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Policy Responses to the European Energy Crisis

The Bad, the Good and the EU Commission

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Three bad ideas in the crisis



- **Cap the price at the international gas hub (TTF in Amsterdam).** This was actually proposed by 20 energy economists (CEPR, 16 November, 2022)! Inevitable result: the market operator (ICE) proposed moving the price hub to London. A good first year economics undergraduate should have been able to predict this result!
- **Cap the price of gas sold to power station operators in order to reduce the marginal price in the power market.** This might protect household consumers on default spot price linked contracts. This was proposed and implemented by Spain, and amazingly approved by the EU. Inevitable result: the burning of significantly more gas in power plants and reversing of power flows from Spain to France and Morocco. There was a California style market flaw in the default household tariff design, where the system would inevitably collapse (or lead to the implemented distortion) under a sustained price rise.
- **Cap the intramarginal price of low carbon generation in order to lower the price charged to customers via the tariff model.** As low carbon generation is only 30% of all generation in Europe, the cap is scarcely binding and other mechanisms lower consumer prices more, the only significant effect of this is likely to have been lowering low carbon investment incentives.

Four good ideas (1/2)

- The German Heating and Warmth Commission proposed **giving a discount on the first 80% of baseline household gas consumption and maintaining the market price on the last 20%**. This was an excellent idea which was implemented by the German government. A similar scheme could easily have been implemented for electricity consumers. This scheme targets support through bills in a way that reduces average prices (and inflation), is household specific and maintains marginal investment incentives.
- **Two-way government backed CfDs for new low carbon power lock in fixed prices for the initial period of the life of a renewables project.** These are a good idea when combined with auctions for projects because they lower the cost of capital and total energy system cost. They can be allocated to household consumers and/or energy intensive industry. This would follow the Low Carbon Contracts Company set up in the UK, where CfD contracts are currently reducing the calculated price cap price.

ExpertInnen-Kommission Gas und Wärme

Sicher durch den Winter

Abschlussbericht

Berlin, 31.10.2022

Safely through the Winter

Four good ideas in the crisis (2/2)



- **Do introduce a short-term profits tax to windfall additional generator profits.** To the extent that this does not tax marginal investment, is short-lived and replaces price capping this is a good idea in WARTIME.
- **High prices have encouraged retailer experimentation with targeted payments for reducing consumption at specific times of grid stress.** In GB Octopus Energy and NG ESO designed a Demand Flexibility Product which notifies consumers a day ahead of stress periods during which reductions in their normal consumption is rewarded with high per kWh payments.

EU Market Design Proposals 14/03/23

- Proposing changes to Electricity Directive, Electricity Regulation and REMIT Regulation
- Protect consumers by allowing **multiple contracts**, including fixed price contract, and access to a **rising block tariff**. Ensuring better protection from supplier failure and allowing **extension of regulated retail price in times of crisis**.
- MSs need to encourage PPA market and all public support for **new non-fossil fuel generation should be subject to a 2-way CfD**. Thus envisaging **more PPAs and CfDs**.
- Encouragement of increased market liquidity via **trading of longer-term financial transmission rights**.
- **Use of capacity market**; design of **peak shaving product by SO**; use of **national flexibility markets** for demand response and storage.
- There will be **enhanced market transparency rules** under REMIT.
- The detailed implementation of much of the above is **delegated to member states**.



EU Commissioner
Kadri Simson

Concluding thoughts

- **This is a short-run gas crisis sustained by a war in Europe. It is not an electricity market design crisis.**
- Sound economics should be our guide in an energy crisis and **predictions of the future path of prices and advice about contract positions are NOT the comparative advantage of economists.** Indeed economists' predictions about prices of energy have historically been woeful in the short, medium and long run. Wholesale electricity prices are already back to less than double their real long-term average in the UK.
- **There are no easy new long-term lessons from the crisis per se,** though the crisis does highlight issues that were around before about price issues on the path to net zero. Indeed, the crisis has led to the reheating of previous good, bad and ugly ideas. None of these ideas are as radical as the 'internet subscription' model in Pollitt (2021).
- At the European level, national preferences for long-term hedging (c.f. Norway vs France) and the use of energy wealth (to cross-subsidise bills e.g. in France) will differ, **it is the job of the EU to make sure national energy preferences do not distort energy related trade across Europe.**

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