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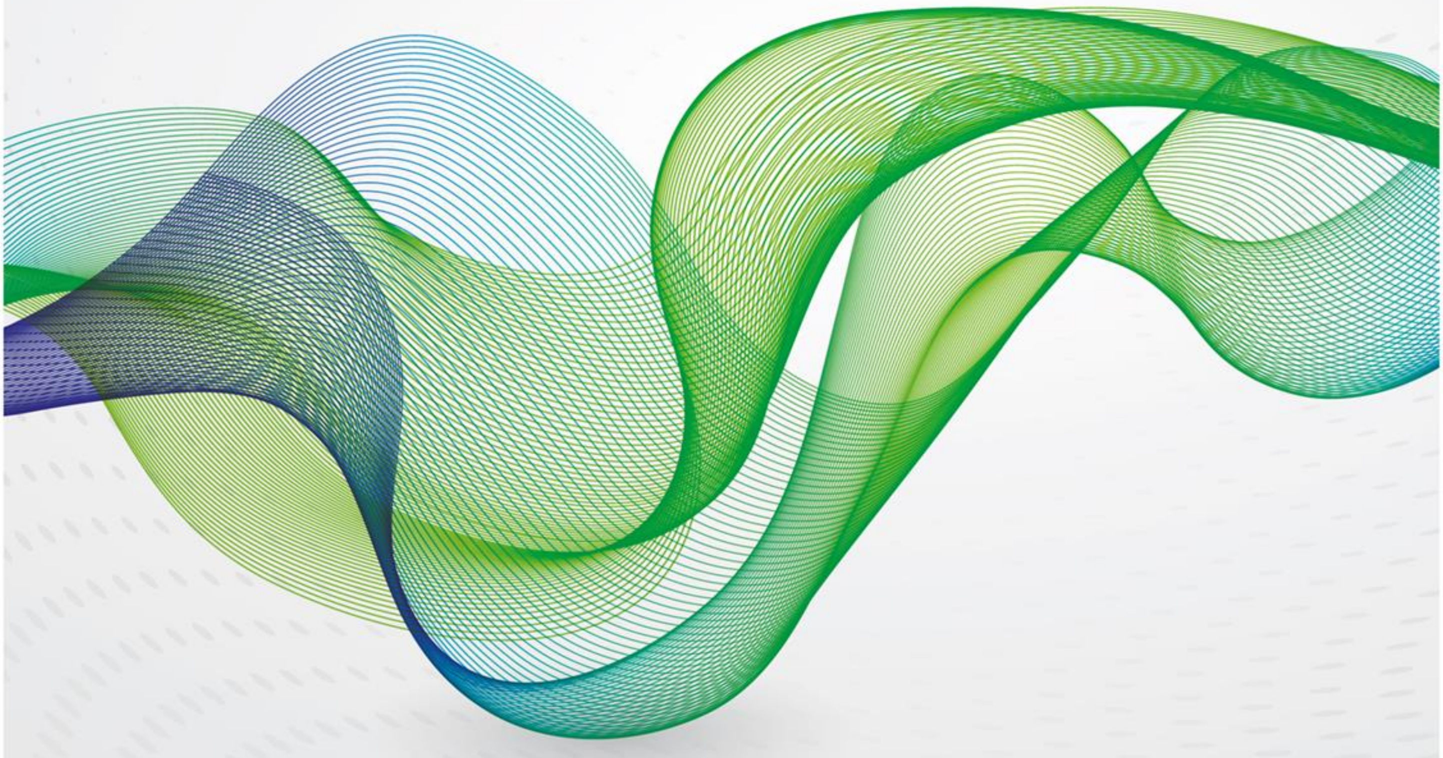
Russian gas to the EU: to sanction or not to sanction



OXFORD ENERGY COMMENT

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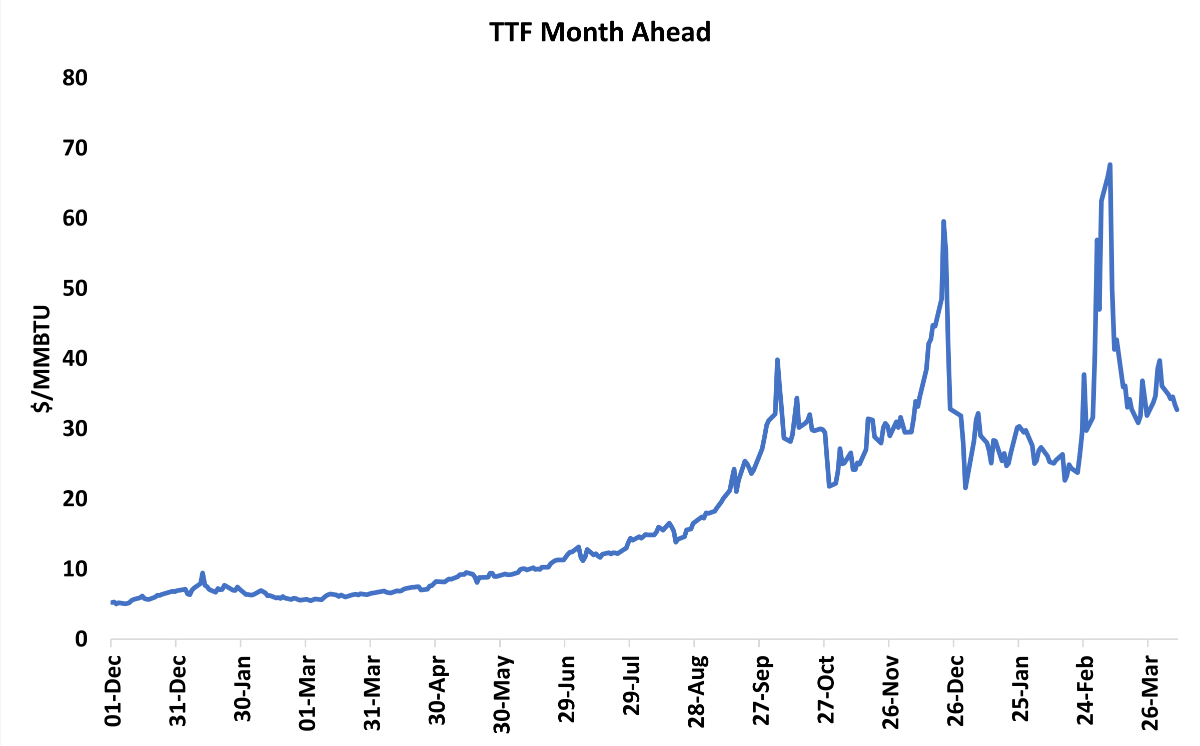
The gas market in Europe is in a state of real uncertainty as to whether Russia will cut off gas supplies to Europe, if, for example, buyers refuse to pay in roubles; or whether the EU should sanction imports of gas on the grounds that their payments are fueling the Russian war machine in Ukraine. Any interruption by Russia would simplify EU decision-making, but any decision by the EU – or decisions since different countries may take different views – needs to be informed by the potential market consequences. These difficult decisions need to be made by governments of countries heavily dependent on Russian gas, in contrast to those outside the EU, or even those within it, that import little or no gas (or LNG) from Russia, and have often been the most vocal in calling for sanctions on Russian supplies

Since the invasion of Ukraine by Russia, European natural gas market prices have been extremely volatile, rising sharply in the couple of weeks following the invasion, then falling back as it was clear flows were not being interrupted, and were actually even higher than before the invasion as European buyers stepped up nominations, reflecting more favourable monthly contract prices compared with prices on the spot market.

Figure 1: TTF Month Ahead Prices



Source: Argus Media

The figure above shows the evolution of the TTF month ahead price from the January 2021 contract to the present. In an OIES paper published in January of this year[1] the reasons behind the surging European gas prices were analysed. The conclusion was that there was a significant tightening of the global gas market, increasing in intensity through 2021, equivalent to almost 10 percent of European demand or 14 percent of global LNG trade, compared to the pre-Covid year of 2019. Around 60 percent of the tightening was driven by the European market, with rising demand, lower European production and lower pipe imports from Russia being only partly offset by higher pipeline imports from North Africa, Azerbaijan and Iran (into Turkey). The remaining 40 percent reflected rising LNG demand outside

[1] https://www.oxfordenergy.org/publications/surging-2021-european-gas-prices-why-and-how/

Europe coming up against a fall in LNG export capacity, because of numerous issues at export plants around the world more than offsetting rising US LNG supply.

Given the evolution of TTF prices in the first three months of this year, it would seem to be a reasonable conclusion that the global gas market has tightened further. However, that does not appear to be the case. The European market has indeed tightened further in Q1 2022 compared to Q1 2021, but this is in spite of demand being significantly lower – by some 7 percent as estimated by the author. It is marginally lower European production and non-Russian pipe imports, together with a large drop in pipe imports from Russia, especially in January and February, that has led to an overall tightening of the market. The LNG market meanwhile loosened significantly, with LNG demand outside Europe falling by 9 percent compared to a year earlier[2], and LNG export capacity rising by some 3.5 percent[3], as some of the constraints in 2021 unwound. Taking the LNG and European markets together, the overall global market loosened by the equivalent of 3 percent of European demand and 4 percent of global LNG trade.

The conclusion must therefore be that high prices in the last few months have been catalysed not by market reality but by the uncertainty over the possible invasion and then the actual invasion of Ukraine, with the possibility of disruption to the flows of gas from Russia. Statements from Russian ministers that gas supplies to Europe could be curtailed in response to sanctions, the EU's REPowerEU plan to drastically reduce imports of gas from Russia this year and the decree from President Putin that all payments for gas from "unfriendly" countries should now be in roubles[4] have all served to spike prices briefly before some easing on the news that flows from Russia are being maintained at much higher levels than before the invasion.

Contract gas is not spot gas

As noted earlier, the flows from Russia to the EU stepped up dramatically almost as soon as the invasion began, with prices in the day-ahead market exceeding the month-ahead contract price, making nominations under the long-term contracts more attractive. Higher nominations under the contracts are additions to supply and take pressure off the spot market, whether for day ahead or further ahead gas.

European buyers with contracts with Gazprom, have three options to meet their requirements to supply their customers – nominating under existing gas contracts at a known price, taking gas out of storage, or buying gas on the market for the relevant period. Only the latter has an immediate upward impact on the gas price. Taking gas out of storage may put upward pressure on summer prices because the storage would have to be refilled. Taking more contract gas by increasing nominations under the contract achieves the opposite of buying more gas on the market as it will add to supply and, other things being equal, will reduce demand for gas and prices on the spot market. Many commentators and politicians refer to European companies buying more Russian gas under the contracts as an increase in purchased flows. This is a misrepresentation. The purchase of the gas was effectively completed at the time when the long-term contract was entered into. With the contract in place, the buyer effectively has an option to lift gas from Russia at a price which is known before the day of delivery arrives, subject to agreeing to take, or pay for, a predetermined volume of gas in any one contract year. The act of nominating under the contract terms is an addition to supply, not the purchase of more gas from Russia.

The EU has a binary choice

The OIES has already published an Insight on the REPowerEU plan to reduce Russian gas imports by two-thirds in 2022[5]. An earlier paper considered the implications of the Ukraine invasion on the

[2] Based on Kpler data
[3] Based on NexantECA World Gas Model and author calculations
[4] https://www.oxfordenergy.org/publications/rouble-gas-payment-mechanism-implications-for-gas-supply-contracts/
[5] https://www.oxfordenergy.org/publications/the-eu-plan-to-reduce-russian-gas-imports-by-two-thirds-by-the-end-of-2022-practical-realities-and-implications/

European gas market[6]. The conclusion of the latter paper was that a complete curtailment of flows from Russia for a whole year would result in significant demand destruction – demand being unable to be met and industries having to close, alongside potential disruptions to power supplies. The EU plan to reduce imports from Russia by two-thirds relies on significant reductions in gas demand through increased efficiency, more wind and solar production and lowering thermostats, but mostly through obtaining increased supplies of gas from elsewhere, principally the diversion of LNG to Europe. The price consequences of these measures were not calculated by the EU but prices would undoubtedly become much higher. If the aim of reducing imports from Russia is to hit Russia's revenues from gas sales, reducing flows and having prices shoot up is not the solution. If imports are reduced by two-thirds and the price triples then revenues remain the same!

The current uncertainty in the market and the conflicting statements, both from within and outside the EU, about stopping or curtailing flows from Russia, simply give more scope for the Russian government to make disruptive statements and policies and impact the TTF price, sustaining the high contract prices to Gazprom's benefit. The market is in desperate need of more certainty. With the additional LNG supply available to the European market since the turn of the year and, in March, with flows from Russia increasing, there is actually a lot more supply available to the global market than a year ago, which ordinarily would have led to falling prices. The uncertainty, however, has had the opposite effect.

The EU has a binary choice now and neither option includes continuing with the current fudge of reducing Russian imports gradually as that won't reduce revenues to Russia. One option would be to impose sanctions and stop flows under the contracts completely; the resulting issues surrounding breach of contract (if the take-or pay payments aren't made) or possible force majeure would keep lawyers employed for years. Nevertheless, this action would immediately stop Russian revenues, albeit at a likely heavy cost to European economies and potentially very large further increases in gas and electricity prices to consumers. There would also be severe knock-on effects to gas prices to all the world's importers, raising their energy costs – particularly damaging to developing countries. In addition, this could well last for a long time and impact global energy costs until the end of the decade or beyond. Even the surge in LNG supply from the mid-2020s onwards plus more FIDs taken in the next couple of years may still not be enough to replace the lost supply from Russia.

The second option would be for the EU, or at least relevant national governments, to be absolutely clear that they will continue to take all the gas from Russia under the long-term contracts and, to the extent possible, encourage the buyers to nominate the maximum possible under the contracts. With more supply on the market and, hopefully, more certainty, that could bring prices down substantially and do more to reduce revenues to Russia and have a much greater impact than many sanctions already imposed.

Conclusions

The current situation of uncertainty and not knowing whether flows from Russia will be curtailed is the worst of all worlds, and is keeping prices high and, as a consequence, keeping Russian revenues from gas at record levels. The EU has only two options – full sanctions on Russian gas with an immediate impact on revenues or a clear statement that contracts will be fully abided by and contract volumes will continue to be nominated, increasing supply and significantly reducing prices – and revenues – to Russia. The latter course of action would not remove the uncertainty that Russia may choose to curtail flows, but it would at least provide certainty to the market from the perspective of the EU and European buyers. Additionally, if Russia cuts off European buyers, then any negative consequences can be laid firmly on President Putin, whereas if the EU stops the flows, with significant consequences for global gas prices, much of the world would be severely impacted, and the blame directed towards the EU.

[6] https://www.oxfordenergy.org/publications/ukraine-invasion-what-this-means-for-the-european-gas-markets/