Oxford Energy Comment
June 2008

Politicians and prices – the itch to intervene

David Buchan

As the oil price has climbed, so has the pressure on politicians to "do something" about it. At their June 19-20 summit, the European Union's leaders could not agree on what the "something" should be, and therefore luckily did nothing. But the issue will not go away. Specifically, France which takes over the EU presidency on July 1 has been "invited in conjunction with the European Commission to examine the feasibility and impact of measures to smooth the effects of sudden oil and gas price increases" before EU leaders hold their next summit in October.

For its part, the Commission warns against fuel tax cuts that merely postpone the necessary adjustment to a low-carbon world. It argues the only correct short-term action, on economic and social grounds, would be for governments to use higher petrol tax revenue to give direct financial aid targeted to the poorest and hardest hit people. Moreover, the Commission contends that cutting fuel taxes would just encourage Opec to raise its crude price correspondingly.

This was the line taken by Germany's chancellor Angela Merkel, and some other north European leaders. Sweden's Fredrik Reinfeldt said he was looking at using higher fuel tax receipts to pay for income tax cuts that could encourage Swedes to work longer and raise production and productivity. "An increase in petrol prices could be met by working extra hours", he said.

Other leaders, however, itch to intervene. France's Nicolas Sarkozy proposes to cap the rate of, or receipts from, value added tax receipts on fuel. Italy's Silvio Berlusconi is planning a "Robin Hood" tax on oil company profits to fund a government-paid discount card for poorer people to buy fuel. Austria's Alfred Grusenbauer would use a tax on oil speculation to achieve the same purpose.

Of these proposals, only the French proposal might blunt the price signal coming from higher prices at the petrol pump, depending of course where the cap on VAT was put. Italy's windfall profits tax might actually raise petrol prices if passed on by oil companies, while Austria's oil speculation tax idea could have the same effect on crude oil prices. And there would be nothing wrong with that, if these taxes provided money for poorer people without interfering with fuel tax rates. But the longer oil prices stay high/go higher, the tighter the pinch on voters' pocketbooks, and the more Europe's politicians will feel driven for electoral reasons to cut fuel tax.

Yet any such cuts will be counter-productive, certainly reducing European consumers' incentive to conserve fuel and possibly encouraging Opec's and other oil producers' appetite to raise crude oil prices to compensate. Europe's high level of petrol tax is a source of frustration to oil producers. A Gulf oil minister once remarked he would be ready to give European governments oil free, if they would just share half their tax proceeds with him.

The high tax level is also a source of price stability. The reason why Americans are so sensitive to oil price rises is not just that they use so much of it; it is also that the crude oil price forms such a large part – and gasoline tax so small a part - of the pump price. The reason why fishermen have led the recent fuel protests in Europe is not just that fuel forms such a large part of their cost base (nature provides the fish free); it is also that in Europe fishermen pay no excise duty on fuel. Moreover, excise is a rather stable tax, based on volume, not price (like VAT). Paying less tax than Europe's other fuel-users makes fishermen more sensitive to crude oil price rises. In addition, all of what tax they pay is the less stable one of VAT, which goes up with price.

In fact, there is a broader political problem about rising energy costs and prices. For Europe's leaders have not come clean with voters that almost every element of their new energy policy – making companies pay for carbon pollution permits on the Emission Trading Scheme, setting compulsory targets for renewable energy and for bio-fuels – will have the effect of raising energy prices.

Even before the oil price surge of the last couple of years, with its knock-on effect on contractually-linked gas prices, several EU governments had refused to de-regulate, or had decided to re-regulate, gas and electricity retail prices. The Commission is pursuing them for regulating prices too widely or too far below cost and thereby infringing various existing EU directives. But the governments do not care, because it will be several more years before the European Court of Justice finds against them, and in the meantime they have more important things to worry about, like elections.

Rising energy prices also threaten to discredit energy market liberalisation, especially in the eyes of those citizens misled by their politicians into believing that liberalisation would lead to lower prices. The sensible way to think of liberalisation is that by creating or ensuring a degree of competition it can keep prices lower than they would otherwise have been, but that does not mean that prices either fall or stay low.

This is the way to view the main aspect of energy market reform under negotiation in the EU at the moment – network unbundling. This is the attempt to make vertically-integrated energy groups give effective independence to any grids or pipelines they own, so that they cannot use their networks to discriminate against or exclude rivals.

Negotiating more effective unbundling has been a long and tortuous business. A minority of EU states led by France and Germany has succeeded in watering down the Commission's original proposal for ownership unbundling, forcing integrated groups to sell their networks. The 27 governments reached a compromise on June 6 that gives the Frances and the Germanys the option for their companies to keep their networks in both gas and electricity, but under closer outside supervision than exists under present EU law. The European Parliament is in two minds, not an unknown state of affairs for Europe's legislature but one that reflects the fact that networks are much easier to unbundle in electricity than in gas. On June 18 MEPs voted two-to-one for nothing but ownership unbundling in electricity. However their vote next month [July] on gas is expected to be much nearer the June 6 compromise within the Council of Ministers.

Governments and MEPs need to come to a rapid agreement on unbundling, for several reasons. One is that if they do not, debate on energy market reform will run into the 2009 European Parliament elections and the reform package will die. More important in the context of rising political temperatures about rising energy prices, EU governments and MEPs will be able to show that they have carried out one of the few things within their power to keep prices as low as possible.