

# The War, Sanctions, and Russian Oil and Gas

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*As a result of war, sanctions, and embargoes, Russia's oil and gas industry is shrinking. This means declining production volumes and export value, increasing production and transportation costs, and much slimmer profit margins. Russia's earnings potential is being eroded. The country's economic capabilities are being degraded. And sanctions will become even more of a "big deal" as time passes.*

Russia is no longer an energy superpower. Because of the war in Ukraine, Russia cuts a diminished figure on the international energy scene. The country is no longer wanted by the West as a provider of fossil fuels. Nor is it seen as an attractive partner in the energy transition.

Yet this perspective tends to get downplayed or lost when we debate the efficacy of Western sanctions against Russia. Sure, sanctions and embargoes may not be working fast enough to empty Russia's "war chest" and help Ukraine win decisively on the battlefield. But they have clearly caused the Russian oil and gas sector to shrink. As a consequence, the Russian economy is being degraded and its future earnings potential curtailed.

We used to think that Russia's energy exports would remain strong at least until the early to mid-2030s. That is when demand, especially European oil and gas demand, was forecasted to drop significantly as the energy transition takes hold in earnest. This is the premise, for example, of Thane Gustafson's book *Klimat: Russia in the Age of Climate Change from 2021*. Now it looks like Russian export revenues could decline almost a decade earlier than expected. And that spells trouble for a country that has no real substitute for fossil fuels as money earners.

Russia can sometimes find replacements for Western energy markets in terms of volume, but seldom in terms of value. Western markets tend to offer higher prices and profitability. Take Russian crude oil exports. Last year, much of the volumes meant for Europe were redirected to Asia. 70 percent of Russian seaborne crude went to three countries: India, China, and Türkiye.

But since the beginning of the war, Russian oil – Urals grade crude – has been selling at considerable discounts, often in the range of \$20 to \$30 per barrel. The longer routes and higher risk now associated with shipments from Russia explain why Urals crude has been trading at around \$60 per barrel over the last few months. In a sense, the oil price cap imposed by the G-7 countries and the EU late last year has institutionalized discounts for Russian oil.

India tops the list of countries that have taken advantage of Russian discounts. Indian imports of Urals crude increased some 1,700 percent last year and now make up approximately 30 percent of the country's monthly oil imports. While most of this crude is being refined for the domestic market, it has also made India a net exporter of petroleum products. Since much of the exports go to Europe and the U.S., India is basically turning cheaper Russian crude into fuel for the West.

China increased its imports of Russian crude by approximately 35 percent between February 2022 and February 2023. This means that Russia has replaced Saudi Arabia as the top crude oil supplier to China. But further growth in Russian supplies to China is likely to be constrained. Not all Chinese refiners can process Urals crude, and many are already well-stocked through long-term contracts with Middle East producers. Even the Saudis are buying discounted Russian oil. They use it to run their power plants, leaving more of the Kingdom's crude for export at much higher prices.

The sanctions risk that looms over Russian crude oil exports has, unsurprisingly, encouraged sanctions evasion and spurred growth in the so-called "shadow fleet". Seaborne crude from Russia is increasingly being carried by older tankers with opaque ownership. They tend to operate outside Western insurance, financial, and shipping services, and keep their transponders (location beacons) turned off. These shadow vessels are now estimated to make up approximately 10 percent of the global tanker fleet. While such sanctions-busting activity clearly still pays, especially for the shady carriers, it is also a further drag on the profits of Russian crude oil exporters.

As the India example shows, Russia will find it a lot more difficult to redirect sales of its own refined product. There is little demand for Russian mazut and diesel in Asia, where they prefer to make their own petroleum products. Over time, as the G-7 and EU embargo of Russian refined oil takes hold, a significant drop in export revenues for petroleum products seems inevitable. Russia will be compelled to reduce refining capacity and shut-in some production.

The outlook for natural gas is hardly any better, even if gas is less of a revenue generator for the Russian state than oil. Gas, especially piped gas, is more inelastic than oil. This is why most of the gas volumes that Russia no longer exports to Europe because of the war will remain stranded for the foreseeable future. These volumes are now estimated to be around 80 billion cubic meters (BCM). If or when gas transit through Ukraine stops completely, they could reach 100 BCM.

The lack of alternative outlets for this gas, whether internationally or domestically, forced Russia to cut its gas production by 12 percent last year. Yet shutting-in production is not without complications and risks. Restoring wells at a later date can prove both technically difficult and economically costly, resulting in value destruction. Russia is also flaring a lot of excess gas. Rystad, an energy consultancy, estimates flaring levels to be around 4.3 million cubic meters (MCM) per day (or 0.5 percent of the EU's daily gas demand needs) and calls this an environmental disaster.

Russia spent over 50 years building up an impressive gas machine to serve European markets. The gas machine provided Moscow with both money and political influence. It has now largely been destroyed as a result of the war and it won't be rebuilt to anything like its former strength. Europe's future dependence on Russian gas supplies will be rather insignificant compared to what it was prior to February 24 last year. This represents a major strategic setback for the Kremlin.

China will not be able to replace Europe as a market for Russian gas anytime soon. Not in terms of volume and definitely not in terms of value. It is estimated that Russian gas to China through the Power of Siberia 1 pipeline fetches a price of around \$3 per million British thermal units (BTU). By comparison, Russian gas to Europe fetches between \$10 and \$25 per million BTU.

Putin remains undeterred, however. The Russian president keeps pushing the Power of Siberia 2 pipeline project to China. He seeks diversity of demand for piped Russian gas, seemingly as much for geopolitical as for commercial reasons. Power of Siberia 2, which in its latest iteration is expected to transit Mongolia, would provide an alternative outlet for the West Siberian gas that used to go exclusively to Europe.

Power of Siberia 2 was clearly on the agenda when Chinese president Xi Jinping visited Moscow in March. A statement of intent or progress report regarding the project would have been expected at the summit. But nothing emerged. For political reasons, Xi could have thrown Putin a bone by signing an MoU that left final negotiations over financing and price far into the future. Yet the Chinese leader seemingly refused to go along. A sign, perhaps, that the Sino-Russian partnership is not without limits.

Russia has long been considered a laggard in climate action because of its concerns about the impact of the energy transition and decarbonization on the oil and gas industry. Over the last few years, however, the Russian government had also come to see big opportunities in low carbon fuels. The ambition was to take 20 percent of an emerging global hydrogen market. Cut off from international finance and technology markets through sanctions, Russia will most likely have to forego such future opportunities as well.

To conclude: as a result of the war, the Russian oil and gas industry is shrinking. The erosion of Russia's earnings potential is underway. This process will be gradual at first, but it could become more sudden and dramatic over time. Declining Russian production from existing fields will increasingly have to be replaced by resources from areas with tougher geological and climatic conditions. These resources may prove more difficult to recover – technologically more challenging and economically more costly. Sanctions and embargoes add to the afflictions of the Russian oil and gas industry, further reducing volumes, increasing costs, and squeezing margins. The question, of course, is if or when we will see curtailed Russian ambitions in and beyond Ukraine as a result of this degrading of Russia's economic capabilities.



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