Commission non-paper for the Extraordinary Energy Council of 9 September 2022

This non-paper for the Extraordinary Energy Council sets out the rationale and main elements of emergency measures, currently under consideration in the Commission, to address the challenges in the energy market.

1) Energy markets under acute stress require new measures

In response to Russia's unprovoked war of aggression against Ukraine and its weaponisation of energy, the European Union and its Member States have taken a series of measures to decrease their exposure to Russian fossil fuels, to increase security of gas supply and address high energy prices. They are aligned with and reinforce the goals of the European Green Deal.

Member States have agreed in March 2022 to phase out the EU's dependence on Russian fossil fuels while scaling up investment in renewables and reducing energy demand. The REPowerEU plan is building on a full and enhanced implementation of the Fit for 55 proposals for achieving the EU's binding commitment to reduce greenhouse gas emissions by at least 55% by 2030. Increased home-grown clean energy will over time lower electricity prices and fossil fuel imports, improving affordability and energy security.

The EU has been working since the start of the war to diversify gas supplies away from Russia, engaging with international partners such as the US, Norway, Algeria, Azerbaijan, Egypt, Israel and others. Record levels of LNG imports and higher pipeline gas deliveries have compensated the drastic reduction in Russian pipeline gas.

This has enabled the filling of European gas storage facilities at more than 80%, two months ahead of schedule of the new Gas Storage Regulation. Together with the adoption over summer of a new gas demand reduction regulation, this makes the EU better prepared for the coming winter on gas supplies.

To alleviate the pressure of high prices on vulnerable households and companies, most Member States have taken measures in line with the European Commission's energy prices toolbox presented in October 2021. The Commission has facilitated national responses by providing a temporary state aid framework.

The coordinated diversification, demand reduction and storage have made the European energy system more resilient. It has been able until now to replace Russian gas and guarantee gas supplies in all Member States.

However, the deliberate disruption of gas flows from Russia through most routes, affecting in particular 13 Member States, and the unjustified halting of gas delivery through Nord Stream 1 point to a scenario of a full disruption of Russian gas supplies. There is no reason to assume that Russia's unreliable behaviour of creating uncertainty and swelling prices will change.

Because of uncertainties, European gas prices broke record highs on six consecutive trading days in August. The effect of these gas prices on the electricity market is now compounded by the shortfall of nuclear energy, the scarcity of European hydropower generation this summer, and draught-induced low river flows affecting coal transport, among others. The effects of record-high energy prices are having an impact on consumers, businesses and energy suppliers.

The Commission has been working over the summer on an additional set of emergency measures that together would mitigate the price pressure through reducing demand and generate revenues to support vulnerable households and companies facing a large increase in prices and accelerate their transition out of fossil fuels.

The measures under development would provide a framework for EU coordination and solidarity. They should meet the following principles: alleviate the impact on consumer's energy bills and accelerate the clean energy transition in line with the European Green Deal, preserve the internal market and its benefits for all Member States, , ensure security of supply and not lead to increased gas consumption, and be simple to implement while being consistent with longer term reforms that are needed in the European energy system, in particular in the electricity market to make it fit for the net zero economy.

Given the severe difficulties arising in the supply of energy, the Commission will propose measures in a spirit of solidarity between Member States. With a view to avoiding the risk of significant distortions in the internal market, which would accentuate the security of supply risk, it is crucial that all Member States act jointly in a spirit of solidarity.

2) An integrated set of emergency interventions

1. Smart savings of electricity

Coordinated efforts to **reduce peak demand** of electricity will lower overall consumption of electricity in the Union, leading to less gas being used for power generation, lower wholesale electricity prices, and subsequent lower prices for consumers.

As regards **peak consumption**, the measure would set **binding reduction targets for Member States during identified peak price hours**. Member States would identify the means to achieve such targets. One way to meet these targets would be to introduce auctions in which particular consumer categories (e.g., industrial, or aggregated retail consumers) submit bids on the amount of financial compensation they would need to cut consumption. A demand reduction organised via such market-based tenders comes at a cost for national budgets as it requires compensation, for which revenues generated as part of some other measures in the package would be available. Such a measure would support the EU's sustainability objectives.

As regards **overall consumption**, Member States would identify the best means to decrease total consumption. Measures would need to take into account consumers who do not have smart meters or flexibility devices installed and can therefore not react specifically to peaks.

Overall demand for electricity will increase in line with the EU's climate and electrification objectives (e.g. heat pumps, electric vehicles). This calls for a smart design of emergency measures.

2. Cap of infra-marginal electricity producers' revenues

A second set of measures would address the issues of high prices and help Member States continue supporting vulnerable consumers and businesses exposed to them.

A further element of the emergency intervention package would thus be a **European revenue cap for inframarginal generation technologies (i.e. cheaper than current final price-setting technologies)**. These technologies made unexpected high profits in the current context of high prices, as their marginal production costs are low. The cap would be set ensuring cost coverage for renewable and low carbon capacity. The same price would be paid to all inframarginal generators in a uniform manner, thus ensuring a European solution and level playing field. It would be set in such a way as to ensure adequate investment incentives remain.

This measure would draw on the main features of **contracts for difference**, i.e. long-term contracts ensuring that both the electricity producer and buyer have certainty of supply and price over the long-term. These are the essential features of a future electricity market in which low cost, low carbon technologies take the main share of the market. This is in line with the objectives of the long-term reform of the electricity market functioning, which is a separate work stream and will be presented by the Commission early next year.

The difference between the revenue cap and the electricity market price will generate **extra financial revenues.** These should be **used to support consumers in need, both households and businesses, and help the energy transformation.** The support should be well targeted for consumers, and for companies, comply with the State aid framework in order to avoid distortions to the single market**. The revenues would thus** serve to **lower electricity bills** for vulnerable households and businesses with conditions for **demand reduction**.

The measure would establish an EU-wide uniform maximum remuneration of inframarginal revenues. Member States would have the possibility to continue existing national measures or to implement, introduce or retain measures which impose stricter revenue limitations (e.g. in the form of existing excess profit schemes) to cater for their specific situation.

3. Solidarity contribution

A third measure would address the **extraordinarily large profits accruing from the high prices to fossil sector companies, as a temporary crisis solidarity contribution**. Applying the solidarity contribution to all companies in the oil, gas and coal sectors (excluding double contributions) would complement the inframarginal revenue cap measure. Both would provide an answer to challenges Member States have faced in establishing such measures. It would also ensure solidarity through joint action and avoid negative spill overs within the Internal Market. Its design would be simple, using as a base profits before tax as calculated for national purposes already. Companies and national authorities are familiar with these rules and procedures.

Revenues from this contribution, collected at national level, should be used to finance reduced energy bills for vulnerable households and businesses and/or support a faster move to green energy. This could include support to companies, notably in energy-intensive sectors such as fertiliser production, provided conditions for transformation are fulfilled and state aid rules respected. A share of the revenues generated could be used to finance REPowerEU national plans.

4. Liquidity in the financial markets for energy

There is mounting worry about the impact that record-high prices and especially volatility are having on electricity trading. Concerns exist of possible defaults by energy supply companies. Already now, some governments provide state guarantees to those companies.

The volatility in underlying gas prices is creating conditions of stress in the functioning of electricity futures markets, notably in the process of margining. Risks faced by market participants have also increased, and so have the amounts of margins collected to secure the system. As a result, energy firms face difficulties financing those margin calls for lack of cash collateral, and some of them have requested state guarantees. However, those margins are indispensable to protect the financial system from energy firms defaulting and to mitigate the subsequent financial stability risks for banks and market infrastructures who manage these risks. Reducing margins on energy companies would only shift risk through the system, to banks and eventually Member State.

To ensure the smooth operation of the margining process, the Commission will engage with the relevant securities and banking **regulators** to explore ways to enable market participants to **find the collateral** to meet margin calls. This might involve accepting a wider range of assets as collateral for margining purpose, facilitating collateral transformation, bank guarantees and, as a liquidity provider, involve state guarantee schemes to support such liquidity mechanisms.

Where state support is needed, the **EU State aid rules and the temporary crisis framework provides an EU rulebook already**[1]. The Commission is continuously assessing if further measures are necessary to complement the toolbox for Member States to support their economy. In this context, it will in the coming days launch a survey to seek Member State views, including on **possible further amendments to and prolongation of the State aid Temporary Crisis Framework** to align with this emergency package and the impacts of the energy crisis.

In parallel, the Commission is engaging with the operators of futures exchanges on the application of so-called “**circuit breakers**” to address episodes of increased intra-day volatility. The aim of a harmonised approach is to limit daily price movements to better manage volatility and the daily exchange of margins.

Separately, to establish market-based and fair prices for gas imports, there is a case for deploying an **EU-based LNG pricing benchmark** that can be used by market participants. The Commission will engage with market participants and regulators to accelerate the creation of a representative and widely used LNG price benchmark for forward deliveries to the Union. The Commission is also considering whether to tender such a reference rate to accelerate further its production. In addition, the Commission will engage with exchange operators to create new exchange-traded derivative contracts that reference the new LNG benchmark, allowing market participants to better manage their input prices for electricity deliveries.

5. Lowering gas prices

[1] The Commission’s State aid Temporary Crisis Framework adopted in March 2022, as amended in July 2022, enables Member States to provide loans and guarantees to cover liquidity needs also derived from these activities. Where state support is provided on terms that private operators would also have provided, this does not involve State aid.

Europe is largely a price-taker for gas traded on the global market. Imposing a strict price cap on **Liquified Natural Gas** (LNG) entails risks to security of supply, diverting deliveries away to other regions. At the same time, Europe faces a global competitiveness challenge due to the high prices it needs to pay for securing LNG deliveries. The EU Energy Platform should be mandated to negotiate lower prices and secure supplies, offering a long-term perspective with a gradual transition to renewable energy sources, in particular green hydrogen. It should also explore other ways to avoid substantially higher LNG prices for Europe than in other parts of the world such as Asia.

For **pipeline gas**, reliable suppliers like Norway have maximised their gas supplies to the EU. Engaging with these partner countries to ensure security of supply and lower prices in a negotiated way should be further pursued. The EU Energy Platform should be mandated to that effect.

Our reduced exposure to **Russian gas**, on the other hand, makes the imposition of a price cap for pipeline gas imports a more feasible option. It is also a compelling case because extremely high natural gas prices have allowed Russia to maintain revenues despite deliberate cuts in volumes. Russian gas by pipe cannot be easily diverted to third countries. A price cap on Russian pipeline gas would allow purchases of such gas insofar as the price does not exceed a pre-established threshold [2]. The price cap would apply at the moment of the import, leaving price formation for the sale of gas within the internal market unaffected.

The measure may well be used by Russia to justify further disruptions under existing contracts. Thanks to diversification, savings and storage, and given the latest disruption, the EU is now better prepared for this scenario. Significant disruptions are already taking place without a price cap.

3) Conclusion

The different emergency measures to be adopted under article 122 of the Treaty on a European level will be appropriate, proportionate and limited in time to address the severe difficulties in the area of energy. They would, in particular, provide revenues to support vulnerable consumers who face very high energy bills, accelerate the clean energy transition and ensure a level playing field for companies across the EU. They will be proposed in a spirit of solidarity and fairness to overcome the energy crisis by acting together.

The short-term emergency measures thus outlined and under preparation by the Commission will complement the previous EU's response to the evolving energy crisis. They equally pave the way towards a more structural reform of the EU's energy system, including the electricity market design, so as to be fit for full decarbonisation with improved energy security and affordability.

[2] Setting the price cap above the marginal production cost could help ensure supplies and lower prices while keeping the incentive to continue exporting gas to Europe at a price lower than current market prices, in particular when no alternatives for the gas not exported to the EU exist.