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BULLETIN

European Electricity Market Reform Faces Dilemmas

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The electricity market reform proposed by the European Commission (EC) on 14 March is part of a structural response to the energy crisis. It continues the trend of further integration of the European energy market and seeks to provide stable conditions for the development of RES. The legislative proposals is currently being negotiated by the European Parliament (EP) and the Council of the EU. Reconciling the interests of Member States, the electricity sector, investors and consumers remain a challenge. There is little chance that the postulates regarding the extension of the capacity mechanisms, which are important from Poland's perspective, will be taken into account.

The last revision of EU energy legislation in 2019, as part of the "Clean Energy for All Europeans" package, strengthened the Community governance framework for energy policy. This was in line with the Energy Union and the European Green Deal objectives. However, the energy crisis that began in the summer of 2021 showed the extent to which consumers and industry were exposed to soaring electricity prices (wholesale prices rose from around €180 per MWh in May 2022 to a peak of over €400 MWh in August). In response, the members of EU and the EC adopted a series of measures to alleviate the immediate impact of the crisis. They saw the genesis of the problem not only in Gazprom's manipulation of the gas market but also in the structure of the European electricity market (e.g., insufficient safeguards for consumers in the event of sudden spikes in energy prices, too much influence of fossil fuels on these prices). This led to an attempt by the EC to coordinate regulatory action.

Aims and Objectives. The reform comprises two legislative proposals, one on electricity market structure (EMD) and the other on protection against wholesale energy market manipulation (REMIT). They seek to improve consumer protection, the efficiency and security of the electricity system and optimise the level of investments. They also attempt to prepare the EU for the challenges of the energy transition (the so-called "3Ds": decarbonisation, digitalisation, decentralisation). The main thrust of the reform is to increase the possibility of smoothing fluctuations in electricity prices in short-term markets (which are often linked to fossil fuel prices) through greater use of long-term contracts. However, the EC draft retains the basic principles of the electricity market, especially the price-setting mechanism in short-term markets.

The reform also envisages supporting the expansion of the flexibility of the electricity system through, among other things, the wider use of energy storage. An important element is to increase the transparency of the activity of transmission and distribution network operators in offering connection capacities to prosumers (end consumers who at the same time generate electricity from RES through micro-installations, e.g., photovoltaic). The position of consumers is also to be improved by better implementation of energy communities (local associations whose main purpose is to produce energy for their own use and sale), self-consumption and sharing of renewable energy (cable pooling, i.e., enabling different RES installations to share a grid connection).

To provide a secure income for companies investing in RES and other low-carbon technologies such as nuclear power plants, but also to avoid excess profits in periods of high prices, the reform clarifies access to long-term contracts—Contracts for Difference (CfDs) and Power Purchase Agreements (PPAs). In the case of CfDs (contracts under which power generators investing in new capacity receive a pre-agreed price for electricity from the state), the EC has proposed that their use should be voluntary for new low-carbon installations, unless they benefit from state aid. On

the other hand, if the market price is higher than the one agreed under the differential contract, the operator will have to return the excess revenue to the state. In the case of PPAs, on the other hand, the EC proposes the introduction of a guarantee for the state to take back energy at market prices in the event of non-payment by the buyer.

Challenges. The EC's proposal is a cautious compromise between proponents of a top-down overhaul of the market structure (proposed by Spain and France, among others) and countries attached to the primacy of market mechanisms (mainly Germany, Denmark, Finland, the Netherlands). Finding agreement is not made any easier by the fact that negotiations are taking place under time pressure due to the European Parliament (EP) elections in 2024. The Swedish EU presidency has made efforts to reach an overall agreement by the end of June this year, but without success. Three key strands of the reform are still open: CfDs, including the scope of their application and the direction of disbursement of revenues raised from them; electricity price caps and how they can continue to be used to feed into national budgets; and, capacity mechanisms, in particular extending the possibility for coal-fired power plants to benefit from support under the capacity market from July 2025 to the end of 2028. Negotiations continue under the incoming Spanish presidency.

Member States' conflicting interests stem from differences in their energy mixes. For example, Germany opposes proposals by France (supported by a group of nuclear-friendly countries) to allow the introduction of CfDs for existing nuclear power plants. They argue that additional support of this kind will distort the European energy market, allowing them to guarantee lower tariffs for industry and a competitive advantage for France.

The Polish demand is to extend the capacity mechanisms until 2028, under which the state could support conventional installations. The justification for this is energy security (including the need to guarantee a power reserve to support Ukraine in a crisis). Countries from the interventionist camp, such as Spain, are in principle in favour of maintaining the capacity mechanisms as a structural solution, but the extension of the instrument for coal units with emissions of more than 550g CO2/kWh, which Poland is seeking, is met with scepticism. Representatives of Germany, Luxembourg, the Netherlands, Denmark, Portugal, and Belgium were particularly critical of a possible derogation for Poland, seeing it is contrary to the decarbonisation goals.

Against the backdrop of the energy sector's capital expenditure on the energy transition, its demands were an important element in the discussion. The industry, from generators to energy traders, opposes the extension of the revenue cap (introduced in October 2022 and due to run until the end of June 2023) for generators and the use of excess profits to help consumers. It argues that price caps will divert funds needed for investments (e.g., in the expansion of electricity grids) to consumers and maintain regulatory uncertainty that is unjustified outside the crisis. In turn, some countries (including Poland) are seeking to extend by one year, until 30 June 2024, the possibility for states to levy a tax on excess profits (above €180 per MWh) on energy producers.

Conclusions and Outlook. The EC proposal is an opportunity to strengthen long-term markets and accelerate the energy transition. Despite its conservative nature, it creates greater incentives for long-term contracts without unduly interfering with the structure of short-term markets.

Crucial to the success of the changes will be the extent to which the interests of Member States, investors and consumers can be reconciled. The future structure of electricity markets can become a tool in the fair distribution of the costs and benefits of modernising the electricity system. However, as a first step, the already agreed legislation, including the Clean Energy or REPowerEU packages, should be fully implemented at national level. The disadvantage of the reform, however, is the fast pace of its procedure, which does not allow for an extensive analysis of the effects of individual measures.

Polish demands for a fair transition and energy security within the framework of the capacity mechanism will be difficult to find broad support for. This could mean difficulties in maintaining some of the controllable coal capacity after 2025 until it is replaced by other technologies. On the other hand, as part of a coalition of countries favourable to nuclear energy, it is worth continuing efforts to promote the idea of technological neutrality, which is strongly supported by countries using nuclear energy or intending to integrate it into their energy mix in the future, such as Poland.

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