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Update on European Measures for Natural Gas Security

Europe – March 2023

In 2022, the war in Ukraine brought along with it an unprecedented energy crisis for the EU, with significant supply shortages, soaring gas prices, a follow-on increase for other fuel prices, an increased focus on the role of gas storage, and oft-repeated concerns about whether Europe would have enough gas for the winter.

Since Russia's invasion of Ukraine, the EU has been working to address the burgeoning energy crisis through a series of measures. In May 2022, the EU adopted a "REPowerEU" plan. This was a mix of financial and legal measures aimed at saving energy, producing clean energy, and diversifying energy supplies, all in order to decrease the EU's dependence on Russian oil and gas.[1]

In terms of diversification of supply, the EU, among other things, (i) concluded a Trilateral Memorandum of Understanding with Egypt and Israel for the export of natural gas to Europe, (ii) executed a Memorandum of Understanding with Azerbaijan on a strategic partnership in the field of energy, and (iii) obtained a US commitment to provide the EU with a minimum additional quantity of 15 billion cubic metres (bcm) of liquified natural gas (LNG). In terms of the numbers, European imports of LNG rose by 19 bcm, and imports of non-Russian pipeline gas (including from Norway, Azerbaijan, the UK and North Africa) also increased by 14 bcm as compared to 2021.[2]

The EU's actions did not, however, stop there. It also passed new legislation imposing minimum gas storage obligations in order to secure supply for the cold winter season and adopted a regulation requiring gas storage facilities within member states to be 80% full before winter 2022/2023, with the additional requirement that those facilities be filled to 90% before winter periods in later years.[3] This was accompanied by measures taken by individual member states regarding gas storage.

For example, in July 2022, new Austrian legislation came into force, which provided that where a gas storage facility was not filled to a certain capacity, then the allocation capacities would be withdrawn and offered to others.[4] Gazprom, a major operator at Austria's Haidach facility, had not filled the storage facility, and, as a consequence, its storage capacities were reallocated.[5] Similarly, Gazprom had rights to 40% of the capacity at Bergermeer, the largest gas storage facility in the Netherlands, but it had not filled it.[6] In November 2022, the Dutch energy ministry announced that the gas storage facility had been filled to 100% capacity,[7] including the unused 40% previously held by Gazprom.

In order to ensure stability in the energy market, the EU also proposed measures on joint gas purchasing, price-limiting mechanisms, the use of infrastructure, and solidarity among member states.[8]

One of the EU's main concerns is the price of natural gas in Europe. Soaring prices have numerous effects, including follow-on price effects for practically everything that requires energy, rising prices for households and small businesses, and demand destruction. In August 2022, natural gas prices in Europe reached not just record highs, but prices higher than any contemplated in the recent past. In August 2022, futures prices at the Dutch Title Transfer Facility (TTF) hub reached €340 per MWh, a price more than 10 times higher than the one recorded a year previously.[9] Consequently, the EU turned its eye toward measures aimed at limiting excessive spikes in gas pricing. The result: a price cap mechanism.

1 EU action to address the energy crisis, available at https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/eu-action-address-energy-crisis_en.
2 EU action to address the energy crisis, available at https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/eu-action-address-energy-crisis_en.
3 Council adopts regulation on gas storage, available at https://www.reuters.com/article/ukraine-crisis-netherlands-gas-idINL1N3260Q4 https://www.consilium.europa.eu/en/press/press-releases/2022/06/27/council-adopts-regulation-gas-storage/.
4 Austria gives away Gazprom's portion of Haidach's gas storage facility, available at https://www.reuters.com/business/energy/austria-gives-away-gazproms-portion-haidach-gas-storage-facility-2022-07-26/.
5 Austria gives away Gazprom's portion of Haidach's gas storage facility, available at https://www.reuters.com/business/energy/austria-gives-away-gazproms-portion-haidach-gas-storage-facility-2022-07-26/.
6 Dutch gas storage facility at Bergermeer 100% filled, available at https://www.reuters.com/article/ukraine-crisis-netherlands-gas-idINL1N3260Q4.
7 Dutch gas storage facility at Bergermeer 100% filled, available at https://www.reuters.com/article/ukraine-crisis-netherlands-gas-idINL1N3260Q4.
8 See EU action to address the energy crisis, available at https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/eu-action-address-energy-crisis_en.
9 Europe's gas prices have broken a new record. How high can they go? Available at https://www.euronews.com/my-europe/2022/08/25/europes-gas-prices-have-broken-a-new-record-how-high-can-they-go; natural gas price at Dutch TTF exchange reaches pre-war level, available at https://bnn-news.com/natural-gas-price-at-dutch-ttf-exchange-reaches-pre-war-level-241656.

The price cap mechanism was agreed in December 2022 after months of negotiations among the member states. As a result of the agreement between the European energy ministers, gas prices on the main European gas exchange, the TTF, will be capped if (a) the month-ahead price exceeds 180€/MWh for three working days, and (b) the month-ahead TTF price is €35 higher than a reference price for LNG on global markets for the same three working days.[10] The mechanism will apply to month-ahead, three-months-ahead and year-ahead derivative contracts, starting from 15 February 2023.

Once the mechanism is activated, the gas price will be calculated by reference to the so-called "dynamic bidding limit", which equals the reference price for LNG on global markets (based on an international basket of LNG transaction hubs) plus 35€/MWh. If the reference price for LNG is below €145, then the "dynamic bidding limit" remains at 180€/MWh (the sum of €145 and €35).[11] Any time the price cap is activated, it remains in place for at least 20 working days unless the dynamic bidding limit is below 180€/MWh for three consecutive working days, in which case the cap will be automatically deactivated. The dynamic bidding limit also will automatically deactivate if the European Commission declares a regional or an EU emergency, including in cases where gas supplies are insufficient to meet demand. Importantly, while the mechanism is intended to be in place for one year, it can be suspended in the event of jeopardy to European energy supply, financial instability, intra-EU gas flows, or of risks of increased gas demand.[12]

The idea to cap gas prices was initially proposed in October 2022 as part of the package measures to address high gas prices and to ensure security of supply in the EU. As the European Commission then announced, the Commission "propos[ed] to put in place a mechanism to limit prices via the main European gas exchange, the TTF, to be triggered when needed. The price correction mechanism would establish, on a temporary basis, a dynamic price limit for transactions on the TTF. Transactions at a price higher than the dynamic limit would not be allowed to take place in the TTF. This will help avoid extreme volatility and excessive prices."[13]

Member states, however, did not have a unified view on these measures when first proposed. A number of member states, including France and Poland, strongly supported introducing a cap on gas prices from the outset. Others – including Germany and the Netherlands – opposed such a solution, with a view that a price cap could threaten supply by driving away producers who could sell their gas at higher prices in other markets.[14]

The initial price cap level was also different from the one eventually adopted. In November 2022, the European Commission set out a proposal that would limit gas prices if the month-ahead TTF price exceeded 275€/MWh for two weeks and if the difference between the TTF price and the global LNG price was €58 or more.[15]

This proposal faced strong opposition – both from the countries supporting the idea of a price cap, and those generally opposing this measure. Both Spanish and Polish ministers reportedly labelled the proposal as a "joke". In their view, the proposed price cap was too high and, as such, unlikely to ever be activated.[16] The Netherlands, on the other hand, emphasised the risks to security of supply and stability of the financial markets that come with measures imposing a cap on gas prices.[17]

The mechanism ultimately adopted is more likely to be activated than the one initially proposed because of the lower price levels, and will more likely apply for longer periods. Of those member states initially opposing the idea of price capping, Germany shifted its approach and voted for the proposal, while Hungary voted against it, and both the Netherlands and Austria abstained.

The reactions from the Kremlin have been harsh. Following the announcement of the measures, Kremlin spokesman Dmitry Peskov reportedly stated: "This is a violation of the market price-setting, an infringement on market processes; any reference to a (price) cap is unacceptable."[18] Other sources cite Peskov as stating that "Moscow's response to the ceiling on gas pricing would be the same as it was when Russian oil was subject to sanctions."[19] In response to the EU's package of sanctions that included a basis for setting a price cap for Russian oil, Russia stated it would stop exporting its oil to countries that would apply price caps.

10 Council of the EU, Press Release, Council agrees on temporary mechanism to limit excessive gas prices, dated 19 December 2022, available at https://www.consilium.europa.eu/en/press/press-releases/2022/12/19/council-agrees-on-temporary-mechanism-to-limit-excessive-gas-prices/.
11 Council of the EU, Press Release, "Council agrees on temporary mechanism to limit excessive gas prices", dated 19 December 2022, available at https://www.consilium.europa.eu/en/press/press-releases/2022/12/19/council-agrees-on-temporary-mechanism-to-limit-excessive-gas-prices/.
12 Ibid.
13 European Commission Press Release, "Commission makes additional proposals to fight high energy prices and ensure security of supply", dated 18 October 2022, available at https://ec.europa.eu/commission/presscorner/detail/e%20n/ip_22_6225.
14 Press release, "EU seals deal on gas price cap after months of wrangling", dated 20 December 2022, available at https://www.euractiv.com/section/energy-environment/news/eu-seals-deal-on-gas-price-cap-after-months-of-wrangling/.
15 Press release, "EU proposes long-awaited gas price cap", dated 22 November 2022, available at https://www.euractiv.com/section/energy/news/eu-proposes-price-cap-for-gas-to-limit-spikes-eu-proposes-long-awaited-gas-price-cap/.
16 Press release, "Emergency measures for energy crisis in limbo after pressure for price cap", dated 24 November 2022, available at https://www.euractiv.com/section/energy/news/emergency-measures-to-tackle-energy-crisis-in-limbo-following-pressure-for-price-cap/.
17 Press release, "Emergency measures for energy crisis in limbo after pressure for price cap", dated 24 November 2022, available at https://www.euractiv.com/section/energy/news/emergency-measures-to-tackle-energy-crisis-in-limbo-following-pressure-for-price-cap/.
18 Press release, France 24, "EU countries agree gas price cap in bid to deal with energy crisis", dated 19 December 2022, available at https://www.france24.com/en/europe/20221219-live-drone-attacks-hit-critical-infrastructure-in-kyiv-putin-set-for-belarus-visit.
19 Press release, "EU countries agree gas price cap, Russia responds", dated 19 December 2022, available at https://english.almayadeen.net/news/politics/eu-countries-agree-gas-price-cap-russia-responds.

At the time of publication of this article, TTF prices have fallen below €50/MWh, the lowest level it has reached since late 2021 and well below the envisioned threshold for the price cap mechanism to apply.[20] With so much volatility in the market and geopolitical events of the future unknown, it is hard to say whether, and when, this mechanism will be triggered.

As noted above, the EU's gas capping mechanism refers to a global LNG price. The LNG price reference will be calculated by the EU Agency for the Cooperation of Energy Regulators (ACER).

In January, ACER was unable to calculate the LNG reference price because, according to publicly available information, there were insufficient qualifying transactions in order to produce a price.[21] In February 2023, the EU provided the first LNG reference price underlying the European gas price cap mechanism. The announced global LNG price was €55.21/MwH,[22] only slightly above the TTF price. The current reference price is just above €40/MWh.[23]

It is difficult to discern how the European gas price cap, if it applied, would ultimately affect the market. However, as the events of the last year have shown, the gas market is a global one, and events and pricing in the European market have significant impacts on those in Asia and vice versa. At present, TTF prices and JKM prices have declined from record highs and the gas price cap is only a regulation without use in sight. Europe has had a mild winter and gas demand and gas prices have reacted accordingly. For the winter of 2023/2024, however, if the European gas price cap were to be activated, and if Russia were to completely stop exporting gas to the EU, this could further seriously affect the complexion of European gas supply. While supplies of Russian pipeline gas have decreased from 40% to 9% in the EU, further reductions of supply during the winter season – the season of high demand – would likely lead to an increase in prices of gas from alternative suppliers.

It is also unclear how global LNG suppliers would react if prices for gas on European hubs were capped at a level below market prices. As these authors have previously discussed, recent events in the gas markets show LNG sellers seeking to arbitrage market conditions. At times of high hub prices, sellers were seeking to take advantage of liability limitations in their contracts in order to fail to deliver cargoes to their contractual counterparties and, instead, deliver into gas-thirsty and higher-priced Europe instead. However, if prices in Europe are limited to only slightly more than a global LNG price marker, then Europe would cease to become such an attractive destination for rerouted LNG. Moreover, one of the reasons so much LNG was able to be rerouted to Europe was because of lower Chinese demand following the reestablishment of national lockdowns. This situation is obviously subject to change, and China has recently emerged from the 2022 restrictions with market activity ramping up again.

The future effects and implications of the mechanism are, therefore, yet to be seen.

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