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Ukraine war reshapes energy geopolitics and decarbonization

Take*aways*

- Russia's aggression is causing Europe to relook elsewhere for gas imports
- Opportunities open up for LNG exporters
- Boycotts might speed up adoption of renewables

Russia's invasion of Ukraine is a watershed geopolitical event, the impact of which will be felt for years if not decades. Although the war is just over two months old, its fallout is reshaping the contours of international relations. The foundations of the post-Cold War security architecture in Europe have been upended, U.S.-Russia relations have entered a new period of enmity and distrust, divisions between China and the West have widened, financial flows have been disrupted, and trade patterns are being altered. These far-reaching impacts are pulling down global economic growth and driving up inflation. With Moscow showing no signs of retreating, and the risk that sanctions will become more stifling, the eventual economic impact could be greater and longer lasting.

The energy sector is also feeling the shock. The most apparent energy impact is the spike in oil and gas prices, as a combination of self-sanctioning, supply concerns, and uncertainty over possible future trade restrictions have driven up prices and led to unprecedented levels of volatility. With the war still ongoing, and growing pressure on European states to formally sanction imports of Russian energy, high prices and volatility are likely to be a feature of markets for some time to come.

A new energy world is emerging

But the impact of the war will be felt beyond prices. The conflict is prompting structural shifts in energy flows, investment, and consumption patterns that will have a lasting impact on the sector and alter geopolitical balances in the process.

Changes in gas flows are one of the most evident signs of these developments. Europe's newly found determination to decouple from Russian pipeline gas will not only create new markets for LNG; it will also force Moscow to look for new buyers for the gas that is displaced, with China likely to take a large proportion of any surplus. The switch cannot happen overnight: It will require new pipeline infrastructure that will take time to build and cost tens of billions of dollars. But the long-term effect will be to erode Moscow's political influence both west and east, as Europe's gas dependency on Russia is reduced, and the importance of the Chinese market increases for Russian companies that lack other outlets for their commodity.

This shift also illustrates how LNG is altering gas-market dynamics and the politics of this energy source. Gas markets have traditionally been regional, constrained by the geography of pipelines. However, the flexibility and marketability of LNG compared to pipeline gas give the fuel a fungibility more akin to crude oil, with flows now able to be redirected to meet demand. This has given consumers and policy-makers in Europe options that they

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have not previously had to diversify their gas supplies, again altering political balances in the process. True, this diversification comes at a higher cost, but the political and energy-security benefits are deemed to outweigh the increased price burden, in the short term at least.

The politics of oil is also changing in significant ways. For the first time since the 1970s, consumer nations have become swing producers in oil markets, using their strategic reserves to replace lost barrels and to influence prices in the short term. Since late November 2021, the United States and other International Energy Agency member states have pledged to release a total of 350 million barrels in a bid to ease high prices. By contrast, OPEC – which traditionally has played this swing role (and jealously guarded its prerogative to do so) – stuck to its July 2021 quota agreement, promising incremental increases of 400,000 barrels per month (although delivering significantly less due to production constraints).

OPEC has prioritized medium-term concerns over fundamentals, and its policies – or at least those of Saudi Arabia, its most influential member – also have been shaped by political animus toward Washington. But in doing so, Riyadh and its allies have squandered the credibility of their commitment to being the producer of last resort, while also allowing a new precedent to be set by consuming states, which may henceforth continue to intervene actively in physical markets based on price concerns, thereby undermining OPEC's market-management effectiveness.

Energy transitions and energy security become more intertwined

But perhaps the most profound long-term impact of the crisis will be its effect on the pace of energy transitions globally, and on divergences in the speed of decarbonization and emission reduction between different regions of the world. In Europe, heightened energy-security concerns prompted by the Ukraine war have supercharged plans to expand the share of renewables in the energy mix, and to improve energy efficiency. This is the first major crisis of the energy-transitions era, and the availability of alternatives to hydrocarbons gives policy-makers new response options. The EU's already ambitious green-transitions targets for 2030 will be brought forward to mid-decade where possible, and the region will become a laboratory for what is possible when political intent, the energy-security imperative, public support, and finance align.

Outside of the EU, the crisis might not propel decarbonization as much. European countries' focus on LNG to provide a medium-term bridge between Russian gas and renewables will drive the cost of the fuel up in the medium term, making it prohibitively expensive for developing states that wanted liquefied gas to replace coal. China is already showing early signs of this impact, with Beijing re-prioritizing coal production and consumption, and temporarily eliminating intensity and emissions targets, as it seeks to protect its own energy and economic security. China remains wedded to capping emissions and transitioning its energy use in the longer term, but while LNG prices remain uncompetitively high, and it lacks sufficient renewables capacity to take up the slack, it will not jeopardize economic growth targets for decarbonization ones.

A similar pattern is likely to be witnessed elsewhere in Asia and in Latin America, with high LNG costs disrupting immediate energy-transitions plans. But high LNG prices will not necessarily prohibit energy transition altogether. Instead, they could encourage some countries to leapfrog directly to renewables, rather than transitioning through gas first. Much will depend on whether the investment for this transformation becomes available at affordable costs, with private-sector financial institutions set to play a determining role. If capital is made available for investment, some developing countries could follow Europe's example and accelerate their decarbonization efforts, rather than being left behind. What is certain is that the next decade will be transformational for global efforts to achieve net-zero carbon emissions targets by mid-century.

About the author

Raad Alkadiri is managing director for energy, climate, and resources at Eurasia Group. He focuses his work on the nexus between politics, economics, climate, and the energy sector, as well as its effects on market behavior and investment risk. He works closely with clients to advise on capital-allocation options, risk-mitigation strategies, and policymaking. He also closely follows medium- and long-term geopolitical, energy, and climate trends, and their impact on the risk environment.

Raad has more than 25 years of experience advising senior executives and government leaders. He came to Eurasia Group in 2021 from BCG, where he was a senior director in the Center for Energy Impact, focusing on country dynamics. Prior to that, he was managing director for petroleum sector risk at IHS and a partner and head of markets and country strategies at PFC Energy. In 2003-2004, Raad served as assistant private secretary to the UK Special Representative in Iraq, and in 2006-2007, he was senior political adviser to the UK Ambassador in Iraq. He holds a doctorate in international relations from the University of Oxford. He also holds a master's degree in international relations and a first-class honors degree in psychology and international relations from the University of St Andrews.