A Stretched Energy Market Gets Stretched Further

March 2022

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The Russian incursion into Ukraine has caused an already-tight energy market to explode. Prices of both oil and natural gas have shot upward to levels not seen in almost a decade, greatly compounding the risks of rising inflation. Governments around the world are scrambling for solutions, but unfortunately, there are no easy answers, and the situation is likely to get worse before it gets better.

Even before Russian forces entered Ukraine, worldwide energy markets were already extremely tight. Oil demand has quickly accelerated back to pre-COVID levels. Supply, meanwhile, has suffered due to regulatory hurdles and under-investment driven by poor historical returns, as well as the shift away from fossil fuels as ESG and the shift towards clean energy became more popular under Biden. Oil prices (WTI) jumped from $48.52 at the beginning of 2021 to $88.15 by the end of January. European natural gas prices jumped five-fold last summer and fall and have remined near those levels as European inventories struggled on a combination of Putin slowing gas exports to Europe, weather, and recent poor European wind output.

WTI Oil Price

June 30, 2020 - March 3, 2022

Source: Bloomberg Finance L.P.

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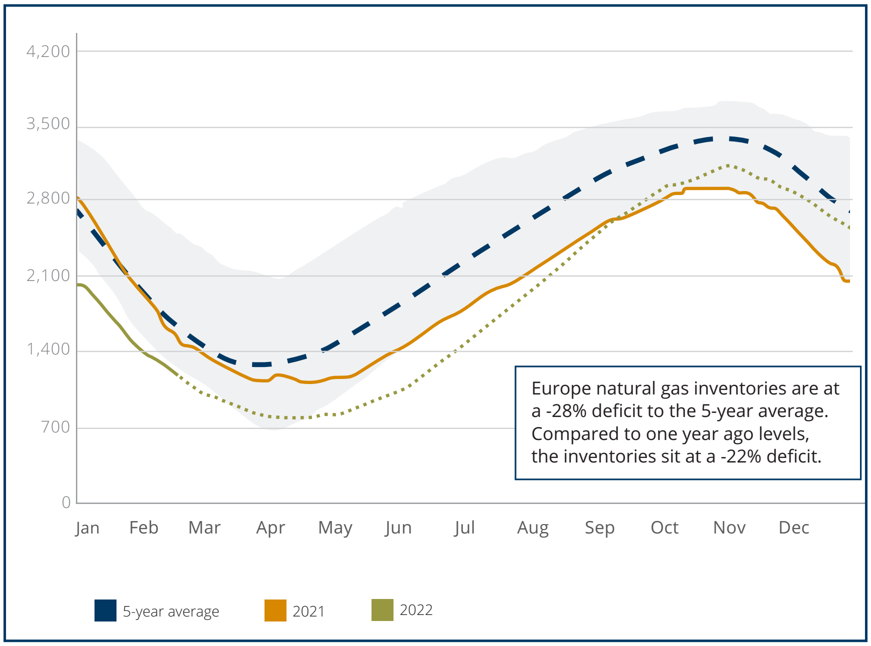
It was against this backdrop that Putin ordered troops into Ukraine. It now seems as if both Putin and the energy markets miscalculated the unified resistance Russia would face. Not only were Russian plans for a quick takeover thwarted, but the invasion was met with a universal rejection of all things Russian. Russia supplies 40% of Europe's natural gas and exports roughly 7 million barrels of oil per day (mmb/d), roughly 7% of the global market. It also supplies a significant amount of refined products (gasoline, diesel, jet fuel) to Europe. Even though governments have been careful so far not to sanction Russian energy exports, a lot of that supply has nonetheless come off the market. A combination of financing issues, logistics issues around securing tankers and ports, and an overall fear of the reputational taint of buying from Russia has curtailed the exports. Analysts have estimated that Russian exports are being curbed by as much as 70%. As evidence of this, Russian oil is currently bid at $20 per barrel below market. The problem, of course, is that with energy markets already tight, there is little supply available to step in and replace the missing Russian oil, thus prices are racing higher with oil now over $112 per barrel, up over $20 from when the invasion began. The situation on the natural gas side is even more dire for Europe. The only alternative to Russian pipeline gas is Liquified Natural Gas or "LNG", but there is very little excess supply available, most of which Europe has already been receiving over the past several months.

There are not a lot of obvious solutions to these high energy prices in the short-term. Oil releases from the IEA and the U.S. strategic petroleum reserves are just a drop in the bucket. There is a lot of noise around Iran and the re-signing of the JCPOA. Even if an agreement is reached, however, it is probably 3-4 months before everything gets documented and signed. Even then, analysts estimate that Iran has 500 b/d of oil that it could start exporting fairly quickly and then another 500 b/d that could be added over the next 6-12 months, but this pales in comparison to the level of Russian exports that have gone away. U.S. shale and perhaps Saudi Arabia could probably add additional production, but both likely require a personal appeal and incentives from President Biden, and so far, Biden has been unwilling to go against the progressive side of his party that wants to end all use of fossil fuels. This then leaves demand destruction as the only avenue for getting the market back in balance. However, real demand destruction will require even higher oil and gas prices, and this runs a significant chance of triggering a global economic recession.

Europe Natural Gas Inventories (bcf)



Source: Tudor, Pickering, Holt & Co.

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The world can hope that Ukraine holds firm or that Russians force a regime change at home, but both are long shots. Maybe Ukraine eventually succumbs and with the fighting stopped, perhaps the outrage against Russia will fade, but the world seems far from a forgiving mood. At the end of the day, there is no obvious exit ramp for Putin, and thus there is no easy exit for this energy crisis. Pressures will also grow as time goes on; inventories will get further depleted and we will move from the current shoulder season into the high summer energy demand period. Suffice it to say, it appears as of now that extended energy prices may be with us for some time.

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