost renewable energy investment: the objective is that deployment triples. To do so, the proposal considers that stability and transparency is essential. Markets for long-term contracts shall be improved, as they provide stable revenues to energy suppliers which ultimately results in a decrease of prices. A flexible power system also promotes stable prices and therefore Member States shall adopt measure with that purpose in mind (capacity mechanisms, new support schemes for demand side response and storage). Finally, transparency regarding grid connection capacity shall be increased.

Specific measures of the Proposal

To achieve the objectives of the Proposal and improve the EU electricity market design, the Proposal amends several EU Regulations and Directives, in particular Regulations (EU) 2019/943¹ and (EU) 2019/942² as well as Directives (EU) 2018/2001³ and (EU) 2019/944⁴.

Some of the most relevant amendments are further considered below.

▶ Forward markets and PPAs

The Proposal foresees for the establishment of regional virtual hubs for the forward market.

The Proposal requires Member States to facilitate PPAs. To that end, and to reduce off-taker financial risk, Member States shall put in place guarantee schemes for PPAs backed by the Member States. Support shall not be provided to the purchase of generation from fossil fuels.

Additionally, in the design of support schemes to renewable projects, Member States shall allow the participation of projects which reserve part of the electricity for sale through PPA or include evaluation criteria that consider projects with signed PPAs or a commitment to do so.

▶ **Two-way contracts for differences**

The Proposal establishes that investments in nuclear and renewable generation projects (wind, solar, geothermal, hydropower without reservoir) may benefit from direct support schemes through two-way contracts for differences.

However, this support only applies to new investments, including, for such purposes, repowering of existing power-generating facilities and investments aimed at extending existing power-generating facilities or at prolonging their lifetime.

▶ **Assessment on flexibility needs and flexibility support schemes**

By 1 January 2025, and every two years thereafter, Member States shall submit to ACER a report on the need for flexibility in the electricity system for a period of at least 5 years and then, within 12 months, ACER shall provide recommendations on issues of cross-border relevance.

Additionally, Member States which apply a capacity mechanism shall consider the promotion of the participation of non-fossil flexibility such as demand side response and storage by introducing additional criteria or features in the design of the capacity mechanism.

Member States may apply flexibility support schemes consisting of payments for the available capacity of non-fossil flexibility such as demand side response and storage in the event the abovementioned additional criteria are not sufficient to achieve the identified flexibility needs.

These measures shall be limited to new investments in non-fossil sources.

▶ **Right to energy sharing**

The Proposal introduces the rights of all households, SME and public bodies to participate in energy sharing as active customers⁵. They may do so by entering into private agreements or through a legal entity. Therefore, consumers may share energy without the need to create energy communities. Additionally, they may use a third party installation, without that third party being considered an active consumer.

▶ **Access to affordable energy during an electricity price crisis**

The Commission may decide to declare a region or Union-wide electricity price crisis if certain conditions are met, for a period of up to one year. In such cases, the affected Member States may adopt certain targeted public interventions in price setting for the supply of electricity to SME, among others, set a price for supply of electricity which is below cost.

Assessment of the Proposal

The general assessment of the Proposal made by the European Commission has been positive, as it refers to several initiatives that improve the current functioning of the electricity suppliers' market while maintaining its way of operating and its integrity, boost renewables, improve the consumer's protection and enhance industrial competitiveness. In particular, **the following aspects are emphasized as positive:**

✓ **The maintenance of the marginalist market**

First and foremost, the Proposal defends and keeps the proper functioning and the integration of the marginalist market as a mechanism for optimizing the renewable investment, promoting the decarbonization and fostering a competitive price levels.

The European regulator, ACER, in its April 2022⁶ report stated that the good functioning of the current market's design (*single day ahead and intraday coupling*) has contributed with more than 34,000 million Euros in annual benefits in the last 10 years compared to a system without interconnections.

✓ **Coexistence of voluntary contracts for differences (CfD) with private PPAs**

Secondly, the coexistence of the CfD with private PPAs and the reduction of obstacles for the latter (such as the credit risks for buyers) are positively valued.

The promotion of private PPAs as a mechanism for energy provision allows coverage for the price risk and a greater stability of the energy provisioning, while encouraging the decarbonization of the industry.

Regarding the CfD, their voluntary adoption, based in competitive schemes (auctions) for new investments in renewables, nuclear and repowering, is positively valued. They could play a role in reducing investors' risks, improving their financing.

Both mechanisms play a key role in the promoting of the renewable investment in the EU countries and in moving forward in the energy transition and the reduction of emissions.

✓ **Forward markets development**

A third positive issue is the promotion of the liquidity and the reduction of the coverage costs in the forward markets. However, it is necessary to analyze deeply if the best way to achieve this goal is through regional virtual hubs or if there could be other options.

✓ **Vulnerable consumer protection**

On another note, regarding the protection of vulnerable consumers, the proposal establishes that the last resort suppliers will not be allowed to cut the service for any vulnerable consumer as a mandatory requirement for the Member States, protecting them from ending up without electricity. In addition, it will provide consumers a wide choice of contracts and clearer information before signing them, having the option of long-term prices to avoid volatility. Furthermore, the proposal allows Member States to extend regulated retail prices to households SMEs in case of a crisis.

✓ **Avoid disturbing the investors' confidence**

The non-retroactivity of the measures is also positively evaluated. It is a key aspect in order to avoid disturbing the legitimate confidence of investors, which would entail a very negative impact on the relevant investments required by the energy transition.

✓ **Active participation of demand/storage in the market**

The active participation of demand and storage in the market is positively assessed as well. In particular, Member States will be required to assess their needs, establish objectives to increase non-fossil flexibility, and will have the possibility to introduce new support schemes especially for demand response and storage. The reform also enables system operators to procure demand reduction at peak hours (peak shaving product).

Nevertheless, in order to face the required discussion regarding this Proposal in the coming months, **it would be sensible to consider the following matters:**

❖ **Evaluate the needs of the capacity markets**

The convenience of modifying the Regulation 2019/943 should be analyzed in relation to the need of reform capacity markets, simplifying the approval procedures and evaluating its temporary duration (among other things).

In case of Spain, the last report published by ENTSO-E, *European Resource Adequacy Assessment 2022*, points out that there could be a resiliency problem in 2025 if Spain does not approve some type of capacity mechanism. In particular, this mechanism should be put into practice to avoid an excessive level of LOLE⁷, close to 6,7 hours, doubling the considered standard. Thus, it would be important for Spain to be able to rely on this mechanism as soon as possible.

❖ **Avoid the price segmentation between Member States**

Secondly, another key aspect is that every reform proposal, in addition to safeguarding the marginalist design, should ensure the proper functioning of the markets and avoid creating price segmentation between Member States derived from the different generation mixes, which would undermine the level playing field.

❖ **Be aware of the importance of grids regarding future challenges within the sector**

The new regulation and the access tolls should take into account the key role that grids play and will continue playing in tackling the relevant challenges that electric systems are facing: higher decentralization (electric vehicles, self-consumption, etc.), higher digitalization and more decarbonization.

Next Steps

The Proposal will now have to be discussed and agreed by the European Parliament and the Council before entering into force.

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Notes

- ¹ Regulation (EU) 2019/943 of the European Parliament and of the Council of 5 June 2019 on the internal market for electricity.
- ² Regulation (EU) 2019/942 Of The European Parliament And Of The Council of 5 June 2019 establishing a European Union Agency for the Cooperation of Energy Regulators (recast).
- ³ Directive (EU) 2018/2001 of the European Parliament and of the Council of 11 December 2018 on the promotion of the use of energy from renewable sources (recast).
- ⁴ 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).
- ⁵ According to the Proposal, 'active customer' means a final customer, or a group of jointly acting final customers, who consumes or stores electricity generated within its premises located within confined boundaries or self-generated or shared electricity within other premises located within the same bidding zone, or who sells self-generated electricity or participates in flexibility or energy efficiency schemes, provided that those activities do not constitute its primary commercial or professional activity.
- ⁶ Final Assessment of the EU Wholesale Electricity Market Design.
- ⁷ The Loss Of Load Expectation.