

Imposition of gas price caps – what can go wrong?

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Discussions about a suggested price cap on wholesale gas markets seem to make a number of assumptions about how markets will react to the imposition of a price cap, which does not necessarily reflect how market parties consider such an intervention.

- 1. It assumes that a price cap will have no impact on the demand shortfall because production and import capacities into the EU are already at a maximum, and higher prices will not attract more gas in the short term.**

In fact a price cap widens the gap between supply and demand and will lead to more rationing.

- The gas price is currently being set by the demand side, not the supply side. Prices rise to a level where consumers self-interrupt, switch to alternative fuels, or invest in other energy saving measures. Without this signal, consumption will be higher, and the shortfall will need to be resolved another way, e.g. mandatory curtailments.
- The high price (where Europe is trading at a premium to Asia) also ensures that the marginal LNG cargo comes to Europe, and gives a price signal for cargoes that are contracted to Asia to be rediverted to Europe.
- The high price at TTF relative to international LNG prices is an indicator of physical constraints, e.g. missing interconnection and/or regasification. The price signal needs to be maintained to incentivize new regasification capacities where these can be delivered quickly, and to resolve bottlenecks.

- 2. It assumes that companies will be forced to transact at or below the cap.**

In fact it will put already contracted and future deliveries at risk.

- Long term contracts typically have reopeners that can be triggered by regulatory change or the discontinuation or change in an index. Many existing contracts could be reopened, putting already contracted supply at risk.
- LNG contracts in many cases take place outside EU jurisdiction (and indeed, sellers may insist that future contracts take place in international waters). An importer could redirect cargoes outside Europe rather than trade at a loss against a lower cap. The consequence would be a risk to security of supply.
- Alternative contract structures may also develop to circumvent a cap.

3. There is an assumption that prices are not necessary to allocate scarce resources effectively.

In fact agreeing on an alternative allocation mechanism will be hard and will produce a less balanced outcome.

- Markets provide allocative efficiency i.e. gas will go to the party who values it most highly. If everyone is seeking to obtain a limited amount of gas at the same price, then an alternative allocation mechanism must be agreed. Gas will need to be rationed by authorities. Given the differences already observed between Member States' exposure to the crisis, differences in fuel mix, and ease of access to international LNG markets, the underlying mechanism is unlikely to be agreed in the necessary timeframe.

The fundamental issue is that there is a shortage of energy. If we cap prices, this does not go away and we must ration demand anyway. A price cap would even exacerbate this by putting existing contracts and future supplies to Europe at risk. If demand can be managed down (whether through high prices, or through voluntary or mandatory reduction measures), then price signals should remain to allocate what energy is available efficiently. EU can also help to remove infrastructure bottlenecks to enable additional LNG supplies to be shared further across the member states and vulnerable neighbours.