MINISTERO DELLA
TRANSIZIONE ECOLOGICA

# A European price cap on natural gas – Protecting consumers and guaranteeing security of supply

Key elements of the proposal

7 September, 2022

# Agenda

**The rationales of the proposal: market failures to be addressed**

Key objectives and pillars of the proposal

Selected elements of the proposal

# The context: an extraordinary increase in natural gas and power prices

**A generalized energy price increase …**

- TTF spot price raising **from 20 €/MWh** at the beginning of 2021 to more than **200 €/MWh on average** in August, with spikes in last weeks above 300 €/MWh
- In turn, in countries exposed to marginal gas price also in the **electricity sector**, the increase has resulted in increasing power **prices from 50-60 €/MWh** up to above **600 €/MWh**

*Including very **high volatility**: swings of 30 €/MWh+ in a few hours*

**… not justified up to now by fundamentals**

- Natural **gas demand** relatively low due to mild temperatures, input from **LNG** terminals at record levels
- **No** relevant **increases in production costs** recorded
- **TTF marginal prices only partially reflecting the actual cost of the overall gas supplies**, which are sourced from different locations and with different indexation formulas
- **Power sector actual generation costs**, thanks to the increased renewable generation penetration as well as to potential specific gas supply contracts, **only partially linked to the TTF marginal prices**
- **Europe** representing the major share of the **connected to gas** pipelines, by far the largest importing market for gas

# The context: market failures leading to critical economic consequences

**Key rationales of the increase**

- **Price reflecting** fears/ **expectations**:
  - Complete stop of **gas flow** from Russia
  - European **system not able to inject enough gas** to cope with winter
  - **Uncertainty about market evolution** (prices and rationing criteria) **in case of physical shortage** of gas supply
- **Operators needs to balance** their positions
- **Speculative** trading
- **Market power situations**
- **Inadequate and not cost reflective market design** translating the marginal spot prices to the entire gas supply, and the marginal spot power prices to a large portion of the electricity markets

**Critical economic consequences**

- **Extraordinary inflationary pressure** for citizens, increase of prices of primary goods, and arrears in payment by most vulnerable customers
- European companies paying a multiple of non-European ones for energy, with impacts on **competitiveness** and contributing to inflation on supply chains
- **Operators unable to fill storage** facilities due to immobilization of large circulating capital, and some MS forced to buy gas to be stored - with public funds - to assure an adequate level of storage volumes
- **Gas exporters**, in particular Gazprom, collecting **very high invoices**

*Only **declarations on 29/08/2022** (e.g. President Von Der Leyen, MS Ministers) already **contributing to a 20%+ price decline** versus the previous day*

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The rationales of the proposal: market failures to be addressed

**Key objectives and pillars of the proposal**

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# Key objectives of the proposal

1. Reduce the **inflationary pressure** deriving from both gas and electricity, delivering immediate benefit to EU consumers, limiting the loss of competitiveness of the European economy, and mitigating the systemic risks of default of market operators
2. Manage expectations and provide a reference framework **for market evolution in case of potential disruptions**, ensuring security of supply
3. Substantially **downsize the extra profits** generated by gas export to Europe, **segmenting the rents** and implicitly limiting the financing of the invasion of Ukraine by Russia

# Key pillars of the natural gas price cap proposal

- **Structural market design** reform urgently needed in order to ensure a more cost-reflective system
- In a **complementary** way an **urgent and temporary measure** is the introduction of a **maximum price at which natural gas can be traded** (not meant to be linked only to a physical shortage of gas)

a The cap would cover **all physical and financial transactions** at the EU hubs, concluded OTC or on exchanges

b The cap should be **high enough vs pre-war levels in order to be attractive** for producers and exporters. This would be a price cap decided by political authorities at EU level, taking into considerations **international LNG prices**, **temporary** and regularly reviewed

c The measure should be complemented by a **CfD mechanism** or other public compensation mechanisms to refund importers of the difference between international prices **above the cap** and the cap **for marginal resources** required to ensure security of supply, such as **spot LNG** supplies. Over the **medium term, overall LNG deliveries could be separated** from pipeline ones with a dedicated trading platform

d A specific regulation should be included to **avoid arbitrage opportunities** when reaching the cap level (extra-EU transactions)

e An **appropriate and coordinated framework for demand management** and **allocation criteria** should be included to be triggered both: i) in the case of achievement of the cap level, but **without** situations of physical shortage of gas supply; ii) **in the case of physical shortage** of natural gas supply

*Providing visibility on price evolution and demand rationing in case of supply shortage would address issues of expectations*

\+ Additional 'no regret' to increase the **transparency** and the **better functioning of the markets** (e.g., reinforced supervision, circuit braker rules)

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**Selected elements of the proposal**

# Selected elements of the proposal (1/3)

| | Proposal | Considerations and rationales |
|---|---|---|
| 1 **Level of the cap** | The cap should be **high enough versus pre-war levels**, temporary, regularly reviewed and taking into considerations LNG international prices (e.g. LNG prices at Henry Hub and JKM benchmark) | • Cap value would be **well above production costs**, so to represent a strong incentive to keep on producing and exporting (in the period 2017-2020 never exceeded 30 €/MWh, with fluctuations between 5 and 30 €/MWh)<br>• Cap **value high enough to continue to encourage energy savings and fuel switching**, as Member States would have to continue to rapidly reduce their dependence on Russian gas, accelerating the diversification of gas imports, increasing the use of LNG, accelerating the installation of renewable energy and the use of alternative sources such as biogas, synthetic fuels, hydrogen etc, and increasing energy savings in all sectors<br>• The savings should be high enough to **outweigh the administrative and implementation costs**<br>• The cap value should be appropriate also to address the objective to **reduce the inflationary pressure** deriving from both gas and electricity prices (i.e. a cap triggered only by major disruptions would not achieve the objective)<br>• A price cap value in such a high range of values is **not considered to raise significantly gas demand**, which is driven by industrial and power consumption and the seasonal demand in winter, depending on climate conditions<br>• The cap should be **temporary, but should provide stability** on the market that would automatically limit fluctuations driven by expectations or speculative behaviors<br>• The cap would be temporary and reflect the **evident extraordinariness of the situation** (war level) and would be managed without impacting operators on current contracts or as a retroactive measure |
| 2 **Transactions subject to cap** | **All physical and financial transaction** in all European hubs should be subject to the price cap (i.e. import from Russia but also other imports, including EU domestic gas production, TTF but also other hubs) | • Cap would be applied to all transactions with delivery at EU hubs, **not only on Exchanges but also OTC** (hence, it would be in the form of a EU Regulation to be enforced and not simply a cap on exchanges)<br>• Cap would **not discriminate imports from Russia**, and would be justified by the aim to reduce speculation of operators in EU gas trading<br>• All **OTC contracts are reported to and monitored by ACER** (according to REMIT Regulation), so a dedicated procedure should be put in place in case of deviations from the introduced policy |

# Selected elements of the proposal (2/3)

| | Proposal | Considerations and rationales |
|---|---|---|
| 3 **Legal basis** | The legal basis may be an Act having the force of law that does not need national transposition, for example a **Regulation of the Council** | • **Art. 122.1 of the TFEU** empowers the Council to adopt measures, based on a proposal from the Commission, "appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products, notably in the area of energy"<br>• **Extra-EU transactions could be restricted** to avoid arbitrage transactions buying gas in EU at price cap and selling it outside EU. Anyways at the moment LNG exporting capacity is constrained and pipeline rerouting outside Europe very limited |
| 4 **Implications on current contracts** | The contracts indexed to hub prices **would incorporate the price cap into the price formation mechanisms**, after the contractual time lag period: no need of changes in calculation of minimum contractual quantities and price formulas | • Exporting operators by pipeline would be **obliged to continue delivering at least the minimum quantity identified in the contracts**, and anyways **incentivized to do so as far as the cap is well above historical values** and production cost<br>• The impact on existing contracts depends on the specific clauses and on the applicable law under which the same are construed. **Price Revision clauses could be activated** by the sellers/exporters (as well as by the buyers/importers): there are different cases and likelihood for their trigger, not necessarily applicable to the potential price cap adoption transposition<br>• Depending on the specific contract, there may be an exposure to negative differences until the contract price gets realigned to the new capped market price (time lag)<br>• It should be noted that Europe still a major share of the market connected to gas pipelines, so **exporters would not have other equally large markets to redirect gas flows** to in the short-medium run<br>• **Only part of the Long Term Contracts are actually linked to gas hub market prices** (e.g. combination of oil and other price indexes are also present in contractual price formulas, to be assessed versus the introduced cap) |
| 5 **Compensation mechanisms** | Potential compensation (e.g. through CfD) may be needed primarily:<br>i. To attract marginal resources contractually **priced above the cap in case of supply shortage, such as LNG**<br>ii. To gas **imports**, both pipe and LNG, already **contracted at the time the Cap measure is introduced** | • **A transitional period is needed** for the realignment of contractual prices formulas to the new capped market references (price formulas have different time lag and/or reference to markers different from European gas hub)<br>• The potential compensation would be **lower than the overall system costs reduction**, as the measure would have limited the extra profits as a minimum on the quantities subject to the price cap<br>• Compensation **could be managed in a central way** (e.g. coordinating the CfD transaction with a single operator)<br>• Compensation should be **shared and allocated across MS** taking into account their gas consumption according Regulation (UE) 2022/1369 (different MS may experience different conditions but would all contribute to the security of the overall EU system, so that the cost should be borne by all of them) and may be funded through EU central budget financed by MS, preferred vs a EU levy on gas bill in order to maximize to price reduction effects |

# Selected elements of the proposal (3/3)

| | Proposal | Considerations and rationales |
|---|---|---|
| 6 **Mechanisms to attract marginal resources and ensure security of supply** | When reaching the cap level, a **CfD mechanism should refund importers of the potential difference between LNG** international price premium and the cap<br><br>In this context, an **operator acting as a centralized EU entity** would coordinate the marginal supply and compensate the marginal spread (and allocation across EU countries)<br><br>*See also point iv. of centralized EU entity proposal in previous block* | • The centralized EU entity would:<br>i. **Monitor and assess** gas supply/demand balance in the different EU MS<br>ii. Coordinate and implement a **joint procurement scheme for the supply of marginal resources** (LNG, or via pipe in case of emergency)<br>iii. Coordinate the allocation of **slots in the EU regasification terminals**, in order to maximize their utilization rate and the use of transport capacity available at MS borders<br>iv. Coordinate the **allocation of transport capacities in the EU gas networks**, in agreement with relevant TSOs, to allow gas **flows towards and within MS in a situation where, after reaching the cap,** the importers would have no interest in transport gas paying additional tariffs from first delivery points by pipelines or by LNG regasification plants to MS far from these points; this could be solved by adopting temporary transport tariffs avoiding pancaking at a fixed value, establishing an ex post compensation for the relevant TSOs<br>v. Coordinate the **implementation of demand curtailments**, if necessary, in different countries, according to a pre-defined framework, established by Regulation (UE) 2022/1369; the possible rationing could be made on the basis of the gas consumption data on the previous 5 year period, already agreed in the same Regulation<br>vi. Providing the necessary **financial compensations** to the importers<br>vii. Allowing other **national entities to purchase LNG cargoes above the cap**<br>viii. Allowing joint **purchases of gas imported by pipelines by auctions** on a fixed maximum price for a six months period, till the end of next winter, in order to reduce speculation and market manipulation<br>ix. Coordinate the **allocation of joint procured** resources<br>• **Different MS might be represented** into such central entity or in otherwise provide their specific instructions / delegation to it. Potentially, such central entity could be working in the frame of the already existing Gas Coordination Group, under the SOS Regulation |
| 7 **Required demand management and allocation measures** | In case of supply shortages (independently from the cap proposal) **coordinated measures** required:<br><br>i. To **allocate the demand management measures across MS** (the impact of shortages may not be symmetric across MS but the relevant effects should be equally shared), taking also into account the Solidarity Measures among Member States<br><br>ii. To allocate the **demand management measures across consumer-classes** (updating and reinforcing the emergency plans) | • Planning demand rationing measures would **be key to enable** the successful implementation of the initiative<br>• The introduction of the **price cap** (also in the range of current market levels) **does not imply necessarily the activation of curtailment**, as CfD for marginal resources may compensate the demand-supply balance<br>• The decisions related to the demand management measure could be possibly taken after **discussion in the Gas Coordination Group**, which is already foreseen under the provisions of the SoS Regulation. The Commission could establish a general draft for these agreements, building upon the agreements already subscribed by some MS, to be adopted by all MS |

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