How Long Can Long Term Gas Contracts Survive?

Long term gas contracts are not set in stone but will evolve under growing pressure from regulators and competition authorities and the increase in new sources of supply (e.g. LNG). John Elkins of Gas Matters explores how the market might develop.

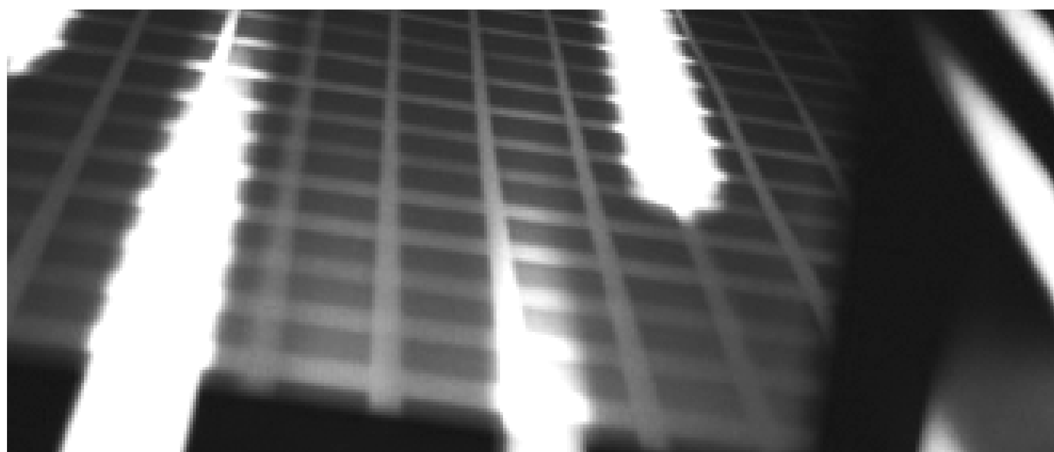
Pressures for change

Why should gas wholesalers and retailers leave the comfort of 15-25 year long term gas contracts with reliable suppliers for the inevitably more uncertain world of short term contracts? And if they choose to do so, how should they do it? The how will depend on the why. For example, it will make a difference whether the change is being made from political conviction, regulatory compulsion, or for commercial reasons, including for instance the emergence of new, possibly cheaper or preferable, sources of supply.

It is usually political dogma which leads regulators to push for change. This is broadly the case in Europe, which is being driven in the direction of liberalisation, although other energy markets have been there before, notably in North America, Australia, Chile, and the Nordic power market.

The initial impetus to change the market structure in the UK came from reports by the then Monopolies and Mergers Commission in 1988 and 1993, and it was pressure from Brussels that led to the dismantling in 2001 of the Gassforhandlingsutvalget ('GFU') system under which contracts for the supply of Norwegian gas were centrally negotiated by a government committee, even though the contracts were nominally between individual upstream companies and the purchaser. The result was the renegotiation of all the existing contracts, and the emergence of contracts such as Centrica's 5 Bcm/year contract with Statoil linked to the NBP gas price, and other "untraditional" long-term contracts for gas entering the UK through the Vesterled and Langeled systems.

Now the liberalising drive from competition authorities in Brussels and Germany



has led to the important challenge of long term contracts between German Stadtwerke and their German suppliers. The importance of this measure can be seen in the vigour with which Ruhrgas has contested the rulings of the Kartelamt. It should be noted that the issue here is not long term contracts per se, but the concentration of contracts with a single supplier upstream and the cosy relationship between supplier and buyer that was encouraged by various "incentives" to use a single supplier.

An important new impetus for change is the entry into the market of major new suppliers – most notably those offering LNG from Qatar, Nigeria and Egypt. Whilst most of the LNG will be sold under long term contracts between producers and wholesalers – for instance Total's plan to buy 5.2 mtpa from Qatar for the South Hook terminal in South Wales – the new sources are likely to create additional liquidity, and increasing levels of short term sales, around European trading hubs. The new LNG terminal capacity could also attract spot cargoes – particularly in the summer months – which by definition would be sold on a short term basis.

What all this shows is that long term contracts are not set in stone, but will evolve as the regulators and competition authorities slowly unpick the anti-competitive elements they may contain. These include GFU-type central negotiations and destination clauses, which restrict the markets into which gas can be sold by the purchaser, and enable the suppliers to lock up markets and prevent catastrophic falls in prices.

The Commission has made some progress through central negotiations with the suppliers, notably in securing the removal of restrictive destination clauses from future contracts, but progress in the area of opening up, for instance, the Russian gas export market to players other than Gazprom is non-existent.

The buyer's rationale

But what about the commercial aspects? Why have European wholesalers and final customers been happy to stick with long term contracts? About 40% of European gas supplies are delivered under "traditional" long term contracts with the national gas companies of Russia and Algeria – Gazprom and Sonatrach – whose consent is necessary if any significant progress is to be made in loosening the ties of the existing contracts.

The answer, presumably, is that the mix of price and security which wholesalers have in the past received from the contracts was acceptable. It could also be that they were happy to prolong the existing, comfortable status quo and were seeking to prolong as much as possible existing barriers to entry into their national markets. It is also easier to deal with just one, large supplier.

A 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. It has been very difficult to promote competition within such a balanced market.

In fact the only real success has been in the UK, 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 at the NBP. Legacy long term contracts lived on, but new long term contracts have become shorter in length and generally indexed against traded gas markets. Much of the new import infrastructure has been funded without assured gas supply contracts, so much so that concerns have been expressed by National Grid, in relation to the winter of 2006/7, that the capacity will not be fully used, either because of price competition or constraints elsewhere in the system.

The role of trading "hubs"

Many European traders are now trading at the NBP, as well as at Zeebrugge and the TTF, partly to gain experience of trading, and partly to gain or consolidate footholds in the north-western European market. One question that would be interesting to ask them all is whether the trading hubs are giving them what they want. Short term trades are clearly already available to the wider European audience but, and this is relevant to the debate about long term contracts, the NBP suffers from a relative thinness of forward trading. Most of this trading is done by intermediaries, with the result that there is high volatility and higher forward prices currently than might otherwise be the case. It has been suggested that one of the reasons for this thinness is the reluctance of UK producers to conclude long term contracts or participate in the forward markets.

The reasons for this have been widely debated and various excuses have been offered. The major one is assumed to be that producers could be exposed if they fail to deliver, and would then have to fulfil contracts by buying on the NBP at very high prices. This is important because a lot of UK gas sales contracts to all but the largest Industrial and Commercial users are set with reference to forward prices.

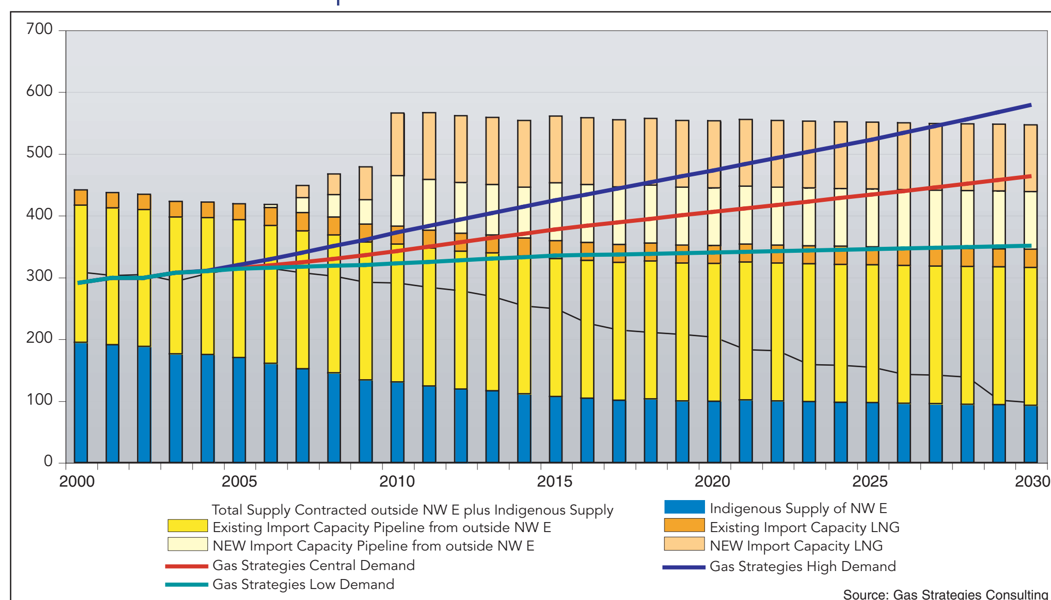
One response to such uncertainty is that it takes time for a hub to develop and that European hubs are still a long way from being comparable with the sophisticated trading that takes place in North America. It is estimated that less than 10% of final demand is bought under contracts of more than 5 years 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. Another factor is that whilst the European systems are physically interconnected, it is still difficult for independent traders at hubs to move gas between these systems.

Impact of alternative suppliers

What could be the catalyst for a North American pattern to emerge in Europe? If we assume that there are many purchasers looking for gas at lower than current prices, but with supply security, the missing link is pressure on suppliers from alternative supplies at lower prices.

Such a scenario seems now to be possible. **Figure 1 below** illustrates the potential for European over-supply led by LNG import projects all round the coasts of Europe, and new pipeline proposals, including those from Algeria to Spain and Italy, NEGP, Nabucco, and others involving gas flowing through Turkey westwards.

Figure 1 - Outlook for Supply Capacity, Contracted Supply and Demand in NW Europe



long term contract price clauses – price re-openers are a standard feature of Continental European contracts.

Where could this lead? Perhaps towards gas- rather than oil-indexation, greater use of a flexible market, and a redefinition of "long term" to mean only 5 to 10 years, and "medium term" to mean 1 to 5 years.

We must of course be careful to distinguish a surplus of capacity from a surplus of gas. The projects listed above are for capacity, and do not represent 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 prices and make room for trading at lower prices.

If the possibility of oversupply does hit Western Europe there will inevitably be pressure from energy users not to renew or extend existing long term contracts, and maybe to renegotiate existing

Conclusion

But even if a supply surplus emerges, an important question is whether customers will expect it to last. A short term gas bubble may not be enough to encourage buyers to leave their long term contracts, but it may be enough to encourage them to venture more deeply into the traded gas markets. No-one wants or expects long term contracts to disappear – they still play a role in North America – but they may be transformed beyond recognition. And 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 under the new definition.

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