Funding the Future

Europe’s energy pricing system could have devastating...

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I received an email from energy expert Mike Parr this week that should worry anyone concerned about Europe's political future. Mike, of course, comments here regularly. He told me:

Natural Gas price @ Rotterdam TTF right now: €73/MWh.

It was in the range €40 to €50 for much of the summer.

I would not be surprised by €150/MWh by November or December on the basis of this.

He then explained the potential consequences for electricity prices:

Electricity marginal wholesale prices are now in the range €150 - €200. If gas hits €150 then electricity will hit €300/MWh.

I am not suggesting that these forecasts will necessarily prove correct. I do not think Mike is, for certain. Forecasting energy prices is notoriously difficult. But Mike’s warning highlights an issue that I have discussed many times, and which policymakers still refuse to address.

That issue is marginal electricity pricing.

The problem is straightforward. Electricity does not all cost the same amount to produce. Nuclear, renewables, hydroelectricity and gas-fired generation have very different cost structures.

Mike notes the particularly absurd consequence of this in France. Most French electricity is generated by nuclear power, which he estimates has a production cost of around €60/MWh. And yet French wholesale electricity prices can be driven far above that level because the marginal price of electricity is determined by much more expensive generation, with cross-border markets transmitting that price between countries.

That makes no economic sense from the point of view of consumers.

Nor does it make sense from the point of view of society.

It does, however, make considerable sense if the objective is to maximise the income of electricity producers who can sell electricity generated at relatively low cost at prices determined by much more expensive gas-fired generation.

That is why marginal electricity pricing matters. If gas prices rise sharply this winter, the consequences will not simply be higher gas bills. Electricity prices could rise with them, even when much of the electricity being consumed has nothing whatsoever to do with gas.

The resulting increases in electricity prices would not represent an increase in the cost of producing much of that electricity. They would instead represent an increase in economic rents being extracted from consumers because of the way in which the electricity market has been designed. That distinction matters enormously.

Governments will undoubtedly claim that they are powerless in the face of international energy markets. They will say that global gas prices have risen and therefore energy prices must rise. But that would only tell part of the story. Governments might not control the international price of gas, but they absolutely can control the rules under which electricity markets operate.

Those rules are political choices. They can be changed. The refusal to change them also has consequences.

If Mike’s pessimistic forecast for this winter is anywhere near right, millions of households across Europe, and in the UK, could once again face substantial increases in energy costs. Businesses would face higher costs as well. Inflationary pressure could return. Governments might respond with subsidies, funded ultimately by taxpayers, whilst leaving the underlying pricing mechanism untouched. We have seen this before.

The public will then be told that there is an energy crisis when part of what they are actually experiencing is an electricity market design crisis. That matters politically. And Mike puts the point starkly:

There will be a political impact.

He suggests that a sufficiently severe winter energy crisis could contribute to Marine Le Pen reaching the Élysée Palace in France in 2027 and the AfD gaining considerably greater political power in Germany.

Whether those particular predictions prove correct is not the issue. The direction of the political risk is entirely plausible.

The problem is, people do not distinguish neatly between energy market design, international gas prices, electricity generation costs and government regulation when they cannot afford to heat their homes.

They just know that they are poorer.

They also know that their government appears unable or unwilling to do anything about it.

And they know that somebody appears to be making money from their hardship.

That combination creates political anger, and we should have learned by now what happens when democratic governments repeatedly tell people that nothing can be done about problems that are, in reality, the consequence of political choices.

The far right thrives on precisely that sense of powerlessness. It tells people that the established political order has failed them. Unfortunately, when governments refuse to reform obviously dysfunctional markets, they provide evidence that appears to support that claim.

There is an alternative.

Electricity prices need to reflect the costs of the electricity actually being produced rather than allowing the most expensive marginal producer to determine the price paid across the market.

Excess economic rents arising from the current system should be eliminated.

Renewable and nuclear electricity should provide consumers with the benefit of their lower and more stable production costs.

And governments should accept responsibility for designing energy markets that serve society rather than pretending that those markets are forces of nature over which they have no control.

This is not just an energy policy issue. It is an economic justice issue. It is an inflation issue. It is a democratic accountability issue. And, potentially, it is an issue about the survival of democracy in parts of Europe.

If politicians continue to impose unnecessary economic hardship on people because they refuse to change market rules that politicians themselves created, they should not be surprised when people eventually reject the political system responsible for those rules.

Electricity market reform is not, therefore, some obscure technical issue. It could become a political necessity.