Published on 19/11/2025

The two sources of geopolitical uncertainty affecting the valuation of European gas infrastructure

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Following the period of extreme market volatility that started in 2021 and culminated in the aftermath of Russia's invasion of Ukraine, M&A activity in Europe's natural gas sector has seen a revival in recent months. This year saw the sale of stakes in two LNG import terminals in NW Europe, the UK's Grain LNG and France's Dunkerque LNG, and more activity is expected in the coming months, with reports of a potential sale of the German government's stakes in SEFE and Uniper that were acquired in 2022.

This is enabled by the progressive return to normality as the volatility that characterised the energy crisis recedes, with the new dependence of the European market on LNG also driving interest in European infrastructure investments. This is being further bolstered by the need for LNG portfolios that are being swollen by the new wave of supply currently under construction to secure capacity to access markets. For such players, the market liquidity and interconnectedness of Europe, especially in the NW European region, represent an attractive route to secure a sink for their diversified portfolios. These factors combined are supporting the value of existing assets or even the investment case for new capacity, opening to new partnerships in the sector.

The other key factor that is driving renewed interest in European gas infrastructure is the expectation that the most ambitious decarbonisation targets are increasingly unlikely to be achieved. Market participants now perceive a complete phasing out of natural gas by the middle of the century as less credible than it was a few years ago. This is especially the case for demand in the industrial and residential heating sectors, where alternatives have failed to achieve the reductions in costs that would have been required to keep up with the most ambitious policy targets.

European gas infrastructure is therefore being seen as an increasingly appealing long-term investment. Valuations of assets are now based on new realities of the European market and gas geopolitics, which has reshuffled intra-European flows and changed how many assets are utilised. In this new reality, though, there are two key sources of geopolitical uncertainty that need to be considered by investors when assessing the value of European gas infrastructure.

The first is the future of Russian pipeline exports to Europe. While the phasing out of Russian supply has been the root cause of the change in the value of existing assets in recent years and has provided the investment case for new assets, the return of any volume of Russian pipeline imports, or the simple prolongation in time of the current status of Russian exports, could just as quickly reverse some of these changes and alter the outlook for infrastructure investments.

When considering the future of Russian pipeline exports, it is true that the current stance of the EU, and the recently announced new package of sanctions, make it unlikely that a material return of Russian gas into the European market will be politically feasible in the short-term. It is therefore sensible for this assumption to form the base case of any investment thesis. A scenario that sees a return of at least some Russian pipeline supply to Europe, however, cannot be ignored by investors as a potential source of downside, given the volatility of the ongoing conflict, the questions regarding the implementation of the EU phaseout, and the uncertainty of the long-term position of Russia in the global geopolitical order.

Russia's vast gas production capacity and existing infrastructure continue to enable its supply to be competitive in the European market and to remain an important element of leverage in the relationship between Russia, the EU, Ukraine, and the US. This is the case even if its weight will be somewhat diminished by the coming wave of LNG supply and the prospect of an oversupplied global market. In this context, the ambivalences in the process to solve the conflict in Ukraine make scenarios that do not seen the planned phase-out being completed by 2028 or maintained in the long-term a concrete possibility. Among all such scenarios, one that sees current flows via TurkStream being sustained for longer, or even potentially increased, is the most likely. A return of some flows via Ukraine could be a more remote possibility, and will largely depend on how the ongoing war will be resolved and the result of a new international security order that will shape the future of Europe.

The second factor to be considered is the future evolution of EU energy policy, and specifically a potential softening of the accelerated decarbonisation agenda being pursued. Recent events have demonstrated that the commitment to some of the most ambitious policies, such as CBAM, the CSDDD, and the EU's methane regulation could not be as strong as when they were initially proposed. This is in part due to the impact these policies have on other markets for imports of energy and other key materials, or the EU's security dependence on allies for defense. This, crucially, expose its policy decisions to external and domestic pressure and may make it difficult to maintain ambitious decarbonisation targets in a world where the second Trump administration has dealt a material blow to the political attractiveness of efforts to mitigate climate change.

The expected period of low prices caused by the wave of new LNG supply also could further contribute to a watering down of EU climate policy, as it will make the economics of alternative energy sources less attractive. Access to lower-cost fossil energy has also the potential to support the case of parties opposed to an aggressive approach to climate change mitigation, especially in those markets where high energy prices are affecting the competitiveness of industry and have raised consumers' bills. From this perspective, all EU countries appear profoundly exposed to these dynamics, potentially generating upside for investors in natural gas infrastructure that could be missed by accounting solely for currently planned policies.

The long-term outlook for the European gas market, and the one for the value of gas infrastructure, therefore remain highly exposed to the evolution of EU policy and its relationships with neighbours and allies. An understanding of such scenarios and of how recent events affect their relative likelihood can enable investors to better capture all potential risks and sources of upside in their investment theses. These are also key aspects to consider for current owners of assets and for those that have recently acquired one, as they can better inform asset management approaches and a commercial strategy that in the future will need to be better equipped to respond to sudden geopolitical changes.