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Energy Union: Can Europe learn from Japan's joint gas purchasing?

Fabio Genoese, Anna Dimitrova & Christian Egenhofer

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Japan's two major electricity producing companies, *Tokyo Electric Power Co. (TEPCO)* and *Chubu Electric Power Co. (CEPCO)* reached a preliminary agreement on 7 October 2014 to establish a joint venture for the procurement of fossil fuel resources, primarily liquefied natural gas (LNG). The new firm, expected to become operational in March 2015, will be the largest private purchaser to enter the emerging global LNG market, with a projected annual demand of about 54 bcm of LNG, or the equivalent of Italy's imports for 2012. Other regional LNG consumers seem to see merit in this approach, too. Singapore's *Pavilion Energy* has already expressed interest in collaborating with the two firms on LNG purchases.

This strategic move seeks to mitigate the high costs borne by Japanese electricity companies since the Fukushima crisis, when they were pressed to replace nuclear with gas-fired power stations (Natali, 2014). To date, Asian markets provide the most lucrative business opportunities to LNG exporters, with Japanese consumers purchasing LNG at the highest prices. Japan's average LNG import price in October 2014 amounted to €501 per thousand cubic meters, whereas the average import border price for the EU for that period was €275 per thousand cubic meters.[1] Moreover, Japan aims to exploit the anticipated surge of LNG supply through seeking a quantity discount on the future global gas market from current and emerging LNG exporters, such as the US and Australia.

What can Europe learn from this? Could this commercial initiative be an example of how to increase the negotiating power of individual EU member states towards Russia and *Gazprom*? Could it become part of current Vice-President for Energy Union Maroš Šefčovič's "step-by-step approach to the common purchasing of gas"?

Even before the Energy Union proposed by former Polish Prime Minister and now Council President Donald Tusk, a mechanism for collective gas purchasing to enhance the EU's energy resilience had been suggested.

Enhancing bargaining power through centralised purchasing is a well-established practice in large companies and in public procurement. It is seen as a successful means of reducing procurement costs. Given that Russian gas import prices in Central and Eastern Europe (Baltic states and Finland included) are on average 10-13% higher than in countries farther

[1] $17.77 per mm Btu and $9.77 per mm Btu, respectively (World Bank 2014).

Fabio Genoese is Research Fellow at CEPS, Anna Dimitrova is a CEPS Research Assistant, and Christian Egenhofer is Senior Fellow, Head of the Energy and Climate programme at CEPS.

west,[2] these member states have shown interest in a centralised gas purchasing mechanism. Joint procurement could well be a regional solution to address this issue of higher import prices.

Rather than a publicly governed purchasing agency, Japanese companies have opted for a private solution. Whether such a solution makes sense in principle – also for those EU member states experiencing unfavourable contractual relations with natural gas producers – depends on the following:

1. Would a joint company be able to accumulate a substantial amount of natural gas demand?
2. Would all companies participating in the joint procurement experience cost reductions on their purchases?
3. Is collective purchasing practically feasible in the near future, given existing long-term contracts and the resulting reserved transmission capacity?

The answer to the first question is Yes. Currently, Central and Eastern European member states (including the Baltic states and Finland) import some 52 bcm of natural gas from Russia, compared to 54 bcm in Japan's case. This amount corresponds to a trade value of approximately €16.4 billion (BP, 2014). But what matters more is the relative impact: a joint agency for ten countries would on average buy ten times the volume of each country individually.

At present, Central and Eastern European member states pay a price premium of about €40 per thousand cubic meters compared to countries farther west, where transport costs should be higher. The possibility of converging gas import prices may in itself provide the economic impetus to seek delivery discounts through purchasing larger quantities jointly. Determining the price effect of this procurement company is a highly speculative process. Currently, most of the imported gas is traded under long-term contracts, in which the importer takes the volume risk, i.e. commits to purchase a certain amount of gas per year for a period of, for example, 20 years. Prices are typically indexed to other commodities such as oil. However, long-term contracts contain clauses to renegotiate the price indexation formula within certain limits at regular intervals (so-called 'annual contract reviews').

It could be argued that the procurement company would allow relative gains for participating firms by providing price (re-)negotiation leverage. Moreover, purchased quantities could be rerouted within the group of participating firms to hedge the volume risk. The existence of the joint procurement company would enhance the bargaining power of participating firms when reviewing existing or agreeing on new contractual terms. Furthermore, by jointly procuring, firms operating in Central and Eastern Europe would be able to effectively compete with the larger buyers in Western Europe.

As for practical feasibility, much depends on the exact expiry date of existing long-term contracts with *Gazprom* and the construction of infrastructure to ensure the necessary interconnections between Central and Eastern European member states. Based on pre-crisis gas demand projections, the majority of contracts in Central and Eastern European member states would have expired in the next ten years. However, given a drop in demand and 'take-or-pay' clauses in natural gas contracts, some volumes have been banked and shifted to subsequent years.[3] Without considering these delays, the total quantity of gas imports

[2] Unweighted average prices in Germany, France, Italy and Austria are compared to those in Central and Eastern Europe, including the Baltic states and Finland (European Commission, 2014).

[3] Due to this 'make-up gas', the actual expiry date of these existing long-term contracts might be later than originally anticipated; effectively blocking existing interconnector capacity for this period.

already contracted to Central and Eastern Europe by *Gazprom* could decrease by 12 bcm by 2018 and an additional 17 bcm by 2025 (BP, 2014; EU, 2014). The joint gas purchasing company would thus gradually expand, with companies joining it upon the expiry of their import contracts.

The very existence of the company would also improve the bargaining position of firms with contracts expiring after 2025. It might create the opportunity to negotiate better contractual terms during annual contract reviews, mirroring the way Lithuanian *Litgas* renegotiated its price formula on *Gazprom* deliveries in light of the LNG terminal 'Independence' located near Klaipeda. According to Bloomberg News,[4] Lithuania received a 23% price reduction from *Gazprom* following the construction of the terminal. Before that, Lithuanian prices for Russian gas were 36% higher than the German border price (European Commission, 2014).

The Lithuania example suggests that sizeable gains might be available rather quickly, even if formally most imports remain governed by long-term contracts for another decade. Even at half the gain for Lithuania, say 10%, the overall gain could be as great as €1.6 billion per year.

A Central and Eastern European joint-purchasing company comparable to the one planned by the two Japanese utilities could be a market solution to the energy import dependency and resulting price concerns of EU member states in Central and Eastern Europe. Jointly procuring the volume of natural gas consumed in Central and Eastern Europe would result in higher security of demand for gas producers. A further advantage is that this kind of joint purchasing can easily be combined with other measures to increase leverage for EU member states, such as building LNG terminals or further gas interconnections. As European gas supply becomes increasingly politicised, a private joint gas procurement company may offer a solution – instead of yet another source of confrontation. Given the political volatility in the region, it could well be the key to balancing out the need for security of supply with an offer to guarantee security of demand, thereby creating the climate for stable commercial relations.

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[4] Of 27 October 2014.