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Gas Buyers Seek End of Europe’s Two-Tier Pricing: Energy Markets
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By Ben Farey and Nicholas Comfort

Feb. 16 (Bloomberg) -- The biggest difference between natural gas and crude oil prices in eight months is fanning calls by Europe’s largest power producers to scrap the almost 40-year-old system for setting their fuel costs.

E.ON AG, Germany’s biggest gas importer, asked suppliers last year to sell it fuel at spot-market rates rather than at prices tied to oil products, two people with knowledge of the matter said this week. GDF Suez SA, operator of Europe’s largest natural-gas network, said in September it was negotiating a stronger link to spot prices for long-term purchases. North Sea Brent crude costs $55 a barrel more than U.K. gas, the most since May 3, according to data compiled by Bloomberg.

Gas buyers on mainland Europe buy about two-thirds of their fuel under long-term contracts, a formula that’s driven up their costs after Brent crude rallied 9 percent this year to a 28- month high. By contrast, U.K. consumers can purchase gas at cheaper spot-market prices, which have fallen 15 percent.

“If E.ON is pushing for 100 percent spot indexation it suggests they believe the entire European market is moving to a fully liberalized structure as already exists in Britain and North America,” said Patrick Heren, a London-based consultant who founded Heren Energy Ltd., the European price-information service bought by Reed Business Information Ltd. to form ICIS Heren.

Oil-Linked Contracts

The contracts are often pegged to gasoil or fuel oil prices with a three-to-six month time lag, rather than crude, in a method that dates back to the 1970s, when oil-based fuels were more commonly used in power generation. Spot gas prices have fallen 40 percent from their 2008 peak as industrial demand collapsed during the global financial crisis and U.S. and Middle Eastern supply rose.

E.ON is in talks with all its suppliers over adapting long- term contracts to the “current market situation,” Kai Krischnak, a spokesman for E.ON Ruhrgas, the company’s Essen- based gas unit, said yesterday. He declined to comment on contract details or the timing of the talks.

Moscow-based OAO Gazprom, the world’s biggest producer, agreed last year with companies such as E.ON, Wingas GmbH, GDF Suez, Eni SpA to reduce prices by including more spot fuel and delaying some contracted volumes to a later period, the Russian company said in a quarterly earnings report on Feb. 14.

Arbitration Confidence

The company reached agreements with E.ON, Eni and GDF Suez on their requests for reconsidering price formulas, Deputy Chief Executive Officer Alexander Medvedev said in November. The deals will last for three years, he said.

“A number of our key customers used their right to renegotiate prices at the beginning of last year,” Medvedev said at an investor meeting in London yesterday. “If it does come to arbitration proceedings, we are pretty confident.”

As much as 67 percent of gas on mainland Europe was sold under oil-linked contracts last year, Societe Generale SA said in a Feb. 2 report. Prices in the U.K.’s National Balancing Point market are determined by supply and demand, without any direct link to oil.

North Sea Brent crude oil settled at $101.64 a barrel on the ICE Futures Europe exchange in London yesterday. U.K. natural gas closed at 52.89 pence a therm, or $48.45 a barrel when converted into similar units.

‘Increasingly Untenable’

“A rising oil price makes things very rapidly increasingly untenable” for consumers with oil-linked contracts, Jonathan Stern, director of gas research at the Oxford Institute for Energy Studies, said in a phone interview from Oxford, England.

E.ON Ruhrgas sold 20.6 billion euros ($27.9 billion) of the fuel in 2009, or about 58 billion cubic meters, according to its website. That’s more gas than India used that year, according to BP Plc’s Statistical Review of World Energy.

While purchases based solely on U.K. gas futures would have averaged $6.40 a million British thermal units last year, the cost for buyers of Gazprom’s contract gas was $8.60 a million Btu in 2010, according to data from Sanford C. Bernstein & Co.

The world’s gas “glut” may exceed 200 billion cubic meters this year, up from 130 billion in 2010, the International Energy Agency, an adviser to developed nations, said in November. The Paris-based agency defines the glut as the capacity of inter-regional pipelines and liquefied-gas export plants minus the volume of gas traded.

Deferred Deliveries

About 5 billion cubic meters of pre-paid Russian gas is weighing on spot prices because customers have deferred delivery to a later date, said Thierry Bros, a senior analyst at Societe Generale SA. The oil link will be preserved and utilities will “suck up their losses” before the market returns to balance by the middle of the decade, he said in London yesterday.

E.ON “didn’t share the money with their customers or with Gazprom when oil-indexed contracts were out of the money” in 2005-2007. At that time, lower oil prices cut gas costs to utilities that bought supplies under multiyear contracts, Bros said.

For Heren, E.ON and other companies are faced with the dilemma of buying gas at a higher price than they can pass on to consumers amid competition from liquefied natural gas shipments and U.K. supplies priced in the free market.

E.ON “cannot support an ineffective two-tier pricing system,” he said. “With the changes in the European energy marketplace it recognizes that it cannot purchase gas on an oil- indexed basis which it will then have to sell on a gas index.”

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