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RESEARCH NOTE

What's at Stake with the Nord Stream 2 Pipeline? A Perspective on European Gas Prices

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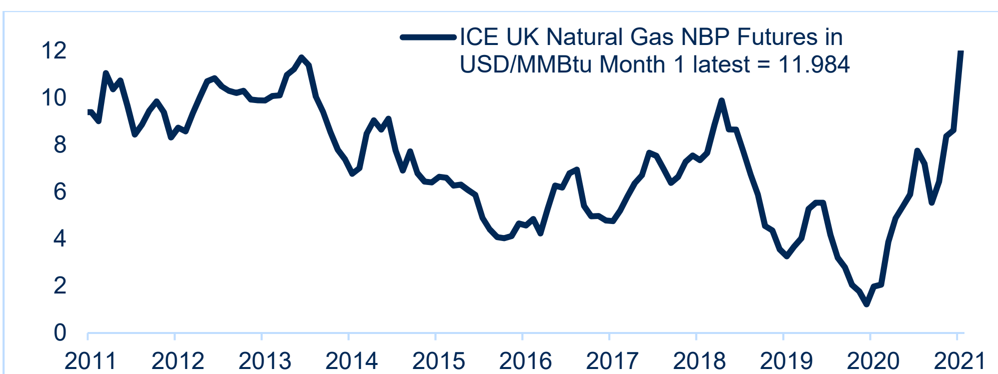
GLOBAL EQUITIES

Natural gas can be consumed either in its natural form or as a liquid. The former travels in a pipeline and the latter on ships (a liquefaction process can transform gas under extremely cold temperatures of -600 C). The ease of transporting Liquefied Natural Gas (LNG) allows a greater number of countries to utilize natural gas and provides a balance of negotiating power between suppliers and consumers, as the number of suppliers available to any one country increases. Natural gas is sold based on contracts, terms of which are usually between five and 12 months, where volume is guaranteed and the pricing formula was traditionally linked to the price of crude. However, as the spot market continues to grow to ~30% of the LNG market, the pricing formula has continued to evolve. Europe's natural gas consumption has been stable at approximately 500 billion cubic meters (bcm) per annum, but fluctuating temperatures in the winter and summer months can create a surplus or a deficit in supply in any given year.



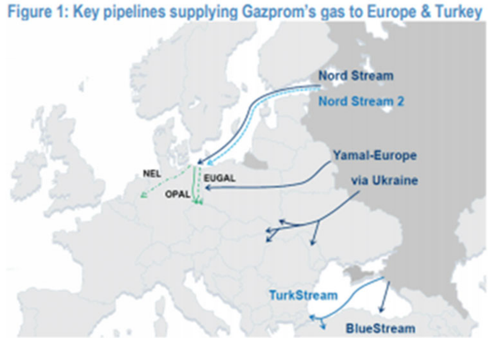
Soure: Bloomberg. As of July 2021.

Europe has increased the share of LNG in total gas imports to approximately 45%, but LNG spot prices can be volatile during periods of high demand as volumes are redirected to the highest bidder, as is currently the case in Asia. Pipeline gas volumes are captive, but the wrangling on the price and additional volumes has historically been a political issue as much as an economic one between most consumers and suppliers.

What is at stake with Nord Stream 2, and why?

Europe's largest supplier is Russia, with Gazprom, a Russian majority state-owned multinational energy corporation, providing 40% of total gas through a number of pipelines. Pipeline gas is sourced from three other countries, two of which have falling production (Netherlands and Norway), and the third, Algeria, contributes less than 10% of the total. Despite Europe's less-than-reliable relationship with Russia, the country offers the most operationally reliable and abundant source of natural gas.

Figure 1: Key pipelines supplying Gazprom's gas to Europe & Turkey



Source: Gazprom. J.P. Morgan.

Gazprom exports 200bcm annually to Europe, including Turkey and the U.K., via five different pipelines. The most politically contentious volume is the 40bcm that moves through Ukraine, via the Brotherhood pipeline, which is contracted until 2024. This pipeline serves as one of the largest sources of revenue for the Ukrainian government, and the government has naturally pushed for higher volumes and fees, particularly during periods of high demand.

Nord Stream 2 (NS2) is Russia's attempt to bypass Ukraine's constant demands for higher revenues and politically weaken its government's bargaining power between Russia and NATO. NS2, if and when fully complete, will consist of two strings with a total capacity of 55bcm when complete that transports natural gas directly to Germany.

From a political perspective, NS2 ruffles many feathers. In Europe, the transit revenues are a form of subsidy from the EU to Ukraine that could be lost if Russia successfully increases export volumes via NS2. European countries with natural gas reserves, such as the Netherlands, or have a geographic advantage that allows them to import LNG, such as France, have been the most vocal opponents of NS2. Countries like Germany and Italy, which account for more than 25% of Gazprom's total exports, prefer a balanced approach between supporting Ukraine and reducing transportation costs. NS2 transportation costs are estimated to be $1/MMBtu lower than for volumes transported via Ukraine, which is a premium that is ultimately absorbed by the EU gas consumer.

U.S. Opposition to NS2

The U.S. government was a vocal opponent of NS2 when former President Donald Trump was in office. Current White House Press Secretary Jen Psaki stated that President Joe Biden believes NS2 is a bad deal for Europe; the U.S. argues that Europe can gain independence by replacing Russian gas with U.S. LNG, or "freedom gas." However, as Europe is currently learning, the mobility and flexibility of LNG is a double-edged sword, while the permanence of pipelines is a commitment to a long-term relationship that may not always be happy one.

U.S. natural gas production is not state managed, and any supply exported outside of existing contracts is landing in Asia, the highest bidder. Competing for this supply would require Europe to pay more.

The largest source of additional export volumes from the U.S. would be higher shale oil production (associated gas), but the industry has remained disciplined despite strong crude prices caused by OPEC+ policies. Economics will always supersede politics in a capitalist society, and therefore the U.S. oil industry will most likely continue to take a cautious approach to production growth as long as OPEC+ production policies remain unpredictable. The U.S. may thus not be a reliable source of natural gas if Europe were to avoid activating NS2, since U.S. LNG will come at a higher price during periods of strong demand.
Realpolitik

News surrounding NS2 will continue to be spun from different perspectives. President Biden has taken a pragmatic approach, since a resolution to the NS2 saga would allow the U.S. to gain support from Germany and Russia when dealing with political issues higher on his agenda, such as China and reviving Iran's nuclear deal.

The pipeline is now 98% complete, and the second string is scheduled to be completed in August. There is a high probability that the first string will be approved for use ahead of the upcoming winter season. Russia will then claim the completion and launch of this first string as a political win, while Western powers will point to the delay of the second string as a sign of discipline and a successful carrot-and-stick approach when dealing with the Kremlin.

Impact on Gas Prices

Use of NS2 in Europe would add to supply, and spot gas prices are unlikely to remain elevated at above $11/MMBtu. However, as with many commodities, the temporary imbalances could remain in place for longer than expected. Also, climate change policies in Europe maybe rebase prices higher. EU carbon credits have rallied this year, as the pace of switching from coal to gas in Europe's power generation industry has continued at steady pace. Natural gas is seen as a transition fuel that can bridge the gap between crude and renewable energy in the short term and is an enabler of hydrogen technology over the medium to long term. Higher supply by U.S. gas producers depends on whether crude prices remain above $55 or OPEC+ discipline crumbles. Finally, mild winters may help reduce demand.

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