Rodney's Take

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Russia, Ukraine, and Energy Inflation

The energy markets are skittish as investors try to anticipate how the Russian invasion of Ukraine will reshape oil and gas sales. Russia consistently is among the top three oil producers on the planet. Any move that curtails the sale of Russian oil on the world markets in a supply-starved world should push oil prices higher, which would translate into higher energy prices for consumers.

Note the "wills," "shoulds," and "woulds" in that logic, which point out that most of this hasn't happened yet. Oil market participants might have pushed prices higher a bit as they anticipated armed conflict in Ukraine, but Russian oil and gas continued to flow. Now, with bullets and missiles flying, Western nations have leveled sanctions on Russia and yet oil and gas continues to flow. The price of oil briefly breached $100 in the early hours of the invasion but then backed off when Germany and other countries refused to cut off energy trade.

The latest moves in the energy complex point out a vexing issue. Our energy inflation is real, but so far, it has little to do with Putin.

From February 2021 through January 2022, the U.S. Bureau of Labor Statistics reported that in general, energy prices rose 27% and gasoline prices rose 40%. Most of those increases happened long before people started Googling "Ukraine" and "Donetsk," and the reasons aren't a secret. Global oil demand rebounded quickly during the pandemic as nations and central banks flooded markets with cash, while energy producers took a much more cautious approach to opening the taps. As I've noted before in this space, American producers are cutting production and exploration for various reasons, and our federal government is curbing our ability to produce oil and gas to expedite our transition to renewable fuels.

We handed control over oil prices to OPEC+, and they did exactly what you'd expect. They've increased supply a bit slower than the increase in demand, resulting in higher prices. They've made more money at the expense of global consumers. This situation can lead to higher prices at any time, even if Putin leaves Ukraine tomorrow; all we'd need is for OPEC+ to tighten supply.

As for the situation in Ukraine, remember that oil is relatively fungible. We can't substitute light sweet crude for heavy sour, which is one reason we can't use all of the oil we produce in the U.S. Many of our refineries are set up to handle the heavy sour crude from distant shores, not the light sweet crude from West Texas. But heavy crude is heavy crude.

Today, we import about 500,000 barrels per day (bpd) of Russian oil out of the roughly 7,000,000 bpd that we buy from foreign sources. We, along with our allies, could trim our Russian purchases or even try to eliminate them altogether, but that would leave us scrambling to find other suppliers in a tight-supply world. Anyone who sold to us would have to cut their supply to someone else. But the world is a big place with many countries, like China, that aren't so keen on the U.S. Also, many countries have no qualms about buying oil from Russia or even Iran, for that matter.

The numbers don't work out evenly. There are more highly developed countries aligned with U.S. interests than opposed to them. If every U.S. ally banned Russian oil imports it would definitely be painful for Russia, but they would still sell oil, as we see happening with Iran. Energy prices also would jump here at home, likely by $10 to $30 per barrel, or 10% to 30%. That's a noticeable increase, but the price of oil jumped 50% last year just due to supply and demand.

The story is much the same with natural gas, except with tighter restraints because of how it is delivered. Western Europe and more specifically

Germany tethered itself to Russian energy supplies over the years by building more pipelines to move the gas and by trimming other means of producing electricity. Because so much gas arrives in Western Europe via pipelines and the region doesn't have that many liquified natural gas import terminals, there's no way to replace Russian gas supplies completely.

Western Europeans are making a choice. By continuing to buy Russian energy, they are choosing to keep their economy on track while financing Putin's invasion.

One more thing is worth remembering about energy inflation and Russia. Because Putin didn't cause our current pain at the pump through his threat of war and eventual invasion, the pain won't subside when the current geopolitical crisis fades. For that to happen, we'd need supply to match, or even slightly outpace, demand. That won't happen unless we get a significant economic setback later this year or the members of OPEC+ decide to pump more oil. Given that Putin has significant sway over OPEC+, it seems unlikely that the group will be doing any financial favors for Western nations anytime soon. He and his cohorts are more than happy to take our money and use it against our interests.

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Got a question or comment? You can contact us at info@hsdent.com.