RBC Global Asset Management

Winter is coming

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As the supply of Russian gas to Europe remains a question mark, investors must prepare for a barrage of potential implications, including rising bills, a shift in the energy mix and multi-layered ESG complications.

Concerns over the cessation of natural gas supplies from Russia are having a profound impact on European energy prices. The one-year forward rate for the Title Transfer Facility (TTF) – the virtual trading point for natural gas – in Europe has risen nine times since last Spring.

This in turn is impacting the outlook for industrial production and driving recession fears, which is filtering down to equity and debt markets.

Natural gas is used to heat about half of European households and powers a big share of industry. Despite considerable investment, renewables still represent less than 20% of the energy mix in Europe so reliance on natural gas for heating, cooling and power will remain high well into the next decade.

Russia is one of the largest providers of gas to Europe. Dr Fatih Birol, the Executive Director of the International Energy Agency, said in June:

"Europe should be ready in case Russian gas is completely cut off. The nearer we come to winter, the more we understand Russia's intentions. I believe the cuts are geared towards avoiding Europe filling storage and increasing Russia's leverage in the winter months."

In October 2021, Birol had already alerted the world to Russia's manipulation of gas supplies to Europe and earlier in September he warned against blaming renewables for the rising price of gas. These were prescient words.

Gas prices and thus electricity prices (as gas is the marginal price setter) look set to remain volatile into 2023, exacerbated by a number of additional factors. These include nuclear power outages and drought conditions across France, Italy and central Europe, which are impacting cooling in nuclear plants and hydroelectric power production, forcing the electricity system to rely even further on natural gas for power production.

Implications for investors' ESG considerations

One of the main results of this backdrop is the impact on customer bills and whether the cost is passed onto the consumer. The cost-of-living crisis continues, and as the colder months arrive for those in the lower socioeconomic banding, a lack of affordability for heating could have dire consequences.

There is also the obvious environmental impact that such events are having, with it increasing the argument to move away from natural gas, even as a transition fuel.

Is coal the unfortunate winner?

We are in a gas crisis and Germany is the epicentre.

Germany recently entered Phase 2 of its three-stage emergency gas plan in a reaction to the threat that Russia, Germany's primary gas supplier, might cut off supplies.

In Phase 2, utilities can theoretically break existing gas contracts and pass on higher prices to customers in order to lower demand. But first they need the authorisation of the Bundesnetzagentur – the German regulatory office for electricity, gas, telecommunications, post and railway markets.

Significantly, Phase 2 is a prerequisite for the ramp-up in the use of coal-fired power stations, which were mostly mothballed as Germany planned to phase out coal by 2030. This target is now under threat.

Phase 3 is needed for the rationing of gas, which would give precedence to households over industrial consumers. Phase 3 could bring energy rationing and black outs and almost certainly send Germany into a recession. From a social perspective, this also has implications.

BIS research has shown that recessions have historically been correlated to higher mortality rates. While this is typically felt more acutely by emerging markets experiencing recession, Germany's supply chain is interlinked across the continent – the home of developed and developing countries – where the impact will also be felt.

There are few near-term solutions available to offset the cessation of Russian gas supplies. Europe has put in place plans to add over 100 billion cubic metres of additional liquefied natural gas (LNG) regasification capacity, a 50% increase on the current capacity for LNG, but this will take a number of years. Current regasification capacity is also focused on regions such as Spain, where there is not the interconnection capacity to reach markets that need it most such, as Germany and Italy.

Structurally higher gas prices

Given the challenging backdrop for gas supplies, we expect gas and energy prices to remain elevated through the winter and a real risk of black outs and rationing.

Gas bills in Germany have already doubled and could as much as quadruple over the winter. Households are being asked to reduce the length of showers and municipalities are being encouraged to cut down on street lighting, to reduce the temperature of swimming pools and even ration supplies of hot water to tenants.

Industrial users could face rationing, which could materially impact output in addition to the impact of higher energy prices.

Italian Premier Mario Draghi's comment regarding the embargo on Russian gas supplies captures the multi-layered nature of the current situation well:

"Do you want air conditioning or peace?"

Today's backdrop is not a simple one for ESG investors to navigate.

An uncertain summer

The level of Russian supply will determine what levels of rationing are needed and won't become clearer until later in July or September. Assumptions are starting to move towards higher prices for several years though, not just from the impact of Ukraine tensions, but broader global lack of supply relative to demand levels.

Net Zero ambitions take a back seat

The environmental impact could be profound. The potential cessation of gas from Russia or even structurally lower volumes would mean greater investment to secure gas, likely at the expense of investment in renewables.

It is also likely to hamper recent progress on Europe's 'Fit for 55' EU 2030 Climate Target as emissions are almost certainly going up as coal is reinstated to meet base-load needs.

ESG-focused investors could do well to consider the importance of energy security, given the impact of higher prices on low-income households (fuel poverty) and lower industrial production output before penalising utilities, which are being forced to re-open coal to meet the urgent need.

The importance of a 'just' transition away from fossil fuels is also a key consideration. This means policies and regulations that promote and enable the efforts of civil society or the private sector for a just transition, but being aware that governments have a responsibility to establish a minimum safety net and build social adaptiveness to stop people being stranded without heat or light.

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