

Energy Market Report: March 2022

As the shocking events in Ukraine continue to unfold, Governments around the world are in an increasing state of panic when it comes to the supply of commodities from Russia. This of course goes beyond energy, with fertiliser prices surging to record highs, alongside the likes of wheat - where Russian and Ukrainian combined production accounts for around 35% of global exports. But it is in oil and gas that the impacts of sanctions are, and will be, mostly keenly felt.

Incredible as it sounds, such is Europe's total lack of energy independence that gas is still flowing from Russia into Europe, even as the war rages on. Even more surprising is that most of it is flowing via Ukrainian pipelines! Nonetheless, there is now a very clear objective amongst European States to reduce Russian gas flows wherever possible. This means that no new Russian supply contracts will be signed in the near future and that automatically means that by the end of this year, Europe will have a 10% shortage of gas (this equates to the amount of Russian gas that comes up for contract renewal in 2022).

The proposed solution is to rapidly increase Liquefied Natural Gas (LNG) imports by ship. The beauty of LNG is that being seaborne, it can literally travel to any port in the world, whereas pipeline gas can only travel where the pipeline takes it. But there are several problems associated with LNG and this will make it difficult to successfully "plug" the Russian gas "gap". Firstly, European customers will be forced to muscle in on the existing LNG market, which is mainly flowing to energy hungry Asian countries. Secondly, because LNG travels as a liquid, it must be regasified to enter the grid networks of Europe. Presently, Europe has 29 gasification plants (3 in the UK), but their capacity of 225bcm (billion cubic metres) per annum only equates to around 40% of Europe's gas demand. A final bottleneck comes in the form of the world's LNG tanker fleet. Quite simply, there aren't enough of these huge and complex vessels to meet the expected (and rapid) uptick in demand. Forget converting existing oil tankers by the way. It's not a feasible option from an engineering perspective and besides, as long as oil demand is buoyant (and trade flows equally upended), almost all crude carriers are already fully chartered.

None of the above are going to do anything to keep a lid on escalating gas prices, but there still might be one factor in the world's favour and that is China's relationship with Russia. It now seems highly likely that China will be buying huge swathes of Russia's gas going forward, as they (along with India?) will be the only major economy ignoring sanctions. Interestingly, this will remove Chinese volume from the global LNG market-place (thus reducing "competitive" demand), whilst simultaneously handing China almost unbelievable power over Russia. It is indeed ironic that as Putin is desperately trying to remold Ukraine as a vassal state of the Kremlin, the same thing - economically speaking - is about to happen to his beloved Russia. As the "only game in town", Chinese buyers will expect enormous discounts on oil and gas (versus global benchmarks) and will almost certainly demand that product is priced and paid for in Renminbi (rather than \$ USD). This will seriously strengthen both China's supply security and balance sheet in the near to mid-term.

This playbook will almost certainly be repeated in the oil world. Only the UK has been in a position within Europe to sanction Russian oil, as only 6% of our crude consumption emanates from Russia. Mainland Europe on the other hand is in a very different and difficult position, with several major economies relying on Russian crude for more than 35% of their needs. This supply can't simply be switched off, but as with gas, European buyers will now look to extricate themselves from Russian contracts and as a minimum, will avoid buying any spot cargoes. Consequently, we will see a huge upending of trade flows as Russia pumps as much Urals crude eastwards (via the ESPO line = Eastern Siberian Pacific Oil), whilst European refiners will race to get their hands on crudes of similar specification to Russian product (eg, Norwegian Johan Svedrup, Nigerian Forcados, Libyan El Sider). The other option available will be to lean heavily on Saudi Arabia and get them to increase their production. This may help suppress prices, but in itself will only be a partial solution to the issue of European supply resilience. This is because Saudi crude is extremely heavy and viscous and does not make a happy bedfellow for European refineries that are configured to process the less dense crudes on the market. In this light, a worst-case scenario could be that European refiners simply give up supplying the "whole" market and only engage in producing grades of fuel that they can easily process.

There is rarely much certainty in oil and energy markets and at this juncture there is less than ever. Clearly there are huge questions around supply sufficiency outside of Russia, but at the same time, excessive high prices could soon create demand destruction as people drive less, reduce the temperature in their homes or decide not to go on holiday this summer after all. Such outcomes would definitely take the heat out of rising prices, as would extensive covid lockdowns in China - the spectre of which still hangs over that particular super-power. The energy landscape is changing before our very eyes, but for those Ukrainians hiding in basements or being bombed in their apartment blocks, it's hardly a pressing issue.