# The geopolitical crisis may trigger changes in energy strategies

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### Gas: the game of two halves

Whatever the eventual geopolitical consequences of the Ukraine–Russia crisis, it has already had a significant impact on the way both gas producers and their customers plan their respective futures. The event has been the catalyst for an intensifying debate over energy security – not just regionally between Europe and Russia but globally – and it is expected to eventually change the way gas is sold and transported. It is not that the crisis has thrown up any new issues or risks; most of the topics now grabbing energy market headlines have been known or subject to negotiation for years. But the events of the last few months do at least seem to have injected a greater sense of urgency to 'get on with it'. Europe was not particularly concerned that 30 per cent of its gas came from Russia and Moscow voiced no worries than 80 per cent of its gas export revenues came from European customers. Now both are very focused on the concentration of risk and the contagion is spreading to others in a similar supply or customer dependency situation. Projects to rectify perceived supply and customer risk are likely to proceed at a faster pace than was expected only six months ago.

To some extent the gas industry is now facing the proverbial game of two halves. The producers have the upper hand in the first half as supply sources are limited – justifying them in building more infrastructure to supply existing and new customers, But the second half – coming into the next decade – may be quite different if all of the planned infrastructure spending is completed. Then the pricing power may quickly shift to the customer side.

The European wish list is for more LNG loading facilities, more pipelines from anywhere other than Russia, and a big move into shale gas production. The Russian wish list is to build more pipes to Asian customers and to take a bigger share of the global LNG market by building more processing plants and commissioning more LNG tankers and ice-breakers to take the gas across the Arctic route. Several of these projects have already been approved since the start of the Ukraine dispute. The Asian buyers, especially the Chinese, are happy to build pipelines (so long as they are exclusive to them) and LNG terminals, as that will give them a more secure supply mix. A greater choice of sources and delivery mechanisms also potentially allows China a more favourable position in terms of pricing in the next decade. The Caspian countries, including Iran, think that they are also finally in a very favourable position as a source of new gas to Europe and Asia, while Turkey's location has already made it a critical part of the energy corridor between Russian/Caspian sources and western consumers. That will definitely increase its bargaining power with Europe in the years ahead.

### Rush to supply demand for gas

The clear risk of this expected, and uncoordinated, rush to add more supply sources and infrastructure is that there will be a glut of gas looking for customers in five to seven years, together with a very high risk of competitive pricing which will, with the benefit of hindsight, severely undermine the viability of current and expected investment projects. In other words, investors are either taking an optimistic view of long-term price trends to justify current spending, or governments are deliberately taking decisions rooted in a political, rather than an economic, bias. Supply and price worries may actually help curb some enthusiasm for new mega projects in the industry and then moderate any price pressures later. But in the current politically charged climate – made even worse following the Malaysian Airliner tragedy in East Ukraine – there is no evidence of the sort of consultation required between the major producers to craft a more viable plan to better balance future supply and to protect pricing power. It is a case of 'build, baby, build' and the customers have every incentive to encourage it.

### Oil and other energy sources

The oil industry is rather more straightforward, even if forecasting the oil price is still guesswork most of the time. But relationships between suppliers and customers in the industry are well developed, and future pressure points are also relatively better understood. The nuclear industry is likely to remain under pressure and the industry will almost certainly lose global market share as opposition grows in Europe, although Japanese reactors are expected to re-start after safety modifications. Amongst the renewable energy sources, solar is by far the most promising and, with the expected advances in technology, should become a more commercially viable and reliable part of the energy mix coming into the next decade. Still, the global demand for gas is expected to grow steadily, as both overall energy demand rises and usage of coal, timber, and other polluting fuels is reduced. The problem is that if all the potential supply sources, together with the announced development plans for shale, for LNG, and for new pipelines, are aggregated, a supply surge is created which will be greater than the expected growth in user demand.

### Power shifts in supply–demand balance

GAS-OPEC was a good initiative but it failed, not least because of the surge in US shale gas production and the expected growth in US LNG exports over the next decade. US producers would never work within any structure resembling a cartel so, in the meantime, there is no incentive for other gas producers to do anything other than to try and grab market share and long-term supply contracts, preferably with fixed pipeline links. It is a strategy which all producers will inevitably regret, as major customers will have the choice between LNG or pipeline volumes and the deciding factor will be price. Hence it is in the best, longer-term, interest of the consumer countries to encourage more LNG spending and more pipelines from Russia, central Asia, Iran, and other gas locations. Typically it is the supplier country which bears the bulk of the capital investment, and even when the customer country pays for a large part of the pipe (for example, China's 7,000 km pipe from Turkmenistan) the price formula reflects a payback for that cost over time. So, in reality, it is the suppliers who are taking a huge risk in the gas market and while that looks very attractive today, and over the medium term, the game will change coming into the next decade.

### Pipeline and LNG

First, let's look at planned new pipelines. South Stream will get built despite objections from Brussels. That is because over the first half of the energy game it represents supply security for those countries connected to it. They have all learned the lesson from Germany that the energy risk is not from Russia but from the transit route across Ukraine. Completing the exclusive Nord Stream link from Russia into Germany made South Stream, with an eventual capacity of 60 bcm, inevitable. The existing trans-Ukraine pipe will remain in place and be available both for Russian gas transit and for possible new supply from Caspian sources and Iran in the future. Meanwhile, the TAP and TANAP pipes are under construction and will deliver about 15 bcm of Azeri gas to Europe in 2018 under phase 1. Phase 2 is likely to depend on gas from Iran, and that prospect is no longer fanciful, as western countries adapt to the latest shifts in Middle East politics. It is possible that even Nabucco could get gas from Iran eventually, although this is still more likely next decade.

China and India are trying to tie up gas from the eastern side of the Caspian. China recently signed a deal with Turkmenistan to more than double its current 25 bcm import deal by 2020, while India is pushing the TAPI pipe to bring gas across Afghanistan and Pakistan. China currently only imports 50 bcm of gas annually so the expanded pipe will cover all of that, while the recently signed deal to import almost 40 bcm of gas from Russia, with an allowance to increase that in the future, should cover much of its increased demand growth. Japan has talked for years about a direct gas link to Sakhalin, and this is expected to be one of the issues on the table at the next summit between the two countries, possibly later this year. Russia's recent decision to cancel $10 bn of North Korean debt was, reportedly, on condition that Pyongyang removes any objection to the building of a gas pipe to the South. What all this means is that projections of rising demand for LNG from these three big consumers may not be as large as previously expected and, unless regional demand for gas surges way beyond current projections, customers will certainly be the ones dictating both the price and the choice of import route.

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That's why it doesn't make sense for the EU Commission to try and block the South Stream pipe. If that new pipe is built to full capacity and the EU works with Ukraine to upgrade the existing transit pipe to take in gas from the Caspian and, later, Iran, it is very likely that there will be an excess supply of gas coming into the European market in about five or six years, especially if the current projections for LNG supply, and even some shale production forecasts, are realized. The only valid reason for the Commission to fear an increase in Russian dependency would be if other energy sources failed or if other gas routes were not developed. As it stands, it is Gazprom which is taking the greater gamble as it is running the risk of competing in a crowded market and of eventually having to compromise on price.

Certainly Gazprom is hoping that having a fixed gas line into as many countries as possible will both help it keep its current market share in an expanding market and also to enable it to get a better price than might be available if it were to sell in the spot market. The theory being that the fixed pipeline binds the customer just as much as the supplier as it deteriorates the economics of alternative sources for the customer, especially in the short to medium term.

### New sources of gas

Such arrangements could be fine for several years, but if there are other viable sources offering cheaper long-term gas supplies (such as Iran, LNG, or shale) then the economics change with a longer time-line. Building huge extra supply capacity to Europe, while ignoring potential competitive supply sources and routes, is a dangerous game for Gazprom. Equally, blocking any new pipelines into Europe is a short-sighted strategy for the Commission. One of the main reasons for the robust revival in the US economy since 2009 has been the plentiful supply of cheap energy. In the USA, this has mainly come from shale gas. Europe is most unlikely to be in a position to replicate the US experience, because of the density of populations and the much more active environmental lobby groups. But Europe may replicate the cheap energy conditions by allowing as many pipeline routes as suppliers wish to build. The pipeline builders and suppliers are the ones taking the medium- to long-term risks. Not the customers.

## Future control over gas markets: suppliers or consumers?

The cross-border gas industry is relatively new and small, relative to the oil markets. But it is going to be substantially bigger and more valuable coming into the next decade. As previously mentioned, there was a short-lived attempt to coordinate the development of the industry, at least from the supply side, several years ago. That opportunity has now passed and we seem to be entering some sort of a free-for-all in terms of supply. The Chinese and other Asian countries understand this and are encouraging or funding as many supply routes as possible. They know that this will both enhance supply security and give them pricing power in the years ahead, as supply volumes increase from a large number of sources. Both the EU Commission and Gazprom, from different perspectives, are allowing political motives to cloud their strategic view. The Ukraine–Russia conflict has only served to add more political emotion into the debate and further crowd out economic pragmatism. One of these parties will live to regret decisions they are making today.