The Impact of the Sanctions on Russian Oil and Gas

The oil and gas industry is a vital part of Russia's economy, accounting for more than half of its exports in 2020. Russia is the third largest oil producer in the world, with its oil traded on the global market. Gas is more difficult to transport and partially because of this, 83% of Russia's gas exports went to Europe. Russian gas is therefore particuarly vulnerable to sanctions affecting market access. Though sanctions have taken time to take effect, they have now gathered significant momentum and the Russian oil and gas industry is in serious difficulty as Western sanctions bite.

Dragoman's key observations on the situation are:

- Russian export revenues increased post-invasion due to higher commodity prices, particularly oil and gas, the lag in transition periods for EU and US import restrictions and higher export volumes going to other markets. Russia's monthly average oil revenue rose from US$14.6 billion in 2021 to US$20 billion in the first half of 2022.
- However, President Putin is not winning the energy war and the well managed Russian oil industry, which was successfully modernised under his leadership after severe decline in the latter Soviet period, will be significantly damaged over the long-term. Sanctions have led to the withdrawal of Western expertise and a severing of the supply of critical components like turbines and compressors. The impact of the withdrawal of oil services companies, notably Schlumberger, will be particularly acute as they have led the introduction of advanced resource-recovery techniques like multi-stage fracking, which have dramatically increase production and profitability throughout the Russian oil and gas industry. The Russians have not built the capacity to do it themselves.
- The impact of sanctions is beginning to be felt. Russian government budget revenue fell to a 14-month low in August. Cutting off gas to the EU is painful, though not terminal for Europe, but it is a disaster for Russia. Gas from Western Siberia and Yamal have nowhere else to go. Whilst much is made of pipelines to China like the Power of Siberia 2, these are years off, if they ever come to fruition. Meanwhile billions of euros have been wasted on the unfinished Nord Stream 2.
- Europe will continue to pivot away from Russian energy, with Germany being ground-zero. After years of resistance to LNG due to its extensive pipeline network, Germany has rapidly shifted to an all-out pursuit for floating LNG import facilities. Over the long-term, this investment will increase dependence on LNG and reduce demand for Russian gas, whilst the EU continues to drive a decarbonising trajectory. Russia's weaponizing of its gas supply – no matter how justified in their mind – renders them an unreliable supplier. Building energy supply resiliency has become a core endeavor in Western Europe.
- The Russian oil industry is suffering less than its gas industry, as China and India take up discounted Russian oil that was purchased by the West pre-war. China has more than doubled its imports of Russian oil since February, rising from 500,000 barrels per day to almost 1.1 million in August. Over the same period, India went from importing almost no Russian oil to a peak of almost 1 million barrels per day in June, though this has fallen back to around 700,000 bpd in August. However, the revenue Russia is earning from these sources is declining, as global oil prices drop, Russian oil production decreases due to the loss of Western operators and the costs of shipping oil to China and Russia eat into profit margins. China and India have also proven to be tough negotiators, purchasing Russian oil at discounts of around US$30 per barrel.

- Nevertheless, Russia continues to have significant sway over the European diesel market. Imports up 22% in July 2022 compared to July the previous year. The EU is reliant on Russia for around 15% of its diesel imports, and there are limited alternative sources. Much of Europe's diesel supply comes from turning crude into fuel products at its refineries, but there is currently a shortage of refining capacity on the continent. High diesel prices may attract US refiners, who typically produce petrol, to switch to supply Europe, though this is by no means guaranteed. China also has spare refining capacity to produce more diesel, though Beijing has directed its refineries to focus on supply the domestic market. Combined these factors demonstrate the difficulty the EU will face in reducing its imports of Russian diesel to zero by February as the bloc has announced.

Dragoman Counsellor Sir Roderic Lyne KBE CMG contributed to this piece.