Close Calls and Cold Winters—The Ongoing Threat of Russia's Energy Weaponization

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KEY TAKEAWAYS:

1. Russia's Gazprom announced its intent to resume significantly reduced natural gas flows to Europe through its Nord Stream 1 pipeline. Russia stated that exports, already decreased by 60 percent, could see a further reduction of 20 percent by next week.

2. Russia may still ultimately move to shut off supplies in advance of the winter. In this worst-case scenario, Europe would face significant GDP loss by as much as 2.7 percent and could directly cost EU citizens upwards of $200 billion due to skyrocketing utility costs or governments intervening to save failing utilities.

3. Europe's energy crisis should be considered a serious threat to global economic growth. Containing the inevitable contractions within the EU single market, which accounts for 16.1 percent of international trade, will prove difficult, if not impossible, under current policy trends.

4. The Biden Administration should embrace the potential of American resources as a long-term strategy to underpin European energy security and remove regulatory barriers that foster market illiquidity.

Russia's Gazprom announced that it would restart supplies of natural gas through the Nord Stream 1 pipeline, spreading a momentary sigh of relief spread across the European continent. However, there's a catch. While natural gas supplies will continue, they are currently capped at 40 percent of total pipeline capacity, following Gazprom's steep reduction of 60 percent since early June. Moreover, Europe could see flows through this integral pipeline further reduced to a mere 20 percent following threats from President Putin. A more dire scenario also looms around the corner—Russia could take advantage of the current energy crisis and completely halt all exports of energy to the EU in advance of the winter season. It now falls to Europe to embark on a policy of energy sobriety, kicking off a lengthy and dangerous rehab from Russian energy supplies. Meeting the current energy crisis in Europe requires a fundamental change in the West's approach to energy security.

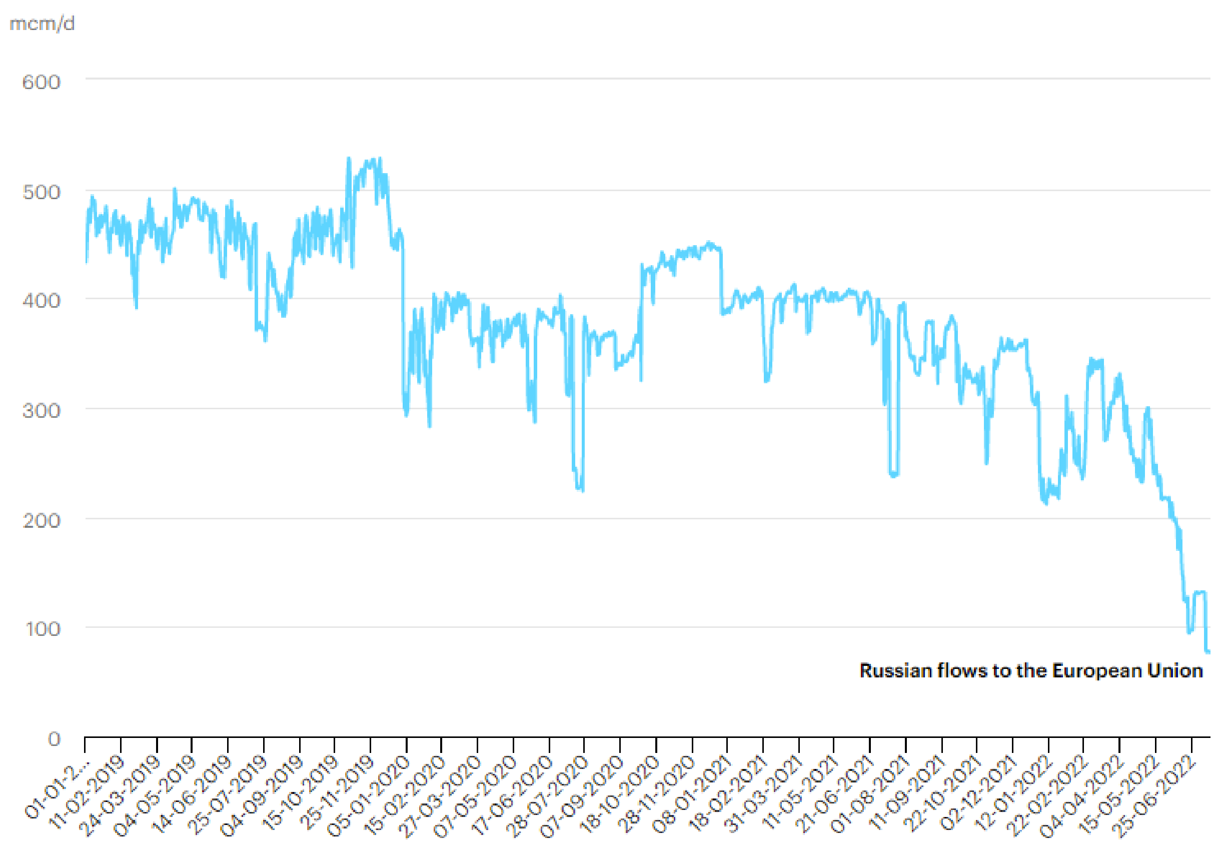
The announcement comes on the heels of a July 14 letter in which Gazprom declared force majeure on past and current supply shortfalls to European customers through the Nord Stream 1 natural gas pipeline. Nord Stream 1 supplies Russian natural gas to European markets via an undersea pipeline linking Russia directly to Germany. Gazprom justified its declaration with what it called "extraordinary circumstances" related to pipeline maintenance and an inflated dispute over releasing pipeline turbines caught up in sanctions. However, this is likely nothing more than rhetoric disguising Russia's anger over the economic countermeasures pursued by Western countries, not to mention their continued support for Ukraine. Meanwhile, Europe's mad dash for supplies to meet current demand and bolster stockpiles has already led to a doubling of revenue for Russia between March and July compared to the average of previous years—now standing at over $95 billion compared to roughly $45 billion.

Assessing the Threat of a Russian Supply Shutoff

Across the European continent, natural gas—a critical component of residential heating and cooling, and industrial output, among others—is experiencing extreme price volatility. With summer peak demand bearing down on Europe, particularly amid a record-breaking heat wave, governments are not simply recommending alternatives to air conditioning. The EU is now implementing a contingency plan that calls on member states to cut consumption of natural gas by 15 percent—an essential move in advance of Europe's winter heating season that kicks off on October 1.

Meanwhile, efforts to engage in full-court energy diplomacy to identify alternative supplies are meeting stiff market barriers as global spare capacity offers less near-term relief than hoped. European storage levels, the backstop against supply disruptions and significant increases in peak demand, also stand at less than comforting levels. For instance, under normal circumstances, the EU emerged from the winter heating season with some 60 percent storage capacity in reserve. Despite Europe diligently filling its storage reserves, levels are likely not sufficient to weather a complete supply shutoff from Russia coupled with a harsh winter, at least not absent significant rationing. The EU's recent ruling that the bloc's natural gas storage reach a mandatory threshold of 80 percent by November 1 offers some relief in terms of energy security, but it will still come at the cost of economic contraction. EU average storage levels stood at 58 percent in June, which is par for average supply scenarios.

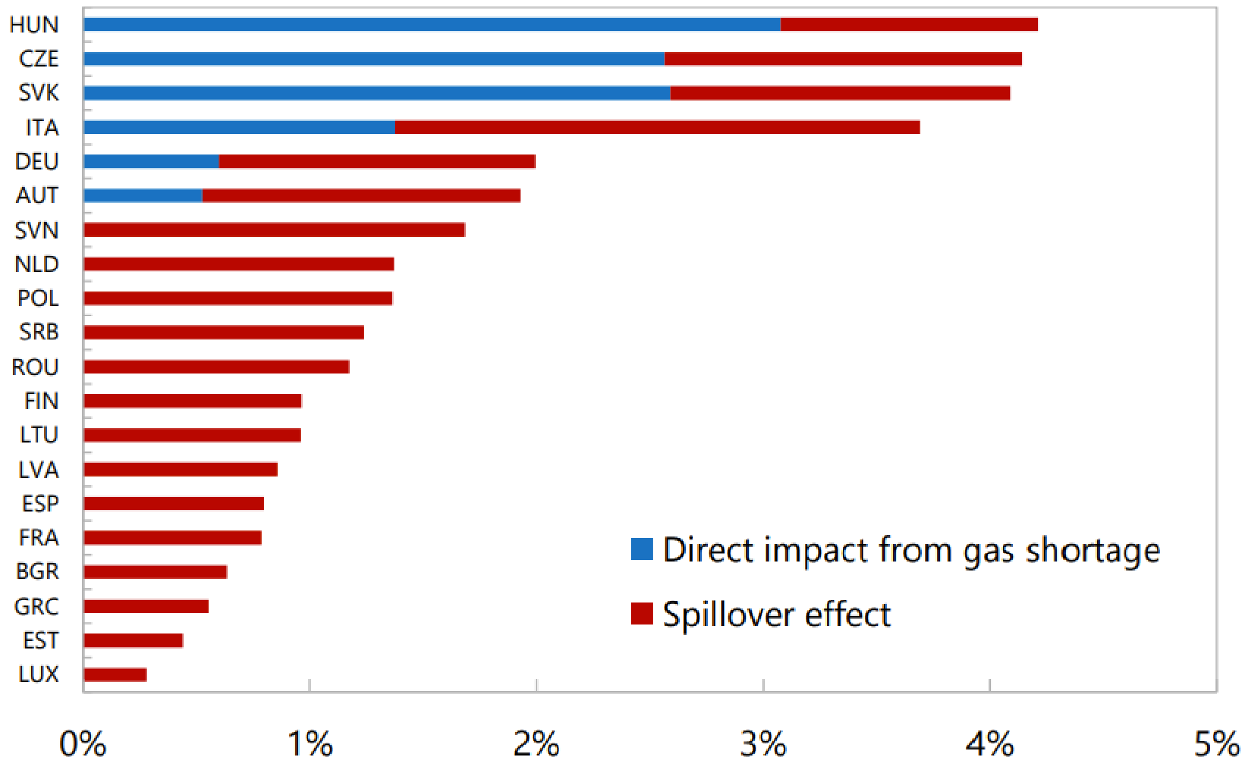
Russian Natural Gas Flows to the European Union (million cubic meters per day)



Source: International Energy Agency

The severity of the situation threatening Europe is impossible to overstate. Beyond flagging utilities necessitating government-backed bailouts, such as Germany's Uniper and France's EDF, Russia is still capable of halting all its energy exports to Europe. This tactic would be consistent with the Kremlin's historical weaponization of energy resources. A complete shutoff of supplies by Russia, if sustained for one year, could significantly reduce the EU single market GDP by as much as 2.7 percent, according to the International Monetary Fund. This worst-case scenario could also lead to a direct cost to EU citizens in the $200 billion range under "conservative" estimates. The EU single market also represents 16.1 percent of global trade in goods, services, and foreign direct investment flows, making the likelihood of containing the economic fallout a herculean task. The primary question remains whether the EU will act in concert to share the burden or if countries will default to navigating the crisis alone. The latter scenario would further inflame the crisis.

Output Losses for Select European Economies (% of GDP)



Source: International Monetary Fund

Germany alone relies on Nord Stream 1 for 35 percent of its total gas supply industrial economy. The Swiss investment bank UBS and the University of Mannheim estimate that Germany, already facing government-imposed rationing across sectors, will be forced to cut industrial consumption by 50 percent and residential consumption by 20 percent. Meanwhile, Germany's natural gas storage reserves are filled to a mere 61 percent as of June, and wholesale electricity prices have surged 650 percent in just two years. The current energy crisis could see Germany experience a loss of between 1.3 and 2.2 GDP, dependent upon the severity of supply shortfalls and the duration of supply constraints—between 600 and 900 Euros per German citizen.

The answer to the looming threat of a supply shutoff for a country like Germany and many other Western European countries is increasingly a matter of political will. Germany was already increasing the use of coal to fill the void left by Russia's throttling of energy supplies, but current supply risks and an EU policy requiring an energy severance from Russia are urgently necessitating additional measures. Germany should also examine its policy of Energiewende—an energy transition platform unveiled in 2014 by Chancellor Angela Merkel's coalition—and restore its once condemned fleet of nuclear power plants.

Moreover, global electricity demand growth is ambivalent towards the plight of European consumers. In 2019, fossil fuels represented 63.1 percent of global power generation, and global electricity demand is expected to grow 30 percent by 2030 from 2021 levels. This means that international efforts to supply viable energy sources to meet global demand, or at least rise to the occasion and displace Russian supplies, will require a significant overhaul in energy policies among crucial producing nations, including the U.S.

Mitigating Threats to Energy Security

The Biden Administration should recognize that global energy demand will continue to increase over the years, requiring energy-producing nations, principally the United States, to rise to the occasion. The current energy crisis demonstrates a need for a fundamental change in the vanguard of global capital markets to signal safe passage for private capital to follow demand signals undistorted by bad policy and invest accordingly in international energy security, global economic growth, and improved standards of living.

Meanwhile, the Biden Administration's policies make supply-side infrastructure projects increasingly cost-prohibitive and distort demand-side infrastructure development in key markets for U.S. energy exports. From a U.S. perspective, the administration must roll back regulatory assaults from the Securities and Exchange Commission, Environmental Protection Agency, and Department of the Interior, among others, to correct the devastation of market-distorting policies driving capital flight from the fossil fuel industry. However, this is simply one symptom of the broader climate-oriented policy campaign promoted by the Left.

U.S. financial support for European energy security, including the Biden Administration's fulfillment of a Trump-era commitment of $300 million in energy infrastructure investments across Central and Eastern Europe, is a significant contribution. Still, U.S. support for demand-side infrastructure and market development is undercut by the Biden Administration's prioritization of dubious climate values over tangible instability and economic suffering. Most notably, this is represented by the U.S. Department of the Treasury's prohibition on financing overseas fossil fuel projects, which limits overseas financing to renewable energy projects that are incapable of filling the void left by Russia.

Unfortunately, the Biden Administration is not the only entity fanning the flames of energy insecurity and potential energy poverty for millions around the globe. The International Energy Agency—an organization ironically founded to promote energy security—has joined with the European Bank for Reconstruction and Development and the European Investment Bank, among others, to call for no new investment in fossil fuels. The abolition of the Biden Administration's flawed approach to global energy markets is no small drop in the bucket. Rather, it would add to growing trends recognizing the need to include fossil fuels within the international energy supply mix and perhaps erode the anti-fossil fuel position of influential multilateral development banks. The European Union, for instance, recently announced a policy that appropriately reintroduced natural gas to the category of "sustainable energy." The Biden Administration should take a step in the right direction and follow suit in a very public manner.

In the near term, however, options for greater U.S. energy flows to Europe are limited, but that does not mean we should sit idle. The United States has for years engaged European countries to provide technical assistance in securing their energy systems. The Biden Administration should double its efforts to deploy the vast potential dispersed throughout the Department of Energy's 17 National Laboratories. Such expertise has proven invaluable for many nations exposed to Russia's energy manipulation and cyber-attacks on critical electricity grid infrastructure, and it no doubt will again. Europe is embarking upon uncharted territory, and U.S. technical assistance and contingency planning support can help Europe weather the storm from a position of greater security.

The current energy crisis will no doubt get worse before it gets better, but the duration of economic suffering remains the primary question. The United States has the tools to assist European consumers through technical assistance, infrastructure development, and over the long-term, to serve as a reliable trade partner underpinning the energy security of the transatlantic community. The Biden Administration needs to remove the regulatory and policy wet blankets it uses to smother American production and infrastructure development. Continuing down this current course will further erode the administration's already dubious climate objectives as Americans increasingly associate climate policies with economic strain. Still, the real concern is the threat of a severe economic contraction on a global scale. That would undercut the standard of living of millions.