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Argus Insight: **Natural Gas**

EU price caps — too high a price to pay?

As EU energy ministers meet on 9 September, the impact of high gas prices on their countries' economies and their citizens' livelihoods will be at the top of the agenda.

European Commission officials have been scrambling to generate ideas to feed into the policy debate. Their goal — to shield EU citizens from penury — is laudable.

But the unprecedented pace of policy generation has resulted in a number of proposals that would not achieve this aim.

Some could even wreck the tightly integrated markets upon which the EU depends to ensure the stability of the physical infrastructure that allows energy to flow across the region.

In this Argus Insight, we set out the likely implications for the energy markets of some of the proposals under consideration.

Capping the price of Russian gas imports

The European Commission is considering recommending the imposition of a price cap on imported Russian gas, potentially linked to Russia's realised export prices in recent years.

- Russian gas exports to Europe would likely halt entirely, including gas flowing through Ukraine and Turkish Stream.

- Moscow would consider European buyers of Russian gas to be in breach of their long-term contracts, and may dispute the move through the World Trade Organisation (WTO).

- These European buyers may need substantial financial support to fund the purchase of replacement gas supply.

- Market prices would soar in response to the further reduction in regional supply.

Capping the price of all European gas imports

The commission is also considering introducing a cap on the price of all gas imports, regardless of provenance.

- Long-term gas suppliers could view this unilateral change in pricing terms as breach of contract and halt deliveries to Europe and/or initiate WTO proceedings.

- Setting too low a cap could reduce the amount of supply delivered to Europe, particularly if competing importers bid above the EU cap.

- Setting too high a cap would create unwarranted economic rents for gas and LNG producers.

- Removing the link between prices and Europe's supply-demand balance could result in costly and wasteful oversupply during low demand periods

Indexing European prices to LNG prices

Another proposal under consideration is the effective removal of the Dutch TTF hub as a price reference, by either replacing it with or pegging it to an LNG price reference. This is also being referred to as a 'dynamic price cap'.

- The commission's long work liberalising the EU gas markets means that the TTF market is much deeper and more liquid than any LNG price reference, and involves a wide range of participants including producers, end-users and utilities, as well as trading houses.

- LNG markets are thin and illiquid. Only a small number of companies participate in the LNG market, many of which are outside the EU's jurisdiction and so are not subject to Remit transparency requirements.

- The large size and cost of LNG cargoes and high barriers to entry mean that few European utilities and even fewer end-users are able to participate in this market.

- The most prompt delivered LNG contracts are for cargoes arriving in 15-30 days. European gas markets trade far more promptly to take into account short-term changes in weather or power generation, and pipeline operators trade within-day to keep supply and demand balanced on their networks.

- Policy makers have observed that northwest European spot LNG deliveries are priced at a deep discount to the TTF. This results from infrastructure bottlenecks, as cargoes are arriving quicker than they can be unloaded. Plans to boost EU LNG import capacity by more than 20pc by early 2023 should ease these bottlenecks and reduce the discount.

- Indexing European prices to northeast Asian LNG prices plus a fixed premium would not account for variations in LNG shipping costs, and could be insufficient to attract cargoes when freight rates are high.

- Northeast Asian LNG prices are already tracking movements at the TTF, but are at a discount because Chinese demand remains weak. Once northeast Asian demand strengthens, an escalatory spiral could ensue as each region competes with the other for marginal supply during their respective trading days.

Suspension of gas trading

Some quarters are calling for the suspension of European gas trading in the belief that this would arrest the rise in prices.

- Halting trade at the TTF would drive liquidity to other European hubs, and would remove a key component of the Netherlands' market-based balancing system.

- Halting exchange trade for all EU gas hubs would drive liquidity back into the over-the-counter market but would not reduce prices.

- System operators that use exchange trade to perform market-based balancing would also be forced to turn to the over-the-counter market, where they would run higher risks of counterparties defaulting rather than rectifying imbalances.

- The high risk of counterparty default in the over-the-counter market would be reflected in higher prices for all market participants.

Conclusions

The policy interventions now under consideration run the risk of throwing out more than 25 years of energy market liberalisation and reform that have given Europe the most efficient and transparent cross-border gas and power markets in the world.

Delinking gas prices from European supply and demand would remove any signal for where in Europe gas was needed most at any given time. It would obstruct the work of the infrastructure operators responsible for ensuring that gas is safely delivered to where it is needed.

Linking the TTF to LNG prices would also put European supply costs in the hands of a small pool of traders many of whom have no direct link to the region, lie outside its jurisdiction and are free from European regulatory scrutiny.

And it is far from clear that delinking prices from European supply and demand would reduce energy costs or address the affordability crisis facing European consumers.

Extraordinarily high gas prices have translated into unusually large margin and collateral requirements for prudent market participants who are hedging their market exposure. The financial strain has been amplified by limits on retail prices.

This has meant a financial liquidity crunch, forcing a number of large gas utilities to go to the debt markets or to their governments to request large additional credit facilities.

This is a luxury that not every company or country can afford. But the EU can collectively provide sufficient funding to ensure that systemically important energy utilities across the region are able to continue procuring supplies for their customers.

By reducing the risk of counterparty defaults, providing financial guarantees for key utilities would also reduce counterparty risks for market participants, and accordingly reduce the elevated risk premiums that are contributing to high energy prices.

The energy sector is every bit as vital to the smooth functioning of the EU's economy as its financial sector. The challenge facing Europe today is as large and as important as the financial crisis was in 2008. Europe needs now, as it did then, forward-thinking solutions that address the problems at hand without wrecking the market infrastructure upon which the region depends.

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