Gazprom: a long march to market-based pricing in Europe?

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Europe: from oil-linked to hub-based gas pricing

For several decades up to the late 2000s, the netback market pricing formula – which links gas prices (principally) to oil product prices – dominated international gas transactions in Europe. This type of price formation is consistent with charging different prices to different national markets, as well as to different end-use sectors within the same market, depending on: their location, the fuels which compete with gas in their energy markets, and their ability to access alternative gas supplies (which was severely limited prior to the introduction of liberalization and competition). The formula institutionalized the practice of discriminating monopoly pricing – charging the highest possible price just short of a level which would cause customers to switch to other fuels and thereby maximizing the returns from sales to different markets – which was practised by all gas sellers (and European utility companies) prior to the arrival of competition.

When European gas demand crashed in the recession following the 2008 global financial crisis, many European utilities struggled to meet the minimum take-or-pay (ToP) commitments in their long-term contracts at oil product-linked prices, at a time when crude prices were rising to $100/bbl. The resulting surplus of gas was a key factor in creating a hub-priced gas market; this situation subsequently evolved to a point where the International Gas Union estimates that in 2014, more than 60 per cent of European gas was sold at hub-based prices, rising to nearly 90 per cent in the north-west of the Continent.

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The impact of these developments was of special significance for Gazprom because of the size and centrality of its supplies to the European gas market, and they resulted in renegotiations with buyers in its major markets. In many cases, these renegotiations reduced ToP volumes to 70 per cent, with volumes taken in excess of that level being sold at hub-based prices for three years beginning in October 2009. Nevertheless, in 2009 and 2010, customers incurred take-or-pay liabilities of 5 bcm and 10 bcm respectively, although the reasons for these figures were different: in 2009 the take-or-pay shortfall was spread across a number of companies, while in 2009/10 it was concentrated on Italian and Turkish companies. By 2012 the ToP problem had been largely resolved, although export volumes remained around 10 per cent below the pre-recession highs of 2007/8, but Gazprom maintained oil-linked prices at the expense of volume sales.

Resistance to hub-based pricing

Gazprom's initial commercial reaction to the price problem was based on reasoning that by 2012 the recession would be over and pricing would have returned to normal. In other words, hub prices would return to oil-linked contract levels as gas demand recovered after the recession (and surplus LNG supplies were absorbed by fast-growing Asian economies).

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When, by 2012, hub prices had become established in many countries and were still 30 per cent below oil-linked long-term contract levels, arbitration proceedings (which had commenced with a number of buyers) forced Gazprom to agree a different type of price mechanism. The new mechanism retained the oil index but reduced the base price (the P0) in the formula – in effect bringing the price closer to hub levels. A rebate mechanism was added which guaranteed buyers a limit on their exposure to hub pricing: at the end of the (one or two year) price period, if the price paid by the buyer under the new P0 + oil indexation formula exceeded the hub price by more than a defined percentage (said to be in the range of 5–15 per cent), the buyer would receive a 'rebate' reflecting the difference. From 2012 to 2014 these rebates amounted in aggregate to several billion Euros annually, but nevertheless Gazprom could claim that it had not compromised on the principle of retaining oil-indexed prices. Figure 3.1 shows that, as a result of this new mechanism, Gazprom's realized export prices fell from more than 60 per cent above the NBP (UK hub) price in 2009, to parity in 2013, before rising again in 2014 (when European hub prices fell significantly ahead of the fall in oil prices), and then readjusting in early 2015. The result was that in 2013 Russian gas exports to Europe rose to record levels (before falling back in 2014). Therefore, despite its public stance, the company can be seen to have adjusted to hub prices in those countries with competitive markets.

The 2012 EU competition investigation

But in countries lacking competitive markets and significant alternative sources of gas, Gazprom's attitude was entirely different and has been the subject of a lengthy investigation for possible abuse of a dominant position by the European Commission's Competition Directorate (DG COMP) which (after two and a half years) issued a Statement of Objections in April 2015. A major conclusion was that in relation to Bulgaria, Estonia, Latvia, Lithuania, and Poland:

> *… the specific price formulae … which link the price of gas to the price of oil products have contributed to the unfairness of Gazprom's prices … [and] seem to have largely favoured Gazprom over its customers.*

Since the Commission's 'dawn raids' in September 2011, it has been reported that Lithuania (following the opening of its LNG import terminal) and Poland (with the ability to access hub-priced gas from Germany) have renegotiated more favourable prices with Gazprom (although in the Polish case arbitral proceedings restarted in 2015). In addition, some of the long-term contracts with Baltic countries expire in 2015/16, allowing for the possibility of renegotiation, or termination in the event of failure to agree new terms. However, in south-

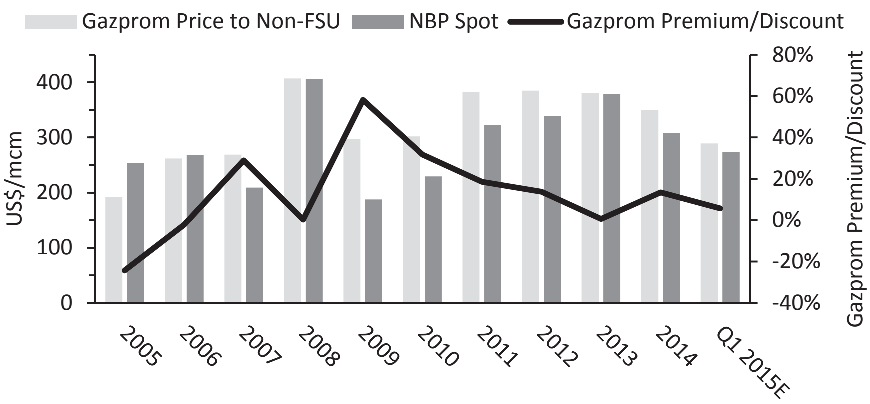

Figure 3.1. Gazprom prices to European customers compared with UK spot prices

Source: Henderson/OIES (from Gazprom financial statements) east Europe (which involves a number of Balkan countries which are not EU member states) alternative gas supply and hub development (and hence price competition) has been slow to arrive, and oil linkage remains dominant.

How the DG COMP case will be resolved remains to be seen. The Commission apparently discovered territorial restrictions ('destination clauses') in some contracts which, together with the price findings, could constitute a case for imposing fines of up to 10 per cent of Gazprom's turnover for the relevant years. Should this happen, appeals to different European courts could delay a final judgment for several more years. But the price outcome is already clear: it will no longer be possible for Gazprom to continue traditional oil linkage, even in those countries which have not (yet) reformed their markets or connected to liquid hubs.

'Political' gas pricing: a variety of interpretations

In the minds of many European politicians, media commentators, and electorates, the principal concern about Russian gas supplies is the political and security threat which they appear to carry. While the pricing of Russian gas in the large, established European markets is becoming more market-related, in smaller markets further away from evolving north-west and central European hubs, it is very often referred to as 'political'. The term 'political pricing' is generally meant to refer to decisions by Gazprom – supported, or perhaps ordered, by the Russian government – to tie gas prices to decisions on gas infrastructure or investments (DG COMP has confirmed this in relation to Bulgaria and Poland), or to other non-gas bilateral issues between the Russian Federation and the country in question.

But while such views are widespread in Europe, they should be questioned – not simply because of regular denials by the Russian government that it uses either energy or Gazprom as a weapon, but because so much of Russian behaviour appears designed to extract maximum revenues rather than political concessions. Where political motives can be clearly identified (these cases are confined to CIS countries) they have involved the importer making a political concession in order to receive a price discount. Analysis of many political pricing claims suggests a confusion between 'political' motivation and the widespread practice of discriminating monopoly pricing (described above) prior to the introduction of competition in European gas markets. However, from the summer of 2014 to March 2015 Gazprom Export failed to meet nominations (daily volumes of gas requested) from a large number of European buyers. While this did not infringe contractual conditions, it seemed strange for a company with a huge surplus of shut-in production to pay penalties for under-delivery to European customers. The reasons for this policy were two-fold: an attempt to curtail volumes of 'reverse flow' gas (Russian gas being sold back) to Ukraine by Gazprom's European customers; and an attempt to support weakening hub prices by generally curtailing available supply. In the event, the action proved to be a failure in relation to reverse flow, its effects were unclear in relation to hub price support, and it was abandoned in March 2015. However, anecdotal evidence suggests that the policy was not instituted by Gazprom Export and may have originated directly from the Russian president which, if true, could be considered directly 'political', albeit with the commercial intentions of forcing Ukraine to buy more Russian gas and of attempting to support falling European hub prices.

The long march to market-based pricing – is the end of the road in sight?

Despite protestations to the contrary by the company and the Russian president, Gazprom has been forced by a combination of the spread of competition, development of liquid hubs, interconnection of markets, and litigation, to progressively adopt market pricing in its long-term contract sales to Europe. This is clearly evident in the case of Ukraine, where reverse flows from Europe have forced a reduction in prices in order to restore the competitiveness of direct sales to one of its major markets, rather than see its gas sold 'second hand' to that market by its European customers.

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By the third quarter of 2015, a move to market pricing makes absolute sense for the company when, due to the fall in oil prices, the gap between average long-term (oil-linked) contract and hub prices had narrowed to around 10 per cent (and in some markets to parity) compared with a figure of 50 per cent a year earlier. As a result of the significantly increased volumes of LNG which started to flow to Europe in 2015 (with more to follow as new projects start up and Asia is unable to absorb all of the new volumes), gas-to-gas competition could create the conditions for a 'price war' which Gazprom is equipped to win, should it choose to defend its European market share. But this would require unambiguous acceptance of hub-based pricing. Substantial Gazprom trading operations in the UK and Germany provide the corporate capacity for such a move, and this would bring an end to the seemingly endless cycle of renegotiations and (threatened or actual) litigation with the majority of Gazprom's European clients. An alternative course of action has been taken in the Czech Republic where, after a disputed arbitral award, Russian deliveries fell from nearly 8 bcm to less than 1 bcm in 2014, suggesting that buyers have been able to access gas from alternative sources at lower prices. In non-competitive European markets, settlement of the DG COMP case could provide guidelines for pricing in these markets until interconnections bring them within reach of hub prices.