Capping wholesale gas prices could worsen the energy crisis

There is a shortage of gas in Europe – that problem can be addressed by increasing supply or reducing demand. While we understand the political appeal of a price cap – or a Gas Market Correction Mechanism - this could make the current situation worse.

A price cap risks increasing demand, reducing supply and reopening contracts

A capped price may not attract supplies

The urgent problem that must be addressed is a physical shortage of gas in Europe. We need suppliers of gas outside Europe to increase supplies and choose to sell their product to Europe. If a capped price is below the global price, this will not happen. Europe is competing globally for a scarce commodity. A cap weakens our negotiating hand, undermines the trust in European gas markets which sellers have relied upon for decades and could weaken our security of supply.

And will lessen incentives to reduce demand

If we can't increase supply, we must reduce demand to manage the current crisis. Europe has done well so far as consumption has fallen. But a capped price will reduce the incentive to save energy at the times when it is most valuable. The consequence could be higher gas consumption.

Meaning Governments will need to manage demand

Markets are extremely good at directing gas to where it is most needed. Gas will flow from lower to higher priced areas (as long as there is network capacity to let it do so). If prices are at a cap, this signal disappears. That means that Governments, rather than the market, need to decide which customers receive gas (and how much) and which don't.

Triggering re-opener clauses in contracts is unwise

Global Liquified Natural Gas (LNG) contracts contain clauses which allow the contract to be renegotiated if an index or a benchmark changes. Therefore a cap could provide importers with a free option to renegotiate contracts. This is unwise in a market where sellers hold the power. It could see existing contracts renegotiated and cargoes diverted to other countries at prices above the cap.

History shows price caps can have unexpected effects, a thorough assessment is needed

Price caps can have a magnetic effect

Price caps have been attempted in other sectors of the economy. History suggests that the presence of a cap can have what has been described as a “magnetic” effect. The risk and uncertainty it introduces creates an incentive to price at the cap (even where prices set by demand and supply would be lower). This is clearly the opposite outcome to that which the policy is intended to achieve and is bad for customers.

The risks are high – a thorough ex-ante assessment is vital

This is not a policy which can be introduced, assessed ex-post and then tweaked over time to deal with problems which emerge. Once the cap exists behaviour will change. Even were the cap removed at a later date, the market would not return to what it was before. There is therefore a very clear need for a thorough assessment of the consequences – something which has not been undertaken to date.

The TTF price is good for Europe

TTF is the most liquid global gas benchmark

The gas market is international. Gas flows are driven by the interaction of global prices – particularly at Henry Hub (in the USA) at the Japan Korea Marker (JKM) and at the Title Transfer Facility (TTF). The liquid reference price provided by TTF attracts LNG cargoes into Europe and makes international traders want to do business in Europe. It provides a level of transparency and stability which is good for the energy market and good for Europe.

And the TTF hub works well

TTF is trusted, is liquid and works well – which is why so many contracts are linked to it. It has developed to become the only global commodity benchmark in the EU and a basis for financial contracts that allow parties to manage the risks associated with large physical contracts. Recently, the Dutch financial regulator confirmed that the markets were working well and there was no evidence of manipulative or anti-competitive behaviour.

A TTF price cap would have a negative effect whether or not it was ever triggered

The existence of a price cap changes behaviour, irrespective of the level at which it is set

There is a temptation to think that a cap wouldn’t be a problem if it was set at a level where it would only be triggered in the most extreme of circumstances. This view is wrong. The mere possibility that a cap is triggered will alter the way parties behave.

A cap will encourage volumes to move away from the front month contract – reduce liquidity, increase price volatility and create the risk of a self-fulfilling prophecy

The first reaction to a cap would be for market participants to trade other contracts or to trade in other ways. That might be via a contract other than the TTF front month, by using a venue outside Europe (such as the NBP in the UK), or by conducting deals bilaterally via Over The Counter (OTC) markets. It is worth noting that larger companies will be more able to do this, creating a potential competition distortion. As volumes in the front month contract fall, volatility is likely to increase and we may see more pronounced swings in price – which makes the chance of triggering the cap greater.

Transactions could still take place above the level of the cap – but managing the risk of those contracts would become impossible.

Capping the TTF front month contract will not prevent contracts being struck at higher prices – if buyers and sellers want, or more likely need, to do this. These contracts will take place through bilateral OTC markets – or even outside the EU in the case of LNG. Normally, a trader might seek to hedge a physical OTC contract using a financial derivative contract based on the TTF month ahead position . However, a cap would take away that opportunity. Prudent companies may simply be unwilling to take this price risk without the ability to hedge and gas would be sold in other markets.

The consequence is a more volatile, more risky and worse functioning European market. Customers suffer - irrespective of whether the cap is ever triggered.

Focussing on increasing supply and reducing demand, removing bottlenecks and targeting support at the most vulnerable is the right way forward

It is clear that vulnerable customers and companies need help to deal with the current situation. In our view targeted financial support remains the best option to alleviate the financial burden they're facing. We also support:

- A coordinated campaign of measures to encourage even greater demand reduction.
- A focus on removing bottlenecks at import terminals and within gas networks to allow more gas to be imported and transported to where it's most needed.
- Efforts to make Europe as attractive as possible to suppliers of LNG, including joint purchasing on a voluntary basis.

EFET would be pleased to contribute to discussions in whatever way we can.