A German Economist and an Italian Political Scientist Debate Europe's Energy Crisis

by Daniel Gros and Nathalie Tocci

Nathalie: Back in July we wrote a commentary unpacking the sense and nonsense of price caps.[1] The international and European debate has evolved since then. The G7 has progressed on an oil price cap and the European Union has set the legal basis to make this possible at European level. As far as gas is concerned, we have moved beyond the black-and-white "to-cap-or-not-to-cap" existential question, examining the pros and cons of the different options and interpretations: Russian vs non-Russian gas, pipeline vs LNG, a cap on consumer prices vs a cap on importers. As we had discussed in our commentary, once unpacked in its various dimensions, the gas price cap story is complex, requiring carefully thought-out solutions to avoid counterproductive effects.

Italy, alongside other fourteen member states,[2] strongly supports a European cap on gas prices. Today, such prices are often set with reference to the Title Transfer Facility (TTF), the virtual hub based in The Netherlands where gas is bought and sold, which has become the benchmark underpinning European gas contracts. The peaks we have seen in European gas, and therefore electricity prices, have far outflanked those in other international gas markets, including the traditionally more expensive Asian one. Some believe this to mean that the TTF market has lost its bearings. The European Commission is now thinking of establishing a different benchmark which, it believes, could better represent market conditions. A generically referred to "cap" on gas prices, Rome believes, provided it is set at the appropriate level and in the appropriate way, rather than distorting

[1] Daniel Gros and Nathalie Tocci, "Sense and Nonsense behind Energy Price Caps", in *IAI Commentaries*, No. 22|31 (July 2022), https://www.iai.it/en/node/15681.

[2] Belgium, Bulgaria, Croatia, France, Greece, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia, Slovenia and Spain.

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market mechanisms, would put a brake on speculation, restore order, without diverting supplies elsewhere. Moreover, it would shorten and mitigate the effects of a recession.

Berlin and others remain sceptical, if not out outright opposed. Help me understand why?

Daniel: Politicians never like the message from markets. The key indicator of the TTF is the "next day" delivery. There is little speculation involved: there is lots of demand and little supply. It is easy to say that a tenfold price increase is pure speculation. But the reality is that gas has become very scarce and the demand for gas is very inelastic. This means that even small reductions in the quantity available can lead to large price increases, because large price increases are needed to reduce consumption until it equals supply. The TTF is only a thermometer, breaking it or disbelieving what it indicates does not change the underlying problem of an extreme scarcity of gas. Moreover, the TTF fulfils very important functions for investors in renewables as well as gas companies which want to offer their consumers a fixed price. They need to be able to use the forward quotes of the TTF to plan their investments. This is not just a German' argument. This is just common sense.

A simple economic reasoning shows that the true cost of additional gas imports is actually even higher than the price (whether TTF or something else). The additional burden of importing more gas into Europe arises from the fact that global supply lacks elasticity. This means that even a small increase European import demand increases the global price. This higher price has to be paid on all imports, not just the additional quantity sought. The true cost of not saving on gas is thus much higher than even the price one observes on the TTF.

That said, it is true that there is a curious difference in what is considered the key problem. The key issue for Germany remains the availability of gas – but apparently not for Italy (and some other countries). We still have no answer to the simple question: who would sell us gas when Asian countries offer more? So, in reality we Europeans have to pay at least the Asian price. This means that in practice we cannot "cap" the price we pay to our foreign suppliers. If this is the reality, one must ask why Italy and other 14 states insist so much on a price cap? And what do they mean by it? Can this be explained by differences in import capacity, prices of long-term contracts (indexed or otherwise at TTF prices) or differences in dependence on future investments in productive and export capacities? Sometimes we get the impression that what Italy is asking for is not a price cap on foreign suppliers, but a cap on prices within the EU.

Nathalie: Let us break down the question of supplies. On Russian gas, Berlin's old concerns have been overtaken by events. Germany used to fear that a price cap would dissuade Russia from playing cat and mouse on gas. Well, Russia didn't need the excuse of a price cap to turn off the gas taps to European countries. It first used the excuse of some countries refusing

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to pay in roubles for their supplies despite their long-term contracts were exclusively denominated in euro. It then concocted pretexts about stuck turbines in Canada due to sanctions. It eventually admitted, somewhat more honestly, that the Nordstream I pipeline would remain shut so long as sanctions are in place. Then, when it saw that its blackmail was not deterring the EU on sanctions, starting with Germany, Moscow went as far as probably sabotaging Nordstream I and II, although interestingly the Nordstream II sabotage was only partial. The sabotages temporarily reversed the gradual trend of falling gas prices since their August peak at 350 euro/MwH. Moscow probably aimed at persuading Berlin to revert to the Nordstream II alternative, a bet that was for the Kremlin to lose. Most significant, the sabotages signalled that in an all-out hybrid war against the West, other European pipelines and critical infrastructures in the Baltic Sea or the Mediterranean might be sabotaged too. All this has happened without an EU price cap on Russian gas.

As for non-Russian gas, as we discussed in our commentary in July, the debate has moved and the discussion in Rome now revolves around temporarily capping the price of piped gas – hence supplies from countries like Norway, Azerbaijan, Algeria and Libya, around 90 per cent of which are indexed at the TTF price. Capping these prices below the currently exorbitant TTF but well above the prices of last year would still mean that these producers would make more than handsome profits. As for new LNG supplies, where indeed there is the risk of diversion elsewhere, the idea would be to adopt a contract for a different approach. In other words, subsidising the price of new LNG for consumers. Moreover, in Italian thinking the cap would not be a fixed price, but pegged to other international benchmarks, including the more expensive Asian JKM.

Daniel: First of all, one needs to clarify whether the price cap should apply only to new contracts or also to existing ones. I believe that it would be legally impossible to break existing long-term contracts. Of course, one can ask the suppliers for a discount. But what do we do if they do not agree? A better way would be to put pressure on Norway to give one half of its extra-profits to Ukraine. Moreover, one should not exaggerate the importance of the TTF for the price we are paying to exporters. Many contracts are still indexed on oil and the indexation is not complete even for those contracts which refer to the TTF (it seems that many long-term contracts have their own, internal "price cap"). If the price cap applies only to new contracts, its practical importance will be very limited as the vast majority of the gas flowing into the EU comes under long-term contracts.

The second "leg" of the price cap idea seems to be to subsidise gas, providing consumers with gas below the import price. This does not make economic sense. If consumers get subsidised gas somebody will have to pay for it. The consumers are also the tax-payers. This is thus a "left pocket" to "right pocket" transaction. Moreover, low prices to consumers means increasing demand at a time where consumption should be falling. Even worse, if EU demand increases the global market price will increase, nullifying the subsidy. In the end we will just pay more for the gas or risk not getting all the cheap gas which consumers are demanding.

Why are Italians not concerned that a price cap within the EU would end up increasing demand, taking into account that Italy's (as opposed in Germany's) demand is actually up year-on-year?

Nathalie: I take it, that is an important point. And indeed there is a credibility problem if countries like Spain that have implemented a price cap are also the ones that have seen their consumption increase rather than decrease year-on-year. Unfortunately, we are not discussing this in Italy nearly as much as we should, while it is the most urgent thing to do to avoid crashing into the brick wall of forced rationing.

But back to Germany, is there not a German problem too? It is true that Germany, as opposed to Italy, has reduced consumption. Yet now, rather than accepting to intervene on prices at EU level, it is doing so at the national level, with its 200 billion euro spending package for families and businesses representing a de facto massive national energy subsidy, that far outweighs how much other European countries have allocated to shield households and businesses from the energy crisis. This is watched with surprise and dismay in Rome. It is Italy with its recent election that has supposedly moved to the nationalist and Eurosceptic right, while Germany is governed by a Europeanist social democrat-green-liberal coalition. Yet it is Olaf Scholz who decided to go-it-alone the day before the Council of energy ministers by announcing a 200 billion euro spending package, while Giorgia Meloni, soon-to-be Italian Prime Minister, speaks of a European solution. It feels like the world turned upside down?

Daniel: Did Italy, or any other member state, consult with its partners before enacting its various support packages? The available data shows that Germany has spent so far less in relation to GDP than others, including Italy. The 200 billion euro announced by the German government is meant as an upper limit for almost two years. It is thus not certain that next year Germany will spend more than its partners as a percentage of GDP. Furthermore, there is a key difference between the Iberian measures and what Germany is planning: the Spanish government is subsidising gas use for electricity generation, which has led to an increase in gas consumption in Spain. By contrast, the German government plans to subsidise (or put a price cap) only on a limited amount of gas, probably 75 per cent of some average over the last years per household or small and medium-sized enterprise (SME). Households and SMEs will have to pay the full market price for the cubic metres above this base consumption. This maintains incentives for gas savings, which the price cap Italy is proposing does not have. An even worse scheme is that of Spain, where the use of gas for electricity generation is subsidised. It would be really bad if this idea were to be applied to the entire EU, as the President of the Commission has recently announced. In Spain, gas consumption has increased considerably as a result of

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these subsidies. If the whole EU copies this approach, prices will increase even further and we will not get through this winter without rationing.

Nathalie: But even if, in and of itself, there is nothing fundamentally wrong with the German package, and assuming that the Commission will put a break on the idea of subsidising businesses insofar as it would contravene state aid rules, does this not create a European problem given that measures such as these would only be available to countries like Germany (and other Northern European countries) that have greater fiscal space to manoeuvre? Do we risk recreating the poisonous Eurozone divide between north and south with an energy spin on top?

Daniel: The payoff from keeping deficits low and reducing debt in good times is that your state can act decisively in a crisis. Governments that pay the political price in keeping debt down during good times are then asked to pay for the others who have not done so. This leaves no incentive to keep debt down. Italy is now clamouring for a relaxation of the fiscal rules, especially the one on debt. In effect Italy is asking to be allowed to increase its debt so that when the next shock comes it can again ask for solidarity because its fiscal position is so weak. This is not credible.

Nathalie: I agree on the principle. I am no economist but in the depths of the Eurozone crisis, when we were immersed in the poisonous debate over austerity, I thought that we simply needed to get serious about our debt here in Italy. However, here we are, again, plunged into crisis. Had the go-it-alone Theodicean logic of the virtuous "doing what they can" and the profligate "suffering what they must" been applied during the pandemic, who knows where we would be today. Fortunately, this did not happen, and Germany's leap of faith in Europe was key to the Union making a gigantic step forward in integration. I understand that this cannot happen again only two years after the approval of NextGenerationEU (NGEU), and that countries like my own must demonstrate their fiscal discipline and seriousness on energy demand reduction. That said, I think it would be tragic if the pendulum swung back to where we were during the Eurozone crisis. The pandemic crisis was well handled and lasted two years, leading to a Union that rediscovered the "Monnetian" art of seeking opportunity in crises. The Eurozone crisis and the economic crisis it gave rise to was handled badly and lasted much longer, fuelling divisions and nationalist-populism that brought the Union to the brink. Is it not essential to find new forms of intra-EU solidarity on prices as well as supplies, which may not be as big as the Recovery Fund, but big enough not leave member states, with their vastly different spaces for fiscal manoeuvre, to go it alone?

Daniel: There is a vast difference between the NGEU package and the argument that in every crisis a new European fund is needed because some countries have not put their fiscal house in order. The purpose of NGEU was to finance investments, for the green and digital transition. Investing into the future is very different from subsidising the use of gas for consumers. Why should the EU/ Germany finance something which does not make economic sense? It might be very different if Italy asked for a joint EU programme for energy saving measures, including for example a premium for households which save on gas. This would be much more credible.

A safety net like SURE, recently proposed by Commissioners Thierry Breton and Paolo Gentiloni, might be useful. This crisis does not seem to involve a lot of unemployment today, although it may do so in future. A revamped SURE would be a political signal, but have little immediate effect on the ground. There is a lot of talk about the need for European solidarity. In a crisis when gas has become a scarce resource, solidarity should mean not just the pooling of fiscal resources but above all joint efforts in reducing gas consumption. Fingers should be pointed not just to one side of the equation: Germany that resists spending at European level; but also on the other: Italy that increases its gas consumption against the interests of the EU a whole. What we need this and next winter is coordinated demand reduction, not subsidies for gas consumption. Poorer households can be protected in many other ways.

Nathalie: I agree that solidarity through joint spending can only be one side of the equation, which holds only if the other – reduced consumption and responsible fiscal policies – are in place. There is an additional aspect of solidarity. If, because of a cold winter, demand outstrips supply, member states should not keep supplies for themselves. This applies both to Italy, that made significant headway in diversifying its gas supplies, and Germany, whose vast underground gas storage must be available to the rest of the EU in case of need.

EU solidarity should be understood as a package including not hoarding gas at home, a drive towards demand reduction, as well as joint financing to help consumers and industry absorb the price shock. It is by looking at all these dimensions together that the contours of a European bargain can be found.

In the fog and urgency of the crisis, it is also striking that other European solutions, like joint procurement and storage, have faded from the policy debate. True, these are not only highly complex and also will not save us from the crisis looming this winter. Yet, lifting our gaze from the urgency of now, is what people like ourselves should be thinking about.

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