The European Commission against Gazprom: Should Gas Contracting Arrangement Be Changed?

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This policy brief discusses EC's claim that Gazprom abuses its dominant position. I argue that parts of the claim, like denying Third Party Access, are warranted but others related to the contracts offered by Gazprom to different Member States need not be. In fact, major market players in Europe offer similar contracting forms. In this case, the literature on the competitive effect of long-term supply contracts have stressed that such effect depends on the exact contract arrangement. For example, offering multi-years contract may indeed increase the competition on one part of the market. Having a gas supply contract with a price fully linked to the price of a gas hub may on the other hand reduce the competition among big gas suppliers. Hence, the assessment of Gazprom's abuse of dominant position should be based on a careful analysis of the many contracting forms that have been agreed between Gazprom and customers in the Member States.

On the 4th of September 2012, the European Commission (EC) opened a proceeding against Gazprom, investigating whether Gazprom has abused its dominant market position in Central and Eastern Europe's gas supply[1]. The allegation relies on two different points. First, Gazprom has been accused of denying access to its network pipeline when requested by competing gas supplier. Second, the contractual arrangement offered by Gazprom itself has been under scrutiny. A Gazprom contract usually includes a "destination clause", that forbids any gas reselling by the buyer. Moreover, the typical Gazprom contract usually specifies a fixed quantity (with a take or pay clause) at a price indexed to the oil price[2].

The objective of this policy brief is to discuss the EC's claim of Gazprom's abuse of dominant position. I argue that while the denial of Third Party Access appears as an obvious case of abuse of dominant position, the contractual arrangements offered by Gazprom need not be.

Characterization of Gazprom's Abuse of Dominant Position

Denying access to Gazprom's pipelines limits competition and thereby benefits Gazprom as controlling a pipeline constitutes a natural monopoly. This fact has been recognized for a

[1] See http://europa.eu/rapid/press-release_IP-12-937_en.htm?locale=en

[2] See Sartori, 2013 for a more extensive description of the EC's proceeding.

long time with the requirement for a third party access to gas networks in the EU Gas Directive (Directive 2009/73/EC). The first part of the proceeding thus seems to be justified.

The EC proceeding also found that the contractual arrangements offered by Gazprom reflected an abuse of dominant position. The claim is that Gazprom locked in its customers. When signing a contract with Gazprom, buyers agreed on a fixed quantity irrespective of their "real" consumption ("take or pay" clause) and are not allowed to resale ex post excess quantity on the market ("destination clause"). Given that gas contracts usually are signed for many years, the lock-in period can be long. Moreover, the price of the gas contract is usually pegged to the oil price so that it reflects current supply and demand conditions for oil rather than for gas. One implication is that the contracted gas prices did not reflect the severe drop in the gas market price in 2008 (BP report, 2012).

The EC's allegation that Gazprom has abused its dominant position is thus based not only on the fact that Gazprom is denying third party access to its pipelines but also on the long term contracts with a fixed quantity and an oil indexed price.

Next, I argue that the second part of the claim is questionable. Forcing Gazprom to propose contracts with flexible quantities, shorter contract lengths and no indexation to the oil price may not limit the abuse of Gazprom's dominance. Depending on the exact contract arrangement (quantity, duration, and indexation), the abuse of dominant position could be more or less severe.

Contract Arrangement and Market Competition

It is important to stress that the major gas suppliers of Europe, like Sonatrach or Statoil, offer similar contract arrangements. So, are long-term supply contract arrangements pro or anticompetitive given that all major competitors use such contracts? The answer to this question typically depends on the contractual details. In what follows, I discuss briefly when contracts provided by major market players could alleviate the abuse of dominant position.

It has been shown that firms may have less incentive to exercise market power, if they have large contract positions (e.g. Allaz and Vila, 1993). Intuitively, a firm obtains a leadership position by selling contracts before going on the spot market. Motivated by this opportunity, all players participate in the contract market and as a consequence compete more aggressively overall. Offering long-term supply contracts may therefore enhance competition among gas suppliers.

The competitive effect of long-term supply contract may not always be present when suppliers and buyers repeatedly sign contracts. In a dynamic setup, it has been shown that allowing contracting for major players may reduce competition. Contracting could be used to reduce demand elasticity by increasing spot market exposure (e.g. Mahenc and Salanié, 2004). Contracting could also increase the likelihood and severity of collusion (Ferreira, 2003; Le Coq, 2004; Liski and Montero, 2006). The reason is that a collusive agreement is easier to sustain in a dynamic setup if firms offer contracts. A collusive strategy is sustainable provided that firms have no incentives to cheat, i.e. the repeated collusive profits exceed the immediate profit from the deviation and the price war following defection. The short run gains from cheating are reduced if all firms have signed contracts as the defecting firm will not capture the demand already covered by competitors' contract sales. Compared to the case with no contracts, this reduces the gains from defection without changing the punishment path, and therefore makes collusion easier to sustain. In a dynamic setup, offering contracts may therefore increase the likelihood of collusion.

Green and Le Coq (2010) have shown, however, that the anti-competitive effect of contracts depends on their duration. The longer the contracts last, the more difficult it is to sustain collusion. Intuitively, a deviation from the collusive agreement will trigger punishments, which depend on the contract duration. The longer the contract lasts, the smaller would be the punishment profit, which would increase the incentive to deviate.

The contract price's format also matters when estimating the anti-competitive effect of any contract arrangement. The stronger the degree of indexation to the spot price the easier it is to sustain collusion (Le Coq, 2013). In particular, if a contract price would be fully indexed on a gas spot (hub) price, irrespective of the contract's duration, it is always easier to collude. The intuition underlying this result is two-fold.

First, given that the contracted quantities are not traded in the spot market, contracts reduce the size of the market that a deviator can serve when undercutting the rival's price. Second, given that the contract's price equals the spot price, the contract does not affect profit levels in the punishment phase. Consequently, profits in the punishment phase can be driven down to zero just as in the case when there is no contract market. Moreover, contracts with others forms of indexation have the same qualitative effects, provided that the indexation to the spot price is sufficiently strong. Interestingly, with full indexation, the anti-competitive effect of supply contract holds even if contracted quantities are flexible (can be renegotiated).

To conclude, changing the contract arrangement between Gazprom and European customers may not alleviate the abuse of Gazprom's dominant position. A detailed analysis of the (many) contract arrangements offered by Gazprom needs to be conduct first to be able to make such claim.

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