

BLOG POST March 9th 2023

Reform of the European electricity market: small steps before the revolution?

Authors

Andreas Rüdinger

Coordinator for the energy transition in France

Nicolas Berghmans

Director, New industrial policies programme

🕒 Reading time: 7 min



Responding to the increasingly pressing political demands of some Member States in the context of the energy crisis, [analyzed in a previous blog post](#), the European Commission indicated in August 2022 its intention to present a "structural" reform of the electricity market design. As the end of the Commission's mandate approaches (2024) and gas and electricity prices have returned for the time being to levels similar to those prior to the invasion of Ukraine, this blog post offers some insight into the issues at stake in this reform, which is expected to be officially published in mid-March 2023.

Strengthening the role of long-term contracts, the central point of the reform

The [consultation launched by the Commission](#) last January makes it possible to outline the contours of the future reform: far from a profound transformation of the organizational principles structuring the market, it highlights two proposals:

- increasing the use of different types of long-term contracts (between market actors *via* the [existing forward market](#) and power purchase agreements (PPAs), or between private actors and the state via contracts for difference (CfDs)), which make it possible to stabilize the purchase price of electricity for electricity suppliers and producers' revenues over time;
- strengthening the regulatory framework for energy suppliers to avoid too much exposure of end consumers to short-term market volatility or, worse, that they abandon their commitments to their customers in the event of a sharp price change on the short-term market.

These measures aim to meet two complementary objectives. On the one hand, to stabilize electricity prices over time by contributing to curb the increase in bills in the case of a rapid surge similar to the one experienced in 2022, while reducing possible price decreases in the event of a return to a more abundant supply in relation to demand. On the other hand, facilitating the development of low-carbon generation, as the visibility on revenues for investors will reduce financing costs, which are particularly important for low-carbon assets with high fixed costs, such as renewable energies and nuclear power. Nevertheless, strengthening long-term contracts alone will not be sufficient to address the drivers that are at the root of the current crisis, whether in terms of dependence on imported natural gas (for Europe) or the historically low production of nuclear and hydroelectric power in France.

Behind the apparent consensus, many questions remain

Long-term contracts are not a novelty in themselves, particularly for the development of renewable energies and nuclear power. Nevertheless, the reform project indicates a certain paradigm shift in favor of what some have long referred to as "hybrid" markets, combining the operational management (dispatch) of the power system via the short-term market with the steering of investment decisions by mechanisms previously considered "outside the market", such as capacity mechanisms and contracts for difference, which could now become a central link in the future electricity market design.

There seems to be consensus on strengthening the role of long-term contracts, but the devil is in the details. Many questions, essential for operational design, will thus have to be addressed.

- What respective roles for the existing futures market, PPAs and CfDs? Which level of public interventionism and what risk sharing between private and public actors via these different instruments?
- How can we ensure that generation resources under long-term contracts still respond to short-term market price signals to optimize their integration into the power system?
- Should we seek maximum harmonization at the European level or leave more flexibility to Member States in the design of long-term contracts?

- Should long-term contracts be mandatory or voluntary? Reserved for new investments or also for existing installations? On which technologies?
- Which groups of consumers should have priority access to electricity under long-term contracts? And how can we build tariff signals that are both stable (avoiding sudden increases) and dynamic (providing incentives for demand management) for end consumers?

A draft reform project that supports France's approach to managing the crisis

This draft reform project seems to be generally in line with concerns expressed by the French government and should leave it the possibility, as with all Member States, to make the political choices it wishes on the deployment of renewable energies, new nuclear and the regulation of existing nuclear.

- Pre-existing measures used to limit the potential windfall effects linked to the strong increase in infra-marginal rents following the rise in gas prices, which have greatly contributed to consumer protection in France (via regulated electricity sales tariffs and two-way contracts-for-difference for solar and wind power¹) could be continued. It should be noted, however, that some Member States, such as Germany, would rather avoid an extension of the cap on infra-marginal rents in the electricity market.
- The emphasis on long-term contracts for new and existing assets could facilitate the financing of new nuclear reactors and the management of the existing fleet after the termination of the regulated access to historical nuclear electricity (ARENH) in 2025, considering the specificities of the nuclear industry (high fixed cost, operational management by a single market player).
- The consultation document recognises the importance of the issues at stake in the retail market, particularly with regard to the definition of "prudential" long-term hedging obligations for suppliers and the possibility of maintaining regulated pricing or setting up other guarantee mechanisms; these would make it possible to target the distribution of energy under long-term contracts to certain groups of consumers to pursue an objective of protecting vulnerable consumers, economic competitiveness, or encouraging the electrification of certain industrial uses and processes that are compatible with a strategy of decarbonisation of the economy.

A project that struggles to integrate the challenges related to the future transformation of the electricity market

While this reform project should make it possible to address political demands regarding the ability of the electricity market to manage the impacts of the gas crisis, the published consultation only partially integrates the challenges related to the low-carbon transition of the electricity sector.

As a matter of fact, according to the [latest projections of the European Commission](#), renewable energies could reach nearly 70% of total production by 2030, with up to 50% coming from variable production sources (wind and solar), leading to unprecedented market price volatility and flexibility needs.

It will therefore be crucial that this first reform of the electricity market paves the way for a much more in-depth process, based on a more precise and quantified inventory and impact assessments on the issues and options considered, to manage volatility on the spot markets², interactions with futures markets and contracts, the massive deployment of flexibility options on the supply and demand side, and the reinforcement of network infrastructure.

This also raises a second essential question: how can we avoid that reform decisions taken "in a hurry" lead to increased fragmentation between national markets, at the risk of slowing down the interconnections among markets in Europe—which is to be favored in order to integrate the variable production of renewable energies—or that they hinder the acceleration of the low-carbon transition in another way?

A political race against time

The European Commission is proposing to push ahead with this reform project in order to integrate it into a broader energy package, including the issue of green industry. In the most optimistic case, an adoption in the second half of 2023 could be envisaged, as the Spanish Presidency of the European Council would certainly like to make this a priority issue.

This means going even faster than usual for complex texts that must pass the co-decision process in the Council of the European Union and the European Parliament: the last revision of the electricity and gas markets, generated by prices perceived as too low, had given rise to two and a half years of political negotiations between late 2016 and mid 2019.

While some Member States are pressing for a rapid reform and others would like to take more time, a good political compromise seems to be a two-stage reform, combining an "express" reform focused on crisis management measures and the opening of a more structural process, aiming to prepare the electricity market for the challenges of the low-carbon transition in the longer term.

¹ The Energy Regulation Commission had published a calculation in the summer of 2022, estimating the gross revenue for the state related to renewable generation at 31 billion euros in 2022 and 2023: <https://tinyurl.com/nh2yanab> .

² <https://analysesetdonnees.rte-france.com/bilan-electrique-prix#Pourmieuxcomprendre>

[CLIMATE](#)[ENERGY](#)[EUROPE](#)[UE](#)[POWER](#)[RENEWABLE ENERGY](#)[ÉNERGIE EUROPE](#)