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Sense and Nonsense behind Energy Price Caps

by Daniel Gros and Nathalie Tocci

In official circles at the highest level, from the G7 to the European Council, a tense debate is taking place on what to do about spiralling gas and oil prices, which have either broken or have come dangerously close to breaking record territory. In Europe, a special meeting of the European Council on energy was originally scheduled for the fall, but is now being brought forward, while the European Commission is working on an emergency plan to prepare for a complete cut-off of Russian gas. Energy prices dominate the agenda of our leaders.

Yet it is a confused and often confusing debate that is worth unpacking.

The debate at the G7 largely revolves around oil, also because gas is not a problem for the US or Canada. The US and the UK have already blocked all imports of Russian oil. This was relatively easy for them to do as the US does not import significant amounts, and the UK received its oil from other sources anyway.

Until recently, the EU imported up to 40 per cent of its oil from Russia. The European Council has in principle decided that by February 2023 all imports of oil and refined products from Russia will stop, with the exception of smaller amounts arriving through the Druhzba South pipeline serving Hungary, the Czech Republic and Slovakia, as well as Croatia for vacuum gas and Bulgaria for shipped oil.[1] An even more consequential measure is the limitation on EU (and UK) maritime insurance companies to provide cover for cargos containing Russian crude. This measure could potentially limit Russia's capacity to export, not just to Europe, but worldwide, driving oil prices even higher.

[1] The exemption is for all pipeline clients, but Germany and Poland decided not to make use of it for the northern branch of the pipeline.

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Given that a Russian oil embargo has already been decided, the oil price cap discussion would only reduce Russian revenues if enacted between now and the end of the year when the EU embargo kicks in. After then, it would not be aimed directly against Russia but rather at addressing the economic, and therefore also social and political, consequences on the West of high oil prices. With commodity prices soaring and fuelling inflation in Europe and the US, the fear is that the European oil embargo would generate intolerably high socio-political costs on the West.

The underlying assumption is that sanctions have exacerbated the increase in oil prices, while the price cap would aim to reduce these. However, a price cap on oil would be extremely complicated to put in place and would probably need to be devised in tandem with the insurance ban, by applying the latter to oil sold above the price cap. Moreover, given the fungibility of oil, the cap would need to encompass much more than the G7 to have any impact. In theory, buyers such as India or China should have an economic interest in capping oil prices, but in practice, they already purchase Russian crude at around 30 dollars discount compared to Brent prices. Moreover, politically they are highly unlikely to buy into a Western buyers' cartel.

Gas is thus the more interesting and yet complicated story.

The politics are sobering in Europe. After six sanctions packages, the European political appetite for passing a seventh one soon, let alone one that includes gas, is low. This implies that a price cap, or a tariff, would be the next best thing that Europeans could do to reduce the billions of euros we continue pouring into the Kremlin's war coffers.

Gas prices, and consequently electricity prices to which they are tied, are also more of a problem because they have risen to levels never seen before. Whereas oil prices are extremely high, they have been this high before and this ultimately reflects market dynamics. Given the tightness of the gas market, gas prices on the major European trading platform, the Dutch TTF, are going through the roof (up to 10 times higher than last year and the previous multi-year average), despite the lack of physical shortage so far (gas supply from Russia while reduced has not yet stopped). This has led many to believe that the TTF price does not reflect physical fundamentals, and perhaps not even market dynamics. The argument then is that a price cap does not distort the market because the market is already distorted.

The fact that Russia is gradually reducing supplies also means that another key argument against a gas price cap – the fear of Russian gas interruptions as retaliation – does not hold water. Russia seems to believe that if it cuts gas supplies, it can endure the pain temporarily – given that it has already earned more this semester than the whole of last year –; while Europeans, with a far lower level of political pain endurance in the Kremlin's view, will become divided, with this generating an irresistible drive to lift sanctions. Hence whereas Russia cannot be unaware of the fact that in the medium term it would suffer far more than Europe from a gas decoupling, it banks on the fact that Europeans will give in politically well before that time comes. After all, liberal democracies, first and foremost European ones, are fundamentally weak and fragile according to the Kremlin's ideology. This logic, faulty as it is, appears to drive Russia's calculus, regardless of any eventual decision on a gas price cap.

The idea of a price cap is thus gaining political adherents. But what is meant by a gas price cap? One needs to distinguish three cases, only two of which make sense.

One meaning of a price cap would be a ceiling on the gas and consequently electricity prices paid by consumers in the EU. This is implemented indirectly in Spain and Portugal, which have put the price for gas at power stations at one half of the market TTF price, with the government paying the difference. However, this encourages demand; leaving less gas available for storage and putting further upward pressure on prices for all. Given the energy isolation of the Iberian Peninsula from the rest of the EU, the damage for the others is limited. But if implemented by other member states in more interconnected areas, this would trigger beggar thy neighbour dynamics. Added to this, the gas price cap for consumers amounts to an undifferentiated subsidy for fossil fuels – which is the opposite of what we need to reach net zero emissions. This subsidy would also mostly benefit the largest and wealthiest households that consume most energy. It is a price cap that makes little sense both in climate and socio-economic terms.

Another meaning would be a price cap only on Russian gas. This, like a tariff, would be aimed at reducing Russian revenues. It would thus make sense only if Russia does not actually interrupt flows first. As of now, it is highly uncertain whether Russia will resume flows through Nord Stream after 21 July, which is when the scheduled maintenance should be terminated. Were those flows to resume, a gas price cap on Russian imports should be envisaged and speedily implemented. Such a scenario would mean agreeing to a Russian gas embargo, which would mean terminating all existing long-term contracts due to force majeure. This would be followed by a take-it or-leave-it renegotiation of such contracts at the capped TTF price. If, however, those flows were not to resume after the 21 July, there would be no Russian gas prices to be capped.

Finally, one might think of a price cap on all gas imports (including Algeria, Norway, Qatar, the US etc.). Such a cap would not affect existing long-term contracts at lower prices. But the key issue is what happens when it is applied to new LNG supplies, which Europe desperately needs. In LNG, Europe competes with Asia. The European cap thus cannot be lower than the Asian price because available gas would otherwise go to Asia (and it would not make sense to set it higher). Such a price cap would not make a huge difference given that European and Asian spot prices tend to track each other, but it would still limit the price increases in Europe to those of our most important competitors and would neutralise any speculation on the TTF market, which might be the case right now. At present,

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the price on the European exchange TTF has reached about 180 euro per KWh (for November delivery when winter starts) whereas the price in Asia (the so-called Japan Korea Marker, for the same delivery period) has remained at only about 120 euro/KWh.

As the energy crisis is yet to peak, let alone subside, the European and transatlantic energy price cap discussion will remain high on the agenda. There are crucial economic, and above all social and political, reasons for this. Precisely because of this, breaking down this debate and dissecting sense from nonsense is essential in the days and weeks ahead.

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