"Subsidies for Putin's treasury".

Electricity and gas prices are going through the roof. Lion Hirth, managing director of Neon Neue Energieökonomik and professor at the Hertie School, warns against state-subsidized energy prices or price interventions on the wholesale market. He says this will not solve the problem of shortages in the event of a gas supply failure by Russia and will create huge new problems.

Mr. Hirth, European gas prices cracked a record high on the spot market yesterday. What's going on there?

Today's prices are currently the result of a weighted average, so to speak, with regard to future expectations: If Russia continues to supply gas as before, the situation is tight but manageable, also in terms of price. If supplies are stopped, we would see a dramatic price increase. Traders and buyers of gas are forming an opinion on how likely the two scenarios are and weighting that - apparently the total shutdown is now given a significant probability. Weather also plays a role, but only for short-term contracts. The price development for longer-term gas contracts can be interpreted as a thermometer for the probability of an escalating war.

In many European countries, the state intervenes in energy markets in the face of energy price crisis and war. In Spain, the electricity sales price for gas-fired power plants is capped and, if necessary, the plants are subsidized; at the same time, revenues are to be siphoned off elsewhere. Is this kind of market intervention also conceivable in Germany?

In the energy sector, in the policy arena and above all in industry, this is currently being discussed both in front of and behind the scenes. In view of the dramatic prices and the immense pressure on energy-intensive industry, I think it's quite conceivable that policymakers could intervene so massively in pricing mechanisms of the wholesale energy market. In Germany, too, for example, there are discussions about whether the price of electricity should not be capped at average generation costs. And the extreme price increases on Monday will further fuel the debate.

But there is no word of this from the German department of energy.

There is no official political proposal, but everyone is at least talking about it. This debate gives me a huge stomach ache. In Spain, it's not just about the electricity market, but also about intervention in gas demand - in this case from power plants. Because their gas consumption is ultimately increased when gas-fired electricity generation is subsidized. Spain, however, has enough LNG terminals to supply itself very well. In Germany, we face a completely different, much more difficult challenge: If gas supplies stop, there will be a physical shortage of gas to meet demand, at the latest in the coming winter. To cope with this shortfall, we would have to reduce gas consumption very significantly. This is different to Spain.

What's the problem with pricing residential and industrial consumers to buy gas to cushion the crisis?

The problem is that we are facing a situation where demand has to adapt to a certain scarce supply. In a market economy, this happens through the price. As a thought experiment, let's assume that at a wholesale price of 200 euros per megawatt-hour, the federal government decides to add 100 euros so that consumers would only have to pay 100. Let's also assume that supply is completely exhausted, meaning that no additional gas supplies arrive – technically speaking, supply is price-inelastic. Then the pre-subsidy wholesale price would simply rise to exactly 300 euros in response to the subsidy - because only then would physical supply and demand balance out again.

In such a situation, subsidies are nothing more than a transfer to producers; they do not change the fact that the price mechanism must balance supply and demand. So the subsidy would not end up with gas consumers, but in Putin's state coffers as long as Russia is still supplying gas. If, instead of a subsidy on purchases, the wholesale price of gas and electricity were outright fixed or capped by the government, the situation would be even more problematic.

Why?

Then the artificially low prices would lead to a demand that could no longer be met physically. In such a situation, there needs to be an arbitrator who decides who gets the natural gas. The medical device manufacturer, the chemical producer, the glass factory? There would need to be a state authority that regulates in detail for which sectors, for which companies and for the production of which goods, at what price, at what time how much gas or electricity is supplied. And there would have to be oversight to ensure that these companies did not then resell the energy under the table or use it elsewhere. Who is supposed to make those decisions? Who is going to do that monitoring? If we eliminate the market coordination mechanism, then we would have to replace it with government planning, but not only long-term planning but day-to-day resource allocation. Ultimately, a broad cap on wholesale energy prices means entering a war economy - and not just for the energy industry, but in principle for all manufacturing.

After all, it is already regulated that small customers, such as households, are served first in the event of physical shortages, as is critical infrastructure, such as hospitals. Gas-fired power plants also enjoy some priority. Industry is not explicitly protected.

It is good and important that we have such regulation. But it is meant to apply to short-term crisis situations, not in a prolonged, fundamental gas shortage. One thing is clear: Industrial demand cannot be fully met if there is no more gas from Russia. And within industry, too, it's a matter of complex prioritization decisions that have to take into account supply chains, world market prices, substitution possibilities and integrated manufacturing processes. And from my point of view, this can only be meaningfully weighed up using prices. This is not to say that in the event of a short-term supply freeze, government emergency planning and allocation can be dispensed with, as is indeed the case under the law.

Is the German economy prepared for the impending gas shortage?

My impression is: No. Politicians should urgently talk turkey with industry and society. Many decision-makers also do not have an adequate idea of what may be in store for us. Otherwise, most households will only understand when the next tariff increase is due. Clear text would also help to sharpen all senses for saving gas already now. Because gas can be stored, every kilowatt-hour we conserve today eases potential scarcity in the coming winter, having a larger gas cushion and do not run unprepared into a supply stop, should it come. It's not just a matter of developing contingency plans for the coming winter, but of reducing gas consumption now and today.

And then leave industry and consumers to deal with the high prices all by themselves?

No, of course not. No one, neither households nor companies, should be penalized for hanging on to gas as an energy source, often by chance and with little influence. I don't know anyone who saw this war and this energy crisis coming in this form. The consequences can and must be cushioned. For example, with labor market support and subsidies to firms that have to shut down its production for a while. And of course with social subsidies, which in the event of a dramatic gas price crisis will probably have to go beyond transfer payments and housing allowances. However, such compensation should not be primarily about artificially lowering energy prices. Those who save gas and electricity should immediately feel the positive financial impact. However, it is difficult to identify the households most affected and to provide targeted support. Should energy prices remain at current levels or even rise further, we will need to discuss regulation of household tariffs.

How could the enormous profits that Russia is currently making on its exports be reduced without having to do without gas?

At a gas price of 200 euros per megawatt-hour, Gazprom generates revenues from EU exports of about one billion euros - per day! It would really be very desirable to achieve a targeted reduction in these payments without sacrificing the fundamental workings of the European energy market. One could, for example, impose a levy or tax on imports that would de facto confiscate all profits above the usual gas prices of the past years. An "embargo light," so to speak. Whether this is legally feasible, I cannot judge. Of course, there is a risk that Russia would then stop deliveries in return. But that would perhaps also be a politically better option than unilaterally deciding on an energy embargo from Germany or the EU.

Are you afraid that the energy price crisis and the war in Ukraine will damage the liberalized energy market to such an extent that it will have difficulty getting back on its feet afterwards?

Yes. It would probably be difficult to move away from price regulation again. But at the moment, my main concern is how we would then deal with the immediate gas shortage in the short term, how we would then manage the allocation of the scarce resource energy. It would simply be counterproductive to stop letting prices speak the physical truth. We can't conjure up the lack of gas, we can only deal with scarcity as wisely as possible.

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Lion Hirth is Managing Director of the consultancy Neon Neue Energieökonomik and Assistant Professor of Governance of Digitalization and Energy Policy at the Hertie School in Berlin.