

GOVERNMENT APPROVAL OF THE TEMPORARY ADJUSTMENT MECHANISM FOR THE REDUCTION OF WHOLESALE ELECTRICITY PRICES

On 14 May 2022, the BOE published Royal Decree-law 10/2022, of 13 May, which temporarily establishes a production cost adjustment mechanism to reduce the price of wholesale electricity (“RDL 10/2022”).

This Legal Briefing will analyse the key aspects of the main measures contained in RDL 10/2022.

1. Production cost adjustment mechanism for the reduction of wholesale electricity prices

To reduce the price of wholesale electricity, RDL 10/2022 establishes a temporary mechanism for adjusting the costs incurred by certain facilities, in an amount proportional to the higher cost of supplying the fossil fuels used by these facilities in the production of electricity.

As stated in the Explanatory Memorandum to the regulation, the measure is designed as a mechanism for reducing the production cost of marginal fossil fuel technologies. The adjustment reduces the offers made by these technologies in the market by an equivalent amount, with the consequent reduction in the market-clearing price.

The mechanism has been adopted simultaneously and in a coordinated manner in Spain and Portugal, although its effective application is conditional upon authorisation by the European Commission. Thus, its starting date will be established in the Ministerial Order pursuant to which the European Commission’s authorisation of the adjustment mechanism will be published in the Official State Gazette (BOE). As this is a temporary mechanism, its application is limited to a maximum period of 12 months from the start date, and under no circumstances may its application be extended beyond 31 May 2023.

The main features of the adjustment mechanism are as follows:

- (i) The mechanism seeks to reduce the production cost of marginal technologies (i.e. those that generally determine the final price of electricity traded on the wholesale market) by reducing the price of the natural gas that these technologies need to produce electricity. This reduction in the price of gas is referred to in the regulation as the “adjustment” and consists of an amount received by the facilities in question which, put simply, is calculated as the difference between the average daily price of gas in MIBGAS and a limit or reference price of €40/MWh during the first six months of the measure’s application. After the first six months, this price will increase by €5 each month, until it reaches a value of €70/MWh in the last month.

- (ii) The facilities included in the scope of the mechanism and which will receive the adjustment are (i) natural gas combined cycle plants; (ii) coal-fired thermal plants; and (iii) cogeneration plants that do not receive regulated remuneration.
- (iii) These facilities must submit their offers on the day-ahead market according to their best production forecast, thereby internalising the amount of the adjustment to be received. Any deviation in this application is classified as a very serious breach under the provisions of Article 64 of Law 24/2013, of 26 December, on the Electricity Sector (“LSE”) and may lead to the loss of market agent status.
- (iv) In any case, the adjustment mechanism does not apply to the energy of the aforementioned facilities that has been designated for the execution of bilateral contracts with physical delivery and only applies to the energy negotiated in energy sale offer units submitted to the market operator.
- (v) The amount of the adjustment or compensation received by the aforementioned facilities is settled by the market operator¹ and the system operator² among the demand as a whole (i.e. suppliers and direct market consumers) pro-rata to the power acquired by each purchasing unit, with the following specific details:
 - Congestion revenue from trade with France will be used to pay the full cost of the adjustment mechanism³.
 - The part of the energy purchased for which forward hedging instruments signed before 26 April 2022 are held is exempt from the settlement of the adjustment cost by the market operator (but not from the settlement carried out by the system operator). However, this exemption ceases to have effect if there are renewals, revisions of pricing or extensions of backdated hedging instruments after 26 April 2022. Therefore, purchasing market agents will have a maximum of 5 working days from the entry into force of RDL 10/2022 to provide the documentation justifying these exemptions.

¹ On the schedule of each of the matched offers for the sale and purchase of electricity on the daily and intraday markets, corresponding to the facilities included in the scope of application of the mechanism.

² For the energy allocated to the process of solving technical constraints on the daily and real-time horizons, as well as in the balancing energy services markets.

³ As the Explanatory Memorandum to the regulation states, “*the implementation of the adjustment mechanism provided in this Royal Decree-law will bring about a significant reduction in the marginal matching price in both the Spanish and Portuguese price zones, which will have two main effects: an increase in the export flow at the border between Spain and France, and an increase in the price difference between the Spanish and French price zones. As this effect is the direct result of the implementation of such a mechanism, an exceptional means has been provided to make use of the additional congestion revenue of said interconnection (congestion revenue which is proportional to both the border energy and the price difference) in reducing the total cost of the adjustment mechanism*”

- Similarly, storage supply units, both battery and pumped storage units, as well as supply units for ancillary generation services, shall be excluded from the payment of the adjustment cost.
- (vi) Operators holding purchasing units are required to provide guarantees to cover the financial obligations that may arise from the settlement of the adjustment mechanism. Failure to provide such guarantees will prevent these units from participating in the various electricity generation markets.
- (vii) Failure to comply with payment obligations resulting from the settlement of the adjustment mechanism shall lead to the enforcement of the guarantees lodged by the holder of the relevant purchasing unit. If the guarantees are not sufficient, the amount due shall be financed by the exchanges subject to the adjustment mechanism (by reducing the amount of their compensation and accruing default interest payable by the defaulting agent). These breaches are considered a serious infringement. Procurement unitholders who fail to comply with the payment obligation, as well as those who fail to provide or maintain the required payment guarantees will not be allowed to participate. To avoid deviations, it is provided that the suspension of a trader will result in the temporary automatic transfer of its customers to the reference trader.

Lastly, it should be noted that the adjustment mechanism involves a modification of the mechanism for reducing the excess remuneration resulting from the price of gas regulated in Royal Decree-law 17/2021, of 14 September, on urgent measures to mitigate the impact of the rise in natural gas prices on the retail gas and electricity markets. Therefore, the formula for calculating the amount of the reduction is modified, consequently, the amount will be calculated not by reference to the difference between the average monthly price of gas in MIBGAS and the threshold of €20/MWh, but by reference to the difference between the reference price set in the new adjustment mechanism and that threshold.

2. Re-establishment of the Value of Market Price Deviation Adjustments from 2023

RDL 10/2022 amends the third and fourth paragraphs of Article 22 of Royal Decree 413/2014, of 6 June, which governs the activity of electricity production from renewable energy sources, cogeneration and waste (“RD 413/2014”) and nullifies the decision adopted in Royal Decree-law 6/2022, of 29 March, adopting urgent measures within the framework of the National Plan to respond to the economic and social consequences of the war in Ukraine (“RDL 6/2022”), which abolished the Value of Market Price Deviation Adjustments (“VAJDM”, using its Spanish acronym) as of 2023, citing the need to promote forward contracting.

This objective of encouraging forward contracting by RECORE plants is also pursued by RDL 10/2022, although, instead of eliminating the VAJDM as of 2023, it re-establishes it but modifies its terms in order to link it to a reference called the “basket price”. This price will not be, as it was before, the average price of the daily and intraday market, but will be a basket of prices that will take into account the average price of forward futures, except for small power

facilities, for which the application of the VADJM by reference to the annual average price of the daily and intraday market is maintained⁴.

The average value of the basket price is determined by a formula which takes into account not only the wholesale market price but also the annual, quarterly and monthly futures on an increasing basis⁵.

3. Modifications to the social discount rate mechanism

RDL 10/2022 amends the wording of certain provisions of Royal Decree 897/2017, of 6 October, which provides for the regulation of vulnerable consumers, the social discount rate and other protection measures for domestic electricity consumers introduced by RDL 6/2022. In summary:

- This clarifies that the contribution of the distributors to the financing of the social discount rate will be per CUPS and not per customer.
- It also clarifies that in order to determine the contribution to the financing of the social discount rate for direct consumers in the market, the energy consumed and not the energy purchased in the market will be taken into account.

4. Modification of the PVPC

The Explanatory Memorandum to RDL 10/2022 states that one of the conditions imposed by the European Commission to authorise the mechanism is the current reform of the voluntary price for small consumers (“PVPC”) so that the adjustment mechanism is configured as an extraordinary measure while this reform is being carried out.

According to the Explanatory Memorandum to the regulation, the modification of the PVPC calculation methodology aims to reduce the volatility of the PVPC for consumers as well as to orientate the energy purchase strategy of the reference suppliers, inducing a greater propensity to participate in the forward markets to purchase energy from their customers, thus promoting the liquidity of the Iberian forward markets on the buyers’ side.

The basis for this reform, which must be carried out by the Government before 1 October 2022, is announced in Additional Provision 5 of RDL 10/2022.

In this respect, the new PVPC calculation methodology must include a reference to forward market prices, incorporating in the calculation formulation a price component based on a basket of forward products, which may take into account daily prices and monthly, quarterly

⁴For these purposes, RDL 10/2022 states that small power facilities are (i) photovoltaic, solar thermal and hydroelectric facilities of up to 10 MW, (ii) wind power facilities of up to 5 MW, (iii) cogeneration facilities and other technologies of up to 1 MW and, (iv) as an exception, geothermal, hydrothermal, aerothermal, wave, tidal, hot and dry rock, oceanothermal and marine current energy, irrespective of their power.

⁵In 2023 this basket price will be 75% of the annual average price of the daily and intraday market, 15% of the annual futures and 10% of the quarterly futures (2.5% for each quarter). In 2024 and 2025, the weight of the futures markets will be more than 50% and 75% respectively, the precise value of which will be determined by Ministerial Order.

and annual futures prices and a daily and intraday market price component that guarantees a certain exposure of these consumers to the short-term price signal and provides incentives for energy efficiency, storage and demand-side management.

A reference is also made to the fact that the modification of the PVPC calculation methodology may incorporate the term corresponding to the infra-marginal energy auctions referred to in Article 3 of RDL 17/2021, in the event that the participation of the reference suppliers in these auctions is enabled.

This Legal Briefing has been prepared by Ana Cremades and Belén Wert, Partner and Associate of the Energy team of the Administrative and Regulatory Law practice.

The information contained in this Legal Briefing is of a general nature and does not constitute legal advice. This document was prepared on 23 May 2022 and Pérez-Llorca does not assume any commitment to update or revise its contents.

For more information,
please contact:

Ana Cremades

Energy Partner

acremades@perezllorca.com

T: + 34 91 423 66 52