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Prospects for Future Oil/Energy Situation: Focusing on Geopolitical Risks

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On February 4, an international panel discussion on the future oil/energy situation took place in the form of an online webinar, cosponsored by ENEOS Corporation, ENEOS Research Institute, Ltd. and the Institute of Energy Economics, Japan. I and two others participated in the panel discussion as panelists. The other two were Fereidun Fesharaki, chairman of FACTS Global Energy Group, and Sarah Ladislaw, a managing director at the U.S. RMI (former Rocky Mountain Institute) and a non-resident senior associate at the U.S. Center for Strategic and International Studies. Nikkei Shimbun editorial writer Hirofumi Matsuo served as moderator. The 31st annual international panel discussion on the matter, as well as the past ones, covered prospects and challenges for the international oil situation and global natural gas and LNG markets over the short, medium and long term, including the impact of the decarbonization trend.

The most impressive point to me regarding the latest panel discussion is that extremely interesting arguments came about the current spikes in crude oil, natural gas and LNG prices. It was apparently significant that the discussion came at a time when the world was bracing for the destabilization of international energy markets, with the tense Ukraine situation attracting global interest as a geopolitical risk. As a matter of course, the key discussion issues included how international oil, natural gas and LNG markets would be affected by carbon neutrality and other ambitious decarbonization goals and initiatives in the world over the medium to long term and what responses are required for energy policies and market participants. While participating in the discussion, I was inspired very much regarding various points. In the following, however, I would like to focus my comments on issues regarding market destabilization over the short term.

The first issue at the panel discussion was how rising crude oil prices should be viewed. Basic factors behind crude oil price spikes, such as Brent's rise above $90 per barrel, include a remarkable decline in oil inventories. Why has the international oil market transitioned from extreme oversupply under the COVID-19 pandemic in the early spring of 2020 to the current low inventories and tight supply-demand balance? The key reason is a coordinated oil production cut by the OPEC-plus group of oil-producing countries in a demand recovery process. The large-scale OPEC-plus production cut has had great effects, leading the market to rebalance and transition to a tight supply-demand balance through a decrease in inventories. Amid this transition, crude oil prices have retained an uptrend.

When the Omicron COVID-19 variant infection was spreading throughout the world late last November, crude oil prices fell back sharply on concern that crude oil demand would stagnate as the global economy decelerates due to Omicron developing into a pandemic. Even amid the continued Omicron spread, however, global oil demand is still increasing as the continuation of economic and social activities with COVID-19 has become a central challenge. Then, a new matter of concern is whether the OPEC-plus group could continue to increase production by 0.4 million barrels per day a month as agreed earlier. As Nigeria and Angola are failing to increase production as planned, crude oil prices are rising on concern that the OPEC-plus group could fall short of increasing production as planned.

The oil market is now even more nervous about the impact of the Ukraine situation than about the OPEC-plus production trend. As Russian troops have amassed on Ukraine's border, their potential invasion into Ukraine has loomed as a great geopolitical risk. As Russia serves as a key oil exporter to Europe as well as a major gas supplier to the region as explained below, market participants are concerned that growing tensions between Russia and Western countries following the potential invasion would disrupt Russian oil and gas supply. As crude oil prices are rising due partly to the risk, participants in the panel discussion frequently indicated that crude oil prices would rise further depending on future developments. Over the short term, the international oil market would be exposed to the geopolitical risk and be very unstable.

In the global gas market as well, any risk event is feared to trigger spikes in European gas prices and Asian spot LNG prices amid growing insecurity and uncertainties mainly about the Ukraine situation. As is the case with the oil market, the gas market has seen price hikes caused by the combination of supply and demand fundamentals and geopolitical risks. Although regional gas and LNG markets had been independent from each other, they have been rapidly globalized in recent years. As a result, a tighter supply-demand balance in a regional market has begun to affect other regional markets. The market structure has changed to lead regional markets to interact with each other. Particularly, a tightening supply-demand balance and spot price hikes in the European gas market have grown linked to those in the Asian market. In Asia, spot LNG prices have soared as LNG demand including massive consumption in China has continued to increase, with U.S. LNG supply growth failing to catch up with demand expansion. Spot LNG prices peaked at unusually high levels close to $50 per million British thermal units before falling back to present levels below $30/MMBtu. The present levels are still high.

European gas prices have posted even greater hikes. As great uncertainties arose about pipeline gas supply from Russia, the largest gas supplier to Europe, amid low inventories, concern about geopolitical risks pushed gas prices up to levels close to $60/MMBtu (equivalent to a crude oil price of $360 per barrel) late last year. As Asian spot LNG prices have done, European gas prices have declined below $30/MMBtu. Depending on Ukraine situation developments including a Russian invasion that may lead to the possibility of disruption of Russian gas supply to Europe, European gas prices could rise to new record highs.

If Russian gas supply that accounts for some 40% of European gas supply is disrupted to a large extent, it may be effectively impossible to cover the loss. The United States and its allies are considering using U.S. LNG, increasing supply from Qatar and utilizing LNG cargo divert from major Asian LNG-consuming countries. Given the massive Russian gas supply to Europe, however, it may be difficult to cover the loss. LNG supply mainly under long-term contracts may be difficult to divert from Asia to Europe, even if some flexible measures are available. Even if U.S. LNG and other flexible LNG supply can be diverted to Europe, such diversion may be designed to respond to an emergency situation and trigger spikes in spot LNG prices. The market is now required to brace for a contingency event.

Whether Russian gas supply would be disrupted on a large scale remains very uncertain. Ukraine tensions have some chance to be eased through diplomatic means. Whether any risk event would trigger large-scale disruptions to energy supply is now difficult to predict. Given that Europe and Russia depend on each other regarding energy trade, an export revenue loss would not necessarily be acceptable for Russia. Amid the current energy price spikes, however, the potential of large-scale gas supply disruptions and further price hikes may be a grave energy security risk for Europe and a grave issue not only for the international gas and LNG market under globalization but also for overall energy markets. While Russia is likely to leverage energy security concerns in Europe and other major energy-consuming regions for strategic purposes, Western countries are trying to embark on developing strategies to counter such Russian action. Energy geopolitics is now about to exert great influence on the overall international situation. We must closely watch relevant future developments.

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