CLIFFORD CHANCE

Briefing note

December 2016

EU Energy Union Package - Reforms to Energy Market and Renewable Energy Legislation

The European Commission has launched a major package of legislative reforms[1] aimed at progressing plans for its Energy Union and implementing the 2030 EU Climate and Energy Framework agreed in 2014 (the Framework). Measures include revisions to the Electricity Regulation and Electricity Directive, the Renewable Energy Directive, and the Energy Efficiency Directive and Energy Performance of Buildings Directive.

In this client briefing, we focus on the key terms of these pieces of proposed legislation, and briefly outline certain other initiatives launched by the Commission as part of the package. Please see our separate briefing on the aspects relating to energy efficiency of buildings[2].

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Key issues

- Reforms to rules for preferential dispatch by renewable generators
- New possibilities for Transmission System Operators to own storage, but uncertainty over application of unbundling rules to TSOs remains
- New EU-wide rules for design of, and participation in, capacity mechanisms
- EU-level binding targets on renewable energy (at least 27% of total energy by 2030) and energy efficiency (30% energy savings by 2030)
- Integrated National Energy and Climate Plans and other governance measures to place pressure on Member States to meet the EU targets
- New framework for renewables support schemes including a prohibition on retroactive changes to levels of support
- Aspiration to increase the share of renewable energy supplied for heating and cooling by at least 1% every year

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1 See Commission web page published on 30 November 2016: Commission proposes new rules for consumer centred clean energy transition

2 EU Energy Union Package - Reforms to Energy Efficiency of Buildings Legislation – December 2016

New Electricity Market Design

The package contains detailed and technical proposals about various aspects of the design and operation of the Europe-wide energy market.

Of particular interest to investors in the electricity sector will be the:

- Reforms to the principles for preferential dispatch by renewable generators;
- Rules applicable to transmission system operators ("TSOs"), particularly in relation to storage; and
- Provisions in respect of the design of, and participation in, capacity mechanisms

Each of these is discussed further below.

Generation dispatch

The EU's electricity directives have historically required TSOs in Member States to give priority to renewable generation (in so far as the secure operation of the relevant national electricity system permits, and based on transparent and non-discriminatory criteria). While a number of Member States are non-compliant including the Netherlands, Sweden and the UK, the principle of priority dispatch has been seen as an important factor in the development of renewables in jurisdictions such as Germany.

This issue has been the subject of much debate, and indeed before the announcement of the proposals, the German Government announced its opposition to the EU plan to limit priority dispatch, saying that it is an important part of the German renewable energy policy. Nonetheless, the EU has confirmed its intention to remove priority dispatch except for existing installations, small-scale renewable plants and demonstration projects for innovative technologies. For all other generation, no matter what the technology used, there will be non-discriminatory third party access rules.

The response to this proposal has been mixed, with WindEurope saying that overall the package was "more good than bad" but asking for clarity on curtailment compensation for renewables. A spokesman for WindEurope said that it would have preferred the principle of priority dispatch to remain but its abolition was unlikely to have a significant impact on new investments (which were more likely to be affected by Governmental clarity on support schemes).

Transmission system operators and storage

The unbundling rules, which effectively require the structural separation of the functions of transmission and generation/supply, have long been a source of frustration for financial investors. Despite a recent relaxing of the rules in the UK, the rules remain very strict in other European jurisdictions and as a result financial investors remain concerned about the extent to which existing investments in transmission (including point to point offshore transmission) could restrict future investments in generation/supply.

Financial investors will therefore be disappointed to read that the main substantive rules on unbundling for TSOs remain unchanged. The only glimmer of hope in this respect is the clarification on the possibility for TSOs to own storage or to provide ancillary services.

As electricity storage becomes an increasingly important part of the energy mix, and the technology develops at pace (while the regulatory framework lags behind), the regulatory clarification in the proposals is timely. The proposals effectively state that Member States may allow TSOs (and distribution system operators) to own, manage or operate storage facilities and provide non-frequency ancillary services if certain conditions are fulfilled, including that:

- There has been an open and transparent tendering procedure, and other parties have not expressed their interest to own, control, manage or operate such facilities or provide such services; and
- Such facilities and services are necessary for the system operator to fulfil its obligations for the efficient, reliable and secure operation of the relevant system.

While the principle of not being excluded from investments in storage facilities and the provision of ancillary services will be welcomed by TSOs (and their shareholders), given the experience with the unbundling rules, financial investors are likely to remain concerned that the conditions are overly restrictive.

The question of the regulatory treatment of storage is now increasingly on the radar of national regulators, and the key issue for investors will ultimately be the way in which the proposals are interpreted and implemented by national regulators. In the UK, for example, the Government department responsible for energy policy and the energy regulator have recently launched a consultation on developing a smarter and more flexible energy system in the UK, including seeking views on how regularity clarity for storage can be achieved.

Capacity mechanisms

The EU recognises that some Member States face genuine security of supply challenges, but has expressed concern about the approach that has been taken to the measures directed at ensuring security of supply.

In a number of Member States, capacity mechanisms have been introduced which effectively pay electricity generators and other capacity providers (such as demand response operators and interconnectors) for having standby capacity and making it available when required. The EU is particularly concerned about such mechanisms from a state aid perspective, and their potential to fragment the market, distort competition by favouring certain generators or technologies and create barriers to trade across national borders if not properly designed.

In the UK, for example, the Government has committed to a "technology-neutral" capacity market, and has recognised the benefits offered by small, flexible generators in relation to the provision of on demand capacity. This has, however, given rise to perverse incentives for the development of small-scale diesel generation facilities (at odds with the decarbonisation agenda). The approach in the UK has been to maintain the principle of technology neutrality but to consider other ways of addressing the issue, such as regulation of the emissions to air from diesel generators.

These considerations are reflected in the proposals on capacity mechanisms. In particular, the proposals set out generation principles for security of supply concerns to be addressed in a coordinated manner, setting out design principles for capacity mechanisms to avoid market distortions and negative impacts on cross-border trade. In relation to restrictions on participation in capacity mechanisms, the EU proposes an emission limit for plants of 550g CO_2/kWh from 2021, but existing plants will only have to meet this limit from 2026. This threshold has been strongly criticised by green groups on the basis that it would only rule out the oldest, least efficient coal-fired power stations (but would effectively subsidise newer, more efficient ones).

Revised Renewable Energy Directive

Proposed amendments to the Renewable Energy Directive (2009/28/EC) aim to provide certainty and predictability to investors, and address the potential of renewable energy in a number of sectors. In its proposal, the Commission notes that if no new policies are put in place, only 24.3% of energy consumed in 2030 will be from renewable sources, which would prevent the EU from achieving its commitments under the Paris Agreement. The Commission seeks to address certain key areas for action, of which we focus on the following:

- A binding EU-level target on the share of energy from renewable sources;
- An enabling framework for further deployment of renewables and financial support; and
- Measures concerning renewables in the Heating and Cooling sector.

Additionally, the Commission's proposals introduce measures to:

- Decarbonise the transport sector;
- Empower consumers by *inter alia* ensuring that they are entitled to consume renewable power that they have generated, and sell excess production; and
- Strengthen the sustainability criteria for bioenergy.

The proposed implementation date of the revised Directive is 30 June 2021.

Binding EU-level target

The revised Directive imposes a binding EU-level target to ensure that the share of energy from renewable sources is at least 27% by 2030 (it was simply "27%" in the Framework). As agreed in the 2030 Framework, the target is not binding at individual Member State level. This marks a departure from the national level binding targets imposed under the 2009 Directive.

Concerns over how the EU target would be met have led to new rules being put in place to encourage Member States to "play their part". In particular, the Commission hopes that two new measures will help to ensure its target is met.

Firstly, Member States will be required to set, and notify to the Commission, their respective contributions to achieving the EU-level target in Integrated National Energy and Climate Plans, drawn up in accordance with a proposed Regulation Energy Union governance. The Commission hopes that dialogue with Member States will ensure that national contributions are aligned with the EU-level target. In the event that a Member State's Plan is not sufficiently ambitious, the Commission will be able to issue a non-binding recommendation to the Member State in question. If all else fails, the Commission will be permitted to seek financial contributions from Member States to support certain renewable energy projects across the EU; alternatively the Commission will be able to raise the targets for renewable energy in the heating / cooling and transport sectors.

Secondly the revised Directive introduces a baseline according to which Member States must ensure that from January 2021 onwards, their share of energy from renewable sources is not lower than their respective 2020 national targets.

Renewable energy enabling framework and financial support

The Commission estimates that to achieve the 2030 target, investment needed from 2015 to 2030 in renewable electricity alone is in the region of EUR 1 trillion. The proposal also highlights that investment in renewables across the EU has fallen by around 60% since 2011, and that this decrease is not just attributable to a reduction in technology costs. Unsurprisingly, following a number of retroactive changes to renewable support schemes by certain Member States, the Commission is now fully aware of the need for a stable and predictable EU legal framework. To address these concerns, key measures introduced in the revised Directive include:

- A partial opening up of renewable energy support schemes to installations located in other Member States. Between 2021 and 2025 Member States must ensure that support for at least 10% of newly-supported capacity is open to installations located in other Member States, increasing to at least 15% between 2026 and 2030.
- A new framework formally entitling Member States to establish renewable financial incentive schemes, subject to a number of requirements for schemes to:
  - Comply with State Aid rules, be market-based and cost-effective; and
  - Avoid retroactive changes to levels of support granted to renewable energy projects which either negatively impact the economics of the project or affect acquired rights.
- A requirement for Member States to introduce a "one stop shop" by January 2021 to coordinate the permit-granting process for all renewable projects and their associated transmission and distribution network infrastructure. The whole permit-granting process must not take more than three years, and is designed to reduce administrative hurdles for renewable projects. In addition, Member States must facilitate the repowering of existing renewable energy plants following, for example, upgrades to relevant plant. In such cases, the permit-granting process must not take more than one year following submission of the repowering request. These reforms build on the current EU-wide regime for larger Projects of Common Interest.

Of the measures proposed under the Framework, low carbon investors will most welcome the introduction of measures to address retroactive changes to support schemes, which will provide some welcome certainty after a number of years of mixed policy messages in several Member States.

Heating and cooling

The Commission highlights that renewable energy in the electricity sector increased by more than 8% between 2009 and 2015. In contrast, the share of renewables in the heating and cooling sector expanded by less than 3% over the same period. Since heating and cooling accounts for 50% of total energy demand in the EU and continues to rely heavily on fossil fuels, the Commission has sought in its proposal to introduce measures to increase the share of renewable energy in the sector.

The Commission had initially proposed to introduce renewable energy heating and cooling obligations on fuel suppliers. However, these were watered down during the course of the impact assessment as a result of two negative opinions from the Regulatory Scrutiny Board. Consequently, the Commission's heating and cooling proposals are "less burdensome" than they otherwise might have been.

Under the revised Directive, Member States must in particular:

- Endeavour to increase the share of renewable energy supplied for heating and cooling by at least 1% every year; and
- Provide non-discriminatory access to local district heating and cooling systems for suppliers of heat and cold.

The fact that the requirement to increase the share of renewable energy supplied for heating and cooling by 1% per year is not binding will be a disappointment to low carbon investors, who will have been hoping for more stringent measures in relation to a sector which has yet to make great progress in decarbonisation.

Revised Energy Efficiency Directive

A number of amendments to the Energy Efficiency Directive (2012/27/EU) are proposed to extend the ambition for energy efficiency improvements up to 2030. In 2014, the European Council agreed to a target of at least 27% energy efficiency savings by 2030 with a view to working towards a 30% target. The proposal now adopts the higher 30% by 2030 target. This will represent a reduction in final energy consumption of 17% as against 2005 levels.

Similarly to the position on renewable energy targets, the 2030 energy efficiency target is only binding at EU level. Again, Member States will be required to set out how they propose to assist in meeting the EU's target in their Integrated National Energy and Climate Plans. There are also analogous provisions to the renewable target provisions allowing the commission to make recommendations and take further measures to ensure that Member States play their part in meeting the EU-wide target. From the energy efficiency perspective, these measures would include strengthening energy efficiency requirements for products, buildings and transport.

The Commission considers that the current provisions requiring Member States in the Directive to establish energy efficiency obligation schemes have generally worked well across the EU and has therefore decided to extend the requirements to 2030 and retain the annual 1.5% per year energy savings target. The method of calculation of the obligation (sales to final customers averaged over the preceding three years) is retained.

See our separate briefing in relation to measures relating to energy efficiency of buildings (see footnote 2).

Other aspects

Other aspects of the package that we have not dealt with in this briefing include:

- Eco-design: A new eco-design plan for 2016-2019 with additional types of products being added to the list for consideration to be included within the Eco-design regime (these include, among others, solar panels and inverters).
- Innovation: A Commission Communication on accelerating clean energy innovation has been published.
- Transport: A Commission Communication on a European strategy on cooperative, intelligent transport systems has been published.

Final Comments

Member States will need to consider how these reforms will impact on the design of their energy markets, and on their domestic efforts to decarbonise their energy systems and improve energy efficiency in all sectors. In the UK, there will be an additional question over the extent to which the revised EU legislation will be adopted before the UK leaves the EU and whether the revised provisions will make it into UK law through the UK's proposed Great Repeal Bill (transposing all "existing EU law" as at the date of Brexit into UK law). Beyond this, uncertainty will remain over the extent to which the UK will have to comply in the future with these legislative reforms in order to retain access to the EU Internal Energy Market, or otherwise, under its future relationship with the EU.

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