Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Europe: Winter of Energy Discontent

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Michael Warren

Yellen's price caps will make no difference to Russia's crude revenues.

The global oil market has been focusing on short-term demand issues, pushing benchmark crude oil prices down into the mid-$80s. Specifically, the media have been hyping Chinese "Zero Covid" policy protests to accentuate regime instability that could severely impact economic growth going forward (see "Zero Covid" Protests? Zero Importance" November 29, 2022). These overly-restrictive anti-mobility policies have been estimated to reduce 2022 Chinese oil demand by about 400,000 barrels per day – the first negative year-over-year reading in three decades, but we think this exaggerates the true scope of the lockdowns and their likely longevity. We don't see China negatively impacting global oil demand growth in 2023.

While the backward-looking focus on Chinese oil demand destruction has hit the media over the last few months, *Russian President Vladimir Putin's reaction to the implementation of increased sanctions, price caps, and shipping insurance restrictions this month could have greater impact on crude oil supply levels going forward and affect short-term oil price movements*.

- The December 5 European Union implementation date for banning seaborne crude imports from Russia, agreed to earlier in the year, should go into force today without a hitch. The EU had been slowly weening itself off Russian oil imports, anyway – falling from 1.3 million barrels per day before the war to about 900,000 barrels per day in October. Most EU member states have been stockpiling oil supplies for the last several months to build winter inventories with a large part of it coming from Russia, which produced 10.9 barrels per day in November (highest level since the invasion) and total exports were up by 539,000 barrels per day over the previous month. While we don't have data visibility to see how much of the increase in total Russian crude exports went to Europe last month, Putin will need to offset about 1 million barrels per day of seaborne crude oil exports that used to go to Europe.
- The next issue on Putin's agenda is the EU insurance ban, enacted in the sixth round of sanctions against Russia at midyear, which will go into effect at the end of this month. The sanctions aim to stop the transport of Russian crude oil on the high seas by restricting finance and insurance. The ban is a serious threat to the Kremlin,

Update to strategic view

OIL, EUROPE MACRO: Price caps on Russian crude exports engineered by Yellen go into effect, but will make no difference to Russian revenues which are already based on steep discounting. Europe has been importing more LNG from Russia to make up for drops in piped volumes, but that remains a revenue hit for Russia, and a self-imposed one. The potentially momentous December OPEC meeting has now come and gone, and the cartel is staying pat on reduced production. Production growth forecasts for the US have been marked down, leaving Europe no sources of relief when bans on imports from Russia kick in. It all adds up to a tight oil market in which global benchmarks should rally back toward $100.

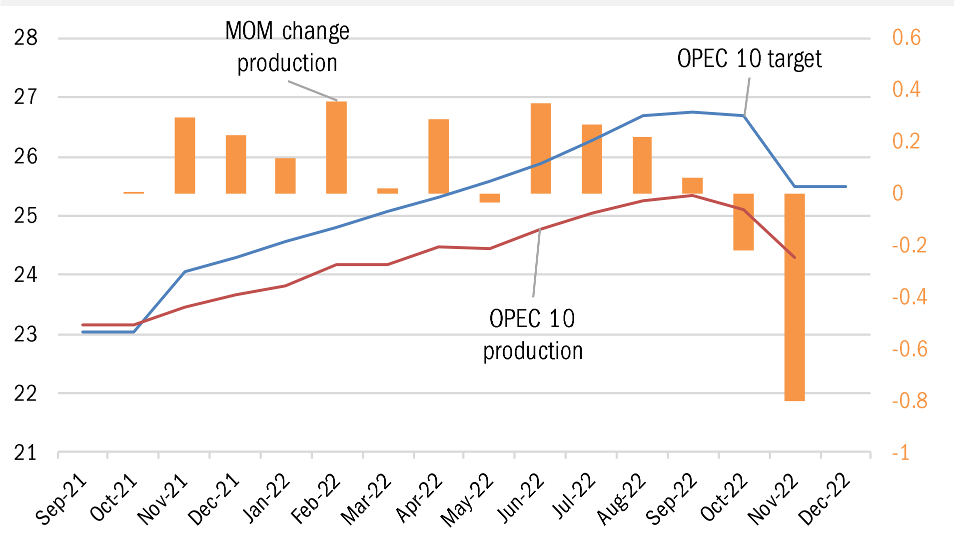
[Strategy dashboard]

restricting 85 to 90% of the companies participating in transportation of Russian crude oil.

- As it was first laid out, talk of a price cap on Russian crude oil – initiated by US Secretary of State Janet Yellen – was *thought to be another ploy to punish Putin for his war in Ukraine. Yet, after much hemming and hawing in Europe, the price cap was set at $60 for Russian crude oil, which is currently higher than what Urals oil trades at in international markets*. A lighter, lower volume oil – called ESPO for the Eastern Siberian Pacific Ocean pipeline – trades at a higher price above the cap, but it is consumed mostly by China, which we do not expect to honor the cap anyway. For all practical purposes, *Putin can still conduct business as usual* when Urals oil price remains under $60 while Europe effectively imposes restrictions on itself. The price cap can be adjusted, but it is unlikely to restrict Russian oil supply because the West (and especially the US) is using it as an off-ramp for bad policies decisions enacted right after the war with Ukraine began, which would have triggered economically untenable global oil prices.
- Russia has many options to deal with the price cap. As Foreign Minister Sergey Lavrov stated in India – a major consumer of Russian crude oil – Russia would negotiate directly with its trade partners as usual, essentially ignoring the price cap as another ploy of the West to merely pretend it is in control of world markets. Russia can also rely on what it calls a "shadow fleet" to move its oil to global customers and avoid using Western crude oil carriers and insurance companies. So the off-ramp that the US created to avoid catastrophically high oil prices seems to have worked so far.

Sitting back and watching all of this unfold were all the participating members in the OPEC and non-OPEC (OPEC+) production agreement. They were ready for a face-to-face meeting in Vienna on December 4 but

Crude oil production and targets (millions barrels per day)



Source: TrendMacro calculations

decided to a virtual call instead. December OPEC meetings historically have been eventful, where policy changes can occur. Not this year: OPEC rolled over its existing policy on the conference call, despite last week's hysterical media stories about a big production boost.

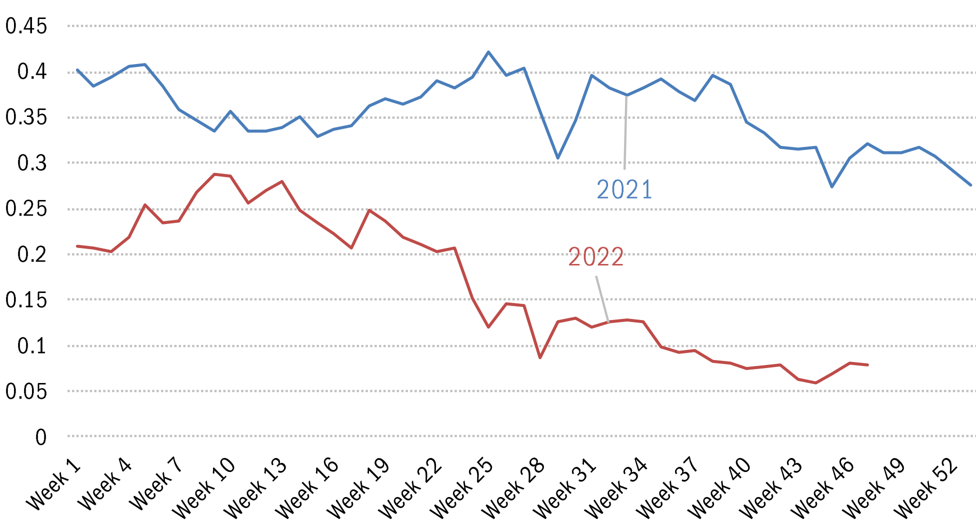
- Preliminary reports suggest that OPEC 10 had held back production – especially Saudi – to let Russia flood oil markets in November before European sanctions on Russian crude oil imports start today. The chart on the previous page shows the OPEC 10 production target and actual production. The September 2021 start date was the last month before Russia began curtailing gas flows to Europe and OPEC began missing its production quotas at the same time, in what we now think is a coordinated action.
- The key element in the chart is the month-over-month change in OPEC 10 production. Even though OPEC 10 had missed its production target on a monthly basis since October 2021, it was at least adding volumes to global markets most of the time (except May and the last two months). The 710,000 barrels per day drop in month-over-month OPEC 10 production last month when Russian crude oil exports were booming reinforces our view that the West's policies of fast-tracking "green energy" are deemed an existential threat by the production cartel (see "Ukraine: A Pawn in Putin's Energy Survival Strategy" July 11, 2022), leading to systematically less production and higher prices, and thus as detrimental to global economic growth.

The EU will have a difficult time replacing Russian seaborne crude imports, especially if they are looking for them across the pond. US oil and gas companies are facing their own challenges: a domestic policy agenda that is overtly anti-fossil fuels, an ESG movement on Wall Street that raises the cost of capital for fossil fuel explorers and producers, and the difficulty of finding qualified workers in a labor market where so many participants are still idled by their pandemic-era stimulus largesse. The US Energy Information Agency, a bureaucracy only gradually understanding the real-world harms done by these policy errors, has had to consistently downgrade its oil production forecast all year. So Europe cannot look to US for oil exports to save them in 2023 unless policy changes are implemented – and right away.

- We do not expect a change or reversal in policies from the current administration, especially considering that it is flush with victory after seeing the much-feared "red wave" fizzle in the mid-term elections (see "Our Hot Take on the Mid-Terms" November 9, 2022). President Joseph R. Biden is making deals with Venezuelan dictator Nicolas Maduro to free up short term supplies of dirty Orinoco heavy oil while stopping the Inter-American Development Bank from investing in cleaner Guyana light oil infrastructure that could have a long-term positive impact on supply. Given the many supply issues that could arise from more political meddling in the oil market and the unwillingness for policy changes in Europe and the US, we remain confident that $100 oil is on the horizon (see "It's Official: OPEC Wants $100 Oil" September 30, 2022).

- Finally, the inflationary impact of high fuel prices cannot be blamed solely on the price of crude oil. Refinery crack spreads – the margin refiners earn when processing a barrel of oil into fuels – blew out when Russia attacked Ukraine in February and show no sign of abating. Crack spreads are currently historically high because of the loss of 3.5 million barrels per day of global refining capacity, mostly in the US and Europe. The press blames the lost capacity on demand destruction brought on by the pandemic. The pandemic, however, is only partly to blame for the loss of refining capacity and high fuel prices – for Europe, it's a decades-long trend consistent with its early leadership of the global green movement.
- Our data indicates that more than 1.6 million barrels per day of European and American crude throughput capacity has been or is in the process of being converted to make animal fats and plant-based feedstock into sustainable airline fuel (SAF) with subsidies ranging from $1.02 to €1.50/gallon. No wonder the EU is so reliant on petroleum product imports and the US won't have the spare capacity to supply them, when Russian refined petroleum product imports are banned on February 5 next year. While Chinese "teapot" refiners are expected to ramp up early next year and new capacity is coming on line in Asia and the Middle East, the timeframe for all this capacity is definitely after the ban on Russian diesel, gasoline and fuel oil exports go into effect. So relief from high fuel prices in the West will not happen anytime soon.
- While Europe will have a hard time replacing sanctioned Russian crude oil seaborne imports, the situation concerning natural gas will prove more problematic. Russian natural gas pipeline imports to the EU have fallen for most of the year (please see the chart below). As of last month, Russian pipeline natural gas imports to Europe have been cut by more than half versus last year.
- So far this year LNG imports to the EU have provided the lion's

Share of EU natural gas imports by Russian pipeline



Source: TrendMacro calculations

share of volumes needed to fill storage in preparation for winter. The EU imported 36% of their total natural gas supply through LNG so far this year versus 22% last year. These imports don't completely offset declining Russian pipeline volumes – Norway also increased EU pipeline imports by 7%. Yet, lack of an LNG infrastructure is a problem for the EU as most of their energy infrastructure spend has been on renewables over the past few years. Simply put, Europe doesn't have the gasification infrastructure to significantly increase imports of LNG. To completely offset Russian natural gas pipeline inflows much more infrastructure (most likely floating regasification units) will be needed quickly.

- More important, some of the growth in European LNG imports has been from Russia! Reports suggest that Russian LNG imports to Europe have risen by 20% so far this year, or 2 million tons, equivalent to 2.75 billion cubic meters (basically slightly less than the amount of gas that Russia would send via its four pipelines to Europe on a weekly basis before the war began). While the annual increase in Russian LNG exports to Europe in 2022 doesn't remotely replace what it used to send via pipelines, we are pretty sure that Putin is receiving between $20 to $30/MMbtu for LNG versus only $8/MMbtu via pipeline. The loss in Russian natural gas pipeline export revenue to Europe far outweighs the increase in revenue received from Russian LNG exports to the EU. For all the triumphalism in the EU about its bans and its caps, this self-imposed ban by Russia may prove to be the sharpest economic punishment it faces.

Bottom line

Price caps on Russian crude exports engineered by Yellen go into effect, but will make no difference to Russian revenues which are already based on steep discounting. Europe has been importing more LNG from Russia to make up for drops in piped volumes, but that remains a revenue hit for Russia, and a self-imposed one. The potentially momentous December OPEC meeting has now come and gone, and the cartel is staying pat on reduced production. Production growth forecasts for the US have been marked down, leaving Europe no sources of relief when bans on imports from Russia kick in. It all adds up to a tight oil market in which global benchmarks should rally back toward $100.