

IFAMD Market Commentary 05/2022

- Why gas auctions are a political minefield in the context of an energy embargo -

In February 2022, Russia invaded Ukraine and largely isolated itself internationally. In addition to the military conflict between the two countries, an economic war has been raging for ten weeks at the time of this market comment, in which the western world is unanimously imposing more and more sanctions on Russia. The dependency on Russian oil and gas is particularly critical, without which a recessionary situation in Europe can be expected in the short term. The big question is whether the regulator needs to intervene to distribute the remaining gas.

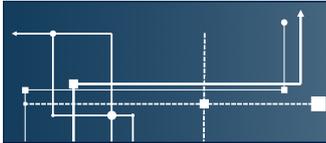
In normal times, the gas market regulates the allocation: supply and demand adjust the market price so that exactly the needs of those customers whose willingness to pay exceeds the market price are met. On this basis, private-sector supply contracts are concluded between, for example, buyers in the West and suppliers in Russia. Apart from defining the legal framework, the state is not involved in this business – at least that is the case in the West. Just think of the famous statement made by politicians a year ago that Nord Stream 2 was a “private business matter”. At the latest, however, when the state announces an embargo, it intervenes in private-sector contractual relationships and must minimize the damage that occurs as a result.

At first glance, the state must make compensation payments to the companies affected - comparable to the phase-out of nuclear power and coal. There, when energy technologies are phased out, the question arises as to which power plants should be shut down first and which should remain connected to the grid a little longer. This allocation is determined using auctions, which give energy producers the opportunity to bid for compensation payments for an early exit. Anyone who opts out for a lower compensation payment gets this deal with the state. The big difference to the gas embargo is that participation in the power plant decommissioning auction is voluntary: Energy producers who do not take part or are unsuccessful bidders do not “get nothing” but simply remain connected to the grid and politics with their power plant must come up with other measures to get these off the grid as well. Incidentally, the winners of such exit auctions are not the more efficient power plants, as one would initially expect from auctions, but on the contrary: it is the more efficient power plants that require a higher compensation payment because they are the higher for themselves generate returns. The less efficient power plants can be satisfied with lower compensation payments.

The gas embargo poses a similar challenge, but with a small difference that, as is so often the case in game theory, makes all the difference: the companies affected cannot be determined by auction, but are evident from the start. The number of private-sector supply contracts affected by the embargo can be seen on the paper of the contracts. The question here, of course, is how much the state has to pay as compensation. This is not about the gas price that was agreed in the supply contract, but rather about the further added value that the purchasing company would have generated and received with the gas. Determining this is not easy. But the fact is that, in contrast to the energy phase-out, all companies affected are ultimately affected, because their supply contract is immediately cut off in the event of an embargo.

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Of course, the simplest way to make the state compensation payment is to use gas instead of money. How much the state pays to a new supplier is ultimately its problem. That's why Economics Minister Harbeck is currently traveling around the world to find gas sources: every cubic meter of gas he finds relieves him of one cubic meter for which he has to pay a compensation payment to an affected customer. Of course, since he's almost certainly not going to find complete failure from alternative sources, allocation continues to be a challenge. The state should give gas to the more efficient companies that can demand higher compensation payments and pay the compensation to the less efficient companies. Companies are currently being asked about their compensation payment claims - if this query were already coupled with a binding decision, it would be a pay-as-bid auction that delivers both: the allocation of the scarce gas and the compensation payment to those who - concerning the gas itself - get nothing. However, such an auction would have extremely high incentives for implicit collusion, i.e. all companies would reflexively demand excessive compensation payments and the result would be a fiasco for the state.

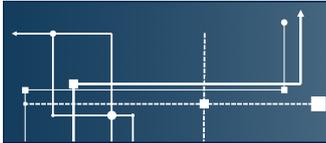
In this situation, the renowned professors Cramton, Wambach and Ockenfels from the University of Cologne now propose an "auction for gas procurement rights" in a guest commentary in the Handelsblatt¹ on May 2nd, 2022 - the President of the German Federal Network Agency ("Bundesnetzagentur"), Klaus Müller, is already thinking about it². Anyone who pays more for it should be able to continue to purchase gas, the others get nothing. This, of course, completely turns what was described above on its head. This proposal is not the analogue of the coal phase-out auction, but a simple sale auction in a seller's market for scarce gas.

As far as the further procurement of gas from sources outside Russia, which will be short in the future, is concerned, the market will regulate the allocation in an efficient sense, as described above, and no separate auctions are required to carry out this allocation. This may well be reminiscent of the industrial goods market, in which there are no sale auctions even when markets turn into sellers' markets. The business model of the suppliers is not geared towards scarcity per se (implicit collusion expressly excluded here) and can be scaled as soon as buyers are found. The same applies to gas suppliers, after all, that's exactly why Mr. Harbeck is traveling the world at the moment.

The real problem, pending 100% implementation of the embargo, is the higher margin per cubic meter that can be achieved in a gas-constrained market. It is said that Russia - where the boundaries between private business and the state are blurred at will - is taking in more money than before the "economic war", for far fewer gas deliveries today. Preventing this is the first requirement for the regulator. Gas auctions are not a solution for this, because they only drive

¹ <https://www.handelsblatt.com/meinung/gastbeitraege/gastkommentar-wer-soll-im-notfall-das-knappe-gas-bekommen-darueber-sollten-versteigerungen-entscheiden/28293594.html>

² <https://www.spiegel.de/wirtschaft/bundesnetzagentur-chef-erwaegt-versteigerung-von-gasverbrauchsrechten-a-8281954c-e0cb-4bd2-862a-2a66777a1dc7>



the price up even more when in doubt. The real question is who collects the higher gas price - regardless of whether it is determined at auction or simply on the open market.

As far as the allocation of the scarce gas among the companies affected by the embargo is concerned, the idea of such auctions is by no means "sexy", as economists would like to believe. We know from practice that auctions are just as sexy for the auctioneer as they are sheer stress for the bidder. Why should a company affected by the embargo now also have to bid for remaining stocks and have to expect to "get nothing" if it is unsuccessful? With regard to the existing contracts cut by the embargo, this is highly unfair and does not correspond to the claims of the affected companies that were triggered by the state embargo. However, the state must ensure that systemically relevant gas needs – in the broadest sense, this can also include private needs if the whole purpose of the system is to generate private prosperity – continues to be served. In the end, this allocation decision will probably always have to remain a political decision – just like the embargo itself – no matter how much this will hurt us who like economic thinking.

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IFAMD GmbH, May 4th 2022