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THE RUSSIA-UKRAINE CRISIS: IMPLICATIONS FOR ENERGY MARKETS

On 8 March the UK, US and EU urgently reviewed their energy policy with a view to reducing dependence on Russian oil and gas. In this article, we explore what happened and what this might mean for energy markets.

Background

In liberalised energy markets like the UK, US and many EU member states, security of supply is attained, not through state ownership, but through market mechanisms. Energy policy is based on free market principles: for the right price, the energy needed will flow to the markets that need it. Governments have justified interference in free-market principles, however, to correct market failures. For example, renewable energy subsidies were originally introduced to correct a market failure where the carbon impacts from fossil fuel generation were not reflected in their costs of production.

The current Russia – Ukraine war is a tragic reminder of the impact that geopolitics can have in energy markets. Russia is the EU's largest oil supplier, supplying c. 27% of the EU's oil imports. Russia also supplies c. 40% of the EU's gas demand (the rest comes from Norway and Algeria) and 46% of coal imports. By contrast, the US and UK are less dependent on Russian imports. At present, the UK relies on Russian imports to meet c. 8% of domestic oil demand, and c. 18% of the country's diesel. Russian gas presently accounts for c. 4% of the UK's supply, although the UK and EU gas prices are closely correlated. In relation to the US, in 2021 Russian oil contributed to only c. 3% of total consumption, and according to the US Energy Information Administration, the country does not currently import natural gas from Russia.

Russian oil and gas companies are state owned, and so it is becoming increasingly unpalatable that trade in energy is funding Russian state activities, with many companies boycotting Russian suppliers. The EU, UK and US are also concerned about over-reliance on Russian energy, with fears that Russia may weaponise its energy exports.

The impact on energy policy

As a result, energy policy has been rapidly turned on its head. Countries such as Germany have rapidly shifted their energy policy in response. Nord Stream 2, a new gas pipeline linking Russia and Germany, built but not approved, that would have increased European dependence on Russian gas, will not now be approved by German regulators. Germany is also exploring options to shore up the country's energy security including the extension of the life-time of their (recently cancelled) nuclear fleet, resurrecting coal generation and building a new LNG import terminal, all to reduce reliance on Russian gas imports.

EU policy

On 8 March 2022, the European Commission published its REPowerEU policy, designed to reduce reliance by the EU on Russian energy imports. The aim of the plan is to make Europe independent from Russian fossil fuels well before 2030, starting with gas.

A number of proposals were already in progress as part of the implementation of the EU Green Deal, a package of measures published in December 2019 which envisage the transformation of the EU's economy to a more sustainable model, and, crucially, for Europe to become the first climate neutral continent by 2050. As part of this, the EU has been implementing a Fit for 55 package which already envisaged a reduction in annual fossil fuel consumption by 30% by 2030. For further details of the Fit for 55 package, please refer to our briefing here.

However, the proposals tabled in the REPowerEU plan go further and faster. The key elements include:

- *Diversifying gas supplies*: Measures include increasing Liquefied Natural Gas (LNG) and pipeline imports from non-Russian suppliers, and larger volumes of biomethane and renewable hydrogen production and imports. In relation to hydrogen, strikingly the Commission invites co-legislators to consider an additional 15 million tonnes (mt) of renewable hydrogen on top of the 5,6 mt foreseen under the Fit for 55 by 2030. The plan also suggests the doubling the objective of Fit for 55 for biomethane to 35 billion cubic metres (bcm) per year by 2030.

- *Increasing gas storage levels*: A legislative proposal, to be tabled by April, will require underground gas storage across the EU to be filled up to at least 90% of its capacity by 1 October each year. Gas storage is to be classified as critical infrastructure and ownership by a third country will need to be certified as to not impacting security of supply. To avoid carbon lock-in and risk of stranding, any new infrastructure will need to be hydrogen compatible.
- *Temporary regulated prices for electricity*: The Commission considers that, using powers in Article 5 of the Electricity Directive (2019/944), member states are permitted to introduce temporary regulated prices for electricity to protect consumers during periods of significantly higher energy prices. The plan includes guidance on the design of these regulated prices, for example recommending they may be combined with measures to empower consumers such as energy efficiency measures or on-site energy production.
- *Establishing a new Temporary Crisis Framework*: The Commission is ready to use the full flexibility of its State aid toolbox to support sectors affected by the current geopolitical developments. This includes consultation on a Temporary Crisis Framework which could allow liquidity support for all undertakings directly or indirectly affected by the crisis, including aid to energy-intensive users.
- *A windfall tax on electricity generators*: To help finance emergency measures, the Commission notes that member states may exceptionally decide to introduce a windfall tax on electricity generators who have benefited from high power prices. If used, this is expected to impact coal and lignite-fired, renewables and nuclear generation plants, which are not exposed to gas input costs. The REPowerEU plan includes guidance to member states on the design of a windfall tax, recommending that any such tax is time-limited, not be retroactively applied and also not extend beyond 30 June 2022. Member states will also need to be careful not to distort the formation of electricity prices or affect the carbon price signal set by the EU Emissions Trading Scheme.
- *Speed up deployment of renewables*: The Commission calls on member states to streamline the permitting process for renewables. Whilst not proposing any increase to the current EU targets, the plan does raise the prospect of review. And in the meantime, the Commission envisages measures to accelerate solar PV, wind and heat pump deployment.

The RePowerEU announcement does not go into detail, but does raise questions about the invocation of the Gas Security Supply Regulation (2017/1938), stating that *"[member states] need to conclude solidarity arrangements. Given the current context this should be done without delay."* Overhauled following the 2009 Russia-Ukraine gas crisis, and revised again in 2017, the Security of Supply Regulation aims to ensure security of supply and raises the prospect of members of the internal energy market supporting each other in the event of a gas short-fall.

UK policy

On the same day as the REPowerEU policy's publication, 8 March 2022, the UK government also announced a planned phase-out of Russian oil imports by the end of the year. Reports also claim that Prime Minister Boris Johnson is preparing to unveil a new UK energy strategy, aimed at ensuring expanded UK energy self-sufficiency. The length of this phase-out period is intended to give the UK time to adjust its supply chains, and allow UK consumers and industry to shift to alternative supplies of fuel products. However, the policy also recognises the need for Russian oil imports to continue in the short term to ensure continuity in supply and to protect UK consumers.

The UK government has established a Taskforce on Oil with industry to help chart such an "orderly transition". Options for such a transition are expected to include greater North Sea production, or higher imports from Norway and the US (both of which are already the UK's largest suppliers).

The government is also considering the adoption of similar measures as the EU on Russian natural gas imports. While Russian gas presently accounts for 4% of the UK's supply, according to the UK Business Minister Kwasi Kwarteng, global gas markets are typically characterised by fewer suppliers than oil markets. This may make any proposed UK phase-out of Russian gas economically challenging.

Last year, the UK met about 40% of its gas demand from domestic production. This could rise slightly in 2022, with the Elgood and Blythe fields in the North Sea expected to begin production. Regardless, some analysts predict the combined effect of these import bans and other sanctions will be to increase inflation above 7% this year, as well as cut living standards in the UK by around £2,500 per household. This comes at the same time as UK consumers face an upcoming 54% increase in gas and electricity bills in April, as well as higher petrol prices. In response, the Chancellor, Rishi Sunak, will be under further pressure to announce more immediate relief measures to assist households to deal with mounting electricity, gas, and oil prices.

US policy

President Biden signed Executive Order of March 8, 2022 "prohibiting certain imports and new investments with respect to continued Russian Federation efforts to undermine the Sovereignty and Territorial Integrity of Ukraine" (the E.O). The E.O. effectively bans the import into the United States of Russian oil, LNG and coal. The E.O. has widespread bipartisan support and seeks to further cement Russia's status as a 'global economic and financial pariah'. As reported by US lawyers Fenwick, the E.O. prohibits:

- The importation into the United States of Russian crude oil, certain petroleum products, LNG and coal.
- New investment in the Russian energy sector by a United States person (individual or entity), wherever located.
- Any approval, financing, facilitation or guarantee by a United States person (individual or entity), wherever located, of a transaction by a foreign individual or company into the Russian energy sector which would be prohibited under E.O of March 8, 2022 in the United States, and in particular, in relation to any investment in the Russian energy sector.

The ban on Russian crude oil, LNG, coal and other petroleum products has immediate effect, although buyers have a 45-day grace period to wind down existing contracts.

President Biden has vowed to continue to ratchet up the pressure on Moscow to stop the war in Ukraine by targeting Russia's energy sector. However, a bipartisan deal on deeper sanctions is understood to have run into difficulties after Republican Party objections. Instead, Democrats are understood to be seeking an amendment of The Magnitsky Act, which authorises the United States government to sanction those it deems to be human rights offenders.

Democrat politicians and analysts have further suggested that Russia's invasion of Ukraine and subsequent sanctions highlights the importance of bolstering the United States' renewable energy sources.

International trade and financial policy

In response to Russia's actions, the EU and Group of Seven (G7) member states—including the UK and US—are also expected to suspend Russia's Most-Favoured-Nation status under World Trade Organization (WTO) rules. Certainly, such unilateral actions may be justified under national security exceptions in the various WTO Agreements that govern trade in goods, services, and intellectual property. Indeed, the WTO Dispute Settlement Body recently interpreted the scope of this exception broadly in a dispute between Ukraine and Russia, arising from Russia's 2014 invasion of Crimea. The panel indicated that countries invoking the exception must offer objective evidence that an "emergency in international relations" exists, explain how that emergency affects their "essential security interests", and establish that the measures they imposed are plausibly connected to protecting those interests. Furthermore, countries invoking the exception need not be parties to the conflict in question.

Russia would then operate under the WTO general tariffs, which apply to countries that are not WTO members. In practical terms, such a suspension would ensure Russian companies no longer receive preferential trade access to EU and G7 markets. This move would allow EU and G7 countries to impose tariff increases on Russian goods. These may include imports of energy-related goods that are not otherwise currently sanctioned. Additional restrictions on trade in energy-related services may also apply. EU and G7 members also announced efforts to suspend Russia from accessing finance from multilateral development banks—including from the International Monetary Fund and World Bank—which might have otherwise helped Russia to absorb the effects of economic sanctions.

The implications

The tragedy of the Russian-Ukraine war cannot be overstated and the events of the last weeks will remain a scar in Europe's history.

From an energy perspective, in the past, climate change concerns may have been perhaps more readily sacrificed for energy security priorities. However, with global consensus on the need to act on climate change, many now see the energy transition as a tool to reduce the dependence on imported energy. Whilst, in the short term, carbon emissions may rise due to measures taken to mitigate the market swing away from Russian energy, the current crisis may deepen resolve to diversify energy supply away from fossil fuels.

The market reacted strongly to the 8 March announcements. Oil prices jumped significantly, with the Benchmark Brent crude LCOc1 for May climbing by 5.4% to US$129.91 a barrel. Meanwhile, retail gas prices in the US surged to an all-time record. Some analysts forecast prices may rise further with the implementation of the EU, US and UK measures, with some suggesting the conflict may push oil prices as high as US$185 per barrel by the end of the year. At these levels, demand and emissions reductions may be driven by market forces.

From a legal perspective, the implications will not become clear until full legislative proposals implementing these decisions are tabled. However implemented, they are expected to have significant corporate and commercial implications, affecting for example:

- *Joint ventures*: Those with joint ventures with Russian counterparties are likely to be reviewing their agreements to assess the implications of the measures under a variety of scenarios.
- *Supply agreements*: Much of Russia's gas is supplied under long-term contracts that Gazprom has with European companies, many of which will include take or pay provisions. European counterparties will be reviewing the flexibility in their nominations and options for termination carefully.
- *Trading arrangements*: Those with wider energy trading relationships with Russian counterparties will be considering the reputational risks associated with continued trade, as well as reviewing their positions both in light of current sanctions and in the event of possible future sanctions.
- *Cash-flow*: With access to international money markets and foreign exchange increasingly restricted and constraints on raising further capital, firms may also be considering their credit exposure to Russian counterparties.

The claims arising as a result of the unwinding of arrangements with Russian energy companies may extend many years beyond the conclusion of the war.

If you wish to discuss any of the issues arising from this briefing, please get in touch with your usual Slaughter and May contact.

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