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Crude Oil Prices Up above $110/bbl amid Intensifying Ukraine Crisis

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

Crude oil prices are spiking. On March 2, the front-month futures contract for West Texas Intermediate gained $7.19 per barrel or 7% from the previous day to $110.60/bbl, closing above $110/bbl for the first time since September 2013. The key Brent futures price also rose to $112.93/bbl. On March 3, WTI soared above $116 before closing at $106.67/bbl, down $2.93/bbl. In the past week, crude oil prices rose by $15-20/bbl. Needless to say, the biggest factor behind the crude oil price spikes is the intensifying Ukraine crisis.

Russia's military invasion into Ukraine started on February 24 and has met strong resistance from Ukrainian forces and people despite Russian forces' intensifying offensive. The war, including the battle over the Ukrainian capital of Kiev, still remains in the balance. As more than 2,000 civilians have reportedly been killed in Ukraine, Russia has come under heavy fire from the international community including industrial democracies. At an emergency session of the United Nations General Assembly on March 2, 141 countries voted for a resolution to condemn Russia's invasion of Ukraine and call for Russia's immediate stop of its use of force and withdrawal from Ukraine. The harsh resolution against Russia indicates that a large majority of countries in the world have concluded that the Russian invasion is an unignorable, outrageous act that infringes Ukraine's sovereignty and territorial integrity, is a use of force to change the status quo and represents a challenge to international order. At present, Western countries have sent no troops to Ukraine, leaving Russia and Ukraine to wage the war. Western countries and the international community have embarked on economic cooperation and the acceptance of refugees to support Ukraine suffering from the Russian invasion, while implementing tough economic sanctions on Russia.

Sanctions target President Vladimir Putin and oligarch business leaders supporting him, as well as the financial industry and the high technology sector including semiconductors. Among them, the exclusion of major Russian financial institutions from the Society for Worldwide Interbank Financial Telecommunications (SWIFT) has become big news as an extremely tough sanction. U.S. sanctions to effectively freeze the Russian central bank's assets in the United States and restrict transactions with the central bank are combined with the SWIFT exclusion to exert great impacts on the Russian economy. The SWIFT exclusion, if targeting financial institutions involved in energy transactions, might affect Russian energy exports, coming as a backlash against Europe that depends heavily on energy imports from Russia. In this respect, the European Union on March 2 announced that the seven major Russian banks subject to the SWIFT exclusion would not include Sberbank, the largest Russian bank, and Gazprombank affiliated with Russia's state-run gas company Gazprom, indicating concern about the sanction's effects on Russian energy exports. However, the economic sanctions that have been implemented so far are far tougher than earlier assumed.

In such situation, insecurity about Russian energy exports has grown, leading to price spikes and destabilization in international energy markets. Russia is among the leading oil and gas exporters, accounting for 7.43 million barrels per day or 11% of global oil exports in 2020 and 238.1

billion cubic meters (197.7 billion m^3 in pipeline exports and 40.4 billion m^3 in liquefied natural gas exports) or 25% of global gas exports. Although Russia has expanded energy exports to Asia including China, most of its Russian energy exports are destined to Europe with which Russia has developed infrastructure including pipelines. Russia's competitive energy supply holds a key position in Europe, accounting for about 30% of oil supply in Europe and about 40% of gas supply there. Russia has thus become an extremely important energy source for Europe.

The important Russian oil and gas exports are exposed to the risk of disruptions due to the Russian military invasion and Western economic sanctions. At present, it is difficult to predict how supply disruptions would arise, how much the disruptions would be and how long the disruptions would continue. Given the current situation, however, the following three patterns of disruptions are conceivable:

(1) Supply will decrease as Western economic sanctions restrict Russian energy transactions.
(2) Supply will decrease or stop as attacks on major Ukrainian energy infrastructure facilities including pipelines damage them or make them inoperable.
(3) Russia will cut or stop energy exports to counter Western sanctions.

Regarding the first pattern, the abovementioned SWIFT exclusion's expansion to cover major financial institutions handling energy transactions would exert great impacts. A spreading view is that the sanctions have begun to affect Russian oil exports as traders have avoided the acceptance of Russian oil in view of Western sanctions, forcing Russian oil prices to be substantially discounted. As for the second pattern, Russian natural gas exports to Europe via Ukraine, now at 40 billion m^3, could be exposed to the risk of disruptions depending on future war developments. Regarding the third pattern, Russia could use oil and gas as weapons. This means that Russia could take hostile actions against Europe and other major energy consuming countries, hurting Russia's position as a reliable supplier that it has taken much time to build. Therefore, this option is difficult for Russia to adopt under usually reasonable decisions. However, what would happen in Russia is now uncertain. We must take the pattern into account.

It is impossible to predict which pattern is plausible, how these patterns would be combined, how Russian energy exports would be affected and how long they would be affected. At least, however, we must seriously consider the possibility of considerable Russian energy exports being affected or disrupted. Therefore, international energy markets will brace for the possibility, leading energy futures prices to soar.

As a matter of course, factors other than the Ukraine crisis were behind the March 2 crude oil price spikes. The OPEC-plus group of oil-producing countries at a meeting on the day decided to increase production in April by 0.4 million bpd as earlier planned, instead of boosting production more as requested by oil-consuming countries. The decision encouraged the WTI price to shoot up beyond $110/bbl. Although industrial democracies hoped that the group would accept an additional production increase to apply a brake to oil price hikes, the OPEC-plus group attributed the high oil prices to geopolitical risks and indicated that the monthly production increase of 0.4 million bpd would be sufficient. Within the OPEC-group including Russia, the Organization of Petroleum Exporting Countries might have given priority to the integrity of the group's coordinated production. Some people point out that the United States has failed to coordinate views with OPEC leader Saudi Arabia. A key point for the immediate future would be how Saudi Arabia would respond to an enhanced U.S. request for the group to accelerate its production increase. Now that the International Energy Agency has led an initiative to release 60 million barrels of oil reserves, its impacts may attract attention. We must also watch the fate of the Iran-U.S. nuclear talks, Iran's potential

comeback to the international oil market and a potential increase in U.S. shale oil production toward the second half of this year. Anyway, however, the fate of the Ukraine crisis and potential disruptions to Russian energy exports will remain the largest risk factor to jolt the international oil market and other energy markets. We must pay attention to future developments and the crisis's impacts on the global economy and energy security, including those on the gas and LNG market that features less surplus supply capacity and fewer alternative supply sources than the oil market.

Contact: report@tky.ieej.or.jp
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