The EU Energy Crisis: EU Commission's Emergency Intervention to Reduce Energy Bills

24 October 2022

On 6 October 2022, the European Council adopted the EU Commission's Proposal for a Council Regulation on an emergency intervention to address high energy prices ("Regulation").

The Regulation aims to:

- **reduce electricity demand** by requiring Member States to put in place measures to lower overall electricity consumption;
- **impose a temporary revenue cap** on 'inframarginal' electricity producers, i.e., producers who do not depend on natural gas for electricity generation, who currently generate electricity at a cost below the price set by the 'marginal' suppliers;
- **introduce a temporary 'solidarity contribution'** on excess profits generated from activities in the oil, gas, coal and refinery sectors; and
- **redistribute surplus revenues and profit** to support consumers and to mitigate the effects of high energy prices, including by financing measures to reduce energy consumption.

The measures are temporary. They provide Member States with discretion as to how to meet reduction targets and mitigate the effects of surging energy prices. Inframarginal producers and companies operating in the oil and gas sectors should plan for the impacts of these measures on their long-term contracts and cash flows.

The Ongoing Energy Crisis in the EU. The Regulation is the latest EU measure to address the current imbalance between energy demand and energy supply. Other steps already taken by the EU include:

- Activation by several Member States of their emergency gas plans under the EU's existing Security of Supply Regulation of 25 October 2017, by means of "early warning" alerts (as reported here).

- Adoption by the European Council of the Commission's "Save gas for a safe winter" plan and regulation on coordinated demand reduction measures for natural gas (as reported here).

- Development by the Commission of plans for an alternative pricing benchmark for liquefied natural gas to be introduced by March 2023, following the EU's shift away from pipeline gas (as reported here). The current pricing benchmark for gas, known as the Dutch Title Transfer Facility ("TTF"), is linked to the pipeline-based market, which has inflated liquefied natural gas prices by up to 30% as a result of shortages in deliveries of gas through pipelines. In the meantime, the Commission plans to introduce a temporary 'price correction mechanism' that would establish a 'dynamic price limit' for transactions on the TTF.

Regulation to Reduce Energy Bills. The Regulation amplifies the Union's existing efforts to reduce electricity consumption, while providing financial support to energy consumers and encouraging green investment. It proposes three key measures:

First, Member States will be required to reduce overall electricity consumption by at least 5% during selected peak price hours, and to identify the 10% of hours with the highest expected price and reduce demand during those hours. The proposals anticipate that reductions during peak price times will reduce gas consumption by 4% over the winter, which should alleviate pressure on prices and maintain energy reserves. Member States have discretion when choosing appropriate measures to achieve these reductions, including by expanding existing schemes or offering national incentives to develop demand response.

Second, the Regulation will introduce a temporary revenue cap on inframarginal electricity producers that generate electricity using nuclear, lignite, crude oil or renewable energy sources. These producers have been selling electricity at inflated wholesale prices while continuing to benefit from low operating costs. Market revenues of inframarginal producers will be temporarily capped at €180 per MWh of electricity produced, which is significantly higher than the average market expectations for peak hours during the past decades across regions in the EU. The positive difference between the price per MWh at which electricity is sold and the cap will be considered 'surplus revenue'. The Commission states that the cap has been calibrated to ensure that operating and investment costs are covered, and that it does not impair future investment in clean technologies. The cap is said to be designed to mimic the market

outcome that inframarginal producers could have expected if gas supply disruptions had not occurred.

The Commission estimates that the cap will raise up to €117 billion in surplus revenue. This money will be redistributed to mitigate the impact of high electricity prices on consumers in a number of ways, including by:

- directly transferring the surplus to final electricity customers to assist with higher bills;
- implementing measures to reduce electricity consumption, such as lowering prices for final electricity customers for a limited volume of electricity consumed, or providing compensation to suppliers who deliver electricity to customers below costs for a limited volume of electricity consumed; and
- promoting investments by final customers in renewables, energy efficiency or other decarbonisation technologies.

Third, the Regulation will impose a temporary solidarity contribution on excess profits generated by EU-based oil, gas, coal and refinery companies, where at least 75% of turnover is derived from extracting, mining, refining petroleum or manufacturing coke oven products. The contribution targets profits from the 2022 fiscal year that are more than a 20% increase on average profits over the last three years, and such excess profits will be taxed at a rate of at least 33%. The Commission expects this time-limited contribution to raise €25 billion.

In addition to providing financial support to energy consumers to meet higher bills, and to reduce consumption, the proposal aims to strengthen the EU's energy autonomy by:

- providing financial support to energy intensive industries, provided that they invest into renewable energies, energy efficiency or other decarbonisation technologies;
- providing financial support to cross-border projects designed to reduce dependence on Russian fossil fuels and foster green investment to drive down prices in the longer term, in line with the REPowerEU objectives; and
- contributing to common financing of measures to protect employment, up-skill the workforce and promote investments in energy efficiency and renewable energy, including cross-border projects.

The Commission recognises that the measures are extraordinary, but states this emergency intervention will be temporary in nature. The demand reduction targets and the inframarginal revenue cap will be effective from 1 December 2022 until 31 March 2023, while the solidarity contribution will only apply to surplus profits in fiscal year 2022.

What Impact Will This Have? With industrial gas consumers already taking stock of their gas consumption under the 'Save gas for a safe winter' plan, industrial end-users are likely to do the same with respect to electricity as Member States look to meet demand reduction targets. Depending on the exact measures introduced by national governments, businesses will need to consider how reduced consumption will impact their operations and products, as well as their supplier contracts.

Further upstream, inframarginal electricity producers and oil, gas, coal and refinery companies will see an impact on cash flows following the imposition of the revenue cap and the solidarity contribution. The fossil fuel industry is already grappling with a patchwork of national windfall taxes in various European jurisdictions, and under the Regulation, Member States will retain the discretion to go beyond the 33% levy. Inframarginal producers and fossil fuel generators may also be faced with midstream customers and end-users reducing their consumption, with potential implications for their supply contracts.

Over time, revenues of inframarginal producers may shift back towards pre-crisis levels as demand decreases, new gas supplies are secured, and the EU pushes ahead with plans to reform the gas pricing benchmark. In the short term, however, inframarginal producers will need to consider whether their contracts are subject to the cap. Some producers may already hedge against price fluctuations, using renewable power purchase agreements, for example, where their market revenue will tend to fall below the cap. Other producers may already have their revenues capped by State feed-in-tariffs and are exempt under the legislation.

Electricity producers, retail suppliers and final electricity consumers should consider:

- monitoring impending national legislative changes and analysing the impact on their contractual obligations and investment decisions;
- assessing their existing contracts and the consequences of reductions in consumption or imposition of the revenue cap, and considering whether *force majeure*, material adverse change or hardship provisions may apply;
- paying particular attention to the notice provisions of such clauses, as some may require early notice to be given to be effective; and

- reviewing insurance policies to confirm whether they cover restrictions of supply due to the emergency gas plans.

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Please do not hesitate to contact us with any questions. We are closely monitoring the situation and expect to continue providing updates of any relevant developments.

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