

## THE ELECTRICITY RISING COSTS AND THE IDEOLOGY OF PRICES

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There is no doubt that the world is at a turning point, in History, in the Economy, and in the lives of us all. In History, the veil is now falling away that for so long prevented us from recognizing one of the greatest tyrannies on Earth (and don't think that Russia is the only one that we have yet to admit as such, as we still have China and countries like Saudi Arabia, which we continue to treat as equals in values when they are not). In the Economy, we have entered an inflationary cycle, which was already inevitable as a consequence of the monetary policies followed in the fight against the effects of the Covid-19 pandemic. And which, with the Russian invasion of Ukraine, nobody can tell where it will lead us. In the lives of us Westerners, fortunate enough to live far from war and poverty, we feel squeezed by the rising prices of everything we consume and perplexed in our lack of understanding of the price-setting mechanisms. Some call for the taxation of capital gains that they adjectivize as unjustified, immoral, and the cause of the famine that affects the majority. Others, more moderate, question the universality of market rules and wonder whether it is not time for a new chapter in Economics too.

In this dire context, the European Commission recently proposed a plan called REPowerEU to erase dependence on Russian fossil fuels before 2030, to rebuild European gas reserves and to address rising energy prices in Europe. This initiative might, besides shaking the gas market, have a significant impact on the renewables sector, as it aims at allowing member States to take price regulation measures, to impose temporary windfall taxes, and to use of revenues from emission trading and state aid mechanisms. In the Iberian electricity market we have also seen discussions about electricity pricing mechanisms. The electricity wholesale prices in OMIE (where the daily price and the intra-daily price of electricity in the Iberian Peninsula are negotiated) are calculated through on a marginal prices mechanism that tries to mirror the meeting of forces between the supply and demand for electricity. There is an algorithm for these calculations called EUPHEMIA (who knows if named after the Greek saint tortured to death for not agreeing to participate in pagan sacrifices in the Roman Constantinople of the 3rd century) and we can say in this regard things are very complex; but, trying to simplify them, the setting of electricity wholesale price at OMIE works as follows:

OMIE puts the demand indicated by the operators of the Spanish (REE) and Portuguese (REN) grids together with the offers made by all different types of Iberian producers. The price established for the purchase of the electricity will be the price of the last offer to be entered into the system (normally, that of those who has less incentive to sell, i.e., those who obtain a lower profit margin). If this last offer comes from a combined cycle gas power plant producer it will reflect the costs of this producer and not, for example, the average of the production costs of all the offers made that day. A photovoltaic plant producer will sell its electricity in OMIE at the selling offer price of the producer of the combined cycle gas plant. This, in the current context, means having a significantly higher margin than it would be willing to accept if all the offers to the market were from photovoltaic production.

Here one may ask whether if, by aggregating different types of offers and choosing a price-setting criterion that seems incapable of reflecting the different production costs, we are not preventing the market from functioning properly as it would if the direct confrontation between comparable offers and demand was possible. Of course, the choice of the marginal prices' principle has a technical explanation, a rationale that may seem more appropriate in a context of abundant supply and homogeneous costs (where the pressure to sell is similar for all producers) but it is apparently necessary because the system needs the energy produced by gas and other fossil fuels burning producers.

The creation of a special tax on renewable generation sources to match the so-called windfall profits (in the style of the infamous claw-back tax created by the Portuguese Government to eliminate the “unjustified” profits of Portuguese producers in MIBEL compared to the Spanish, victims of a special tax of 7%) implies a disincentive to what we are all saying we want to encourage. A disincentive with not only immediate impact, but also for the future of investment in renewable energy marketplace, which needs fiscal predictability. It is important to remember that the market operates based on a perception of risk, which includes factors within the market itself, such as technological developments or, conversely, negative developments in the cost of production factors. If we add non-market risks, such as administrative pricing or the imposition of taxes, the market will be disrupted, affecting, without discrimination, the supply (with high costs producers having to close doors) and the demand (which may have to endure either higher prices or shortages of electricity).

Therefore, ideas like the setting of a price ceiling at 180 euros per MWh, as has been suggested to the EU Commission by the Spanish and Portuguese Governments, will result production at a deficit in gas-fired plants. Certainly, producers with higher costs will withdraw their supply from the market generating supply shortages, unless they are subsidized (making the measure useless). We would risk not having electricity for everyone, because, at the present moment, the energy supply is not elastic (much has been said in this regard about the Portuguese Government's haste in anticipating the closure of the coal-fired plants).

Because all the above results of prices following natural laws and having no ideology, any electricity prices' regulation is to be avoided. And taxation on the so-called windfall profits will naturally cause prices to rise or electricity to be in short supply for everyone. The least harmful way of State interference will be the direct support to those consumers who are least able to bear the increases in electricity market prices: the individuals and small companies with the fewest resources and the electro-intensive consumer companies whose activity is indispensable to the country's economic fabric. And the most efficient way of providing such support will always be paying individuals and companies in cash (and never by granting them new credit lines, the equivalent to offering water to a drowning person); or, better yet in the case of companies, offering them direct tax rebates.

Consequently, the EU Commission and the EU member States should, first of all, give priority to a consensual reassessment of the electricity pricing models and, if possible, adjust them so that they allow the market to function better, because it is not the market that is failing, but possibly the rules to which trading platforms like OMIE are subject to.

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