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Real Decreto-ley 17/2021 on urgent measures to mitigate the impact of the increase in natural gas prices in the gas and electricity markets

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EFET views and recommendations – 1 October 2021

The European Federation of Energy Traders (EFET)[1] wishes to provide comments on the Real Decreto-ley (RDL) 17/2021 on 'urgent measures to mitigate the impact of the increase in natural gas prices in the gas and electricity markets', which was adopted by the Spanish government on 14 September 2021.

We understand why the Spanish Government is concerned about the recent rises in price and the affordability of energy supply for citizens. However, two of the measures which have been adopted as part of the RDL alter the functioning of the wholesale markets, increase regulatory uncertainty, and create long-term distortions. These distortions will make it harder for private investors and electricity companies to provide stable prices to consumers.

This paper analyses the way in which these two mechanisms – the gas "clawback" mechanism and the compulsory auction scheme for dominant market participants – affect the functioning of the market and outlines how they could lead to unintended consequences. It also proposes alternative measures in addition to those already adopted, which avoid these negative long-term consequences, that may more effectively mitigate the Spanish Government's concerns.

Executive summary

We fully support the objective to protect the most vulnerable citizens from peaks in energy prices, and we acknowledge the importance of advancing the economic recovery after the health crisis caused by the COVID-19 pandemic.

However, we believe that the gas clawback mechanism and the mandatory auction scheme for dominant market participants create significant risks, by:

- Not recognising the current efforts of market participants to secure stable prices at the lowest possible cost in the forward market for consumers' energy supply;
- Splitting the liquidity of forward market and undermining market participants' ability to continue to hedge risks cost-efficiently, creating unnecessary costs for society;
- Taking the risk of a regulation-induced overdrive in short and long-term electricity prices, which will ultimately hit consumers;
- Undermining investor confidence in Spain, in particular in non-CO2 emitting technologies so far supported by a booming PPAs market, but also in other innovations;
- Driving carbon emissions up in the short term, and threatening the goals of the European green Deal as well as Spain's own commitments as part of the Paris Agreement.

[1] The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. We build trust in power and gas markets across Europe, so that they may underpin a sustainable and secure energy supply and enable the transition to a carbon neutral economy. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org

Therefore, **we recommend continuing with alternative measures** to cater to the Spanish government's concerns with regard to ensuring the affordability of energy supply to its citizens, including:

- A further VAT reduction on electricity;
- Targeted system charge suspensions;
- Direct aid to small and medium enterprises;
- Direct financial support to vulnerable consumers.

1. Analysis of the gas "clawback" mechanism and its effects

I. Design of the Mechanism

The RDL establishes a temporary gas clawback mechanism, to run from 16 September 2021 until 31 March 2022. The measure is designed to redistribute so-called "excess" remuneration that certain power plants are perceived to receive. The measure establishes that all electricity production facilities in mainland Spain that do not emit greenhouse gases – nuclear, hydro, and renewables[2] – must "give back" any remuneration considered as excessive to the electricity system when the price of gas exceeds EUR 20/MWh. This revenue will be used to offset the higher cost of electricity generated from natural gas and reduce bills for consumers.

The measure excludes the two following categories of installations:

i) plants under regulated remuneration schemes (plants not located on the mainland; RES, CHP or waste plants until the end of their regulated remuneration scheme);
ii) installations with a nominal generation capacity up to 10 MW.

A complementary clarification note[3] specified that the measure will not apply to electricity covered by any forward contracting instrument signed before the entry into force of the RDL, as long as the prices of these contracts are fixed (not indexed to the spot price) and that they are not intra-group transactions.

II. Consequences for the energy markets – which risk adversely impacting consumers:

a. The measure fails to reflect the realities of hedging – and the way markets shield consumers from price spikes

The measure is based on the idea that generators earn a higher return when the spot price of gas is high. This is generally not true: in order to manage volatility in wholesale markets and ensure a continuous, least-cost supply to customers at stable prices, firms, including vertically integrated companies of all sizes and profiles, employ sophisticated hedging strategies. This means that **production is sold several years ahead** – at a range of prices.

[2] In practice, the measure will affect over 6 months roughly 31 TWh of nuclear power, 14 TWh of hydropower and 10 TWh of solar & wind power generation.
[3] See MITERD clarifications on Real Decreto-ley 17/2021 (20 September 2021).

For 2021, 100% of baseload production (including hydro, nuclear and renewable), and more than 75% of baseload production for 2022 has been already sold by these generators months ago at the prices that existed at the time. The price at which these contracts have been negotiated is round EUR 50/MWh, far from the price levels we're experiencing today.

In short, generators have already sold most of the electricity needed for the supply of customers over the September 2021-March 2022 period, and at much lower than the current spot market prices. By not taking this reality of forward markets into account, and explicitly excluding intragroup contracts in the exemption criteria, the clawback measure will require market participants to reimburse money that they have not earned, which would have unintended effects on many actors of the sector and **endanger the ability of these firms to supply electricity in the long term**.

b. The measure will alter the price signals faced by market participants – and risk pushing electricity prices further up

The gas clawback mechanism modifies the relative costs of different technologies. In simple terms, generators subject to the ex-post clawback measure and able to reduce output are likely do so. In turn, those not impacted by the measure will need to operate more in order to compensate.

With **cheap volumes disappearing from the merit order** and being replaced by more expensive bids (from within Spain or neighbouring countries), the marginal spot price of electricity risks rising even higher. As a result, **the measure risks exacerbating the spot price spikes currently being experienced**.

c. The measure is difficult to view as truly temporary – which will impact investments in the long run and amplifies the regulatory uncertainty

Although conceived as a temporary measure, reference in the gas clawback measure to a gas price of EUR 20/MWh makes it difficult to view the measure as truly temporary. Were, for example, the gas price to be above this level in March 2022, or to move above this level at any other point in future, it would seem logical to assume there would be pressure to reintroduce the measure.

Further, the gas clawback measure is inspired by the permanent "carbon clawback" proposal[4] currently under Congress scrutiny. The threat of an extension or resurgence of the gas clawback, along the lines of the carbon clawback, is **a risk that will be factored in by any market participant in the short to medium term, with a direct effect on prices in the spot and forward markets**. Most importantly, **investors will also take this threat into account for their investment decisions, potentially endangering security of supply in the long term** (or, at a minimum, increasing the rate of return an investor needs in order to invest in Spain – a cost ultimately paid by customers).

[4] EFET has already expressed its strong concerns on the "carbon clawback" measure: see [EFET response to MITERD consultation on reducing the remuneration of low-carbon plants constructed before the launch of the EU ETS]().

This will affect not only technologies directly targeted by the measure, but also other innovations in the market that rely on a stable market environment and the free formation of prices in all timeframes, such as demand-response, electricity storage and power-to-X. Measures of this sort are likely to act as a **strong disincentive to invest in research and development and innovative projects**.

d. The measure threatens Spain's progress towards a decarbonized energy supply – and the fulfilment of its international sustainability commitments

In the short and medium term, the measure encourages the reduction of electricity production from hydro, nuclear and RES-E generation. Therefore, it is probable that **the reduction of the power produced by non-emitting technologies would have to be replaced by thermal power plants** in certain hours in order to meet demand. This could lead to an increase in GHG emissions from the power sector.

The regulatory uncertainty which the measure generates in the short term will have a long-term impact. The measure is likely to **discourage the development of new renewable assets in Spain** and make their financing, including through Power Purchase Agreements[5], more expensive. This would appear to make it more difficult, and more costly, to meet the objectives of the Paris agreement and the Green Deal.

2. Analysis of the mandatory auction scheme for dominant market participants

The RDL also introduces a new type of long-term power purchase auction which will be held alongside the wholesale market. A subset of market participants will be required to offer up to 25% of their non-emitting generation into these auctions.

We understand that one aim of the mandatory auction scheme is to reduce the volume of energy materially exposed to the spot price, and to promote forward contracting. However, we believe this measure to be counterproductive and likely to increase the financial burden on consumers in the long-term as:

a. The measure will deteriorate the forward market rather than improve it – making long-term contracting more expensive

We are unconvinced that mandatory auctions separate to the forward market can promote liquidity in forward contracting. On the contrary, the mandatory auction scheme will split the forward market into two, as a sizeable amount of electricity production in Spain will be moved to the auction mechanism.

When markets are split into two, liquidity suffers, meaning that it will be more difficult for market participants to enter into transactions at the volume and price of their choice. This risk of not finding a buyer/seller, or not being able to buy/sell at a reasonable price represents a cost for

[5] It important to note that Spain is a relevant market for PPAs: according to BNEF, 4.2GW of capacity (mostly solar) has been contracted under PPAs in 2020 alone.

all parties – sellers and buyers – which is internalised in the price of electricity[6]. **The mandatory auction scheme hence risks pushing electricity prices further up, to the detriment of consumers**.

b. The measure is unnecessary as electricity affected by the auctions is already hedged on the forward market

Most of the non-CO2 emitting production is already transacted on the forward market[7], meaning that the scheme will simply remove these volumes from the forward market and force them into the mandatory auction. **The mandatory actions do not increase long-term contracting, but force production that is already sold on the forward market to "switch avenues", with the negative liquidity effects and increase in risk hedging premia already highlighted above**.

In particular, the first one-off auction (in the form of annual or multi-annual products) foreseen in *Disposición adicional segunda* will require a total volume of 15.830,08 GWh to be sold before 31 December 2021. This will concentrate an incommensurate volume of electricity sales in the auction compared to the overall figures of the current Spanish forward market[8].

c. The measure will be replaced by a restricted access mechanism where liquidity and competition cannot develop

The mandatory auction will be reserved to those market participants targeted by the scheme, i.e. large generators on the sell side, and industrial consumers or retail suppliers with end-consumers on the buy side. Energy traders and other market participants without direct presence in the retail market, as well as intra-group retailers belonging to an "operador principal" will be excluded from the mechanism.

Participation of all market actors in any form of auctions is crucial to achieve adequate levels of liquidity and price competition. A scheme from which certain market participants are excluded is not conducive to healthy liquidity and competition. **Splitting the long-term Spanish market into two will not even be a null-sum game: it will deteriorate liquidity and competition in the forward market while not succeeding in recreating them in the auction scheme**.

[6] In its report following the consultation of MIBEL on the subject, the MIBEL BR indicated that it "takes note of the view of the participants in the public consultation who commented that the establishment of energy auctions for integrated groups would affect the liquidity of the forward market's trading on the continuous market of organised market trading venues. Furthermore, they consider that the establishment of this instrument as a regulatory measure can, artificially, affect efficient price formation". For further details, see the BR MIBEL website: MIBEL BR Assessment Document of the replies received in response to the MIBEL BR Public Consultation.

[7] According to the National Electricity Balance of 2020, the Spanish market supplied over 200 TWh of electricity to consumers at a fixed price (out of total system consumption of 251 TWh). If we break down the electricity sold at fixed price (200 TWh), 116 TWh was hedged with physical contracts, while the remaining volumes were back by financial hedges (with intermediaries willing to assume that risk) or left exposed to the price fluctuations of the daily market.

[8] Representing: i) 65% aprox. the yearly regulated demand in 2019 (PVPC); ii) 20% of the traded volume in 2020 (Cal+1), when the activity in forward markets was relevant, due to volatility related to the covid crisis; iii) 72 times the daily volume currently released by market makers.

EFET recommendations for alternative measures

We believe that **alternative measures exist, which Member States can use to help citizens to cope with sudden increases in energy prices**. These include:

- *VAT and excise policy:* such as a further temporary VAT reduction from 10% to 5% for electricity until 31 March 2022
- *Targeted measures for energy poor and vulnerable consumers*: such as a temporary reduction or suspension of network charges applied to domestic users and non-domestic low voltage users
- *Temporary measures for households and small businesses*: such as a 3 to 6-month extension of direct aid to self-employed individuals and SMEs, which the Spanish government granted only until end of September 2021
- *Direct support to consumers*: such as an "energy voucher" for low-income households

These are all *"steps that can be taken, fully in line with the EU rules", a*s stated by Commissioner Simson following the Informal Energy and Transport Council meeting on 22 September 2021[9].

The measures approved in the form of a Royal Decree-Law, without the active involvement of stakeholders and the ordinary process of debate, amendment and approval in the national Congress, has created considerable regulatory uncertainty in Spain. The approval of the measures without the possibility of a dialogue between citizens, market participants, the national regulatory authority and the Government creates a precedent that further undermines confidence.

Hence, **we call on the Spanish government to withdraw the rules of the RDL establishing the gas clawback mechanism and the mandatory auction scheme. We also invite the Government to reopen a dialogue with all interested parties, with a view to address its concerns over affordability of energy supply in a manner that is effective, that does not further threaten customers in the long run, and that is fully compliant with EU rules**.

[9] See Remarks by Commissioner Simson following the Informal Energy and Transport Council meeting (22 September 2021)