MACRO: Why energy prices might remain high and volatile

- Western leaders are looking at options to ratchet up sanctions, including a potential ban on Russian oil imports.
- Insufficient options to backstop for any losses of Russian crude and to calm markets will support recent, higher crude prices for a sustained period.
- Hub gas prices in Europe have soared to unsustainable highs with no immediate fix. The 2022/23 heating season will remain one of the biggest concerns.

Events in Ukraine have sent commodity prices surging with Brent crude reaching USD 140/bbl at the start of trade on 7 March, and benchmark TTF gas prices rising 75% to trade above EUR 345/MWh. The Russian invasion of Ukraine and the ensuing global response have raised unsettling questions about extended supply disruptions and the risk of a Western ban on Russian oil exports. These uncertainties have been compounded by factors like existing market tightness, negotiations on a revival of JCPOA (Iran nuclear deal), and, more broadly, a step-change in energy market policies with investments and resources shifting to support clean energy developments. In this context, sustained, higher prices can be expected if the conflict drags on. Governments will have to strike a balance between ensuring energy security and regulating consumer prices on the one hand and staying the course on energy transitions progress on the other. If energy security concerns become more acute, the latter is at risk of disruption.

Initially, governments on both sides of the Atlantic reassured markets that sanctions would include carveouts for oil and gas. In the intervening weeks, a de facto ban has emerged on purchases of Russian oil as buyers have self-sanctioned for political reasons or to better understand the reach of existing sanctions. This has stranded up to 70% of Russian oil exports, driving up prices and creating problems with credit lines, shipping, and insurance for Russian commodity exporters. It has also likely emboldened leaders to review an official ban. US Secretary of State Antony Blinken said that Washington is actively discussing a ban on Russian oil imports with European allies to deprive the government of revenues and try to expedite a resolution. Any ban (whether official or de facto) or disruption will deliver destabilizing commodity supply and price impacts and require a variety of emergency measures.

Oil market disruptions and responses

Russia exports about 7.8 million barrels per day (mbpd) of oil and products, of which 5mbpd is crude. 60% of this crude goes to Europe and 20% to China. A ban on Russian oil could see prices rise to USD 150/bbl or higher. In any event, prices will remain significantly higher because buyers are in self-sanctioning mode (even with discounts on Russian crude in the USD 20/bbl range to Brent), and there are simply not enough options to backstop for losses of Russian oil and products in the market.

A few options can introduce a modest drag on oil prices. The one of most immediate interest is the potential for a new JCPOA nuclear deal with Iran. Iranian crude can serve as a near substitute for Urals exports. However, besides what is immediately available for export in offshore floating storage (some estimates suggest nearly 100 million barrels), it could take several months before Iranian compliance can be confirmed, sanctions lifted, and higher production restored. Elsewhere in the market, US officials traveled to Venezuela over the weekend for talks. While there is no guarantee a deal

would emerge, Venezuelan crude could substitute at US Gulf Coast refineries for part of the estimated 670,000 bpd of Russian crude imported by the US.

Such solutions could offer some relief, in addition to extra supply from key Middle East or North Sea producers to help backstop. However, given the sheer size of Russian exports, no combination of solutions will entirely offset Russian losses and ease current tight market conditions. A case in point is the announced 60 million coordinated SPR release by the US and allies last week, which did very little to offer sizable or sustained oil price relief. In addition, OPEC+ members continue to produce below current, targeted levels, so any coordinated move to raise quotas would likely have limited impact.

Fewer options to calm volatile gas markets

The risk to Russian gas supplies from sanctions, potential pipeline disruption risks, or trading disruptions due to payment issues have doubled futures prices for next winter, and European and Asian gas prices are set to remain very high and volatile through the spring and summer. This would further spill into European and Asian electricity prices.

The global gas market was tight even before the Ukraine crisis. Moreover, Europe is the hotspot for gas market volatility, with Russia comprising 40% of gas supply and countries in Central and Eastern Europe still the most exposed. Thanks to warmer-than-normal temperatures and fuel-switching to coal, Europe can sustain through the remainder of this heating season despite lower-than-average gas storage levels (currently at 27%). The main concern is storage rebuilding in the months ahead amidst higher prices and the associated financial pressures this will add to households and businesses. Additional LNG capacity coming online globally, including from the US, can help in Europe, in addition to larger pipeline supplies including from North/Northwest Europe and Azerbaijan. However, the volumes are insufficient to refill seasonal storage in Europe, Asia, and North America without steady flows of Russian gas. European buyers will be competing especially with South and East Asian buyers for LNG to refill storage ahead of the 2022/23 heating season, implying higher prices for longer.

Prices have crept so high in recent days they appear detached from market fundamentals. Governments will have to step up to push through backstopping solutions and more impactful policy changes. In this regard, the European Commission is expected to present a ten-point plan on 9 March with potential policy options. This is likely to include a call to accelerate climate change policies to support efficiency measures, renewables, and other green energy solutions, as well the introduction of annual, minimum gas storage levels for end-September for all EU countries (Italy and Germany are already reviewing minimum storage level measures).

Several countries are also considering options to reduce gas burn in favor of some mothballed nuclear or coal plants. In addition, there are plans to expedite the construction of new LNG import capacity, particularly in Germany, and countries can purchase floating LNG regasification units as a temporary measure to cover some import capacity shortages in the near term.

What about energy transition plans?

Market tightness and price spikes are in many ways a reflection of underinvestment in fossil fuels as climate policies put their future in question. Certainly, concerns about any type of supply disruption are pushing policies that could favor additional oil, gas, and coal as temporary solutions if the conflict persists. But current levels of clean energy investment were already insufficient to keep the world on track for net-zero emission by 2050, and investments in alternative sources would need to triple from current levels to pick up the slack from oil and gas. The rough energy transition that lies ahead will demand the need for tools and policies that smooth energy market volatility, and this conflict is certain to highlight current shortcomings.

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