



PORTLAND MARKET REPORT

MARCH
IN VIEW

THE CHALLENGE TO ACHIEVE ENERGY INDEPENDENCE

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).

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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 these 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 equates to only 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. And forget converting existing oil tankers. It's not a feasible option from an engineering viewpoint and besides, as long as oil demand is buoyant (and trade flows equally upended), almost all crude carriers are already fully chartered.

Clearly 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 almost all of Russia's gas going forward, as they are the only major economy that will completely ignore sanctions. This then 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 spot cargoes. Consequently, we will see a huge upending of trade flows as Russia pumps as much Urals crude eastwards (via the ESPO (Eastern Siberian Pacific Oil) line), whilst European refiners will race to get their hands on crudes of similar specification

to the Russian product (e.g., 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, it is only a partial solution for European supply resilience. This is because Saudi crude is extremely heavy and viscous and does not make a happy bedfellow for European refineries, which are configured to process lighter crudes. This could lead to a worst-case scenario where European refiners simply give up on supplying the 'whole' market and only produce grades of fuel that they can easily process.

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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. It's true to say that the energy landscape is changing before our very eyes, but for those Ukrainians hiding in basements or being bombed in their apartment blocks, it will hardly be a pressing issue.

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