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Geopolitics vs. Economics: Will North America Miss the Boat on LNG Exports?

James Brooks, RBAC, Inc., July 15, 2015

With the recent shale revolution in North America, the potential to become a world leader in supplying a reliable clean energy source has never been higher. US natural gas prices have hovered around \$2-\$4 while overseas markets have seen price ranges from \$9 to \$10 in Europe and \$13 to \$18 in Asia.

The opportunity to gain market share and capture enormous profits is very clear. However, there is a process that needs to take place in order to be able to deliver North American gas to those markets. The costs associated with building the necessary infrastructure and getting the necessary approvals is quite extensive.

At the World Gas Conference held in Paris, France in June 2015, the influences of geopolitics and economics were a prevailing theme. Dr. Robert Brooks, PhD., who spoke at the conference about the relationship between gas and power markets, indicated that “Europe is very worried about Putin’s ambitions as exemplified by the annexation of the Crimean Peninsula, a part of Ukraine, and the war in Eastern Ukraine. They are terrified that he will repeat these actions in other areas of Eastern Europe and Central Asia to establish a new Russian Empire. They combine this fear with their worries about climate change into a strategic decision against natural gas.”

Germany for example has decided to solve climate change by lavishly subsidizing non-carbon-emitting renewables such as wind and solar (yes, photovoltaics that far north!), at the same time phasing out non-carbon-emitting nuclear, to the point that 1) electricity costs skyrocketed for residential and commercial customers (but not industrial), and 2) they’ve been using locally produced coal and buying very cheap US coal to make up their electricity shortfall rather than buying more, much-less-carbon-emitting, natural gas from Russia or LNG exporting countries.

France, sitting on top of the likely largest shale deposit in Europe (the Paris basin), decided to ban fracking, including any exploratory wells which could be used to prove up the resource. Turkey, desperately needing more natural gas and badly desiring to become the new transit nation for Russian and Azeri gas, replacing Ukraine, can’t get any real traction in Europe, even though the Russians are also anxious to do this.

Russia takes the stand that they have reliably provided natural gas to Europe at negotiated prices since the 1970’s and will continue to do so into the future, so what’s the problem? Europe responds that Russia must liberalize its domestic market, not to mention get out of Ukraine, in order to play in Europe.

Russia is very upset that new EU rules (the “third package”) force them to set aside 50% of the capacity in new Gazprom pipes in Europe. This is part of the plan to establish a Europe-wide competitive market similar to that in North America. This affects utilization of Gazprom’s North Stream pipeline, which bypasses Ukraine, Poland, and the Baltic States, running underwater from Russia to Germany. It is operating less than full because it feeds into the new Opal Pipeline in Germany, 50% of which Europe requires to be available for third party access, which Russia doesn’t want to do. Russia has sought an exemption for Opal since 2013 but is not getting anywhere with their request.

Similar requirements and European opposition to Russia caused them to cancel the South Stream pipeline through Turkey and Bulgaria to Europe. But since they had already ordered the

Geopolitics vs. Economics

pipe and had contracts to build it, they created a similar new project called Turk Stream or Turkish Stream and are building it anyway, at least to the Turkey-Greece border. (Recently they got an agreement from Greece to continue into that country.)

Turkey wants to create a gas-trading hub, the Turkish Hub, similar to Henry Hub, for Europe and Eurasia. But where are the players? Russia and Azerbaijan? Israel and Cypress (offshore Mediterranean)? Maybe there is more than one supplier, but where are the customers?

Western Europe just doesn't want to play. Eastern Europe and the Baltic nations probably would, but they are either captives of Russian gas or worried about their status with the EU (and/or with Russia).

Going east many time zones, things are a bit different. China doesn't really care what Russia does with Ukraine or in Europe. They need energy and they need to diversify away from coal and have made some big deals for natural gas from Russia.

The first project, the Power of Siberia, is in service delivering gas from Eastern Siberia to China. The second one is quite different: it involves Russia's attempt to diversify away from Europe by tying Western Siberian gas to China. The main problem is that it is such a big undertaking that Russia could lose its shirt on it. China negotiates hard, maybe even harder than the Russians. They know that the Russians are a bit desperate and they know that they have a large shale gas resource themselves, so they don't have to cave to Russia on this project.

According to Dr. Brooks, "It seems like everyone is assuming that China is so worried about their coal-caused-pollution (not really CO2 emissions) that they are desperate for natural gas and will pay any price to get it. I think the reality is that the Chinese will bargain hard for pipeline gas and LNG imports but believe that these imports are only temporary necessities; eventually they will have plenty of shale gas to meet their long-term needs."

As for Japan and Korea, they also don't seem to be particularly ideological in their support of climate change initiatives, in spite of the first major conference's location in Kyoto these many years ago. They are both building coal-fired plants to take advantage of cheap Australian and American coal, even with higher capital costs, rather than solely building lower-carbon-emitting, but higher fuel cost natural gas power plants.

What does this all mean for North American gas exports? Have we missed the boat?

Until we have fully developed our exporting capabilities and are ready to deliver, we will not know the true market effects of global geopolitics on North American LNG exports. In order to play this game one must be able to identify the opportunities in any market condition. In order to do that, you need to model the many possible scenarios that can play out to position your company to capture global market shares and profits in this increasingly competitive market.

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