



DECOUPLING AND WHERE IS THE GAS WORLD COMING TO? SPECIAL FOCUS: EUROPE

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SETTING THE SCENE

Over the last few years radical changes in the global gas market have taken place. In Europe renewable energy sources and energy efficiency matters have been strongly promoted. The dependence on nuclear and fossil fuels has gone down. In addition, mild winters throughout recent years, the economic crisis and the

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inefficient CO₂ emission certificate trading scheme, which made coal fired power plants more competitive, were pushing the decrease in gas demand at the level of 2004. The exploitation of non-conventional gas (“shale gas”) made the United States the global leader in production of natural gas. In 2012 United States natural gas prices were at record lows. Liquefied natural gas (LNG) allows worldwide trading. Over decades only regional markets existed due to the dependence on access to transmission networks. But in recent years a more integrated global market has established which will push national markets and the necessity of pipeline transportation into the background. Currently 32 per cent of the global natural gas trade consists of trading with LNG.

Asia, especially China and India, will increase production of unconventional gas becoming possible players on the LNG market. Furthermore in the Middle East, Iran and Qatar – already important players on the LNG market – are vastly increasing their production.

Although Europe, especially Poland, also has reserves of shale gas, it is not to be expected that the production of unconventional gas will be of such importance in the near future. Marathon Oil just announced plans to step out from its exploration licence in Poland due to lack of success. In any case, because of the density of population and the strict environmental legislation,

production costs will be much higher than in the United States. Furthermore, some European countries have already stopped exploration due to environmental concerns.

The gas demand of European countries has been traditionally met to a great extent with long term supply contracts with Russia, Norway and Algeria transported via pipeline systems.

From the establishment of the gas market in the 1960s onwards, the determination of gas prices in long-term supply contracts was tied to the development of oil prices. In the course of the launching process of natural gas as a substitute for heating oil, production companies aimed to secure their investments in the exploration and transportation of natural gas by concluding supply contracts with a long duration of about 20 to 30 years, including take-or-pay clauses obliging the consumer to pay for the contracted amounts irrespective of receipt. Gas prices were tied to the oil price, because no other price index was available at that time. Another reason was the fact that producers,

who were also selling oil, wanted to avoid price competition between these two fossil fuels.

Over the years both preconditions have changed. Due to the liberalisation process forced by the European Union throughout Europe, gas hubs are becoming more and more liquid, with trading points increasing their traded volumes by an annual rate of 85 per cent from 2006 to 2011.

The fact that the United States is no longer dependent on gas imports and therefore LNG volumes intended for the US market are heading to Europe leading to an oversupply of LNG entailing cheap spot market prices.

However, most gas pricing is still indexed to oil because buyers are bound by their long-term supply contracts over decades. The take-or-pay clauses force buyers to put the gas they do not need on to spot markets, putting further pressure on the price.

The oil price was not that strongly affected by the economic crisis and recovered soon, making oil-indexed gas much more expensive than gas traded on the spot market.

This led to the well-known decoupling of oil and gas prices. While prices on gas hubs responded quickly to the economic crisis, oil-indexed contracts use an average oil price over a three-to-nine month response period, leading to an even higher divergence in prices.

Additionally, in Europe electricity prices on a wholesale level decreased due to renewable subsidy schemes and cheap coal leading also to a decoupling of electricity and gas prices.

WHAT TO DO AS A BUYER UNDER A LONG-TERM SUPPLY AGREEMENT

All this is forcing buyers to renegotiate their long-term gas supply contracts.

Under long-term contracts the underlying and globally accepted principle is: “the seller takes the price risk; the buyer takes the volume risk.” This is reflected in the price revision

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clauses included in most long-term supply contracts, giving both parties the right to request price revisions to reflect changes in the market price of gas. However, the specific wording differs from contract to contract and is often ambiguous leading to divergences between the contracting parties which often end up in arbitration proceedings.

In case a buyer looks for means to change the contract outside the contract, or would even like to get rid of a long-term supply contract given the current market developments, the buyer may think of taking recourse to competition law. In autumn 2012 the European Commission opened proceedings against Gazprom, assuming that Gazprom may have imposed unfair prices by linking the gas price to the price of oil. Other issues relevant in a competition case could be the long duration of such contracts in combination with the take or pay clause and the demand of the respective buyer always taking into account the relevant market. However, competition law cases may take a long time – and always carry legal, as well as economic and even political, aspects that must be taken into account before starting the process.

REACTIONS OF THE MARKET SO FAR

Some producers are already changing their marketing strategies, at least for new contracts. In November 2012 Norway's Statoil, Europe's second biggest gas supplier, announced that it had concluded a long-term supply contract (10 years) with Germany's Wintershall AG, based on spot gas prices. However, Gazprom is still insisting on oil indexation although the European Commission has already started antitrust proceedings.

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WHAT IS THE RIGHT INDEXATION FOR THE FUTURE?

Indexes should represent the sources of energy with which gas is competing in the end-user market of the respective buyer. This could be in the case of gas-to-gas competition, as well as a gas hub index. In Europe, the matter of whether European hubs are already liquid enough to be used as a price benchmark is being discussed. Using hub prices-indexation is risky if the hub is not liquid enough to reflect the true value of the gas. For

example, hub-priced gas is, at the moment, no acceptable source for gas fired power plants in Europe, due to the low electricity prices.

By contrast, for some competing sources of energy no liquid market exists at all.

WHAT DOES THE FUTURE BRING?

In the event that existing measures, in long-term contracts, to adapt prices to market conditions prove ineffective due to the in-built ambiguity of the respective clauses, and in the event that the liquidity of price-setting hubs and gas exchanges increases, buyers may no longer be willing to conclude long-term contracts. This may have an impact on security of supply issues, as well as on the financing of production and transmission development.

It remains to be seen when and how producers of gas will be willing to react to these changed economic circumstances.