



10 QUESTIONS & 10 ANSWERS

Iberian Gas Price Cap Mechanism for Electricity Generation

1. What is the Iberian mechanism to limit the price of gas for electricity generation?

A: This adjustment mechanism, which was **created by the governments of Portugal and Spain**, is **temporary** (valid until 31 May 2023) and sets the reference price of natural gas, intended for electricity production, at 40 EUR/MWh (euros per MWh) in the first six months (rising each subsequent month by 5 EUR/MWh, which corresponds to an average of 48.75 EUR/MWh in the approximately 12 months of the mechanism – from 15 June 2022 to 31 May 2023).

The setting of this administrative "ceiling" on the price of gas for electricity production aims to mitigate the impact on the price of electricity of the rise in fossil fuel prices in international markets, caused mainly by Russia's invasion of Ukraine.

The Iberian mechanism was approved by the European Commission.

2. How does it work?

A: The Iberian wholesale electricity market (MIBEL) - where suppliers buy electricity from producers - forms its price based on the cost of the most expensive technology needed to meet electricity demand each hour. This is called a marginalist market and is the market model used in the European Union.

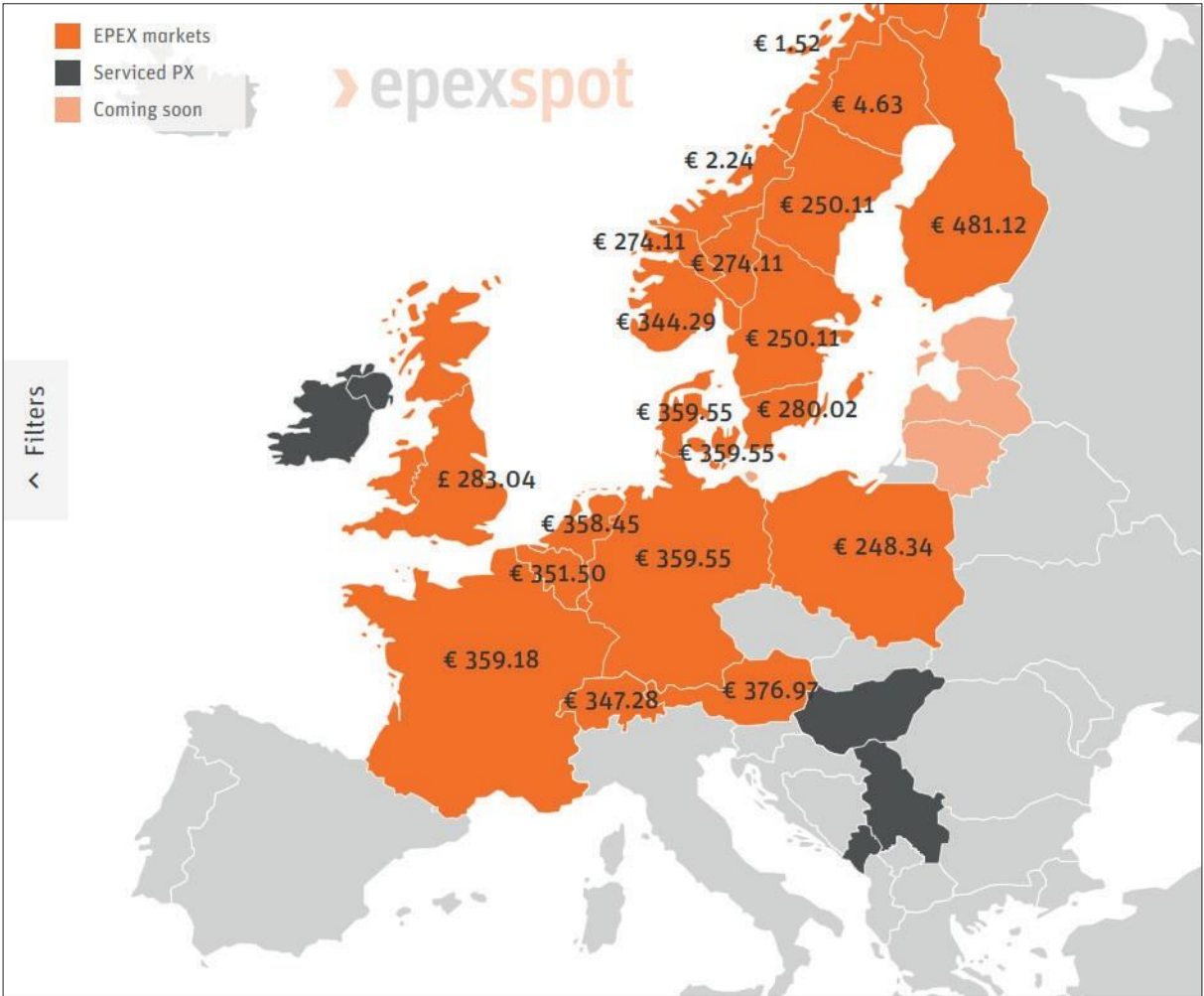
By setting a "ceiling" for the price of natural gas for electricity production, the aim was to protect the Iberian Peninsula from the sharp variations recorded in the international reference markets for this raw material.

However, by setting this "ceiling" (at the average value of 48.75 EUR/MWh), it is necessary to **compensate** electricity producers with natural gas-fired plants for the difference between the reference price and the actual price they pay for purchasing natural gas on the markets: this is called the **adjustment cost**.

3. Who benefits from the mechanism?

A: Final consumers with contracts indexed to the daily market, new electricity contracts, as well as renewals of contracts entered into after 26 April 2022, will benefit from paying a lower price on their bills than would exist without the Iberian mechanism.

For example, the average daily wholesale price for 8 August 2022 was 359 EUR/MWh in France and 360 EUR/MWh in Germany, prices substantially above the values registered in Portugal with the Iberian mechanism: 146 EUR/MWh in daily average.



4. Who pays the adjustment cost?

A: The compensation paid to producers, i.e. the difference between the (average) administrative cap of 48.75 EUR/MWh imposed on gas-fired plants and the real cost of this raw material purchased on international markets, is initially borne by Portuguese and Spanish suppliers exposed to the daily market price.

These suppliers, in turn, pass on this adjustment cost to **final consumers with contracts indexed to the spot market**. New contracts signed after 26 April 2022 are also covered, as well as **contract renewals** as from that date.

5. Why are these consumers paying and not all Portuguese consumers?

A: Because it is these consumers who benefit from the "cap" imposed on the price of gas. Without this administrative "cap" of 48.75 EUR/MWh, they would be exposed to the real prices of natural gas traded daily in international markets and, as such, subject to greater variations in the price of electricity.

As of August 2022, the electricity consumption indexed to the spot market, which benefits from this ceiling, is around 28%. Excluded are 72% of electricity consumption associated with contracts with fixed prices, including consumers in the regulated market, whose tariff is fixed by ERSE (about 900 000).

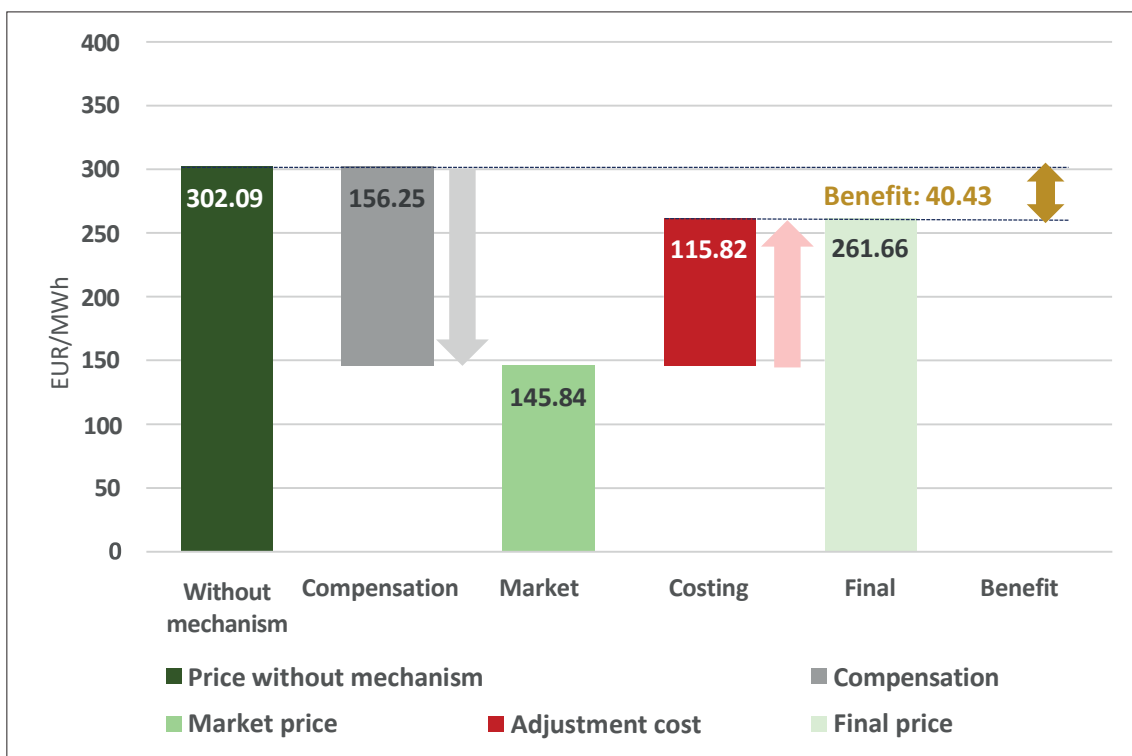
6. What would the price be without the mechanism?

A: Using as a reference the prices in the Iberian daily market (MIBEL) for 8 August 2022, the price without the mechanism would be 302.09 EUR/MWh, which corresponds to adding the compensation paid to gas-fired power producers of 156.25 EUR/MWh to the price formed on that same day for Portugal, which was 145.84 EUR/MWh (daily consumption weighted average).

On the other hand, with the mechanism working, and starting from the price formed for 8 August 2022 of 145.84 EUR/MWh, if we add the adjustment cost of 115.82 EUR/MWh (value calculated every day by the spot market operator, based on the production that was actually mobilised to meet Iberian demand), the final price to be paid for the electricity consumption exposed to the market (without fixed price) was 261.66 EUR/MWh.

This results in a net benefit for consumption with contracts indexed to the daily market of 40.43 EUR/MWh, i.e. instead of paying 302.09 EUR/MWh without the mechanism, it pays 261.66 EUR/MWh in the presence of the mechanism.

The figure below illustrates how the mechanism works based on the example of 8 August 2022.



7. Does this mechanism, through the formation of prices in the wholesale electricity market, affect all agents and entities?

A: Since the Iberian electricity market is marginalist, i.e. there is a daily auction in which demand matches supply, and the price (which is the same for everyone) is set by fossil fuel power plants (natural gas and coal), the fact that there is a "ceiling" for natural gas means that the prices that are formed in the Iberian market are lower. Usually, it is the gas-fired power plants that set the final price, particularly in periods of drought when hydropower plants have less production.

Thus, by limiting the final market price, the remaining technologies (hydro, nuclear, wind and solar), receive less revenue because they are limited to the market price which, in turn, is the result of a natural gas price which has been subject to an intervention.

Consumers - and only those exposed to indexed prices or with contracts after 26 April 2022 - only pay the cost of adjusting the energy produced by marginal plants (natural gas) and not the entire production, resulting in a gain for the entire Iberian market.

This solution leads to the recovery of what is called windfall profits appropriated by this technology.

8. What can consumers do in the current market circumstances?

A: For all consumers, ERSE's longstanding recommendations about choosing and changing suppliers and signing supply contracts remain valid: evaluate the offers available and adjusted to their specific situations, including the choice of contracted power (ERSE has a [price comparison tool](#) and a [contracted power simulator](#) on its website). Also, check, for example, how long the contract lasts, if it is associated with the contracting of additional services or if it creates any loyalty obligations, as well as what the penalties are in case of early termination. It is also important to validate all the conditions of the offers proposed by suppliers, before signing.

Consumers can also access supply from a supplier of last resort, whose tariffs are set by ERSE. For contracts in force, it is important to check that the supply invoices reflect what is in the supply contract and to have a concrete notion of the contract's validity period and its possible renewal.

Given the current high volatility of energy prices, it is also important to reinforce energy efficiency and responsible consumption measures and actions, avoiding, for example, unnecessary energy consumption or favouring the use of more efficient equipment.

9. How can consumers verify what benefit results from of this mechanism?

A: Order no. 9799-B/2022, provides that ERSE shall regulate in what terms the net benefit resulting from the application of this mechanism shall appear in the bills of customers with electricity supply contracts after 26 April 2022, in situations where the supplier chooses to reflect the cost of the adjustment.

Within the scope of this Order, ERSE will also approve the methodology for defining the value of the adjustment cost of the Iberian mechanism to be applied to invoices for new contracts or renewals.



10. How will ERSE regulate and supervise the application of these rules?

A: ERSE, through instruction no. 6/2022, published on 12 August, aims to ensure that electricity suppliers do not reflect the value of the adjustment cost in the bills of exempt consumers. That is, those who have fixed contracts concluded before 26 April 2022. Violation of this duty constitutes an administrative offence under the Energy Sector Sanctions Regime.

If consumers detect any non-conformities related to the application of this mechanism, they may complain to their supplier and through the [Electronic Complaints Book](#).

Lisbon, 12 August 2022