

The War in Ukraine Rages On: The Energy Fallout

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Last month, Protiviti issued two Flash Reports on the crisis in Ukraine. The first¹ addressed Vladimir Putin's recognition of two Ukrainian regions as "independent people's republics," deployment of "peacekeeping forces," and demands that Ukraine disarm and negotiate the sovereignty of the two separatist regions; the West's initial wave of sanctions as a proportionate response to Putin's actions; and the implications for companies worldwide. The second² reported on Putin's ordering a full-scale invasion of Ukraine, the punishing sanctions levied upon Russia by the North Atlantic Treaty Organization (NATO), United States and other jurisdictions around the world in response to this unprovoked aggression, actions by private sector organisations to discontinue their investments in and pursuits of Russian markets, and an update on the global implications.

Over the last two weeks, the world has witnessed harrowing images of Russian atrocities in targeting civilians with indiscriminate bombardment of residential areas, medical facilities and infrastructure. Ukrainian resistance has stiffened as a tragic humanitarian crisis has unfolded. Almost three million refugees have fled the country as the Russian military relies on long-range firepower, leaving untold billions of dollars of damage to the country's beautiful cities and death in the streets and rubble in its wake. A protracted conflict is underway.

Meanwhile, the West's sanctions on Russia have overturned nearly 30 years of reforms undertaken since the Soviet Union's collapse, setting the country back for perhaps decades. More than 300 companies have ceased operations and direct foreign investment has stalled to a standstill. The ruble has tanked, leading the Central Bank of Russia to take extreme steps to pre-empt further devaluation. The Russian stock market has been frozen since February 25, the day the invasion began, to prevent investors from pulling out. Russia has

¹ "The Russian Invasion of Ukraine: Its Potential Implications and Impact," Protiviti, February 23, 2022, available at www.protiviti.com/US-en/insights/flash-report-022322-russian-invasion-ukraine.

² "Putin Pulls the Trigger and the West Responds Again: What Happens Now?," Protiviti, February 28, 2022, available at www.protiviti.com/US-en/insights/flash-report-022822-putin-pulls-trigger-west-responds-again.

begun to default on its bond payments, causing a dive in its credit rating. Russia's favoured nation trade status has been revoked and the list of sanctioned entities grows every day.³

In retaliation. Russia announced it is halting its foreign exports of grain, banning the purchase of dollars and other foreign currencies, and limiting the amount of foreign currency Russians can withdraw from their bank accounts. The Russian government has also initiated seizures of foreign assets. The situation remains fluid as new developments arise every day. The risk of a broader conflict remains as the West ships defensive weapons to Ukraine and Russia launches attacks on supply lines close to the Polish border. There is also pressure building to support a no-fly zone over Ukraine, particularly if Russia deploys chemical weapons. Meanwhile, European and U.S. companies and government agencies responsible for critical infrastructure assets remain on high alert to Russian cyberattacks.

Finally, the question begs itself: Where is China? In this situation, this question is not about geography. Will China help Russia circumvent the West's sanctions? If it does, to what extent? Finally, how will the West (and other countries) respond?

The global energy picture hangs in the balance

The most powerful sanction the world has available to check Vladimir Putin's aggression is restricting Russian oil and gas exports, which are believed to be the primary means of financing his war-making capabilities. Oil price upside is primarily due to the speculative market driven by the war. However, if Russian oil is not allowed to trade, the price hike could spike much higher.

Thus far, the U.S. has banned the import of Russian oil and liquefied natural gas (LNG), and the UK has announced a phase out of imports of Russian oil by the end of the year. The U.S. ban goes into effect immediately but gives buyers 45 days to wind down existing contracts. It also forbids new U.S. investment in Russia's energy sector and prohibits Americans from participating in any foreign investments that flow into the Russian energy sector.⁴ The UK ban allows companies even more time to adjust supply chains and support consumers.⁵ All

³ "Russia's efforts to salvage economy could have devastating impacts," Sylvan Lane and Karl Evers-Hillstrom, The Hill, March 13, 2022, available at <https://thehill.com/policy/finance/economy/597923-russias-efforts-to-salvage-economy-could-have-devastating-impacts?rl=1>.

⁴ "Biden bans Russia oil imports to U.S., warns gasoline to rise further," Trevor Hunnicutt, Steve Holland and Andrea Shalal, Reuters, March 8, 2022, available at www.reuters.com/business/biden-bans-russia-oil-imports-us-warns-gasoline-prices-will-rise-further-2022-03-08/.

⁵ "UK to Phase Out Russia Oil Imports," Gov.UK, March 8, 2022, available at [www.gov.uk/government/news/uk-to-phase-out-russian-oil-imports#:~:text=source%20of%20income,The%20UK%20will%20phase%20out%20imports%20of%20Russian%20oil%20in,today%20\(Tuesday%208%20March\)](http://www.gov.uk/government/news/uk-to-phase-out-russian-oil-imports#:~:text=source%20of%20income,The%20UK%20will%20phase%20out%20imports%20of%20Russian%20oil%20in,today%20(Tuesday%208%20March)).

eyes are now on China to see if it intends to fill the gap as a primary buyer of Russian liquid fuels, but there may be logistical challenges to assuming that role.

As for the EU, natural gas supply disruptions due to the conflict in Ukraine are a significant concern. Russia accounts for about 45% of the EU's supply. By contrast, U.S. imports from Russia are about 8% of total liquid fuel imports. The EU said it planned to cut its imports of Russian natural gas by two-thirds by the end of this year. The EU's plan is focused on building gas reserves, diversifying supply and accelerating the clean energy transition.⁶ However, there may also be a move to traditional dirtier sources of energy to help bridge the reliance on Russia as progress is made in shifting to renewables, e.g., Italy is evaluating firing up seven coal plants that have been offline.⁷

As an immediate step to alleviate the pressure of these decisions on prices, the 31 countries comprising the International Energy Agency agreed to collectively release 60 million barrels of oil from strategic petroleum reserves, with about half of that release from the United States' national reserves. However, this release is expected to have little impact as it is the equivalent to only about two weeks' worth of Russia's crude exports.

Saudi Arabia, UAE, Iraq and Kuwait have spare capacity and capability to produce in a supply crunch through a combination of expected brownfield production (entailing the purchase or lease of existing facilities), field start-ups and utilisation of spare capacity. Qatar is a gas-rich country with a major expansion plan to increase LNG capacity by 40% by 2026. In the short term, Qatar can direct shipments to Europe. Currently the fastest-growing Arab exporter of LNG, Egypt is considering long-term LNG contracts with European buyers. While Egypt and Qatar offer a potential market to the EU, logistical challenges remain. Iran is also viewed as a potential source of imports; however, the Joint Comprehensive Plan of Action (the nuclear deal) must be revived to make it work. Finally, last week, a U.S. delegation began discussions about easing sanctions on Venezuelan oil in exchange for the present government's promise to cut ties with Putin—an overture by the Biden administration that is facing substantial opposition in the U.S. Congress.

⁶ EU Pledges to Cut Russian Gas Imports by Two-Thirds Before the End of the Year, Silvia Amaro, CNBC, March 8, 2022. www.cnbc.com/2022/03/08/eu-pledges-to-cut-russian-gas-imports-by-two-thirds-before-next-winter.html.

⁷ "Energy Emergency, in Italy 7 Coal-Fired Power Plants Ready to Restart," Davide Madeddu, 24, February 27, 2022, available at [Emergenza energia, in Italia 7 centrali a carbone pronte a ripartire - Il Sole 24 ORE](https://www.emergenziaenergia.it/italia/7-centrali-a-carbone-pronte-a-ripartire).

In total, the combined impact of these sources could result in production of up to 3.8 million barrels per day.⁸ In 2021, Middle East exports to the EU were three to four times lower than Russia's. If the war continues, Middle East oil exports to the EU are likely to increase significantly. In fact, talks are already underway to secure long-term contracts.

Other longer-term measures are available. Replacing Russian oil on the European market is likely to take years and may even prove to be more expensive for European consumers. For example, in the U.S., there are calls for more drilling. Some are urging reauthorisation to complete the Keystone XL pipeline transporting Canadian crude to the states. Some European nations are doubling down on their commitments to transition to clean energy. The Biden administration has indicated it is open to bolstering both the country's green technologies and drilling capabilities.

An interesting development to watch is the impact of these geopolitical developments on the expectations around environmental, social and governance (ESG) reporting. For example, in Europe there is a possibility that reporting standards might be eased for nuclear power.

Meanwhile, it is estimated that around 70% of Russian seaborne oil is struggling to find buyers. The West's sanctions relating to liquid fuels and their shipment are starting to bite.⁹

Can the U.S. do more to reduce EU dependence on Russian oil and gas?

Amid shifting geopolitical pressures, can the U.S. increase production enough to significantly offset the EU's shortfall over the next 12 months? Many argue that drilling on federal lands offers low hanging fruit. But it isn't quite that simple.

Because the U.S. oil and gas industry isn't state-run like most oil-producing countries, it is necessary to gain consensus across many players. These players are reliant on oilfield services organisations to bring materials, labour and equipment to bear. During heaving drilling or completion cycles, their costs increase substantially, not to mention the added costs from supply chain challenges, e.g., the inflationary rise in costs of pipe and trucking. There is also the continued effect of COVID-19 on the labour market; in the field, oil and gas is highly people dependent.

⁸ "Is There an Oil Supply Crunch or Just a Minor Pinch?," Bjørnar Tonhaugen, Arabian Post, February 17, 2022, available at <https://thearabianpost.com/is-there-an-oil-supply-crunch-or-just-a-minor-pinch/>.

⁹ "FACTBOX-Countries and Companies Shun Russian Crude Over Ukraine Invasion," Staff, Reuters, March 14, 2022, available at www.reuters.com/article/ukraine-crisis-russia-oil-idCAL5N2VE520.

These economics directly impact the upstream operators' capital programs because drilling programs are based on assumed costs. If there are capital constraints, operators are not positioned to increase their plans which have been vetted with the board of directors. Furthermore, in most states, drilling programs must be mapped out to front run the permitting process which, unfortunately, drags out when activity rises dramatically.

That's the micro perspective. The macro view is that the entire U.S. industry has been crushed by investors for eroding equity by taking on excessive debt in good times and declaring bankruptcy in unexpected down cycles. As a result, upstream operators have shifted to an "operate within cash flow" model that has become "table stakes" for investors. This constraint is on top of a diminished investor community that has become increasingly focused on ESG-screening considerations; therefore, operators are fighting for a share of a smaller segment of the capital markets. Many companies have hedged production, resulting in lower realised costs at the present time. Thus, they are still making money, but they are not selling in the spot market to reap windfall returns.

With the price of oil peaking (for example, WTI crude was at \$130 per barrel), President Biden has urged U.S. oil companies to add more production. Interestingly, WTI crude has since fallen below \$100 and the price of Brent crude—the world's benchmark price—has fallen 20%. The fall is a reminder that oil remains a very volatile and unpredictable commodity.

The industry as a whole remains hesitant to respond to the president's call. He campaigned on a platform that was hostile towards fossil fuels. More than a few industry executives will say that they have seen the "drill, baby, drill" movie before. Drill lots of holes with a wary eye on two things. First, there is the potential for U.S. over-production, which can easily occur because, as noted earlier, the U.S. oil industry is comprised of many companies functioning in a free market environment. Therefore, it is challenging to have full visibility into the extent of drilling activity before prices swing. Second, OPEC can add more supply. Either way, prices can drop significantly, leaving companies holding the bag on billions of capital expenditures and at risk due to weakened balance sheets. With the uncertainty over the duration of the Ukrainian war and Russian sanctions, reruns of this movie are not popular right now. To ask the industry to suddenly begin drilling with everything else going on ignores the fundamentals of drilling programs—namely, that they are a multiyear bet. In the U.S., this industry has essentially been left on its own to survive and has had more bad years than good over the last 10 years.

Oil is a global business. Prices are set by the world market. If Russia, as the world's second-largest oil producer, goes offline, the price of Brent crude goes up. In turn, the price of WTI crude goes up and the price of a gallon of gas or pound of jet fuel goes up. Notwithstanding the constraints to the initiation of U.S. drilling, as noted above, if immediate drilling in the U.S. were to begin, it is not likely to materially affect the price of gasoline in a significant way for at least a year given it takes roughly six months to drill and stimulate production in, say, West Texas.

Concluding comments

The war continues. There are few short-term options available to reduce the EU's and other regions' dependence on Russian oil. But other alternatives are available that more than likely feature countries in the Middle East as the predominant source of supply. The U.S. itself is not likely to be a substantive contributor for some time, if at all.

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