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Energy price crisis in the light of war in Europe: Long term strategy needed

Overview

The flagrant violation of Ukraine's sovereignty marked by the Russian invasion of Ukraine not only spells catastrophe for Ukraine, it has also triggered an earthquake to the already shaken foundation of the European energy system. First sparked by a gas shortage, the European energy market has seen a steep rally in consumer prices over the last months. To shield their citizens from the increase, the 27 have tried to implement different individual measures. In October last year the Commission offered guidance by providing a first toolbox on short and long term measures. While Member States were reluctant to embrace the Commission's long-term proposals, this climate briefing aims to explain the various short-term measures taken by Member States and explore whether the eruptive events in Ukraine will push Member States to adopt long-term strategies that will likely be enshrined in the update of the toolbox, as announced from the Commission for this week.

Background

Europe is groaning under an energy price crisis. Costs have been rising for several months now. The crisis was triggered by falling gas supplies. EU Member States are adopting a series of approaches to cope with the crisis, which we shall examine in this briefing. These short-term measures will be very important in particular in supporting poorer households during the energy price crisis, especially because the war in Ukraine and the sanctions imposed on Russia will lead to a further shortage of supply in Europe and to even more sharply rising prices. This increases the pressure on governments to maintain this measures longer, to ensure financial compensation and to do more to relieve the economically weaker sections of the population. The Commission's medium- and long-term proposals on enhancing European resilience and strengthening the Green New Deal, have not yet been implemented sufficiently.

Numerous weaknesses in the European energy system are now coming to light. Europe has simply not prepared itself for these challenges. Consumers and industry are now footing the bill. In the Eurozone, energy prices are at their highest level in 13 years. The European Commission responded in October 2021 with a range of short-term measures to cushion price spikes, as well as proposals to enhance Europe's long-term resilience in the face of future shocks. Now, at the beginning of March, the European Commission will publish a revised toolbox on how to alleviate the continued energy crisis.

Status quo: the energy price crisis and the measures taken to curb it

The Commission's toolbox contains a long list of proposals on curbing the energy price crisis in the short term. These proposals include, for example, the provision of vouchers, the state's covering the additional cost, the possibility of delaying bill payments, and tax

concessions. The possibility of state support for companies has also been mentioned, as long as it is accompanied by European aid schemes.

European Member State governments have also reacted. In fact, their policy measures are largely oriented towards the Commission toolbox. What follows is a selected overview.

- **Payments and subsidies**

In Italy, in the first quarter, around 5.5 billion euros were spent on keeping down consumers' gas and electricity bills. Electricity prices at that time had risen by 131 per cent for an average family, gas prices by 93 per cent.

In Germany, too, energy prices have once again risen significantly. Driven by high energy prices, consumer prices increased by 5.1 per cent in February 2022 compared to February 2021. The federal government responded with a heating cost subsidy for low-income households, as well as for many students and trainees.

Greece has paid out subsidies in the amount of 1.7 billion euros and would like to continue them, if required, in March and April.

In Norway the government decided that the state would cover half the basic kilowatt price for consumers, as long as they use less than 5,000 kilowatt hours per month.

The Swedish government has made 600 million euros available to help out the hardest hit households with energy price increases.

- **Price caps**

The Hungarian government has imposed price caps on petrol and gas. Although companies can continue to buy fuel at the wholesale price, they may no longer pass cost increases on to consumers. Naturally, Hungary's private service station operators, which do not have the resources of the MOL Group, a state-integrated oil and gas group, are hostile to this. The Hungarian government is well aware of this. Even before the sharp energy price rises, the MOL Group already declared that it is prepared to buy out private providers that sell up.

The United Kingdom had also already formulated price caps. However, the government has had to announce that these price caps will be raised by 50 per cent in April. Even so, energy bills that were already set to increase will be 700 pounds higher, on average.

France is bracing itself with price caps on energy prices, as well as direct payments to counteract the crisis. Electricity price increases for March are to be capped at 4 per cent, while the remaining costs will be borne by the state. At the same time, six million low income households are to receive 100 euros directly.

- **Tax burden**

Poland has lowered taxes on electricity, heating oil and petrol, and has suspended them completely on gas and food, for the time being.

Spain has also opted for tax relief. Thus a 7 per cent tax on electricity generation products was postponed. VAT on electricity was also cut from 21 to 10 per cent. As a result, Spanish companies' profit margins have been sharply capped. At the end of last year, the major electricity suppliers warned that government decisions were jeopardising investment and security of supply. As yet there has been no upswell in the number of lawsuits, however. After the Russian invasion of Ukraine, the Spanish government announced an extension of the measures, and particularly vulnerable citizens are to be given a discount of up to 70 per cent on their electricity costs.

Consequences of the energy price crisis on European emissions trading

The energy price crisis is also affecting European emissions trading. This is because, in parallel with gas shortages, some nuclear power stations in France have been shut down due to defects of various kind, and as the expansion of renewable energies and related storage technologies has stagnated in many countries, coal-fired power plants have been brought on line again. Because coal-fired plants emit far more CO2 than gas-fired power stations, this has given rise to a corresponding demand for emissions certificates, the price of which has risen in parallel with gas prices. After the start of the Ukraine crisis, however, concerns about an impending recession and the need for higher financial security, which traders had to deposit on the stock exchanges, led to a rapid slump in certificate prices again. Thus apart from anything else the energy price crisis is highlighting the volatility of European emissions trading.

Various solutions are now under debate. The European People's Party (EPP) would like to issue 100 million certificates from the Market Stability Reserve as soon as the certificate price has remained above double the average for the past two years for more than six months. By contrast, the Greens in the European Parliament, more consistently than heretofore, would like to remove certificates from the emissions trading system in order to make the use of fossil fuels more cost-intensive and unattractive. Germany's Economic Ministry, on the other hand, would like to reorganise the electricity market and has called into question the existing marginal cost model, in accordance with which power generation plants are brought on line in sequence according to their cost intensity until needs are met. The generation costs of the last power station that has to be connected thus defines the final electricity price. Under this low-cost model the costs of emissions trading are supposed to make coal-fired power stations unprofitable. The connection of the coal-fired power plants due to the high gas price meant that the certificate costs in emissions trading also rose for a while in parallel with the high energy costs, before collapsing again after the start of the Ukraine war.

Overall it seems clear that at present emissions trading provides for insufficient predictability, in relation to both costs for consumers and industry, and progress with the climate and energy transition. The question of the reorganisation of emissions trading or of supplementary and alternative instruments thus remains.

Recommendations for a long-term strategy

It is striking that governments in many countries are trying to resolve the energy price crisis caused by gas shortages by capping energy prices and thus fossil energy sources. Ultimately this amounts to state subsidisation of continued use of fossil fuels.

Other short-term measures from the Commission's toolbox have received little attention so far. For example, little has been done to terminate competition-disrupting structures in energy industry systems and to facilitate access to electricity from renewable sources. Think tanks such as Bruegel or the Kiel Institute for the World Economy have evaluated previous government measures and come to the conclusion that the best way to tackle the crisis is by direct cash transfers, not tax concessions that are difficult to make sense of. Furthermore, cash transfers have a direct economic effect. Therefore, many governments have latched on to this approach. Market interventions such as tax cuts and price caps, by contrast, have been criticised mainly by the business sector. Prominent among their concerns are the putative "crowding out" of private investment and a resulting fall in demand, which over the long term could even lead to price rises. A final review of these arguments should include an economic evaluation of whether companies, in individual cases, have previously invested sufficiently in supply and infrastructure when there were no price caps. Regardless of any evaluation, such interventions in the market clearly need to be implemented sensitively.

In the long term, the Commission is already recommending, for example, massive increases in investment in renewable energies, energy-efficient measures and building refurbishment, while speeding up bureaucratic procedures. Similarly, consumers' choice of and ability to switch energy suppliers are to be simplified. The role of consumers in the energy transition is also to be upgraded through active participation in energy cooperatives (prosumers). Furthermore, storage technologies are to be expanded and cooperation between EU Member States in the gas sector enhanced, so that common action and emergency plans can be developed. When it comes to implementing these long term measures, the member countries are not yet showing enough commitment.

Barbara Pompili, the French minister for the ecological transition and representative for France as the country holds the rotating EU Council presidency until July, observes that for the updated toolbox of the Commission now a "voluntary mechanism" to reduce energy consumption is under discussion. As she points out, so far this is being done by some national grid operators at a smaller scale. A system like the Demand Side Management, which is installed in Germanys power system and which creates incentives to consume electricity in individual industries when the demand for electricity is slightly lower, could then be discussed in all Member States on a larger scale. In addition, the energy ministers of the Member States called for new measures to particularly protect the most vulnerable consumers in the context of volatile energy prices.

None of the proposals from the toolbox is completely new, any more than the overall goal of a strengthened energy policy cooperation within the framework of a European energy union. Coordinated implementation on the part of the Member States is not yet evident, however.