THE OXFORD INSTITUTE FOR ENERGY STUDIES

January 2023

Final agreement on wholesale gas price caps foreshadows future challenges for EU energy policy

In late 2022 the EU Council finally agreed on a wholesale gas price cap mechanism in response to the record high gas prices. However, the 'market correction mechanism' is problematic as it does not address the underlying causes of high gas prices, primarily the reduction of Russian gas supplies from 41 per cent of the EU gas market to 9 per cent, and the lack of low-cost alternatives to fill the gap. It serves as a warning that, even in the face of a serious and immediate emergency, the EU Council lacks either the will or the imagination to develop and implement policies which meet its stated objectives. This bodes ill for the decisions that the Council will need to take to transform the EU's energy systems to meet its climate goals and it raises questions about what will happen in the EU gas market when the mechanism takes effect in February 2023.

The Council was divided on the value of a price cap and its level. The Commission was against a price cap, and it tried to avoid one by creating a framework without any detail. When this was rejected by several Member States, the Commission proposed a price cap at such a high level (€275/MWh) that it would be unlikely to be triggered. This was also rejected prior to agreement on a price cap of €180/MWh at the TTF and if the TTF price was at least €35/MWh above a benchmark price for LNG for at least three working days. The mechanism applies from 15 February 2023, and will last for at least twenty working days if triggered. If the TTF price falls below the cap for at least three consecutive working days, the cap is automatically deactivated. There are also 'safeguards' so that the cap is deactivated if it causes an increase in gas demand, a reduction in LNG imports, a significant drop in TTF liquidity, or if the EU Commission declares a supply emergency. The Commission, and the European energy and financial market regulators, ACER and ESMA, are charged with monitoring the functioning of the mechanism. If the mechanism causes market problems, the Commission will suspend it.

The legislation makes grimly amusing reading. The drafters tie themselves in sophistic knots trying to justify the price cap, while at the same time explaining the need for all the safeguards to prevent it from harming the EU gas market. This is a circle which cannot be squared as the problems of a price cap are inherent to its nature.[1] For the cap to have an impact it must override the prices which result from normal market functioning. Current prices are not caused by a market malfunction, but by a fundamental change in the supply-demand balance. It is no wonder that prices have increased dramatically as the EU has lost a third of its gas supply. Moreover, the recent falls in gas prices have been driven by demand reductions as the consumers have reacted to price increases, and the EU has been blessed with mild weather. Only by rebalancing supply and demand will prices be reduced sustainably. By

[1] For a detailed examination of the issues see Barnes (2022) 'EU Commission proposal for joint gas purchasing, price caps and collective allocation of gas: an assessment' Oxford Institute for Energy Studies

Alex Barnes, Visiting Research Fellow, OIES

implying that current prices are not a reflection of market reality, the very name of the ‘market correction mechanism’ is disingenuous.

Some may take comfort from the safeguards in the package but in reality, the problem of the price cap has only been kicked down the road. At the lower level of €180/MWh, gas prices in 2022 would have been above the cap for a fifth of the time, compared to a fiftieth of the time with the Commission’s original proposal of €275/MWh. If the price cap is triggered at any point after February 15 then the market will need to find some other way of balancing which makes it more likely the safeguards will be triggered. But if the cap is suspended and prices rise to their natural level the price cap proponents will likely cry ‘foul.’

As a result, the agreement is fragile and could lead to significant political dispute during the year if prices rise about €180/MWh. Germany reluctantly agreed to the mechanism in return for more ambitious renewable targets, but Austria and the Netherlands abstained. Agreement seems to have been driven more by the need to unblock the Council’s agenda than any real meeting of minds. For example, price cap discussions have delayed progress on key elements of the ‘Fit for 55’ package put forward by the Commission in 2021, including legislation on energy efficiency, renewables, reform of the gas market, and hydrogen. Therefore, it will be vital to monitor all reactions should gas prices start to rise towards the price cap level, not only from politicians from the various member states but also from market participants who will have to deal with the consequences of their actions. As with all state-interventions in markets, the unintended consequences could be significant.

Alex Barnes (mailto:alex.barnes@oxfordenergy.org).