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Ukraine: A Pawn in Putin's Energy Survival Strategy

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The West's green utopia is an existential threat to fossil fuels. Countermove: get prices up.

Since the invasion of Ukraine, analysts have had to pretend to be able to read the mind of Russian President Vladmir Putin, in order to understand his war aims and lay rational plans for how to deal with him. One narrative, to which we have subscribed from the beginning (see "Our Hot Take on Russia's Attack on Ukraine" February 24, 2022), is that the invasion is a classic "great power" strategy to create a buffer state and build a sphere of influence. But there's another motivation, just as powerful, that is likely operating too: *the invasion is a response to the fact that anti-fossil fuel policies in the West have become an existential threat to Russia and other oil and gas exporting countries.*

- Isn't it obvious? *The West is the buyer. Russia and the rest of OPEC+ are the sellers. The West says very clearly it intends to stop buying. The problem for Russia and the rest of OPEC+ is that selling fossil fuels is the only thing they know how to do*.
- In the face of this threat, *the obvious strategy for the sellers is to raise prices*. If nothing else, it maximizes cash flow while the West is still buying. At best, it teaches the West about its dependency on abundant fossil fuels until a bridge to a utopian green future can be completed – and makes it too expensive to build that bridge.
- Russia had already begun restricting natural gas exports to Europe before the invasion of Ukraine. The subsequent invasion checked lots of boxes – the "great power" ambition, a driver for even more supply restrictions, and control over pipes that have flowed natural gas to Europe well before the downfall of the USSR.
- We have assumed that when the conflict in Ukraine is resolved, the historical relationship of Russian energy exports to Europe would be resumed. Surely Europe would like that, since it has no alternatives until that utopian bridge is completed many years in the future. Indeed, Europe designed its ban on buying Russian fossil fuels to exclude gas, and only kick in for oil at year-end when, presumably, everyone will have kissed and made up (see "A Very European Ban on Russian Oil. Maybe." April 18, 2022).
- But does Russia want that? Well, why would it? *Arguably Russia just wants high global prices and continued shortages*. Right now, even with Russian crude priced well below other benchmarks, those benchmarks themselves are sharply higher. So Russia is still receiving more oil revenue than last year when global oil prices

Update to strategic view

OIL: The West is building a bridge to a utopian future without fossil fuels, leaving Russia and other producers with nothing to sell. Optimal cartel strategy is to earn an exit premium by raising prices. The invasion of Ukraine was a catalyst and producers have done nothing to offset it. Usually cartels limit high prices because they motivate buyers to find alternatives, but in this case the buyers have already declared they demand alternatives no matter what the price. So resolution of the Ukraine crisis won't automatically lower prices; it would have to include pledges by Europe to keep buying Russian oil and gas. Already Europe has extended an olive branch by declaring natural gas a green fuel. In the US, the same logic applies to domestic producers, who fear stranded capital if they invest to increase supply if the Biden administration makes regulations even harsher. The industry may begin to see a reversion to a pre-Biden regulatory environment when congressional control flips in November, pointing to a Republican White House in 2024.

[Strategy dashboard]

were much lower. So far Russia's gradual tightening of natural gas supplied to Europe hasn't been offset by sufficiently higher prices to preserve prior revenue levels – it's nevertheless a very effective shot across Europe's bow.

- And why would the rest of OPEC+ feel any differently? *So long as the West is committed to stop buying their fossil fuel exports, keeping prices high is a rational survival strategy*.
- Cartel theory holds that a monopolistic seller should set his price to maximize the present value of price times quantity. OPEC has traditionally seen this as ruling out prices so high as to trigger recessions that destroy demand, or more important, that motivate buyers to pursue alternate energy sources (it was an era of persistently high OPEC oil prices that gave birth to the US fracking revolution).
- *But now the buyers are already openly committed to finding alternate energy sources anyway – and for reasons that have nothing to do with price. So why not raise prices, since there's no penalty in terms of the buyers' incentives to substitute?*
- *The day may come, if the West doesn't relent, and if it succeeds in building its utopian bridge, that optimal cartel strategy would be to slash prices in order to get any remaining revenues at all. But that's not today's seller's optimum – the West is still addicted to fossil fuels at the moment, so the seller's play is simply to (a) keep prices high to maximize revenues, and (b) let shortages develop to harshly remind the buyer that he is indeed dependent and rub his nose in the cost of green utopianism.*
- Again, the Russian invasion of Ukraine checks these boxes. And more.

That's a formulation for high energy prices even after the Ukraine crisis resolves. More precisely, it is to say that *prices won't automatically revert to pre-invasion levels just because the invasion ends*. Not automatically, though there are credible paths to nevertheless get them to revert.

- A post-invasion settlement – depending on the extent at the time of Russia's conquest of Ukraine – could include pledges by Europe to continue to buy Russian fossil fuels on an ultra-long term schedule that would sharply slow the construction of the utopian bridge. That would lessen the existential threat that Russia faces as a seller of fossil fuels. It doesn't have to be entirely withdrawn – at the end of the day, Russia would be happy to pivot to Asia anyway, where economic growth is faster.
- Has Europe extended an olive branch already? Perhaps that's how we should see last week's declaration officially classifying natural gas as a green fuel, eligible for "clean energy" investment.
- That's just Europe and Russia. What about the other buyers and the other sellers? So far, Saudi Arabia and other OPEC producers have been happy to let prices stay high by doing little to increase production and help alleviate historically sparse global storage. In other words, the rest of OPEC is free-riding on the instabilities that Russia set in motion. Why would their position change just because peace eventually breaks out in Ukraine?

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- At least between the United States and Saudi, there is some reason for hope (see "Biden Pivots on Oil, Or At Least on Saudi Oil" June 22, 2022). President Joseph R. Biden Jr. is planning a visit to the Middle East this week (according to the *New York Times*, delayed to allow him to rest up after his European trip, given his advanced age) – in which he will surely try to persuade Saudi Crown Prince Mohammed bin Salman to pump more oil.
- Saudi has already rebuffed Biden's pleadings. And it has sent word to Biden, via French President Emmanuel Macron, that they don't have much spare capacity anyway. But that's all just positioning for the upcoming negotiation when Biden arrives. They've got spare capacity – it was only a little more than two years ago that Russia and Saudi got in an over-production war (see "Just What We Didn't Need: An Oil Price War" March 8, 2020).
- With the apparent collapse of talks to restart an Iran nuclear deal, the threat to Saudi from its regional rival is probably more existential than the utopian bridge to green energy. Saudi is going to need defensive missile technology. *At least where the US is concerned, there's something Saudi wants more than money – missiles – and the US is the monopoly seller*.

Fossil fuel producers in the US face the same existential threat as Russia, Saudi, or any other seller.

- Biden immediately upon taking office re-joined the Paris Agreement on climate change, making it clear that the US was going to line up with Europe in eliminating the use of fossil fuels. He went further than any other US president when he said that natural gas – our lowest carbon-emitting fossil fuel – would be phased out in 15 years. Past administrations followed an "every molecule counts" policy to increase our energy security – that is, it's a good thing to substitute a dirtier fuel with a cleaner one, even if the cleaner one isn't perfectly clean. But now, from the industry's perspective, Biden doesn't have an energy policy – he has a de-carbonization policy.
- So just like Russia, US producers have little motive but to squeeze the highest price possible from "every molecule" – with no fear of diminishing demand, because demand is to be abolished by fiat anyway.
- That said, for better or worse, such policies are quite fluid in the US, depending on how the political winds blow. Why would domestic producers assume the perpetual continuation of policies in place now for less than two years, put in place by a president whose approval ratings are the lowest in the history of approval ratings? There's a mid-term coming up where even the smallest red wavelet will end the Democrats' tenuous control of Congress, and it's a good bet that Republicans will take the presidency in 2024.
- No domestic producer wants to make large capital investments now just because a sitting president has an embarrassing inflation problem – if that same president's policies are going to strand those investments when the problem goes away. But at this point, shouldn't producers be including in their CAPEX models the possibility that it's that president who is going to go away?

Bottom line

The West is building a bridge to a utopian future without fossil fuels, leaving Russia and other producers with nothing to sell. Optimal cartel strategy is to earn an exit premium by raising prices. The invasion of Ukraine was a catalyst and producers have done nothing to offset it. Usually cartels limit high prices because they motivate buyers to find alternatives, but in this case the buyers have already declared they demand alternatives no matter what the price. So resolution of the Ukraine crisis won't automatically lower prices; it would have to include pledges by Europe to keep buying Russian oil and gas. Already Europe has extended an olive branch by declaring natural gas a green fuel. In the US, the same logic applies to domestic producers, who fear stranded capital if they invest to increase supply if the Biden administration makes regulations even harsher. The industry may begin to see a reversion to a pre-Biden regulatory environment when congressional control flips in November, pointing to a Republican White House in 2024.