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New Russian Move Regarding Gas Pricing Problem

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A senior official at Russia's Gazprom has made an interesting remark on gas pricing issues between Gazprom and major European gas buyers. Media reports quoted Vlada Rusakova, a Gazprom director heading the strategic development department, as making a statement which implies that it would be reasonable for natural gas prices to be based on gas supply and demand factors in principle.

Heated arguments on how to price gas have continued between the Russian gas seller and European gas buyers since an economic crisis emerged in 2008. In the face of slack gas demand and an influx of cheaper spot LNG, major European gas buyers including Germany's E.On have strongly urged Russia's Gazprom, their largest gas supplier outside Europe, to revise the traditional gas pricing approach under long-term contracts to move away from gas prices linked to petroleum product prices and adopt a new approach allowing gas prices to better reflect natural gas market conditions. European gas buyers have had a growing sense of crisis as Russian gas prices linked to petroleum product prices have deviated far from spot gas and LNG prices that have plunged on the easing gas supply/demand relationship.

Any easy compromise may be unacceptable for Gazprom because sales to Europe are its cash cow accounting for most of its gas export revenues. Moved by the easing supply/demand relationship and major European customers' strong demand, however, Gazprom has made a concession allowing some part (reported at around 15%) of gas sales under long-term contracts to reflect spot prices. But the European customers have sought to link all gas purchases under long-term contracts to spot prices.

In response to the European request, however, Gazprom Chief Executive Officer Alexey Miller in June made clear his policy of continuing to link natural gas prices to petroleum product prices for sales to Europe under long-term contracts. The recent remark by Rusakova, though representing no official decision at Gazprom, is far different from the Gazprom CEO statement from two months ago.

Why has the responsible Gazprom official made such remark? There are two conceivable reasons. The first reason is that Gazprom could have faced up to the “reality” of market supply/demand situation and changed its recognition of the situation. In 2010, gas demand in the European Union recovered to 492.5 billion cubic meters (BCM), up 7.4% from the previous year. But gas supply from Russia via pipelines declined 2.0% to 110.4 BCM while LNG imports expanded 16% to 79.8 BCM. Under the wide price gap, Gazprom’s sales to Europe remained sluggish in 2010, reducing its share of the European market. Since early 2011, the future situation has grown more difficult to foresee due to the impact of Great East Japan Earthquake, the Middle East and North Africa crisis and other developments that are expected to affect future Russian and European natural gas situations. But Gazprom might have acknowledged that the decline in its European market share is intolerable for the gas company and Russia’s national interests and may grow more serious if Gazprom sticks to the traditional policy.

In this respect, Rusakova made an interesting point in a manner to justify her view that it would be basically reasonable to base gas prices on the gas supply/demand relationship. If supply/demand conditions for gas and oil are the same, gas prices’ linkage with oil prices may see no problem. Actually, however, oil supply is limited with gas supply expanding remarkably while demand is increasing for both oil and gas. Rusakova noted that the difference between oil and gas markets indicates that oil and gas prices should be based on their respective market conditions.

The second reason may be that European gas buyers including E.On and RWE have resorted to the tough measure of bringing the gas pricing problem to the European Court of Arbitration as no breakthrough has been made in negotiations between Gazprom and European gas buyers over the problem even this year.

As noted above, the Rusakova’s remark may represent no official decision at Gazprom. This means that it is still uncertain whether gas prices under Gazprom’s long-term contracts for gas exports to Europe would be based on gas market conditions. In addition, even if these gas prices shift away from their linkage with petroleum product prices, a more important problem may be the specific formula to link these prices to gas market conditions. No specific formula has come into sight.

Nevertheless, it is significant that a sign of new remarkable move has emerged in regard to the gas pricing problem between Russia and Europe that has attracted global attention. As gas is expected to play a greater role not only in Europe but also in the world including Japan, the gas pricing problem and the relevant issue of how best to enhance the price competiveness of gas are very significant. Those who are involved in gas market in Japan may have to keep close watch on future relevant European and Russian moves.

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