HEMISPHERE
CAPITAL MANAGEMENT INC.
Reflections
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THE LOOMING EUROPEAN NATURAL GAS CRISIS

Energy concerns have intensified in the EU following the Russian invasion of Ukraine.

The Russian invasion of Ukraine has amplified energy security concerns, particularly in European Union (EU) nations. The EU has historically relied on Russia for over 40% of their natural gas consumption. With Russia restricting natural gas flows to the EU, the EU has been forced to look elsewhere for alternative supplies. Securing adequate energy supplies and building reserves for the fast-approaching winter has been a major priority.

Remaining natural gas flows from Russia to the EU are estimated at roughly 10% of historical levels.

In September, Russia responded to the latest round of Western sanctions – a planned cap on the price of Russian oil – by shutting off natural gas flows through the Nord Stream 1 pipeline to Germany. Nord Stream 1 was the largest operating natural gas pipeline from Russia to the EU and accounted for more than a third of the natural gas exported between the two regions in 2021. The total supply of Russian natural gas to the EU is now estimated at roughly 10% of historical levels with no signs of increasing in the near future.

The EU has turned to U.S. LNG to offset Russian natural gas.

Even with continued curtailments of Russian natural gas, the EU has been successful in building their storage reserves to over 90% of capacity. They have looked to offset natural gas from Russia with U.S. liquified natural gas (LNG). Since the start of the year, almost 70% of U.S. LNG exports have gone to the EU. LNG exports from the U.S. to the EU will likely remain at elevated levels this winter.

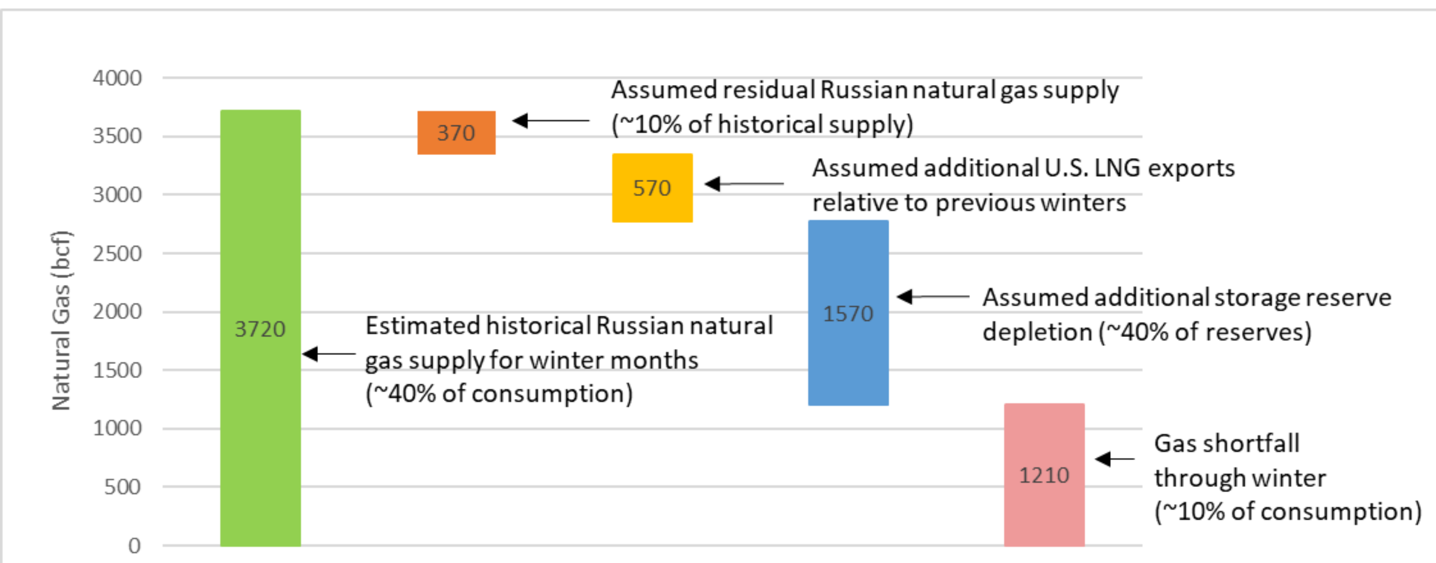

Figure 1: High level analysis of the EU natural gas shortfall for the upcoming winter months.

A high-level analysis shows that the EU may experience a moderate natural gas deficit (~10%) for the upcoming winter but will need to further deplete reserves.

This leaves the question of whether there will be sufficient reserves and alternate natural gas supplies to endure the upcoming winter. A very high-level analysis (Figure 1) shows that the EU may experience a moderate natural gas deficit – approximately 10% of winter consumption. This is a level that could potentially be managed through various energy savings measures and the use of substitute energy sources where possible. In reality, the outcome will ultimately depend on a myriad of factors, some of which are impossible to predict (i.e. residual Russian natural gas supply, the weather, etc.).

The EU may suffer major economic consequences trying to shelter businesses and consumers from high energy prices.

The EU has thus far benefitted from warmer-than-normal weather in October and a delayed start to winter. While still extremely high, natural gas prices have decreased by almost 65% since hitting an all-time high in August. Though the EU may now be in a better position to get through this winter, the risk of major economic consequences persists. EU governments are pursuing electricity price caps in an effort to shelter consumers and businesses from elevated electricity costs. They will be required to issue more debt at higher interest rates to fund these caps - driving up already elevated debt levels. The bigger challenge may also arise during winter next year. The EU will be challenged to replenish severely depleted reserves without Russian natural gas. This will be even more difficult as U.S. LNG export capacity is not expected to materially increase until 2024.

Energy shortages risk becoming a major concern for European companies. We remain focused on maintaining North American exposure.

If energy shortages persist and debt levels continue to rise, European governments may look to protect households at the expense of industries with high natural gas use (chemicals, metal processing, fertilizer, etc.). This risks becoming a major concern for European equities as companies curtail production and economic growth stagnates. Outside of a select few existing European holdings, we remain focused on predominantly owning North American companies to shelter from a potential energy crisis in the EU.