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Viewpoint

Ensuring security of supply for the European gas market – Alliance of long-term gas import contracts and open trading points ("Cohabitation des régimes")

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More than ever there is a great deal of debate in the EU about the challenge of supplying markets with gas at reasonable prices on a long-term basis. The discussions focus at present on the form, function and potential of forward-looking market and procurement models. In this context one should by no means overlook the benefits, especially given rising dependence on imports, deriving from the alliance of open trading points and proven long-term gas import contracts.

1. Supply security is a major challenge

In Europe, significantly increasing dependence on gas imports is anticipated in the years ahead. Particularly the steady rise in demand for gas and falling indigenous production require the procurement of additional gas volumes with the aid of new import projects (Fig. 1).

The gas reserves currently relevant to Europe, totalling approx. 128 trillion m^3, are no doubt adequate (BP Statistical Review of World Energy, 2006). Problematic, however, is the fact that these reserves lie outside the European Union's direct sphere of influence and that gas production in those countries is controlled by a few, frequently state-owned companies. The dependence of European gas markets on a global oligopoly of producers and the international competition to obtain gas supplies, fostered not least by the additional demand from China and India as high-growth regions, are likely to have a great impact in the long run on the procurement of the gas volumes needed for European markets (Krude et al., 2006).

Yet these aspects are still not adequately taken into account in the debate on future supply security for European energy markets. In some cases it is argued that simply the establishment of open trading places on European consumer markets and the free interplay of supply and demand will safeguard long-term gas supplies at reasonable prices.

The risk of a temporary (physical) supply shortfall or resultant supply at an unreasonably high price level, which may ensue from the free interplay of supply and demand in an increasingly global producer market on the supply side and rising dependence on imports on the demand side, is often mentioned only vaguely.

2. Experience gained from the UK supply situation

In winter 2005/2006, National Grid, the operator of the UK gas system, proclaimed a "gas alert" for the first time in the history of the British gas industry on 13 March 2006. Due above all to declining indigenous production in the UK and inadequate storage capacities as well as extremely high gas demand because of a very cold snap, National Grid felt that there was an acute risk of a physical supply bottleneck (Gas Matters, 2006).

Given this anticipated shortage of gas, the UK spot market at NBP reacted with a very steep increase in the gas price to 255 pence per Btu. This reaction illustrates the high price sensitivity on open markets with spot trading, especially when compared with markets supplied under long-term import contracts having oil price pegging ("oil as the key currency") preferred by oil and gas producers.

Although such extreme weather conditions as during the past winter occur seldom, one cannot rule out the possibility in future of similarly extreme price fluctuations or price levels arising on open trading markets due to (feared) supply shortages triggered, for instance, by political conflicts between producer and transit countries.

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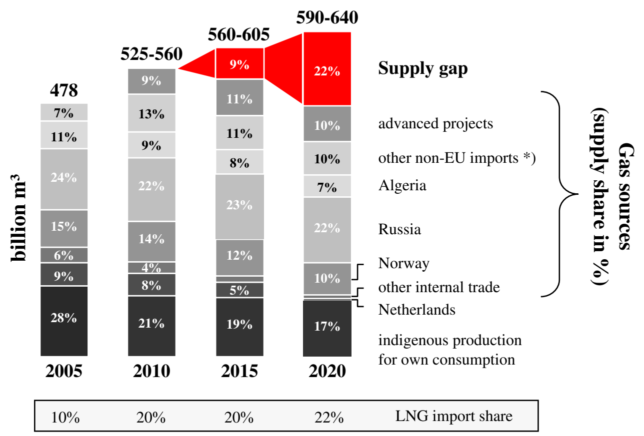

*) including: Nigeria 3%, Qatar 3%; basis of imports: contracted volumes and prospective contract extensions

Fig. 1. Anticipated development of gas supplies in EU25 (source: E. ON Ruhrgas).

3. Long-term import contracts ensure gas supplies at reasonable prices

Adequate gas volumes under long-term supply contracts, which could have prevented the sudden extreme price fluctuations by means of contractually fixed price mechanisms like oil price pegging, were not available (any longer) in the UK in the aforementioned period. Between the mid and late 1990s these contracts were largely cancelled by the former monopolist British Gas, which had to pay large contractual penalties to UK producers in some cases, as preparations were made to introduce spot markets.

In the continental European gas industry, on the other hand, long-term import contracts continue to form the backbone of gas supply and protect consumers, by pegging the gas purchase price to the price of the relevant competing energy, against erratic price fluctuations or unreasonable price demands on the part of the producers operating worldwide.

At the same time these long-term gas import contracts, which usually have terms of 10–25 years, have throughout the history of the continental European gas industry ensured that the development of additional reserves and new import infrastructures can be financed.

Particularly in view of the foreseeable supply gap in Europe and hence the need to develop new reserves and put new import systems in place, the positive effect of long-term import contracts should by no means be forgotten.

It remains questionable whether open trading markets can likewise bring about the capital-intensive development of new gas reserves. Furthermore, additional investments in the development and expansion of expensive pipeline or transit systems and LNG supply chains to take gas to consumer regions are likely to be very risky and scarcely attractive to producers or importers in the absence of offtake commitments as well as uncertain capacity utilisation and return on capital.

Consequently, it is dubious whether the highest possible gas supply security can be achieved in open trade markets without supply commitments contractually secured with producers.

4. Conclusion: "Cohabitation des régimes" not to be ignored in the long run

Given the advantages ensuing from the proven bilateral contractual arrangements between gas producers and importers, the notion of an alliance of long-term import contracts and open trading places should be pursued intensively in the future with a view to ensure gas supply security for European energy markets.

Long-term import contracts with price pegging to the relevant competing energy safeguard the international supply of adequate gas volumes at reasonable, fairly stable prices and lay the basis for the expansion of gas production and transmission systems needed in future. At the same time, open trading markets within Europe create the conditions for competitive gas supply to (regional) consumer markets and increase the freedom of customers to choose the most adequate supplier. The harmonious interaction of the two instruments (cohabitation des régimes) is the route leading to secure and reasonably priced gas supplies for Europe in the future.

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For details of supply competition on the international gas market, see: Krude, G., Halstrup, D., Wolf, S., 8/2006. Versorgungssicherheit bei globalem Nachfragewettbwerb – Herausforderung für die europäische Erdgaswirtschaft. p. 30et seq.

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