QNB Economics
economics@qnb.com
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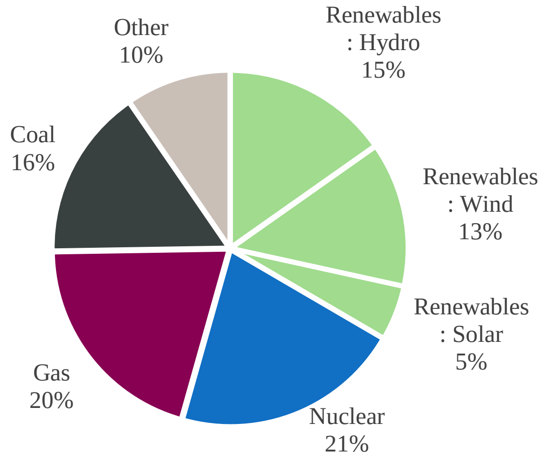
Prices caps and windfall taxes won't fix Europe's broken energy market

European policymakers are facing an unprecedented constellation of shocks hitting the economy, including stagflation, the war in Ukraine and record-breaking heatwaves over the past summer. Together, these shocks have impacted European energy and electricity markets. Gas produces 20% of Europe's electricity (see chart) and most importantly is often the marginal producer, so gas prices set electricity prices. Indeed, electricity prices have soared in Europe and are breaking new records, rising to more than 10 times their average over the past decade.

European electricity generation, by source
(%, 2021)



Sources: European Electricity Review, QNB analysis

In July, members of the European Union (EU) agreed to reduce gas use in Europe by 15% until next spring via the European Gas Demand Reduction Plan. This plan however was insufficient as Russia has continued to reduce and even threatened to continue to halt the volume of gas delivered to Europe. This leaves political leaders desperately looking for effective policy responses.

In this week's article, we discuss the various policy proposals being considered in the EU area to understand their potential impact as well as likelihood of implementation in the immediate future.

European policymakers have made three main policy proposals ranging from windfall taxes to price caps and relief packages.

One concept being considered across Europe is a tax on companies that have made unexpectedly high profits from high energy prices. Nevertheless, there is no agreement within the EU which companies should be targeted by this tax and which sources (i.e., oil/ gas/ nuclear/ renewables) are to be included. While some countries, such as Spain, Greece and Italy have already introduced such taxes, others, such as Belgium, Germany and Austria have not yet done so. These taxes leave the re-allocation mechanism to consumers open with an unclear effect on the desired intent. Additionally, their design and implementation might not be harmonized across EU countries and consequently bear potential constitutional challenges on a per-country level. This also limits the idea of re-investing profits for energy transition from fossil fuels to more clean and sustainable energy sources.

The idea of price caps set a maximum ceiling for the price that European energy companies can charge their customers. This would in principle limit the level of inflation from high energy prices at first sight for consumers, both households and corporates. While price caps can help control the effects of rising energy prices, they however neglect the wealth effect of consumers. Wealthier consumers have less pressure and incentives to reduce their energy intake compared to consumers with a lower level of income and liquidity. Consequently, the effect is limited as in most cases the 20/ 80 rule applies where the largest corporates and most wealthy households have the highest energy consumption contribution. Furthermore, price caps are not putting an energy price brake when meeting certain base needs of energy consumption. German policy makers pointed out that price caps would reduce excess profits for energy companies and therefore limit the effect of windfall taxes.

Last but not least, relief packages are targeted measures that provide financial support to low income households, small businesses and essential industries in order to reduce economic damage caused by the temporary surge in prices. Relief packages are focused and more likely to lead to larger economic benefits than the other alternatives in discussion. Relief packages are likely to be more effective as they motivate users to reduce consumption.

To conclude, the measures suggested so far to decouple electricity prices from energy prices seem insufficient and not effective to reduce energy consumption, protect consumers from rising prices and avoid rationing supply to prevent a significant slowdown in economic growth. High energy prices are likely to last at least until next spring, if not longer. This represents a sizeable economic risk for Europe with further inflation and low growth as it will be challenging and time consuming to find a mutually beneficial consensus among a widely disperse economic region.

QNB Economics Team:

Luiz Pinto*
Senior Economist
+974-4453-4642

James Mason
Senior Economist
+974-4453-4643

* Corresponding author