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Russian Gas Crisis Seeps into Europe

Russia cuts off natural gas supplies to Europe as its conflict with Ukraine goes on, leaving energy-dependent EU countries out in the cold

By Mark Scott

As the dispute between Russia and Ukraine over natural gas enters its second week, European countries are being left out in the cold—literally. On Jan. 7, Russian energy giant Gazprom (GAZP.RTS) shut down all supplies to Europe through Ukrainian pipelines, cutting off gas imports just as snowstorms hit and temperatures plummet below freezing across the region. Both sides continue to accuse each other of dragging out the disagreement.

Whoever is to blame, the fact remains that Russia's natural gas supply to Europe—about two-fifths of the European Union's total imports—has been turned off. That's especially bad news for Eastern European countries highly dependent on Russian imports; 10 of the 12 new member states rely on Russia for at least 60% of their natural gas.

The crisis also raises questions over Europe's supposed push toward greater energy independence. Despite talk from EU policymakers about finding alternatives to Russian gas, the most recent Russian-Ukrainian standoff demonstrates Europe is no nearer to resolving its energy security problems than it was the last time gas imports were shut off for three days in 2006 during another Russia-Ukraine spat.

"The situation in Ukraine illustrates the need for countries in Europe to develop a broad energy policy," says Arthur Hanna, global energy lead at consultants Accenture (ACN).

DWINDLING RESERVES

Even as policymakers search for long-term solutions, Eastern European countries—many already hit by the economic crisis—are suffering acute shortages now. On Jan. 7, Slovakia declared a state of emergency due to dwindling gas reserves. Hungary has limited gas consumption for industrial users, including a car manufacturing plant owned by Japan's Suzuki (7269.T). Others, including Croatia, Slovenia, and Turkey, have also had their supplies either severely reduced or shut off completely.

The EU's response is furious but largely toothless. "The European Commission demand[s] that gas supplies be immediately restored to the EU and that the two parties resume at once negotiations," the Brussels-based EU executive said in a statement. Russian and Ukrainian leaders are set to meet again on Jan. 8 to try to negotiate a solution.

One roadblock to a coordinated European response is that the 27 member states are affected very differently by the gas cutoff. According to Pierre Noël, a researcher at the European Council on Foreign Relations, the countries most at risk are Hungary, Latvia, Lithuania, and Slovakia. All are highly dependent on Russian imports, although natural gas overall constitutes less than 40% of their total domestic energy mix. "Russian gas supplies a particularly high share of total energy in the four countries," he says.

In Western Europe, by comparison, most countries have a more diversified energy mix, so Russian gas constitutes a smaller percentage of overall consumption. Indeed, Noël says, only 5% of Western Europe's primary energy needs are met by Russian gas, compared with 15% for the EU's Eastern countries.

FEW FUEL ALTERNATIVES

To address the current gas shortfall, the most vulnerable countries are now scrambling to switch to other fuels. But alternatives such as oil or coal are less energy-efficient, and the changeover can take two days or longer.The time lag is already leaving some consumers in the deep freeze: Thousands of households in Bulgaria went without central heating on Jan. 6 as utilities converted power plants to alternative fuels held in reserve.

The need to switch quickly to other fuels is less acute in Western Europe, where utilities are digging into gas reserves held in domestic storage facilities. That's particularly true for Germany and Italy, which are the two largest importers of Russian gas in Europe and together account for 40% of Gazprom's total annual profit. Analysts don't expect either country to be greatly affected by the current crisis because, thanks to other sources, imported gas accounts for only 10% to 15% of their total energy mix.

The bigger questions posed by the crisis of 2009 concern Russia's perceived reliability as a supplier and the dependability of Ukraine for gas transit.

Throughout the latest standoff, Gazprom has tried to portray Ukraine as untrustworthy—Russia's stated reason for cutting off exports to the EU on Jan. 6 was that Ukraine was siphoning off gas for its own use—while the Ukrainians have blamed Russia for making gas imports into a political issue. That debate will continue, but the need for new transit routes that avoid Eastern Europe entirely grows more paramount, particularly the controversial Nord Stream project that would transport Russian gas under the Baltic Sea to Germany.

The dispute has also created volatility in European gas markets. Spot prices from London to Prague have all jumped by at least 10% since the crisis began. Traders say both the Russian standoff and freezing temperatures underlie the price spike.

LONG-TERM SOLUTIONS

Beyond the current situation, which could be resolved in a matter of days, policymakers are calling for renewed efforts to improve Europe's energy security. After the 2006 standoff the European Union outlined a three-point plan to boost its energy independence: building more domestic gas storage; creating a unified gas pipeline network across the continent; and adopting a united negotiating stance toward Russia.

Analysts say only the goal of increased domestic gas storage has been met, most notably in Italy and Spain. But plans for a more efficient continentwide gas network remain on the drawing board. And instead of a common negotiating position, individual countries, specifically Germany, have continued to strike separate deals with Russia, undermining the EU's ability to speak for the bloc. "At a European level, no one has wanted to talk in a unified way," says Colette Lewiner, global energy, utilities, and chemicals leader at consultancy Capgemini (CAPP.PA). "Europe didn't get organized to face the problem."

That might finally change in the wake of the latest gas crunch. The Russian-wary Czechs currently hold the six-month rotating presidency of the EU and have made energy security a top priority. The economic crisis could also force the issue, with money from the multibillion-dollar European government stimulus packages being poured into energy infrastructure investments. "The current environment creates more pressure for change in the system," says Mark Spelman, Accenture's global head of strategy.

He may be right in the long run. The problem now is getting the heat turned back on quickly, before Europeans suffer any more—or the economy takes another blow from tumultuous geopolitics.

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