Changing Gas Price Mechanisms in Europe and Russia`s Gas Pricing Policy

By Tatiana Mitrova*

Since 2009 European gas market is undergoing a deep transformation process accompanied by a dramatic change of the gas pricing mechanism with the expanding share of spot-indexed gas supplies. Russia is traditionally one of the key players on this market so the question of Russian gas export strategy adaptation to these changes is extremely important for understanding of the future European gas pricing evolution.

Russia's traditional export strategy in the European gas market, which was successful for almost five decades, has noticeably lost traction in recent years, with gas pricing becoming the most critical issue: Russia is still officially preserving the traditional pricing model of oil indexation, while all European stakeholders demand of competitive, spot-linked pricing. But statistical analyses, undertaken by the author, demonstrate that although Gazprom still formally follows the traditional oil-indexation rhetoric, it has in fact already significantly reviewed its pricing policy. During the period 2009 –2014 nearly 60 gas supply contracts were reviewed with 40 clients, providing price discounts, easing of take-or-pay obligations and a certain introduction of a spot component.

In 2013 Gazprom started to implement a new price discount model with so-called retroactive payments. According to this model the company has to compensate its customers for the difference between contract price and spot price by the end of the year. This was an elegant way of executing a de-facto switch to spot indexation, while remaining formally within the framework of oil-indexed contracts (and to protect these contracts that were signed under the auspices of intergovernmental agreements). All these "compensations" are presented as temporary, and Gazprom has a right to remove them should the market become tighter.

Calculations using Russian Customs Service statistics, Gazprom reports and the Nexant World Gas Model, clearly show the increasing differential between calculated traditional oil-linked price and real Russian gas export prices to Europe. By 2014 Gazprom had already provided nearly a 15% average discount (around 70 $/mcm) to its European customers compared to its pre-crisis traditional oil-linked price formulas and this process is ongoing further – this figure exceeded 20% in 2014.

As a result of all these price discounts and also the tightening European gas balance, by the end of 2013 Gazprom`s contract price at the German border equalled NBP hub price level and Russian gas exports had partially been restored, though they did not recover to their pre-crisis levels. But at least Gazprom managed to restore its market share of 30%.

The future development of Russia's position in the European gas market is still unclear. The basic question is whether Russia will go for explicit spot pricing or if it will continue to provide all price reviews within the framework of oil indexation. Theoretically, Russia can choose between two strategies:

Post-facto adaptation by providing limited concessions to its buyers. In this way, Russia can continue to focus on price maximization, staunchly refuse to move to spot pricing, employ the tactic of minimal price concessions, or defend its position on oil indexation in arbitration and even go for further reduction of delivery volumes for the sake of maintaining the pricing principle. The following arguments work in favour of this strategy:

- A global LNG surplus is not expected for the next two years, and consequently the absence of any gas oversupply on the European gas market in the medium term will most likely narrow the gap between oil-indexed and spot prices;
- With higher prices, even lower export volumes guarantee growth in revenue;
- Gazprom's major contracts only expire after 2022, before that time annual contracted quantities exceed 160 bcm, and even minimal contractual quantities guarantee Russia approximately 120 bcm of annual gas export to Europe (equal to the level of 2009 supplies);
- The intensity of any conflict can be somewhat mitigated by further individual concessions by Gazprom to its major buyers;
- Arbitration lasts several years, during which time deliveries continue to be made based on previous conditions;
- Gazprom really needs oil indexation for its new expensive projects financing.

This may be more of a winning strategy in the medium term, though it does

* Tatiana Mitrova is Head of Oil and Gas Department, Energy Research Institute of the Russian Academy of Sciences (ERIRAS). E-mail: mitrovat@me.com

not allow Russia to expand its exports to Europe. But, most importantly, in the longer term it will undermine the competitiveness of Russian gas vis-à-vis that of the new suppliers targeting the European gas market. In this scenario, if massive new supplies become available, Russian gas can be partially squeezed out of the market by cheaper gas from competitors unless the export strategy is amended.

The alternative is a **strategy of anticipatory adaptation** and a transition to spot pricing. Russia can agree with buyers to a "buyout" of long-term contracts and then set up simultaneous price and volume optimisation, depending on current market conditions. In this case, in order to maintain its market position, Gazprom has to agree to prices that will ensure the competitiveness of its gas in the power sector (no higher than 6-7 $/MBtu) and ensure greater flexibility in supplies. This option is fraught with higher volatility, though it does have the following advantages:

- The possibility of profitably "trading off" changes to contractual terms in exchange for financial compensation (as was done in the review of contracts in the UK in the deregulation period) or regulatory exemptions (like OPAL and NEl exemption from the 3rd party access or more favourable environment for Turkish Stream or restored South Stream);
- An increase in Russian export volumes and European market share;
- If finally Russia should choose (or is forced) to move completely to spot-based pricing, Gazprom with its dominant position in the market fluctuating at around 30% of total European gas consumption (and far exceeding this level in certain countries, especially in Central and Eastern Europe), will be in a good position to manipulate prices through higher or lower supply volumes.

The future strategy choice will largely depend on the market supply-demand balance and the availability of cheaper supply options that are able to compete effectively with Russian gas.

The outlook for European gas demand remains unclear, but most analysts and research organisations assume that European gas demand will only recover to pre-crisis levels post-2020. Nevertheless European import needs will increase even with flat demand due to declining indigenous gas production. Analyses of the current and projected European gas market supply-demand balance and contracts conditions show that until 2022 all demand is covered by existing long-term contracts, the termination of which would result in high penalties for the European consumers. Afterwards a market niche for additional pipeline and LNG supplies is expected to appear and by 2030 it could amount for one third of the European gas market. So the threat to Russia's position will not be that great over the next few years, as there are no real supply alternatives, and Gazprom's export volumes are well protected by long-term contracts and beyond 2028-2030, when much more gas imports would be required from all supply sources.

The most challenging situation for Russian gas is foreseen in 2018-2028: huge growth of liquefaction capacities is expected by this period of time. If massive new LNG and pipeline gas supplies from Africa, the Middle East, North America and East Africa become available to European consumers at spot-indexed prices, these competitors will be able to propose more attractive prices than Gazprom and thus squeeze it partially from the market if it does not change its pricing model.

This means that in the short to medium term there are no incentives for Gazprom to turn its back on oil indexation, but by the end of the decade this discussion will most likely be high on the agenda again, forcing Russia to protect its market position through more thoroughgoing price reviews and stronger spot linkage.

Summing up, Russia is trying to adapt to the fundamental changes occurring in the European gas market, though in a "concealed" manner; formally following the principle of oil indexation, while defacto providing strong price discounts and linking pricing to spot prices via the retroactive payments model. The price concessions provided by Gazprom contributed to recovering of its gas exports volumes to Europe in 2013, though political events in 2014 and the desire to reduce dependency on Russian gas destroyed all these achievements. Nevertheless at least in the next decade the role of Russia in the European market shouldn't be underestimated. With the growth of alternative supply, primarily with the coming wave of LNG glut, Russia will have to enter into stronger price competition with the new suppliers, provide additional discounts, and introduce an explicit spot price component.