

## The Gas Exporting Countries Forum and Europe

By Hadi Hallouche\*

### Gas and Security of Supply in the EU

With the Russia-Ukraine gas dispute in January 2006 and a particularly cold winter in Europe, including the UK, natural gas has hit the headlines. The geopolitical dimension of gas has become ever more important as gas supplies come from ever further away.

The depletion of reserves in the OECD, high prices and a tense international political situation have given security of supply a whole new meaning. At the European level, the Commission has passed the Security of Supply Directive and there is also discussion about an EU wide energy policy in which security of supply will be key. Gas will be at the centre of this debate.

Gas can be imported by pipeline or by LNG. The former is cheaper for short distances and links, exclusively, one supplier to one, or more, buyers. The latter is more economic for longer distances and is becoming, slowly but surely, a market with many buyers and many sellers. In the nineties and early 2000s, LNG had a high importance in South European markets such as Spain and Italy. The prices witnessed in the UK last winter have demonstrated how important LNG can be in North Europe, especially in the period of low supplies that we are witnessing today.

Because of the cost of transporting LNG, the global market is divided into two regional markets: the Atlantic and the Pacific. Liberalisation of the gas market in Europe, pioneered by the UK more than a decade ago and followed by the two EU Commission Gas Directives and a series of Competition Rules in the late nineties and early 2000s, combined with the high recent U.S. prices, has transformed the Atlantic market.

### Security of Supply vs Security of Demand

In these times of security of supply concerns, particularly with the Russia-Ukraine dispute in the background, there are inbuilt fears aroused by the media and by some policymakers that gas can be used as a political weapon. Nevertheless, selling gas is as important to the producers as buying it is important to the consumers. Many producers depend heavily on exporting hydrocarbons in general, and gas in particular, for their growing populations and fast developing economies – more so if prices are as high as they are at the time of writing. The geopolitical equilibrium of inter-dependence and diversification that the market is witnessing is beneficial to both producers and consumers alike.

Having said this, however, the market will remain cyclical. In a period of tight supply that is being witnessed today, and which is likely to remain, at least in the short term, it is important for Europe to make itself an attractive buyer of gas, as attractive as the U.S., with which it is competing for supplies.

\*Hadi Hallouche is with the Centre for Shipping, Trade and Finance at the Cass Business School, City University London. He is currently one of the student advisers to the IAEE Council. He may be reached at [h.hallouche@city.ac.uk](mailto:h.hallouche@city.ac.uk)

## The Gas Exporting Countries Forum (GECF)

The GECF was set up in 2001 in Tehran by some of the largest gas exporters, including Algeria, Iran, Nigeria, Qatar, Russia, Indonesia, Malaysia, Brunei and others. Norway attended as an observer. The GECF meets at the Ministerial level on a yearly basis and at the experts level 2 to 3 times a year, to share information, data, research, views; discuss projects, markets, human resources... etc.

The Ministerial Conference of the GECF met in Algiers in 2002, Doha in 2003, Cairo in 2004 and Port of Spain in 2005. It was expected to meet again in Caracas under the Venezuelan presidency in 2006 but has met instead in Doha on the 18<sup>th</sup> of September.

The GECF members discuss projects of potential mutual interest, such as a contracts database and a supply-demand model, in order to have a collective insight into potential situations of global over-supply or under-supply. It is a loosely structured organisation that has slowly but surely gained structure with the setting up of an Executive Bureau in Cairo in 2004, and a liaison office in Qatar, which was established at the Port of Spain meeting in 2005. The GECF does not have a secretariat.

The GECF has often been accused of being a Gas OPEC in the making and, indeed, its structure increasingly resembles that of OPEC, with, for instance, 7 of the 11 OPEC members being also members of the GECF. The GECF, however, was not set up to be a cartel. Gas producers do not want, nor do they need, such an organisation, as it would not serve their interests, economically, strategically or politically, and certainly not in the current market conditions:

- In the first place, when prices are high, supply is tight and the industry is still in its infancy, any collective action between suppliers would be counter-productive.
- Secondly, oil and gas are different commodities: while there is an international price and a global market for oil, gas is still a regional market dominated by long term contracts with a regional pricing structure.
- Thirdly, demand elasticities for oil and gas are different; while the scope for oil substitution is virtually non-existent, gas is highly substitutable in power generation by coal, nuclear, renewables and, as is the case in the U.S., by oil products. As the oil shock in 1973 prompted a worldwide effort of diversification of fuels away from oil, any 'political' or cartel-like use of gas would prompt an even wider effort of diversification away from gas.

It is, however, instructive to observe how the GECF has evolved. Since its first meeting in 2001, the membership grew and consolidated around all the existing LNG players except for Australia and the U.S., together with important gas players such as Russia, Iran and Venezuela. The combined GECF membership in 2004 totalled 97% of the world's LNG exports, about 90% of the world's gas reserves, 40% of the world's pipeline exports (Norway and Canada are not members) and 40% of the world's gas production. These market shares, even by OPEC standards, are significantly high. For instance, in Europe in 2004, 53% of the pipeline imports and

100% of LNG imports came from GECF members, that is 38% of total gas consumption.

### **Security of Demand and EU Regulations: An Important Driver for the Creation of the GECF**

As mentioned above, security of demand for gas is as important for sellers as the security of supply is important to buyers. Natural gas trade has always been based on mutual trust, since its infrastructure is highly capital intensive.

One of the important reasons for the creation of the GECF, and a major subject of discussions in its meetings, are the regulatory changes within the EU, which were initiated without, or with very little, consultation with the sellers. The liberalisation of gas markets, introduced by the Transportation and Energy Directorate of the EU Commission (DG-TREN), had an important effect on the suppliers. But more significantly, the changes made to the competition rules, introduced by the Directorate for Competition (DGCOMP), have had an even greater effect, and have raised key concerns for the sellers. The most controversial of the changes in the competition rules is the phase-out of the destination clause. The destination clause is a customary clause in natural gas long-term contracts restricting the offloading of the gas/LNG to one, or a number of, destination points. The rationale behind this was to justify pricing at locally competitive levels for the buyer and a netback for the supplier.

The most contentious element is that the new competition rule implementation was retroactive, applicable not only to future contracts but also to existing contracts (some of which were negotiated more than a decade before the rules were published). DGCOMP has been criticised by many EU Member States and by the sellers, who found themselves with the obligation to renegotiate contracts. Additionally, the change in the destination clause has given the opportunity to many gas buyers to redirect cargoes to the U.S., where prices were coincidentally much higher, resulting in arbitrage profits for the buyers (later renegotiated to be shared with sellers). This had the related result of creating under-supply within some consuming markets in Europe, which formed the basis of the criticism of Member States.

The change in these rules was one of the drivers that prompted the GECF to be set up. Members of the GECF who were particularly affected by the changes, such as Algeria, Russia and Nigeria, strongly criticised the process under which the rules were introduced. The issue of the destination clause, however, has not been resolved by the GECF, even though meetings of the GECF (with some members who are not Atlantic area suppliers) have been able to develop appropriate arguments, nor has it been resolved at the political level. In practice, each specific case has been negotiated between the relevant parties, usually resulting in a mutually-beneficial profit sharing mechanism.

The important element, bearing in mind the 'security of supply versus security of demand' principles, is that the EU acted as a monopsony since it *de facto* set the rules for the most important LNG buyers in the Atlantic at that time - France, Italy, Belgium and Spain. Europe's dependence on

gas imports have increased the sensitivity of its policy-makers to any sign of producer cooperation (for example recent reaction to a Gazprom-Sonatrach Memorandum of Understanding), while at the same time strongly encouraging consumer cooperation.

This is perceived as double standards by producers and impedes, rather than helps, any producer-consumer dialogue on security of supply and security of demand. It is also not consistent with making itself an attractive destination for scarce long term LNG supplies compared to the more attractive, liberalised, transparent, high priced U.S. market.

### **The GECF and Other Potential Producer-producer Coordinated Export Policies**

It is highly unlikely that gas will ever be used as a 'political weapon' under the collective auspices of the GECF. Certainly, under existing market conditions there is no theoretical or practical case for the GECF to develop any cartelisation or coordinated export policies. It is, of course, possible that joint export policies might be discussed and developed when the industry cycle shifts from a sellers market, as is the case presently, to a buyers market, with a situation of over-supply, particularly if there were at the time other issues of confrontation with the EU Commission, related, for instance, to joint-bidding, profit sharing mechanisms, long term contracts and price indexation clauses.

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Cambridge, MA 02138

