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Germany's E.On requests Gazprom to peg gas supplies fully to spot prices

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Oil price problems have attracted global attention as crude oil prices have spiked on growing tensions in the Middle East. In addition, however, an attention-attracting development has emerged with regard to gas prices in Europe. On February 21, Russian gas giant Gazprom unveiled that Germany's E.On, one of Gazprom's largest European gas customers, had requested for gas prices under long-term contracts to be pegged fully to spot prices.

Gazprom has basically pegged gas prices under long-term contracts with European customers to petroleum products prices. Under market environment changes including a gas demand slump in Europe after the Lehman Shock as well as surplus LNG inflows into Europe on a U.S. LNG demand fall following a sharp increase in shale gas production, however, Gazprom has reflected spot prices for some part (reported at about 15%) of long-term contracts with some customers including E.On. But the E.On-requested measure to peg 100% of long-term gas supply contracts to spot prices, if realized, would be of great significance, bringing about very drastic changes in gas pricing in the European market.

As a matter of course, Gazprom stated that it rejected the E.On request, retaining a traditional stance from the viewpoint that the traditional system to link gas prices to petroleum products prices is very important for securing investment over a long term and stabilizing a supply expansion to meet demand. For Gazprom, the requested change may be serious enough to shake its business management. The Russian firm might have had to emphasize that it would not make any easy concession.

Why did E.On make the drastic request despite Gazprom's well-expected strong opposition to such request? The first reason may be a structural problem in that two gas pricing systems coexist while the gas supply/demand balance is basically easing in Europe. Economic recovery is still weak in Europe, although it has overcome serious problems including the recession after the Lehman Shock and sovereign debt crises in Greece and Ireland. Signs of a gas demand recovery, though being seen, are not necessarily firm. Meanwhile, surplus LNG has continued to exert pressures on the market, leading to the easing of the supply/demand balance. Nevertheless, gas prices under long-term contracts remain pegged to high petroleum products prices, irrespective of the present gas supply/demand balance.

The situation is now difficult for E.On that sells gas to final consumers at home and abroad. As gas sales competition has grown fiercer in the deregulated European gas market, E.On, which buys gas from Russia at the high prices pegged to petroleum products prices, is forced to decide whether to accept price cuts and lower profit margins or lose customers in the face of rivals that may take advantage of the easing supply/demand balance to offer relatively lower sales prices.

The problem is that the situation is likely to remain difficult for the immediate future. Particularly, steep hikes of Brent and other crude oil prices amid the recent destabilization of the Middle Eastern and North African situation must have put new challenge on E.On. The Brent futures price topped $110/barrel at the end of February and reached $115/barrel on March 1. While future developments are uncertain, crude oil prices are likely to remain firm on an actual Libyan oil supply interruption and the destabilization's expected spillover to major oil producing countries. Under the traditional gas pricing system, gas prices reportedly rise some six months after crude oil hikes in many cases. European gas prices are thus expected to soar substantially toward the second half of this year in response to petroleum products price hikes following the Brent spike. Consequently, gas prices may deviate further from the present gas supply/demand situation. This could cause an even more serious problem for E.On.

Under such circumstances, the request to peg long-term contract gas prices to spot prices is difficult to withdraw for E.On, which is urgently required to promote its business realignment in the face of the severe business environment and has sold and swaped large assets. Given the Gazprom side's conditions as well, the two firms are expected to continue fierce negotiations or bargaining. Since Gazprom is a representative gas supplier versus E.On as a representative buyer in the European market, we may have to pay much attention to the results of the two firms' negotiations and their impact on the entire European market.

What are the implications of the European development for the Asian market? When the Pacific Energy Summit 2011 meeting took place in Jakarta in late February to focus on the development of the Asian natural gas market and relevant problems, a key opinion was that one of the top priority lessons was how to secure and enhance the competitiveness of gas. Under the Asian LNG pricing system that is somewhat different from the European system, LNG prices are basically linked to Japan's crude oil import prices. But European and Asian gas prices are commonly pegged to oil prices. An argument in the meeting was that LNG prices' peg to crude oil prices in Asia was unlikely to change. Another was that various changes in the world including the Asian gas market would naturally affect the Asian gas pricing system in the future. Opinions given at the meeting varied, failing to provide any consensus direction for the future Asian gas market. This may mean that the current situation entails various uncertainties and opaque factors. As expectations on natural gas grow globally, problems with gas pricing systems and price competitiveness hold the key to the future development of the gas market. Therefore, we may have to closely monitor relevant global and Asian developments and consider strategies and countermeasures based on these developments.

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