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Is the European Energy Situation in a Lull?

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From September 11 to 14, I visited the United Kingdom and had the opportunity to exchange views on the energy situation in Europe with various energy experts in London and Oxford. Europe was hit directly by the international energy market turmoil caused by Russia's military invasion of Ukraine. In 2022, Europe faced a significant surge in energy prices. Then, concerns about energy shortages in winter became a serious problem, leading energy security to suddenly emerge as the most important issue in Europe. On the other hand, Europe has been actively playing a leading role in enhancing climate change countermeasures not only regionally but also globally. Therefore, achieving both the enhancement of energy security through the phaseout of dependence on Russia and decarbonization has become the most important challenge in Europe. To this end, Europe has promoted the REPowerEU Plan, as known well.

More than 18 months after the outbreak of the Ukraine crisis, various changes have been seen in the international energy market. Crude oil prices are still around $90 per barrel, with European gas prices remaining in a range of $10-15 per million British thermal units. These levels cannot be called “cheap” from a historical point of view. From last year's levels reflecting extraordinary spikes, however, oil and gas prices have declined, indicating a relatively calm energy market. We discussed the status of the European initiative to achieve both energy security and decarbonization in such an energy situation. As a result of the discussions, I feel that Europe (or the entire world) is in a kind of lull. In the following, I would like to present my awareness of the lull from two different perspectives.

First, the lull is related to the energy market stability. As noted above, the European energy market has restored stability as price hikes have calmed down. Some attribute this to the successfulness of European energy policy. Regarding the gas market, which had faced the most severe situation, there is a kind of euphoric sense that the crisis is over. In fact, gas prices are hovering in the $10-15/MMBtu range, with inventories reaching extremely high levels earlier than usual ahead of the winter season. Through my talks with energy experts, however, I have realized anew that the supply-demand balance in the international energy market cannot restore the traditional equilibrium unless the loss of energy supply from Russia is covered.

Before the Ukraine crisis, Russian gas exports were huge, accounting for one-quarter of global gas exports. Russian pipeline gas supply to Europe, which accounted for the majority part of Russian total gas exports, has declined sharply through the crisis to about one-fifth of the earlier level. Russian oil exports, though subjected to a Western embargo, have been maintained in volume as a decline in exports to Western countries has been covered by an increase in those to India, China and others. Since destinations of Russian gas exports via pipelines are difficult to change over the short term, however, global gas supply has declined by the equivalent of the lost volume of Russian pipeline gas exports to Europe. As global energy demand as a whole tends to increase moderately, any large-scale supply decline is significant. The net supply decline occurred in the gas market, but its impact

spread globally to various energy markets through the substitution of gas demand. For instance, developing countries have become unable to procure gas due to price spikes and expanded coal consumption. The net decline in Russian gas supply has created a major distortion in the supply-demand balance of the international energy market, which has not yet been resolved.

In order to remove the distortion in the supply-demand balance, supply must be expanded to cover the decline. While expanding the use of coal and nuclear power is important for the removal from a global point of view, what has been important for increasing energy supply in Europe is the expansion of renewable energy supply and LNG imports mainly from the United States. However, LNG imports from the United States to Europe have been increased through changes in destinations for existing U.S. LNG export facilities, which has led to a rise in international LNG prices. What is happening in the world now is that U.S. LNG project investment decisions are coming in response to price hikes in a manner to anticipate an expansion in U.S. LNG supply. While renewable energy and U.S. and other LNG supply is expanded, the supply loss problem may not be resolved until the loss of Russian pipeline gas exports to Europe is covered fully. Through my talks with European energy experts, I have felt that the Russian pipeline gas supply loss may be fully offset by the renewable energy and LNG supply expansion around 2026 and beyond. Until then, the market may remain vulnerable to sharp price surges to be triggered by risk events such as lower winter temperatures, increased demand from China, and unforeseen supply disruptions. In this sense, the seemingly calm market is in a sensitive lull while remaining vulnerable until the supply loss is covered.

Second, a lull may be emerging in the much-awaited expansion of renewable energy supply. This point was frequently raised at my talks in the United Kingdom, leaving a particularly strong impression on me. The expansion of renewable energy supply is viewed as extremely important for promoting both the phaseout of dependence on Russia and decarbonization. As symbolized by the recent failure of U.K. offshore wind farm auctions, however, there are moves in Europe that seem to be affecting the expansion of renewable energy supply, which has progressed smoothly until recently.

For instance, it has been pointed out that capital investment and operating costs for renewable energy are rising amid continued high inflation, undermining the profitability and economic attractiveness of renewable energy projects. Of course, if renewable energy electricity prices are high enough to make up for cost hikes and secure profitability, there may be no problem with profitability. Amid the Ukraine crisis, however, soaring energy prices have become a serious social, economic, and political problem in Europe, prompting the region to introduce energy subsidies ahead of other developed regions. The European economy is still struggling, with inflation lingering. The social sensitivity to energy price affordability has changed. In addition, the implementation and enhancement of various economic and social measures since the COVID-19 outbreak has greatly increased fiscal costs in each country. Under these circumstances, I heard the view that the profitability of renewable energy projects is declining, affecting the promotion of these projects. The promotion of renewable energy, though expected to continue over the medium to long term, might have come to a lull now.

If the promotion of renewable energy fails to make progress as originally planned for the immediate future, the phaseout of dependence on Russia, as well as decarbonization, may be affected. In particular, any lull in the expansion of renewable energy supply may affect greenhouse gas emission reduction goals for 2030 to some extent. For governments responsible for promoting energy policies, it is politically difficult to easily tolerate higher energy prices or costs. Political parties, which had raced to enhance climate change commitments in elections until recently, are apparently required now to pay attention to the impact of policies on costs and economic burdens. As Europe is considered to be in a lull in various ways, its future energy policy developments may attract much attention.

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