THE OXFORD INSTITUTE FOR ENERGY STUDIES

April 2023

EU energy policy between emergency measures and energy transition legislation: do we need to fear for our liberalized gas market?

OIES ENERGY COMMENT

Klaus-Dieter Borchardt, Senior Research Fellow, OIES

Introduction

The European Green Deal, launched in 2019, is the European Union's flagship decarbonization strategy. The Green Deal has put the EU on a path to climate neutrality by 2050, through the decarbonization of all sectors of the economy. In its new Climate Target Plan for 2030 the European Commission (Commission) has set an intermediate target of at least 55 per cent green house gas (GHG) emission reduction to be reached through a number of legislative actions. In July 2021, the Commission proposed its Fit for 55 package, followed in October 2021 by the proposal of the Gas and Hydrogen package which encompassed all the measures necessary to achieve the decarbonization targets. If adopted, it is the most ambitious and coherent decarbonization package ever seen.

However, since 2021, the EU has experienced an unprecedented energy crisis with economic, social and geopolitical impacts, caused first by a strong increase in global demand after the lifting of COVID-19 restrictions and then dramatically exacerbated by Russia's invasion of Ukraine, which led to substantially lower levels of pipeline gas deliveries to the EU and increased disruption of gas supply. The skyrocketing energy prices put enormous pressure on politicians which initially led to national actions such as the Iberian gas reference price model and the Greek regulated price mechanism, but was then followed by a complete set of emergency measures at EU level.

Although the work of the EU co-legislators (the European Parliament (EP) and the Council) on the Fit for 55 package and the gas and hydrogen package continued, it is clear that the necessity for interventions at national and European level to combat the energy crisis have deflected attention away from energy transition legislation towards emergency measures. The question is whether this is only a temporary phenomenon or whether this shift in attention and the deep market interventions of the emergency measures will have a more long-term impact on the functioning of the European internal energy markets.

1. The energy transition legislation and EU emergency measures

1.1 Energy transition legislation

Under the Fit for 55 package, each individual proposal (notably revisions of the Renewable Energy Directive, the Energy Efficiency Directive, the Emission Trading System, the Carbon Border Adjustment Mechanism, the Tax Directive, and the Methane Emissions Reduction regulation) was drafted taking into account the vision and overarching target to reduce GHG emissions by 55 per cent by 2030. It is an ambitious package because many of the proposals will require a step-change in the level of action and determination by Member States – meaning much greater and faster action than has been seen up to now.

A number of proposals, including the revision of the EU Emissions Trading System (ETS), the introduction of a Carbon Border Adjustment Mechanism (CBAM) and the revision of the Energy Efficiency Directive, have already been adopted by the EU co-legislators. However, the adoption of a number of key proposals (notably the revisions of the Renewable Energy Directive, Tax Directive, Gas and Hydrogen Directive and Regulation and Methane Emissions Reduction Regulation) remain subject to inter-institutional negotiations between the co-legislators which is currently ongoing. All the legislative acts of the Fit for 55 package, complemented by new proposals regarding electricity market design, a Net-Zero Industry Act and a Hydrogen Bank, still need to be adopted by the EU co-legislators before the end of Q1 2024. This timing is not only crucial in order to speed up the implementation of the Fit for 55 packages but is vital because the EP will not be able to exercise its role as co-legislator after Q1 2024 due to the European elections in June 2024 and the start of the election campaign in April 2024.

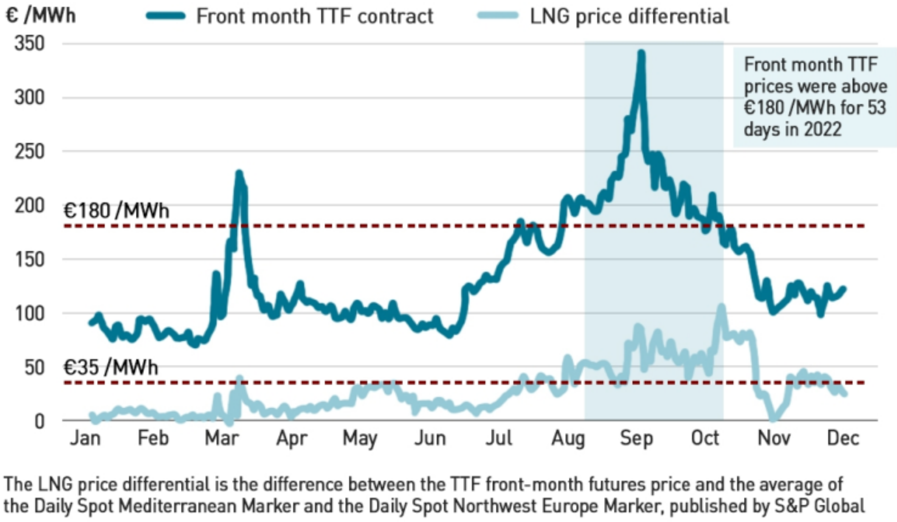
1.2 Emergency measures for the gas sector

At the start of the energy crisis the Commission was initially rather reluctant to propose its own market-related measures but left the initiative to Member States and reduced its own role to the supervision of these measures. A first intervention at EU level only came in June 2022 when the EP and the Council adopted the Gas Storage Regulation. It sets a Union-wide gas storage target, requiring 85 per cent (for 2022) and 90 per cent (for the subsequent years) of underground storage in the EU to be filled under a stated trajectory by 1 November of each year. The storage requirements introduced by the Regulation will apply until 31 December 2025, and have so far been achieved by Member States. This measure was followed by a Regulation aimed at ensuring reductions in gas demand during the crisis period adopted by the Council on 26 July 2022. Member States accepted a non-binding target, which would become a legally binding obligation in the event that the Council triggers a 'Union alert', to reduce their gas demand by 15 per cent in the period 1 August 2022 to 31 March 2023 compared to their average consumption in the past five years. The Commission has already announced that it will propose an extension of this measure for another year to ensure that the EU is prepared for winter 2023/24.

Beyond this, Member States and the European Council have continued to put significant pressure on the Commission to table a much more ambitious emergency package, including concrete measures addressing the extremely high gas prices. The Commission reacted to this request on 18 October 2022 with an emergency package including measures to address the ongoing gas price crisis and to ensure security of supply. The Council adopted this package in the form of two Regulations on 19 December 2022, Council Regulation (EU) 2022/2578 establishing a market correction mechanism to protect Union citizens and the economy against excessively high prices and Council Regulation (EU) 2022/2576 enhancing solidarity through better coordination of gas purchases, reliable price benchmarks and exchanges of gas across borders. In particular, the following elements of these Regulations should be noted:

(1) *Market Correction Mechanism or wholesale gas price cap* (*Regulation (EU) 2022/2578)*: after much disagreement between Member States, the Council agreed to a form of emergency gas wholesale price cap. Member States were divided between those well connected to non-Russian pipeline supplies (Spain, France, Belgium) that were in favour of a gas price cap, and those that were (previously) dependent on Russian supplies (notably Germany, Austria, Romania, Bulgaria) which were not in favour. After months of disagreement, a price cap was nonetheless agreed. However, it was set at a very high level (the price on the Dutch TTF must exceed €180/MWh for three working days, and the month-ahead TTF price must be €35/MWh higher than a reference price for LNG on global markets for the same three working days), meaning it is more a 'safety valve' than a real price cap - given a combination of a high price cap and a requirement for a minimum high price duration, the cap would have been triggered on 53 days in the past two years, based on prices seen in the EU (see Figure 1). However, as the cap does not cover over-the-counter (OTC) trades, any country would have been able to continue to source gas above the price cap if it could afford to do so. The mechanism started applying on 15 February 2023 for one year and was extended to other hubs. It may be extended beyond 15 February 2024 by a new Council Regulation. Given the sharp fall in prices over the past few months, it has to date (as of end March 2023) not had any effect.

Figure 1: The EU price cap and its theoretical impact in 2022



Source: ICE, S&P Global, Bloomberg

(2) *Gas demand aggregation and joint purchasing platform* (Articles 3-11 Regulation (EU) 2022/2576): One of (but certainly not the only) underlying reason why gas prices peaked at above €200 MWh in Q3 2022 was the storage filling obligation with a mandatory trajectory, creating high short-term demand via competition between Member States to acquire gas to meet the targets. Because of this, and also due to the perception of many (notably smaller) Member States that they were being 'out-competed' for gas by Germany and that the EU was failing to exercise its 'gas buying power', there was agreement on the need for a Regulation requiring Member States to ensure that a certain amount of their expected gas purchases would be aggregated (to promote transparency and predictability). The scheme follows a two-step process involving a (partly obligatory) demand aggregation of an estimated 13.5 Bcm of natural gas as step 1 followed by (always voluntary) coordinated gas purchasing as step 2, where a service provider (PRISMA was selected in a competitive procedure) subsequently matches customers and producers of natural gas via an IT tool to meet the submitted demand. The Commission intends to issue a tender in April with contracts to be signed in June 2023.

(3) *A new LNG price benchmark* will be developed by ACER in order for gas market participants to have a price index that reflects the actual conditions in the market by early 2023.

2. Emergency measures as a game changer for the implementation of the Green Deal and as a challenge for the liberalization of the gas market

2.1 Slowing down the process of adoption and implementation of European legislation for energy transition

Looking at the increasing number and scope of market interventions in the emergency measures the questions are whether they have the potential to slow down the process of the adoption and implementation of European legislation for the energy transition and/or to have long-term effects that could undermine the EU's competitive gas market.

There is absolutely no doubt that the legislative activities concerned with the emergency measures have had a negative impact on the timetable for the adoption of the legislative packages for the implementation of the Green Deal. Notably the Council, which had to act alone to address the emergency proposals of the Commission, was forced to review its priorities and to deal with the very necessary, albeit controversial, emergency measures first and to delay the development of its general approach to the energy transition packages, in particular its work on the gas and hydrogen package. However, this does not mean that the EU co-legislators will fail to adopt the packages in time. Too much is at stake and both the Council and the EP are working hard to achieve the necessary compromises. Regarding the gas and hydrogen package, the EP is now ready to start the trialogues, and the Council seems to be almost prepared to adopt its general approach, which would allow it to start the trialogue in April.

2.2 Impact on the ambitions set for the energy transformation path

Although the 'extra work' on the emergency measures by Commission and Council will not put in jeopardy the timely adoption of all Fit for 55 measures, another question is whether the discussions around the emergency measures and the attitudes taken by Member States to fight the energy crisis will have an impact on the ambitions set for the energy transformation path.

There seems to be a general understanding among Member States and European institutions that the current geopolitical and economic challenges should not lead them to lose sight of the continued concern about the climate challenges for the planet. The ongoing and ambitious fight against these climate challenges is still receiving significant attention and remains a political priority. Therefore, the current geopolitical and economic challenges should not be (ab)used to push back on the Green Deal, but rather the Green Deal and its legislative implementation through the Fit for 55 packages should be used as a vehicle to pursue the pathway towards the net-zero emission target by 2050. If this remains the common position and EU and Member States act accordingly, then the 2050 target for a zero-carbon economy in the EU need not be in jeopardy.

However, the 2030 targets might be compromised. The reason for this is not so much that the Member States in the Council might disagree with the proposed increase of the headline targets in light of the energy crisis; indeed, as the discussion so far in the EP and the Council has shown, there seems to be broad agreement that the increased primary targets for 2030 in the Fit for 55 proposals will be accepted by the EU co-legislators.[1] Rather, the problem exists in terms of reaching the targets in practice. It seems to be evident that the newly increased headline targets for 2030 cannot be achieved and this is not only because of the new geopolitical and economic challenges but also because these new 2030 targets were too aggressive in the first place. In light of the emergency measures that will be applied in the next few years, it is now even less likely, if not impossible, that those targets will be reached by 2030. The new reliance on increased imports of LNG in 2022, the installation of a number of floating storage regasification units (FSRU's) in record time (notably in Germany) and the expansion of regasification facilities in the EU will not be a temporary exercise for a couple of years only but will stay for quite some time until LNG can be replaced by hydrogen, which will not happen at large scale before 2035. Until then considerable CO_2 and methane emissions will be present in the system. In addition, there is currently a revival of the use of hard coal and lignite in some Member States (notably Germany); although these are temporary 'emergency' actions, they have a slow-down effect on the development of other renewable energy sources at least until 2030, the currently envisaged (but still disputed) phase-out date of coal in Germany.

2.3 Threat for the liberalized energy markets in the EU

Finally, the substance of the emergency measures taken at EU and national level and the attitude of quite a number of Member States with regard to more and more short- and long-term market interventions begs the question - can open, competitive and free energy markets in the EU continue?

It is fair to say that, in substance, the emergency measures taken at national and EU level have led to important distortions of the EU's Internal Energy Market. These mechanisms initially focused on electricity rather than gas, as capping gas prices was considered politically and economically very difficult, despite the fact that high gas prices are the root cause of the gas and electricity price crisis. Thus, electricity prices were the initial focus of EU action. In large part this focused on the extreme profits that generators of renewable and nuclear electricity were assumed to be making during these periods of exceptionally high electricity prices. Gas generators pay high gas input prices, and then (generally) set the marginal electricity price. Renewable and nuclear energy generators, receive this marginal price, even though their input costs have not risen. Member States have sought to claw back this extra profit based on this argument. In addition, a number of Member States, notably Spain, France and Italy, have called on the Commission to fundamentally amend the marginal pricing system underpinning the whole Internal Energy Market. Commission President Von der Leyen has committed to do so, stating that the existing system does not meet the EU's needs.

Despite the pressure from Member States and the declaration of the Commission's President, the recently tabled proposal of the Commission to improve the Union's electricity market design speaks a rather different language. The marginal pricing system remains untouched; instead, the proposal concentrates on those issues for which the energy crisis has clearly exposed a lack of protective measures and some shortcomings. The proposal therefore limits itself to 'corrective' measures including the use of two-way contracts for differences (CfDs) to provide direct price support to renewable and nuclear energy, the implementation of a guarantee scheme to promote power purchase agreements (PPAs), the improvement of market flexibility and the improvement of consumer protection.

This clearly indicates that, at least from the Commission side, there is no intention to rush through a fundamental change in an electricity market design which has served its purpose over the past few decades. In addition, the Commission has (at least until now) refrained from incorporating the infra-marginal revenue cap as a permanent market design mechanism, showing its clear understanding that this mechanism would distort the internal electricity market and should, therefore, only be activated and

[1] This is confirmed by looking at the positions of Commission, EP and Council as known end of March regarding their respective views on the headline targets. RES targets: COM and EP: 45%, Council: 40%; energy efficiency target: reducing the final energy consumption at EU level by at least 11.7% agreed; green hydrogen used in industry: COM 75% by 2030, EP 55% by 2030 and 75% by 2035, Council 35% by 2030 and 50% by 2035.

applied in extreme emergency situations (as it is required when using Article 122 TFEU as a legal basis).[2]

When it comes to the gas market the situation is slightly different. The new gas market design will be covered by the imminent revision of the Gas and Hydrogen Directive and Regulation. This revision ‘updates’ the provisions of the existing market design for natural gas but creates a similar design for hydrogen and biomethane. Nothing in the Parliament’s report or the Council’s (provisional) general approach indicates that this revision will profoundly change the basis of the gas target model which is based on free, competitive and well-functioning markets. The emergency measures and instruments are, in principle, not deemed to alter or undermine this gas target model. Looking at the impact of these measures and mechanisms on the functioning of the gas market, it is clear that the gas storage obligation, which will be applicable until 2025, is a typical security of supply measure which is needed even in a well-functioning and liberalized market because the market is not deemed to provide security of supply in crisis situations. The situation regarding the gas demand reduction measure, the market correction mechanism and the gas demand aggregation and joint purchasing platform is quite different. These measures have a direct impact on the free market (which is impacted by the demand reduction), price formation based on supply and demand (replaced by regulated pricing when the conditions of the market correction mechanism are met) and the competitive market (impacted by the introduction of a single buyer mechanism for gas, LNG and hydrogen); in this sense, all three measures and mechanisms represent a direct public intervention into the functioning of the gas market. However, these interventions are only covered by Article 122 TFEU, the legal basis of which only allows for the adoption of those measures and mechanisms by the Council in severe emergency situations and only for a limited period of time; therefore the gas demand reduction regulation was limited in time until 31 March 2023 (most likely to be extended until 31 March 2024), the market correction mechanism for gas was created for one year until 15 February 2024 and the gas demand aggregation and joint purchasing platform is established for the winter 2023/24 (with a review by 1.10.2023 which might lead to a prolongation for one year). This does not constitute a challenge to the liberalized gas market.

A real threat for the liberalized gas market would, however, occur if these measures are incorporated into the ongoing revision of the Gas Directive and Regulation and become permanent measures and mechanisms within the gas target model. However, there are currently no signs that this is the intention of either of the two EU co-legislators. On the contrary, currently the Council is opposed to the accelerated incorporation of emergency measures into the text of the gas regulations and is asking instead for an in-depth discussion on the efficiency and effectiveness of these emergency measures. The EP only wants to copy and paste the Enhancing Solidarity Regulation into the Security of Supply Regulation (EU) 2017/1938 which would have no impact on the liberalized gas market.

3. The Temporary Crisis and Transition Framework and the Net-Zero Industry Act Proposal: is the EU on its way to more state intervention and dirigisme?

In response to the United States' €369 billion green subsidy package - the Inflation Reduction Act - and concerns that high energy costs are eroding European industrial competitiveness, on 10 March the Commission adopted new state aid rules (Temporary Crisis and Transition Framework, ‘TCTF’) and, on 16 March, proposed the Net-Zero Industry Act.

The TCTF sets out the conditions under which national support measures can be swiftly approved by the Commission under State aid rules and declared compatible with the internal market. In contrast to the previous practice where the rules and the assessment were about the functioning of the single market; private investments; and competition and competitiveness, with the new rules more flexibility is introduced for granting aid in key sectors necessary for the transition to a net-zero economy, notably for the manufacture of strategic equipment, such as batteries, solar panels, wind turbines, heat-pumps, electrolysers and CCUS.

[2] https://www.clearygottlieb.com/news-and-insights/publication-listing/article-122-tfeu-as-a-legal-basis-for-energy-emergency-measures#:~:text=122(2)%20TFEU%20provides%20that,exceptional%20occurrences%20beyond%20its%20control%E2%80%9D.

In addition, the proposal of the Net-Zero Industry Act aims to scale up the manufacturing of these technologies which are key to achieving climate neutrality (‘strategic net-zero technologies’). The objective is to approach or reach, in aggregate, at least 40 per cent of the annual deployment needs for strategic net-zero technologies to be manufactured in the EU by 2030 and the Act urges countries to use a set of policies, from permitting to subsidies and procurement, to meet them. Although this approach avoids openly protectionist provisions such as Washington’s ‘Buy American’ rules, it is however pushing for ‘strategic autonomy’ that has been asked for by an increasing number of Member States in recent times.

These are clear signs of more state intervention, and of course, this relaunches the problem of the internal market and the dominance of the most industrialized countries like Germany or France over other Member States. It facilitates the emergence of global green tech giants, but also compromises the EU’s commitment to guarantee fair internal competition and a level playing field for all market actors. The idea now to ‘pick winners’ is quite a paradigm shift from the previous way of thinking about industrial policy.

These changes might have mid- and long-term consequences for the design of the energy markets, moving away from free market ideals to more and more interventions into the markets which, in the end, risks leading to more and more re-nationalisation. Indeed, in contrast to the emergency measures adopted to combat the energy price crisis, this shift toward increased market intervention does not seem to be a short-term or temporary movement but is a response to a structural problem which cannot be solved by the EU alone; the world is entering a new era, a period of global competition where issues like industry, green technologies and climate become part of the overall strategic rivalry between countries.

Conclusion

To summarise the opinion expressed in this paper, the following points can be highlighted:

(1) Although there is no doubt that the legislative activities concerning the emergency measures combatting the energy crisis have had a negative impact on the timetable for the adoption of legislation for the implementation of the Green Deal, this ‘extra work’ by the Commission and Council will not ultimately put the timely adoption and implementation of all Fit for 55 measures under the two packages in jeopardy.

(2) Although there seems to be a general understanding among Member States and European institutions that the current geopolitical and economic challenges should not lead the EU to lose sight of a still growing concern about the climate challenges for the planet, it is unlikely that the increased 2030 targets for the energy transition will be met. Not only were these new targets too optimistic in the first place, but also the energy crisis and the resulting emergency measures at national and EU level have made it even more difficult to believe that the achievement of the new 2030 targets is a realistic outcome.

(3) There is no doubt that the emergency measures and mechanisms (demand reduction, market correction mechanism, demand aggregation and joint gas purchase platform) constitute a direct public intervention into the functioning of the gas market. However, the legal basis for these interventions (Article 122 TFEU) only allows time-limited interventions in severe emergency situations and does not represent a challenge for the liberalized gas market. A real threat for the liberalized gas market would, however, occur if these measures were to be incorporated into the ongoing revision of the Gas Directive and Regulation and become permanent measures and mechanisms within the gas target model. However, there are currently no signs that this is the intention of either of the two EU co-legislators.

(4) The real danger for the liberalized energy markets comes from global competition where issues like industry, green technologies and climate become part of the overall strategic rivalry between countries; because other countries like the USA and China have started behaving in a more interventionist manner, the EU has also started to feel the need to shift away from its free market ideals to be tempted to pick winners in a more state-controlled manner.