European Commission Sector Enquiry

The Energy Sector Enquiry, published in January 2007, cited long term contracts as a causal factor in three (of eight) of its “key findings”: Market Concentration, Vertical Foreclosure and Price Formation. Through largely controlling up-stream gas imports, and trading only a small proportion on exchanges, incumbent importers are recognised as generating dependency for supply on the part of potential new entrants; in particular, the prevalence of long-term supply contracts between producers and incumbent importers makes it very difficult for new entrants to access gas in the upstream markets. Moreover oil price indexation of gas contracts has further obstructed wholesale price response to changes in supply and demand for gas.

The Commission has already demonstrated the use of merger regulation to ensure that the competitive structure in relevant markets (currently at-most national in scope) does not “further deteriorate” as a result of corporate transactions. In recent merger cases remedies such as divestitures, contract and /or gas release have been applied. In addition, the impact of long-term upstream contracts on downstream concentration has emerged as a major theme in such merger reviews.

Following the experience of gas release programmes, they are recognised by the Commission as a means to develop market liquidity and increase entry opportunities. The Sector Enquiry notably recognised the suitability of gas releases not only in merger cases but also under antitrust rules. Gas releases, through increased hub liquidity, are also recognised by the Commission as supporting the introduction of price signals not biased by the gas-oil price link.

One conclusion that can be drawn from the Sector Enquiry is that existing and indeed future upstream contracts are not of themselves in question, but their effect on the downstream markets will give rise to attention. When such contracts, concluded by dominant firms, foreclose the market, Article 81 or 83 EC may be infringed unless there are countervailing efficiencies benefiting consumers. For that we might read that long term contracts will be a significant target where there is cause for antitrust action.

The effect of the Sector Enquiry appears to be the framing of enforcement actions that we can expect to follow in the future, with attendant remedies.

Regarding continued high levels of supply concentration in gas markets (Figure 1), reflecting pre-liberalisation monopolies, the Sector Enquiry encourages national regulators and competition authorities to make proposals, including release programmes. Specific note is given to ceilings on control over long term upstream gas contracts introduced under national law by some Member States. The Commission seeks to encourage contract release, contract swaps and / or divestiture of domestic production as have been applied in recent merger cases.

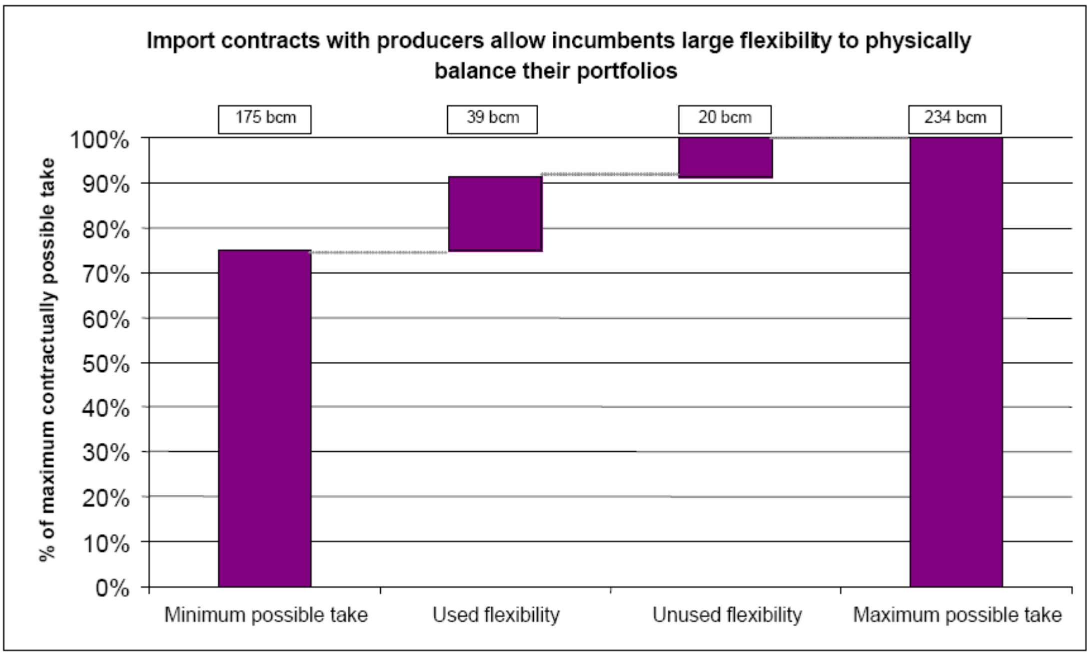
Figure 1

Incumbents control the majority of the gas in their home countries				
	Total imports (2004, in bcm)	Incumbent share of imports (2004)	Total domestic production (2004, in bcm)	Incumbent share of domestic production (2004)
Austria	9	80-90%	2	-
Belgium	16	90-100%	0	-
Czech Republic	9	90-100%	<1	-
Denmark	0	-	10	80-90%
France	49	90-100%	1	-
Great Britain	13	20-30%	105	40-50%
Germany	88	90-100%	18	80-90%
Hungary	11	90-100%	3	90-100%
Italy	67	60-70%	13	80-90%
Netherlands	18	50-60%	73	90-100%
Poland	10	90-100%	5	90-100%
Slovakia	7	90-100%	<1	-

Source: Sector Inquiry, Eurostat, National Regulatory Authorities
Note: "Total imports" means gas imported for use in domestic consumption and do not include transit gas or imports that are subsequently exported. Due to differences in countries reporting methodologies percentages are presented in ranges.

There is however recognition of the extent of price and flexibility risk generally borne by the producer within these long term contracts. Sector Enquiry analysis (Figure 2) of a sample of 306 contracts, relative to 2004 actual take, shows collectively that these contracts offered the buyers 25% flexibility (i.e. the minimum that could have been taken in 2004 under these contracts was only 75% of the maximum total take).

Figure 2



Source: Energy Sector Inquiry 2005/2006

The further frequency with which producers were identified as having agreed to deliver outside contracted limits underlines the flexible and co-operative nature of these contractual relationships.

Physically, the Commission also recognises the role of incumbents' portfolios of these contracts – and the management of these portfolios - in the economic management of supply. This is notably the case for companies operating in more complex situations, handing various qualities of gas, and located towards the geographic centre of Europe where pipeline congestion may mean they are physically unable to flow gas from certain sources.

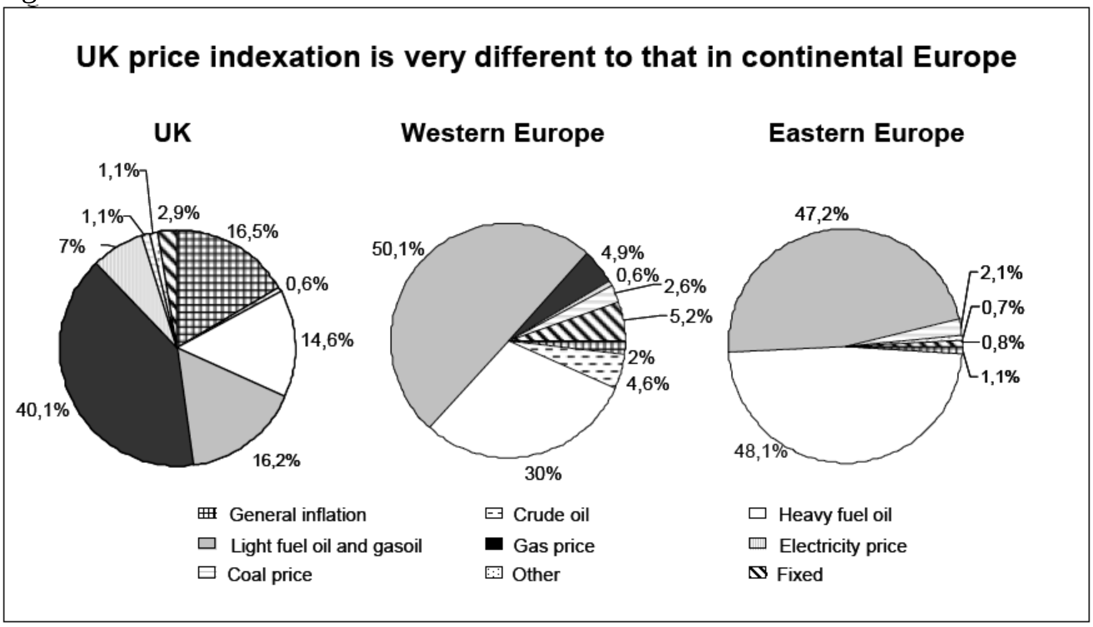
It is argued that this flexibility results in incumbents avoiding buying more gas than they need, which limits their need to buy and sell on hubs.

Commercial Realities

The crucial point is that with relatively few suppliers into Western Europe, the dominant suppliers and buying monopolies have been able to manage the market and keep supply and demand more or less in balance. For the Commission and national regulators it has been very difficult to promote competition within such a balanced market.

The only real success has been in the UK market, which has been characterised as being relatively closed and relatively over-supplied by a large number of North Sea producers. Once the British Gas monopoly was broken the conditions were right for an outbreak of competition and for the development of trading. The creation of the National Balancing Point (NBP) provided the mechanism. Legacy long term contracts lived on, but new contracts have become shorter in duration and generally indexed against traded markets (Figure 3). Much new import structure, pipelines as well as LNG terminals, has been funded without assured gas supply contracts.

Figure 3



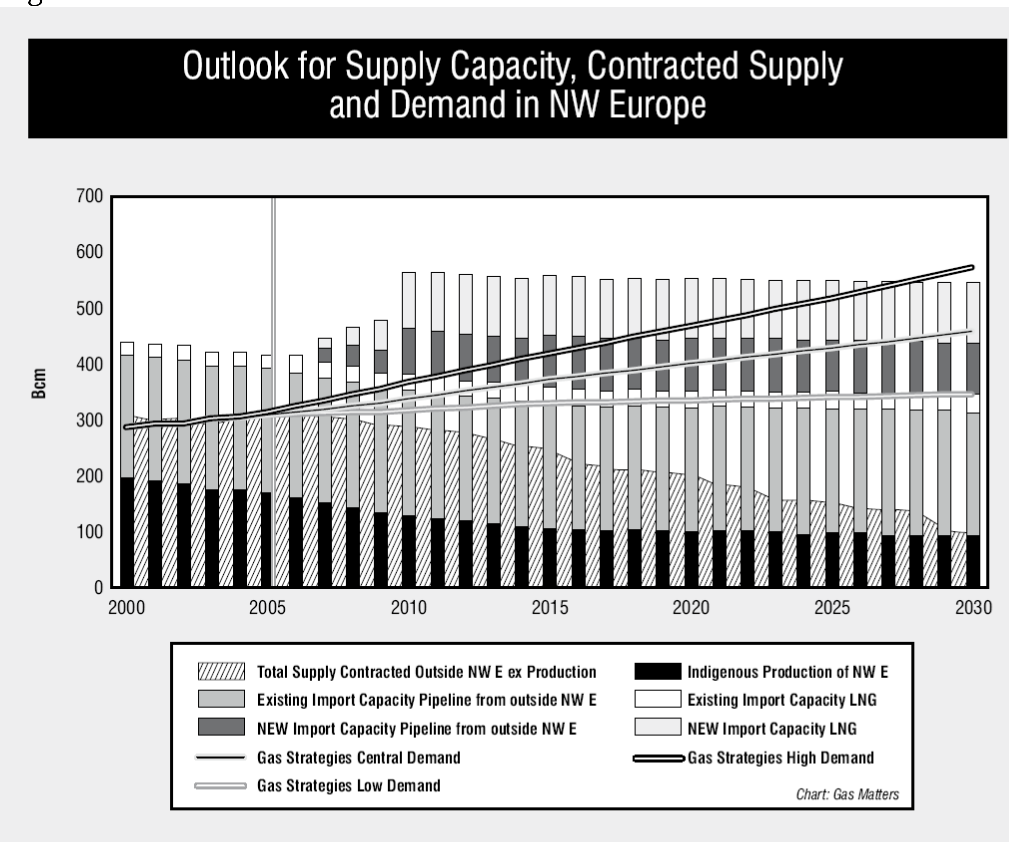
Source: Energy Sector Inquiry 2005/2006

But the NBP still falls short of perfection for market purists with the relative thinness of forward trading. Most of the trading is done by intermediaries, with the result that there is high volatility and higher forward prices of late than might otherwise be the case. The reasons for this have been widely debated and various explanations offered. The major one is assumed by many to be that producers could be exposed if they fail to deliver, and would then have to fulfil contracts by buying at the NBP at very high prices. This is important because a large volume of gas sales contracts to all but the largest industrial and commercial users are set with reference to forward prices.

One response to both the Commission aspirations and the NBP hiatus is that it takes time for a hub to develop and that activity at European hubs is still a long way from being comparable with the sophisticated trading that takes place in North America. It is estimated that less than 10% of final demand is bought under contracts of more than 5 years in the United States, about 30% on one to five year contracts, and around 60% on contracts of less than one year. And almost all contracts are indexed against traded gas markets.

If we assume that there are many purchasers looking for gas at lower than current prices, but with supply security, the missing element for a "North American pattern" to emerge in Europe is pressure on suppliers from alternative supplies at lower prices. The potential for European (Figure 4) over-supply is led by LNG import projects all around the coasts of Europe, and plans for new pipelines including those from Algeria to Spain and Italy, NEGP, Nabucco, and others involving gas flowing through Turkey westwards.

Figure 4



There is of course a significant distinction between a surplus of capacity and a surplus of gas available for sale. Nevertheless if a large proportion of the infrastructure proposed by these projects is built, then a lot of gas could potentially be hunting for a market. This could include gas from existing long term suppliers, whose customers might be expected to switch their supplies down to minimum levels allowed in their contracts, to escape high pries and make room for trading at lower prices.

Strong belief in the possibility of oversupply in Western Europe will lead inevitably to pressure from energy users not to renew or extend existing long term contracts, and maybe to renegotiate existing long term price clauses. Where could this lead? Gas rather than oil-indexation; greater use of flexibility market; a redefinition of "long-term" to mean, for instance, only 5 to 10 years?

Even if a supply surplus emerges, an important question is question is whether customers will expect it to last. A short term gas bubble may not be enough to encourage buyers to altogether abandon their long term gas contracts. No-one, not even the European Commission, wants or expects long term contracts to disappear – they continue to play a role in North America – but they may be transformed beyond recognition. Once suppliers have learned to dabble with a portfolio approach to their purchases, maybe as much as 20-30% of the portfolio could become medium term as in 1 to 5 years.

Changing Contracts – New Competitive Dynamics

Conventional wisdom, based on the North American experience, is that long term contracts in liberalised markets are priced in relation to a hub. Incumbents will negotiate their contracts with existing suppliers in response to the threat form new suppliers that buy at spot prices in an over supplied market. How easy this is to achieve will depend on the nature of the existing contracts. With standard re-openers in Europe this could be fairly easy. In the UK it was never fully achieved – Centrica still purchases a lot of gas at oil-related prices.

Whilst the adoption of hub pricing may be described as a "no brainer" in an over-supplied market, it is clearly a defensive strategy that may offer the prospect of survival but not prosperity. The harsh reality of a competitive gas market in which everyone buys gas at the same price and buys transport capacity from the same regulated supplier, is that it becomes increasingly difficult to secure the competitive cost advantage which is essential for significant profit in a commodity business. Insofar as gas supply is a major element of cost, the attraction of securing a competitive advantage in WACOG (weighted average cost of gas) is obvious. On the other hand operating a spread of different supply prices is high risk compared to the "all sink together" strategy of hub-related pricing.

Prospect for Change

The European Commission's position on long term contracts, particularly from the Sector Enquiry, has an aspirational tone. The role which the shortening of contract terms may play is clear, but remedies appear to lie in the hands of national regulators and competition authorities on foot of cases for market dominance. It is however clear that this situation could change in the case of Article 81 or 83 infringements found in anti-trust cases.

Meanwhile Continental European buyers are currently gaining experience of hub-related pricing, as they secure new supplies on this basis running along-side existing contracts. In particular LNG contracts are at hub prices. Whether they will further develop a mixture of pricing in their long term contracts may well depend upon their expectation of trends in the gas market compared to trends in the oil market.

Thus whilst the realignment of long term contracts on short term pricing remains conventional wisdom we see the intriguing alternative of a portfolio approach. The opportunity always remains to revert to the safe strategy if it does not work out. We wait with interest to see just how quickly the price renegotiations of long term contracts will follow the emergence of a truly competitive liquid market in Continental Europe.