



## Nord Stream 2 – advantages outweigh risks in the new gas world

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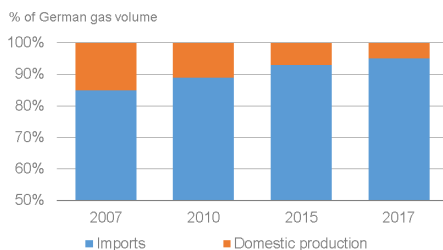
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### Germany's gas demand: imports increasingly important



Source: BDEW

The third and fourth pipeline strings for Russian gas transports through the Baltic Sea to Greifswald/Germany, which are also known under the term of “Nord Stream 2”, are now under construction, doubling the existing transit capacity of Nord Stream 1. The project continues to be highly controversial, given arguments that it might drive a wedge between the EU countries, the United States’ opposition and the risks it poses to the triangle of energy, environmental and security policies. That – also thanks to Germany’s initiative – Russian gas flows through the Ukraine look set to continue following the expiry of the old contracts in 2019 is a step forward and may foster acceptance of Nord Stream 2. In the face of the recent realignment of global gas trading, this would be in the interest of (nearly all) players.

On the surface, the main beneficiaries of Nord Stream 2 are the shareholder, Russian Gazprom, and the five western financial investors, Engie, OMV, Shell, Uniper and Wintershall. Aside from political considerations, the Baltic Sea pipelines are Russia’s response to conflicts with the current transit countries in particular, but not exclusively, the Ukraine, which basically result from different views regarding transit fees. Going forward, Nord Stream 2 will doubtlessly lower gas transport costs, thereby improving the balance sheet of the supplier. In the light of the recent sharp uptrend of oil prices, former oil-indexed pricing would be very profitable for Russia today, for the further benefit of the balance sheet.

Meanwhile, however, the Russian side can only realise market prices, due to the liberalisation of European gas markets and the liquefied natural gas (LNG) related integration of regional markets worldwide (alongside Europe, especially Asia, Australia and America). Should market prices for gas, whose marginal price is ultimately determined by competition for the final consumer, eventually drop to an extraordinarily low level in the new global gas world, Nord Stream 2 investors would suffer most; they are hence exposed to more risks than in the old gas days.

What is often overlooked in the Nord Stream 2 context is that Russia itself has been a supporter of more competition and diversification in gas distribution over the past years. In this regard, Nord Stream 2 is only one element. Russia is gradually breaking up the export monopoly of Gazprom. Thanks to the development of an efficient liquefied natural gas infrastructure, the production of LNG tankers that can also be operated in arctic regions, and the permission to domestic competitor Novatek to export LNG from the Yamal peninsula in



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Siberia's Arctic Sea, competition and - hopefully – also efficiency in Russian gas industry is increasing.

The announcement that Russia will continue to use the Ukraine as a transit country in future is put into a somewhat different perspective once greater significance is attached to the normative power of the factual. The capacities of Nord Stream 1 and 2 will hardly suffice to offset the still-looming total lapse of the Ukraine. Another factor playing a role is the Ukraine's abundant gas storage capacities. In a worst case scenario, there is a risk that these facilities may no longer be used. To date, however, they are essential to manage peak demand resp. transit in Europe in the winter.

Opponents of the project (such as gas supplier Norway and the other important East European transit countries alongside the Ukraine, namely Poland, Slovakia and the Baltic countries) argue that Nord Stream 2 will undermine supply security. The opposite is true, though. For more than 40 years, Russian gas supplies to Western Europe have been flowing uninterrupted, even in times of the Iron Curtain, which were as frosty at times as in the face of the EU/US conflict surrounding the Crimea. As the new gas transport affects only a limited number of countries, it is even more secure than in the recent past.

Contrary to fears of some critics, Nord Stream 2 will not lead to a gas market divide between Eastern and Western Europe. After completion of EUGAL 2020, up to 50 billion cubic metres of gas can be transported eastwards, from Greifswald via the Czech Republic, which will boost security there. Furthermore, Europe will be faced with a supply gap in the future, given the imminent decline in domestic gas production (e.g. in the Netherlands). The large Russian gas capacities and the pipes are ideally suited to make a significant contribution to closing this gap.

With respect to competition, an argument voiced by some critics is that Russia's market position could be excessively strengthened. This point, however, is no longer convincing, as the relevant market is meanwhile ripe for redefinition from a competitive standpoint. In the decades ahead, all major energy institutes (e.g. the IEA) expect global gas volumes and shares to rise across highly different regions. 19 countries worldwide are already exporting LNG. A wide variety of addresses such as Qatar, Indonesia, Australia, which is gaining in importance, and recently also the USA are putting the global gas markets into balance and enhance security of supply.

With the climate footprint disappointing of late, natural gas is becoming an attractive bridging energy, not only in Germany. Even in China, the focus is shifting to gas and massive investments are flowing into its energy transformation away from coal. In 2017, China's LNG imports soared by 46%. Europe ought to be pleased that it is facing less competition from the energy-hungry emerging markets in Asia, thanks to the Baltic Sea pipelines.



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It is sometimes argued that the reason behind the United States' opposition to Nord Stream 2 is not the stabilisation of the Ukraine but the economic interests of US gas industry. According to the rationale, gas prices in Europe are likely to rise if the pipeline is abandoned. For the US gas sector, this would have a two-fold benefit: Firstly, because LNG export revenues in Europe would go up and secondly, because less imports would be added to abundant supply in the US market, which would enable domestic gas companies to raise prices. As regards this argumentation, it is certainly correct that the United States is readjusting its energy policy and expects to be an energy superpower and a net energy exporter in the future. But the new global gas market has its own laws. Hence, future US LNG supplies to Europe will not be driven by Russia sanctions resp. the abandonment of Nord Stream 2, but by the laws of economics which are observed by all honest merchants. Going forward, the LNG US export infrastructure, which has undergone massive expansion in recent years, will be used for shipments to Europe, when the price spreads between the European trading markets (e.g. TTF, NBP) and the US Henry Hub point to reasonable yields (albeit inclusive of costs for liquefaction, long-distance transport and regasification).

Thanks to the imminent continuation of Russian gas transit through the Ukraine, which has always been a German condition for Nord Stream 2, future gas shipments to Europe will exceed volumes in 2017, which marked an all-time high in Russian gas exports to Europe. Led by large resp. rising volumes, margins in European gas trading will be put under pressure, which, in turn, ought to benefit the typical buyers of gas, namely consumers, industrial clients and operators of gas-fired power plants. For all those who are not on principle opposed to gas as a bridging energy, this should be good news. Let us hope that Russia will find its way back into the international community in future. Greater flexibility in the gas conflict is a first sign of hope.

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