Special Bulletin

August 26, 2010

A Japanese Perspective on the International Energy Landscape (8)

German Chancellor Merkel Supports Non-Oil-Linked Gas Pricing Formula

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During a visit to the European Energy Exchange(EEX), known as a leading European energy commodity market, in Leipzig on August 19, German Chancellor Angela Merkel indicated her basic support for switching from an oil-linked natural gas pricing formula in Continental Europe including Germany to a new one that reflects natural gas supply/demand conditions and market competition. It is interesting for the top leader of Germany as a major country to make such an in-depth remark on the gas pricing formula that represents a business practice or arrangement. I would like to analyze the background and significance of the remark.

Cited as the most notable background factors are European gas supply/demand structural characteristics and problems of Europe's gas supply and demand, including problems peculiar to the European gas market that have surfaced since the global financial crisis. The world's three largest gas markets – the United States, Europe and Asia including Japan – have their respective supply/demand or market structures and pricing formulas. These structures and pricing formulas have wide differences and unique characteristics.

The United States has a pricing formula to leave the gas supply/demand balance (or the competition between gases) to determine prices, while the Asian market including Japan links gas prices to crude oil import prices (irrespective of the gas supply/demand balance). Europe's pricing formula is intermediate between the U.S. and Asian formulas. The supply/demand balance-based pricing formula in Britain coexists with the oil-linked formula in Continental Europe. The whole of Europe thus has a "hybrid" pricing formula. As Britain and Continental Europe have been linked by the Interconnector pipeline between Bacton in Britain and Zeebrugge in Belgium and as many LNG terminals receive LNG deliveries on a Europe-wide basis, the two pricing formulas or their respective prices have growingly interfered with and influenced each other in recent years.

More direct background factors for the Merkel remark include the easing gas supply/demand balance in Europe and the growth of relevant interests in the gas price problem. Although European demand had been continuing growing for natural gas that is environment-friendly and abundant in the North Sea, the trend has been reversed since the financial crisis. The European Union's gas demand in 2009 posted a substantial decline of 6% from the previous year on a recession. As Europe has plunged into a gas demand slump, gas sales have grown difficult in power generation, industrial and consumer sectors. Nevertheless, gas prices have not necessarily reflected real demand conditions (or the real supply/demand balance). This is because Continental Europe as noted above has basically linked gas prices to oil prices (irrespective of gas supply/demand conditions) under long-term contracts with major gas suppliers including Russia.

Meanwhile, the easing global gas supply/demand balance has begun to affect the “hybrid” European market along with the regional demand slump. In a typical development, the “shale gas revolution” in the United States has led surplus LNG in the U.S. market to flow into Europe at cheaper prices reflecting the supply/demand environment. As noted above, EU gas demand in 2009 declined from the previous year. Nevertheless, the EU’s LNG imports in the year scored a substantial increase of 25%, indicating European moves to cut relatively costlier gas supply under long-term contracts subject to the oil-linked pricing formula and expand cheaper LNG supply. Another phenomenon indicating such moves was a 10% decline (larger than the overall gas demand fall) in Russian gas supply via pipelines subject to the oil-linked pricing formula.

Under such situation, European gas buyers have increasingly sought to switch from the traditional pricing formula in a bid to benefit from the gas supply/demand balance that is easing and expected to remain easy. Already, Germany’s E.ON AG has persuaded Russia’s Gazprom apparently through tough negotiations early this year to reflect spot gas prices for 15% of gas supply under their contract. Although Gazprom might have resisted such change in pricing mechanism, the present market environment might have forced it to compromise.

The Merkel remark came apparently against the backdrop of such European or world gas supply/demand environment which has changed dramatically. It was a top national leader’s message calling for taking maximum advantage of the present market environment and the current balance of power between buyers and sellers to seek a change favorable to Germany (or Europe) as a major gas consumer. Chancellor Merkel might have also given political considerations to her remark in a bid to support the development of the Germany-based EEX as a pricing information center at a time when spot gas deals have been increasing in Europe.

The European changes have yet to have any direct impact on the Asian market. At a time when expectations on gas are growing in Asia including Japan, it may naturally become important to secure gas supply at more stable, competitive prices to allow further progress in gas consumption. As a global spread of the U.S.-originated “shale gas revolution” and Europe’s gas market structure changes have a potential to become an important driver of the entire global market, Japanese gas market participants may have to collect and analyze up-to-date information and implement strategies based on such analysis.

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