Global Counsel

Qatar and the future of European energy security

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Summary

Commenting on Europe's gas crisis, the prime minister of Belgium recently said that Europe would face "terrible winters" for the next five to ten years. The warning by the Belgian premier is echoed by the chief executive of Shell, Europe's largest oil and gas company, who has said that Europe may need to ration access to energy for several years as it weans itself off Russian hydrocarbons. The comments come amid fears that Russia's shutoffs of pipeline gas to the continent may become permanent. Natural gas and electricity prices in Europe have soared to record highs, forcing industry to curb output and fuelling a cost-of-living crisis. As European utilities seeks alternatives to Russian gas, Qatar's historic expansion of its LNG export capacity has made the Gulf state an increasingly sought-after provider of energy. While no single gas producer can immediately offset the collapse of Russian supply, the scale of Qatar's expansion puts it in pole position to meet Europe's long-term needs. As a bloc that has often led the shift to cleaner energy, however, the EU faces the conundrum of building an extensive LNG import infrastructure while making good on net-zero commitments – or steering an energy transition during an energy crisis.

Qatar's decision to move forward with a massive expansion of its liquefied natural gas (LNG) output may prove timely for European states grappling with the worst energy crisis in at least a generation. In June and July, Qatar's state-owned oil firm, QatarEnergy, signed up five western oil majors as joint-venture partners for its landmark North Field Expansion (NFE) project. The companies are the UK's Shell; ExxonMobil and ConocoPhilips of the US; France's Total Energies; and Italy's Eni. The NFE project envisages six new LNG 'trains' that will increase Qatar's production by 48mn tonnes per year (t/y) in 2025-27. For context, that is about 20% more gas than Russia's stalled Nord Stream 2 pipeline can transport and will boost Qatar's total exports to 126mn t/y, comparable with Russia's total pipeline and LNG supplies to Europe.

Russia's weaponisation of gas in its confrontation with the West has given Qatar new prominence as a depoliticised source of energy. Qatar has developed a reputation as a highly reliable energy supplier that keeps geopolitics apart from its supply commitments. During the 2017-21 Gulf crisis, Qatar maintained gas supplies to the United Arab Emirates via the Dolphin Pipeline despite a severing of diplomatic relations between the two Gulf nations. As Qatar's energy minister, Saad Al-Kaabi, puts it: "Keeping our contractual word is sacrosanct", a reference to Qatar's reluctance to divert to Europe gas shipments already contracted for delivery to other countries. Given that Russia accounted for 40% of the EU's gas imports last year, Qatar insists that no single supplier can immediately offset the collapse in Russian supply. Qatar estimates that only about 10%-15% of its LNG can be redirected to Europe in the short term and those shipments will cost more than Russian gas. In addition, significant new volumes of Qatari LNG will only come online starting 2025, when the Golden Pass Terminal in Texas – a joint venture between QatarEnergy and ExxonMobil – begins exporting LNG (around 16mn t/y). In the interim, Europe will continue to pursue alternatives, with American LNG at the forefront and other sources like Azerbaijan, Algeria, Egypt, and Israel rising in importance.

The Ukraine war only exacerbated existing supply constraints

Europe's energy crisis, however, was afoot before Russia's invasion of Ukraine and the subsequent disruption of Russian gas flows to Europe. Gas shortages at the end of last year in the EU and the UK were disrupting the supply chain for products ranging from meat to steel and driving up household energy bills. Qatar has argued that Europe's gas shortages, which began translating into sharply higher gas prices at the end of last year, should be traced back to years of underinvestment in oil and gas by energy majors that have been "demonised" by western governments and climate activists pushing for net-zero targets. Recent years have seen a slate of LNG projects cancelled as the pandemic weighed on energy demand and an oversupplied market made greenfield LNG investments uneconomic. The resulting lack of investment, coupled with the post-Covid rebound in global energy demand and the Ukraine war, have today sent the price of natural gas soaring – with prices of the fuel in Europe up almost five times from a year ago.

These pressures reportedly led the UK to hold talks with Qatar in November (months before Russia's aggression) about a long-term gas arrangement that would make the Gulf state a "supplier of last resort" to the UK. At that time, Qatar, ostensibly at the request of UK prime minister Boris Johnson, dispatched four LNG shipments that were previously unallocated to the UK to alleviate a painful gas supply crunch. Although the UK imports far less Russian energy than its European peers do, it remains exposed to market forces, such as unusually hot or cold weather or interruptions to Russian pipeline gas, that drive competition for supply and provoke a gas price escalation.

The shift in the 2000s to spot markets left Europe exposed to gas price volatility

This vulnerability has played out since the early 2000s when Europe liberalised its gas market and gradually shifted away from long-term contracts linked to the price of oil. Underpinned by 'oil-indexation,' such contracts provided a relatively stable reference price and largely shielded European importers from gas price volatility. Instead, Europe moved toward "gas-on-gas" competition, where prices reflect multiple sellers and buyers of natural gas on spot markets. While this approach has been hugely advantageous from a cost-savings point of view, it has left European energy importers without the protection of guaranteed supply at predictable prices. The UK today meets half of all its demand through this market-based import strategy, leaving the UK reliant on an increasingly competitive LNG spot market for as much as a fifth of its gas supply.

Long-term contracts and 'destination clauses' have fallen out of favour

In 2020, Qatar accounted for half of all the UK's LNG imports. However, this figure is down from 98% of all the UK's LNG imports in 2012, reflecting the increases in global liquification capacity and the UK's efforts to diversify its supply portfolio. The trend also reflects the UK's move away from long-term (typically 20-25 years) supply and purchase agreements (SPAs) preferred by large gas exporters like Qatar, Algeria and Russia. Long-term SPAs provide exporters with demand and revenue security, underpinning multi-billion-dollar capital expenditure to ramp up LNG capacity. Qatar also insists on so-called 'destination clauses' – historically a fixture of long-term LNG deals – that prevents buyers from re-routing cargos to third countries. In a liberalised market, gas traders (e.g., Shell, Total, British Petroleum, Trafigura) can take advantage of arbitrage opportunities, whereby they re-export excess supply to other markets to generate returns (benefiting from supply and demand imbalances). To protect against the erosion of its gas revenues and market share, Qatar Petroleum, as QatarEnergy was known before a recent re-brand, has traditionally sought to inhibit such behaviour by signing up customers to long-term SPAs that include destination restrictions.

In the last five years, as global LNG supply expanded and spot markets deepened – on the back of huge LNG investments by Australia and the US – key buyers have mounted stronger resistance to destination clauses in contract negotiations. Thus, the European Commission in 2018 opened an investigation into whether Qatar's long-term contracts were in breach of EU antitrust rules. In launching the probe, the EU cited "problematic territorial restriction clauses in gas supply contracts" that could segment the EU's internal gas market. The investigation led QatarEnergy to double down on its strategy of signing up energy-hungry Asian gas buyers to long-term contracts. Today, Qatar's long-term contracts represent some 60% of its natural gas exports, most of which are sold to its key Asian clients, the likes of India, China, South Korea and Japan. Al-Kaabi, who is also the chief executive of QatarEnergy, has described the EU case as having "no basis" and has called on Europe to give a "clear signal" about whether "they want more investment in gas and additional supply from Qatar or not". The probe had frustrated QatarEnergy's plans for allocating greater output to Europe, causing delays to projects in France and Belgium.

Qatar is keen to expand its supply of LNG to Europe

In a significant development, in February 2022, amid rising concern around the stability of Russian gas flows to Europe, EU regulators halted their anti-trust probe into QatarEnergy, albeit with denials that the decision was related to an imminent Russian invasion of Ukraine. It has since emerged that Germany, France, Belgium and Italy are in talks with Qatar to buy LNG on a long-term basis. In May 2020, during a visit to Berlin by Qatar's Emir, Germany and Qatar signed an agreement to deepen their energy partnership, with a focus on LNG trade. German Chancellor Olaf Scholz, whose country imported more than half of its gas from Russia before the war, said that Qatar would play an "important role" in its strategy of diversifying away from Russian gas. However, several obstacles to a long-term gas deal between Qatar and Germany have emerged, not least Qatar's firm stance on destination clauses that the EU opposes. In addition, Germany is reluctant to commit to Qatar's conditions to sign deals of at least 20 years (given Germany's bold ambitions to move away from hydrocarbons) and is opposed to oil-indexation.

Tough talks between Qatar and German energy buyers indicate that a slate of long-term LNG agreements between Qatar and European importers is not a forgone conclusion – despite Europe's obvious need for reliable supply. According to analysts, Qatar is eager to allocate as much as half of NFE's output to Europe – a significant development, given that Qatar had traditionally put the emphasis almost entirely on Asia. Qatar's geographical location makes it better suited than the US to supply Europe and Asia. As a small but influential regional power, Qatar also prizes the diplomatic dividends of more closely linking itself with the future of European energy security. In recent years, Qatar has booked additional European LNG storage and regasification capacity, including the full capacity at Belgium's strategically located Zeebrugge terminal through to 2044. QatarEnergy has struck similar deals with the Montoir terminal in western France (from 2021 2035) and with the Isle of Grain LNG terminal in southern UK (from 2025 50) – evidence of QatarEnergy's long-term ambitions to supply Europe and the UK with gas.

Qatari LNG exports are currently maxed out

As Europe rushes to fill natural gas storage ahead of the winter months, the search for alternatives to Russian gas has intensified. The most important source has been the US, the world's largest producer of oil and gas. During the year's first four months, the US exported 74% of its LNG to Europe, compared with an annual average of 34% last year. Since the onset of the Ukraine crisis, the US has sought to corral Qatar and other major gas producers, like Azerbaijan and Egypt, into ramping up supplies of natural gas to Europe. Qatar provides about 5% of Europe's natural gas and is already a major LNG supplier to Europe's top five LNG importers (the UK, France, the Netherlands, Spain and Italy). Qatar's LNG export capacity, however, is currently at its maximum of around 80mn t/y, meaning it cannot offer a short-term fix to Europe's gas woes (a dearth of LNG import terminals in some of Europe's key economies is part of the challenge).

With the NFE project moving forward, Qatar is embarking on the largest LNG project by liquefaction capacity undertaken to date in the industry. Qatar reached a Final Investment Decision on the $30 billion NFE project in February 2021. With the first LNG from North Field East, the first phase of the NFE, expected in 2026, an additional 32mn t/y of potential Qatari LNG exports can prove instrumental to Europe's strategy for diversifying away from Russian gas - and to the continent's long-term energy security. By 2027, following a second planned output expansion, known as North Field South, Qatar's production capacity will reach 126mn t/y, or 64% higher than its current output, allowing the Gulf state to vie with the US for the crown of top global LNG exporter.

QatarEnergy faces a massive pipeline of uncontracted LNG

Having committed substantial financing to the NFE, Qatar is prioritising security of demand. Qatar faces the need both to find buyers for huge new NFE volumes and to replace several of its existing medium and long-term supply agreements that are up for renewal before mid-decade. More than ten of those agreements are due to expire by 2025. According to research firm Wood Mackenzie, Qatar will have more than 75mn t/y of uncontracted LNG volumes to sell by 2027, equivalent to 70% of its LNG portfolio. Thus, QatarEnergy has accelerated its efforts to market additional volumes, making it clear that a main role for its equity partners in the NFE project - Shell, Exxon, TotalEnergies, Eni and others – will be to help market the additional production.

Over the past two years, Qatar has signed at least ten long-term SPAs, committing to supply 17.8mn t/y of LNG for 10-20 years. Five contracts for 8.5mn t/y were signed with China, while another five contracts for 9.3mn t/y were inked with Bangladesh, Pakistan, Taiwan, Singapore and South Korea. The predominantly Asian composition of Qatar's evolving LNG client portfolio is consistent with Asia's enduring energy security concerns. Those concerns have risen to the fore as European demand for LNG soars, sending spot prices of the fuel to record highs. In August, the European benchmark gas price reached the equivalent in energy terms to almost $400 a barrel of oil. Higher prices in Europe are giving traders an incentive to send LNG cargoes there for better profits, just as Asia's largest LNG buyers (China, South Korea and Japan) step up their purchases to secure supplies for the winter months and beyond. As a result, traders in Europe and Asia are bidding the market up.

Qatar benefits from competition between Europe and Asia for LNG

These market dynamics strengthen Qatar's negotiating position as it enters into talks with its Asian and European partners over long-term LNG contracts. One German official, commenting on his country's talks with Qatar over gas supplies, described Qatar's strategy as "playing hard ball" over the price and duration of potential agreements with German companies. The relatively low-price environment of early 2021 in which Qatar negotiated its latest set of long-term SPAs forced the country to accept record low pricing formulas. Now, however, as Europe scrambles to replace Russian pipeline gas and Asia looks to stay ahead of the spike in European demand, Qatar enjoys far greater leverage.

While Qatar can drive a hard bargain, there is a limit to that, given the Gulf state's need to lock in new customers to underpin a $30 billion output expansion that it is largely self-financing – especially in the face of new US and Australian LNG projects. As Asian and European economies look to replace coal with gas in their energy mixes and Europe seeks to cut its dependence on Russian gas, the current energy crisis is an important window for Qatar to re-assert its dominance as the world's top LNG provider. Europe, meanwhile, must balance the pressures of an acute energy crisis with its net zero emissions goals. Germany's reluctance to sign on to gas contracts of at least 20 years stems from its desire to avoid derailing progress on decarbonisation. As Europe looks to head off long-term economic pain for households and industry, deepening energy ties with Qatar will be a crucial element of the continent's historic pivot away from Russian gas.

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