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MACRO ADVISER: Russia has eager new oil and gas customers in Asia

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September 25, 2014

The main focus of Western sanctions against Russia has been to cause disruption to the banking and oil sectors. The former has directly squeezed the availability of liquidity on the domestic interbank market and raised the cost of capital for both consumers and business. That is a major contributory factor to the slowdown in the Russian economy since May. The sanctions against the oil sector are aimed at disrupting investment into new oil projects, which, if they remain in place for long enough, might result in a slowdown in the country's oil output in a few years rather than more immediately. For the US that move makes some sense, as its fast growth in oil and gas production means it may be a major exporter of hydrocarbons by the end of this decade and force Russian product out of some markets, which would open up sales opportunities.

For the EU, which is, and will remain, very dependent on imported energy, the attempt to disrupt future oil flows from Russia makes no sense. Neither does Brussels' effort to block the construction of the South Stream gas pipeline, which has a flow capacity of 60bn cubic metres (cm) and would allow Russian gas to be delivered to customers in the Balkans and Central Europe without having to transit the troublesome Ukraine transit pipeline system.

One of the basic tenets of economics is that the greater the supply relative to demand, the greater the likelihood of a lower price and the smaller the risk of shortages. The Chinese understand this and are rushing as fast as possible to build new oil and gas import pipelines, from Central Asia and Russia, in addition to the liquefied natural gas (LNG) loading facilities and investment into shale gas projects. Other Asian energy dependent countries, such as Japan and South Korea, are planning similar moves.

The reasons for Brussels opposition to South Stream and support for oil sector sanctions are very well understood; they stem from political emotionalism rather than economic pragmatism. But by early next decade the major Asian energy importers will have multiple supply options and, very likely, be in a strong position to get competitive prices. Europe, if it continues to block major new supply routes and actively tries to damage future energy supply from Russia, may find itself in the opposite position.

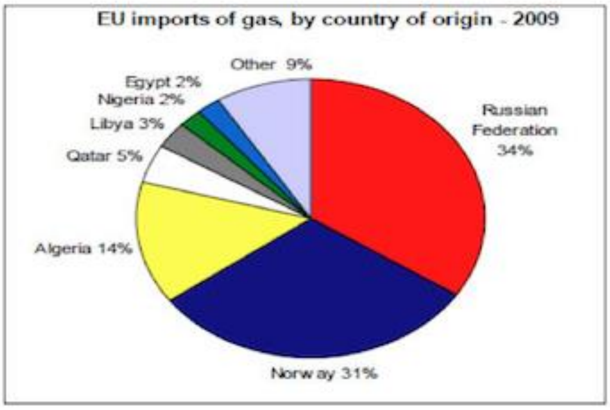
Sense of urgency

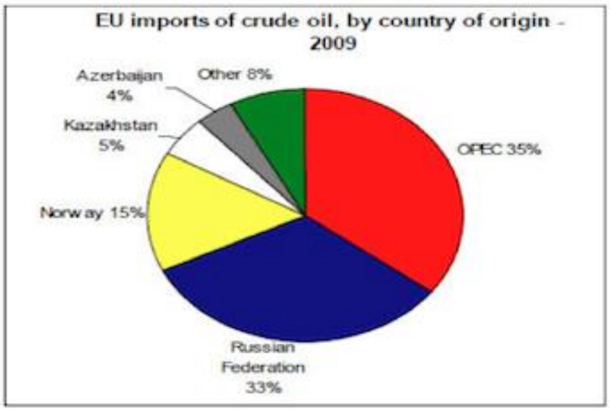
The Ukraine-Russia crisis, and the sanctions fallout, has already changed the way gas producers, in particular, and customers are planning their respective futures. It is not that the crisis has thrown up any new issues or risks; most of the topics now grabbing energy market headlines have been known 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". Previously Europe was not that bothered that 30% of its gas came from Russia and Moscow voiced no concern than 80% of its gas export revenues came from European customers. Now both are very focused on the concentration of risk and diversification has become the mantra across the energy world.

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, albeit the latter looks unrealistic given the greater environment sensitivities. The Russian wish list is to build more pipes to Asian customers and to eventually 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 because that will give them a more secure supply mix and a favourable position when it comes to price. The Caspian countries, including Iran, think they are also finally in a very favourable position as a source of new gas to Europe, although it is clear that the available supply from the Caspian is relatively modest while China has most of the Central Asian gas deposits already under contract. Iranian gas, which in any event will be a very long time before volumes increase and exports a realistic option, may also go the same way or to its energy hungry neighbour to the south, India.

The oil industry is rather more straightforward, even if forecasting supply shocks and the oil price is still guesswork most of the time. But taking actions, in the form of sanctions to block future new sources of oil, is a price-raising rather than a price-reducing strategy. The nuclear industry is likely to remain under pressure and while Japanese reactors are expected to restart after safety modifications, the industry will almost certainly lose global market share as opposition grows in Europe. 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 demand for gas is expected to grow steadily as both overall energy demand rises and usage of coal, timber and other pollutants is reduced.

EU imports of gas and crude by country of origin - 2009





Build and they will come

South Stream will eventually get built despite objections from Brussels. That is because 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 the transit route across Ukraine. Completing the exclusive Nord Stream link from Russia into Germany made South Stream inevitable. South Stream countries also understand economic reality and prefer that strategy to short-term political point scoring. The existing trans-Ukraine pipe will remain in place and available, if not for additional Russian gas, then new supply from Caspian sources and Iran via Azerbaijan and the Black Sea. Meantime, the Trans Adriatic Pipeline (TAP) and Turkey's TANAP pipelines are under construction and will deliver about 15bn cm of Azerbaijani gas to Europe in 2018 under phase 1. Where Phase 2 gas is to come from is yet to be determined.

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 25bn cm import deal by 2020 and India is pushing the TAPI pipe to bring gas across Afghanistan and Pakistan. China currently only imports 50bn cm of gas annually so the expanded pipe will cover all of that while the recently signed deal to import almost 40bn cm of gas from Russia, in phase 1, should cover a lot of increased demand growth. Japan has talked for years about a direct gas link to Sakhalin and, despite a delay because of sanctions sensitivities, this is expected to become a live issue in 2015. Russia's recent decision to cancel $10bn of North Korean debt was, reportedly, on the 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, the customers will certainly be the ones dictating the price and the choice of import route.

That’s why it doesn’t make sense for the European Commission to try and block the South Stream pipeline nor to try to disrupt future oil flows. Russia has options for new gas and oil exports to eager customers in Asia. Despite the hype of Caspian and, eventually, Iranian gas, these cannot substitute for the capacity of South Stream if that project were to be blocked. In that event, Europe would very likely be looking enviably at the cheap energy in Asia next decade much as it has been looking at how cheap energy has powered the revival in the US economy in recent years.

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