Industry Insights
Flash Note

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Regional Energy

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Oil prices close to US$100/bbl as Russia makes the first move

- Russia begins to show its hand as it recognises the independence of separatist areas in eastern Ukraine and could potentially advance its military into these areas
- Difficult to make a call on whether this is the start of sustained hostilities or the beginning of the end of the tense situation
- Limited options for the West at this point of time; threat of war will continue to loom for a while, keeping oil prices elevated in the US$90s or higher
- We will look to review our existing forecasts for Brent with a potential upside bias as the situation continues to unfold

What's New

Russia makes the first move. On Monday (Russian time), Russian President Vladimir Putin played his first major hand in the evolving great game in Ukraine . Putin announced, by way of decrees, that Russia would be recognising the two breakaway regions of Donetsk and Luhansk as independent, and that Moscow would launch a "peacekeeping operation" in the area. This basically clears the decks for the Russian Army to cross the official borders and move into eastern Ukraine, a move which Ukraine and its western allies could claim as tantamount to an invasion of Ukraine, though some of these areas have for long been under the de facto control of pro-Russian separatists, and thus the move would not technically be an invasion or annexation of these territories either, unlike Crimea in the past.

What is the backstory here? The eastern industrial areas of Luhansk and Donetsk (shown on the map) have been embroiled in a bitter civil war for years, with Ukrainian forces clashing often with Russian-backed separatists, leaving more than 14,000 people dead over the last eight years. The unrest started shortly after the Russian annexation of Crimea in 2014, and rebels and Russian "volunteers" from this majority Russian-speaking eastern part of Ukraine have since then tried to claim independence from Ukraine in a bid to become part of Russia. This was also the region where the ill-fated Malaysian Airlines aircraft was shot down in July 2014. Russia had so far not made official its involvement in the bid for independence, but things are changing rapidly now.

Understanding the geography of geopolitics

Source: Press reports, DBS Bank

Is this the start of war or is this the endgame? It is not immediately clear whether this move is intentioned by the Russian military as the start of the invasion of Ukraine that US and NATO allies have been warning about for the last few weeks, or whether this is a move similar to the annexation of Crimea back in 2014, giving Putin more bargaining chips to bring the West to the negotiation table in lieu of limiting further hostilities and loss of civilian lives. In our view, this seems to be akin to Scenario 2 (see below) that we had outlined earlier, where Putin would be keen to avoid a stalemate and get something out of the situation, while not opting for an all-out invasion as his first move (contrary to what some have been projecting). What will follow next is difficult to predict – whether Moscow will use the excuse of defending the territories to threaten Ukraine with war or advance deeper into Ukraine by recognising the claims of these separatist governments or wait for the West to budge from their current positions before making its next move. It is also entirely possible that Russia has more or less achieved all it wants already – i.e., to ensure Ukraine's NATO ambitions are deferred indefinitely, and try open up some cracks on the NATO front, which could mean further hostilities from the Russian side may not be that imminent unless provoked. Of course, all this is conjecture at best and we hope it doesn't come to war.

Previously anticipated scenarios of how the situation could unfold and affect oil prices

Scenario	Fallout	Oil price trajectory
Russia invades Ukraine within a few days	Russia claims swift victory, NATO responds with some sanctions, but makes sure it doesn't shoot itself in the foot	Sharp increase in oil prices towards US$100-110/bbl and even upwards, depending on the nature of sanctions, but it would not be sustainable at those levels
Russia de-escalates its presence but does not withdraw completely	Situation drags on for some time but ultimately Putin will need to show some results **(read: recognition of breakaway provinces?)**	Oil prices hover around US$90-95/bbl, seeking direction from incremental news flow
West accedes to some of Russia's demands in future talks	Threat of imminent war averted	Oil prices fall back to US$80-85/bbl

Source: DBS Bank

What now? How does the West respond? US and EU countries have gone into emergency response mode and are expected to impose limited sanctions to condemn Russia's move to attack the sovereignty and territorial integrity of Ukraine. The US has issued an executive order placing sanctions on the two breakaway regions. These are separate from sanctions that would be imposed if Russia invades Ukraine. EU countries have agreed to impose a limited set of sanctions "targeting those who are responsible" for Russia's recognition of the rebel regions. UK's Boris Johnson has said that the UK will immediately institute a package of economic sanctions and will impose further sanctions if there is more "irrational behaviour" from Russia. Britain has threatened to cut off Russian companies' access to US dollars and British pounds, and pledged to target Russian oligarchs, given that London has become the western city of choice for Russia's super wealthy and other former Soviet republics. Germany has, meanwhile, halted the certification process of the contentious Nord Stream 2 project, shooting up spot gas prices in Europe.

We don't think these are major deterrents for Russia yet, and real economic sanctions will be tough to impose, given Europe's dependence on Russian oil and gas. We have explained the energy market situation earlier in our previous note. Since the US will not be able to make up for the loss of Russian gas in case the situation arises, it is unlikely that the West will be able to put up a fully united front when dealing with Russian advances hereon. Hence, we reckon Russia could hope to win this war on the diplomatic front without a shot fired in anger.

Meanwhile, Brent crude oil prices went very close to US$100/bbl before retreating. After reports of President Putin's announcements emerged, Brent crude oil prices temporarily went north of US$99/bbl, before moving back to around US$96.7/bbl as we write, as further aggressions haven't occurred and the Russian oil minister was quoted speaking against high oil prices. According to reports, Russian Energy Minister Nikolai Shulginov indicated that high oil prices, while good for Russia's budget, impacts oil demand growth and growth in other sectors of the economy. In his view, the optimal oil prices should be at around US$55-70/bbl.

If oil supplies are disrupted, OPEC is unlikely to emerge as a hero, given current constraints. OPEC has, in the past, played the role of swing producer and adjusted production to ease supply shocks if possible. Now, oil at US$100/bbl is necessarily not something that OPEC countries would want, despite the attractive revenues, as it leads to some demand destruction globally and high inflation, even in their own countries. In the case of war, OPEC may be expected to increase production, but surplus capacity is low, some OPEC members are struggling to meet even existing production quotas, and it may be tough for the ones who can increase production (Saudi, UAE, Kuwait, etc.) to increase unilaterally bypassing the existing OPEC+ production cut agreement, which non-OPEC allies are also party to, including Russia. So, it will definitely be a delicate issue to discuss at the next OPEC+ meeting, and it seems unlikely that Russia will be happy to lose market share to Gulf countries, thus limiting the OPEC+ group's ability to stray too far from the pre-decided 0.4mmbpd per month increase for the next few months.

Iran nuclear deal – the only moderating factor? The US-Iran nuclear deal is among potential moderating factors for oil prices in the near term. Discussions on reviving the Iran nuclear deal have been ongoing in Vienna since late last year, and in recent days, indications have been that a deal may be imminent, possibly before the end of February 2022. Moreover, experience has shown that delays are likely. Whenever the final agreement is signed, though, it will definitely have a one-off negative impact on oil prices, and potentially wipe off some of the current geopolitical risk premium, but timelines are quite hazy at the moment, so we wouldn't count on it.

Overall, looks like the current levels of very high oil prices could persist for longer than we earlier estimated. With Russia more likely interested in a diplomatic solution first than a direct invasion, the threat of war and subsequent sanctions et al. could keep oil prices at current levels for weeks, if not months. Thus, while fundamentally oil prices do look overheated to us at current levels, we will need to factor in the geopolitical risk premium for a longer period. Thus, there is an upside risk to our existing forecasts for Brent for 2022, especially in 1H2022, and we will review our forecasts as the situation in Ukraine continues to unfold.

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