Gazprom's concessions in oil-indexed long-term contracts reflect "forced adaptation" to new realities

The relationship between long-term oil-indexed gas supply contracts (LTCs) and hub-based pricing is a recurring subject of conversation in the gas world. A lot of ink has been spilled about the inclusion of a "spot price element" in LTCs by producers such as Gazprom in an effort to protect its market share in the increasingly competitive European market – its core market.

Gazprom seems to be betting that the erosion of the global LNG supply glut will narrow the spread between hub and formula gas prices, prompting continental European buyers to increase their gas offtake under oil-indexed LTCs.

Gas Matters talked to Andrey A. Konoplyanik, consultant to the board of Gazprombank and advisor to the board of Gazprombank subsidiary GPB Neftegas Services. For him, a lot will depend on how tight the supply-demand balance will become by 2012 – the end of Gazprom's three-year price concession period.

Andrey A. Konoplyanik

Are we already seeing a recoupling of gas and oil prices, compared with last year? What effect does this have on the pricing of LTCs? Do you think that an expected increase in LNG demand from Japan for power generation to replace its nuclear capacity will speed up the recoupling process between oil and gas prices in any way?

Historically, the coupling periods between oil and gas prices correspond with a tight supply-demand balance, and the decoupling periods, usually with gas oversupply. The tragedy in Japan has boosted demand for gas – to substitute lost nuclear electricity generation by increased import of LNG for gas-fired power plants.

Historically, the coupling periods between oil and gas prices correspond with a tight supply-demand balance, and the decoupling periods, usually with gas oversupply

This will tighten the supply-demand balance not only in Asia Pacific but in Europe as well since some of the LNG produced in the Middle East will be re-routed from Europe to Japan. The Russian Prime Minister Vladimir Putin has already proposed a "global gas swap" deal – to compensate for this re-routing by an incremental rise of Gazprom's gas supplies to Europe in order to cover the balance.

A tightening gas balance in the Eastern Hemisphere will speed up the recoupling process, especially in Europe, since gas and oil prices in Asia-Pacific have always been more strongly correlated than in the Atlantic basin.

Do you expect this recoupling to affect Gazprom's previous decision to extend its 3-year concession on downward quantity tolerance with some Europeans customers and selling 15% of the committed volumes in oil-indexed long-term contracts at a spot price level?

A tightening of the supply-demand gas balance [on global markets] may lift gas spot prices above the contractual ones. This will enable Gazprom to rethink whether to grant a continuation of price concessions to off-takers and an eventual prolongation of the concession period beyond 3 years.

At a lower long-term contract price level, big parts of the increased spot transactions will return back into the long-term oil-indexation framework. This means a reverse of the earlier shift from long-term contracts to spot of some of the contractual volumes above the diminished minimum Take-or-Pay (TOP) level.

The reduction of minimum TOP obligations in Gazprom's European contracts from 85% to 60%, while converting 15% of contractual volumes from oil-indexation to spot price (calculated as the average value at major European hubs) were involuntary measures. They reflect Gazprom's forced adaptation to the new realities of the Continental European market.

If the gas glut will continue longer than expected, say, until 2012 according to Gazprom's estimate or until 2015 according to E.ON's forecast, Gazprom will most probably present additional flexibility in its contract structure. However, this depends on the reassessment of the situation at the end of the three-year-long "concession period".

As soon as the demand-supply balance will become tighter, long-term contract gas will not compete with other gas supplies [gas-to-gas competition] but with alternative energies and replacement fuels. This could lead to a coupling of gas prices with prices of alternative energy sources [like coal, hydro and renewables in the power generation sector], but not necessarily only with oil prices.

To what extend is the current glut of comparatively cheap LNG – especially since Qatar ramped up four LNG mega-trains last year – undermining a return to Gazprom's traditional pricing principles in long-term contracts?

Competitive LNG pricing is leading to an expansion of gas-to-gas pricing in spot transactions and the percentage of these deals has grown extensively in Europe

Under the recent "gas glut" situation, exporters began to discount LNG prices to win delivery contracts against competitors – a phenomenon seen especially amongst partners of new LNG ventures, who have to pay back their debt financing raised to develop their projects. This competitive LNG pricing is leading to an expansion of gas-to-gas pricing in spot transactions and the percentage of these deals has grown extensively in Europe. It has, in turn, influenced the pricing formulae of oil-indexed (LTCs).

This development is one of the major challenges for Gazprom. Qatari LNG has a very low break-even gas price due to the "economy of scale" effect – both in production and transportation – and a high component of associated liquid hydrocarbons, which enables Qatar to significantly downgrade its gas price against its competitors. And Gazprom is one of those competitors.

Notwithstanding the currently depressed gas market, Qatar is obliged to pay back its debt capital raised earlier for project financing of its LNG projects by selling its LNG now at any competitive price. And Qatar does not only attract buyers who seek a low floor price level. Qatar has also become more desirable as a gas supplier for many European politicians, especially after the January 2006 and 2009 Russia-Ukraine "cut-off supplies" episodes. So, Qatar is a major competitor for Gazprom in Europe and both countries may face a "lose-lose" situation from this fierce competition.

Due to the development of spot pricing undermining Gazprom's contract price levels and its low flexibility in adapting its contractual structures, the Russian company has lost part of its market share in Europe. But Qatar has also been losing part of its export revenues as it has not been receiving the full "replacement value" of gas within its spot transactions in bearish gas markets. Qatar has not been receiving, at least currently, the maximum resource rent from developing its giant Northern Field.

Is the decoupling of oil and gas prices a "short-term phenomenon" that will disappear once gas demand picks up as the European economy improves?

A revival in global gas demand will propel spot prices up and will most probably make the pricing of long-term contracts more attractive than spot prices. Continental European importers will again turn to pipeline gas – provided long-term contract prices stay below spot quotations.

Producers will then return to linking the gas price to its "real substitutes" – not only oil – thus maximising their long-term resource rent at the marketable contract prices. The spot sales segment of the market, which has been expanded earlier by diminished minimum TOP levels in LTCs and a shift in gas purchase volumes from LTC to spot transactions during the economic downturn, will narrow again. This will prompt a return of at least some spot sales back into the LTC framework. In turn, this will be attractive for consumers as it enables them to buy gas at a discount to its competing energy sources. And this is what indexation formulas are ultimately aimed at.

Gazprom is interested to protect its market share in order to maximise its long-term revenues and does not want to maximise its short-term returns only

Does it make economic sense for Gazprom to include a spot price element in its gas sale and purchase agreements or is it better to fully restore the 100% oil-indexed LTCs in order to maximise returns?

Gazprom is interested to protect its market share in order to maximise its long-term revenues and does not want to maximise its short-term returns only. If in periods of gas glut the gas offtake is falling below minimum TOP in Gazprom's contracts with European buyers, it is preferable for the company to sell some gas below its TOP contractual obligations, hence not at oil-indexed but at spot prices. This means in practice that Gazprom downgrades its minimum TOP to a new lower level and is selling the difference at spot.

By taking this step, Gazprom firstly preserves its role as a key counter-party and continues its long-term business relations with European buyers. Thus it saves transaction costs related to possible change of trade partners in case of price disagreements. Secondly, it ensures that it will get the achievable revenue for its gas sales as the concessions are designed to stop buyers refusing to buy from Gazprom by turning to the spot market. Thirdly, Gazprom saves prospective litigation costs which it might face in case of price disagreements and arbitration.