DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

"Oil, gas, Russia, OPEC—What's happening in world energy markets?"

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Episode Summary:

Samantha Gross, director of the Energy Security and Climate Initiative at Brookings, talks with David Dollar about the state of world energy markets. How does Russia's war on Ukraine impact Europe's access to natural gas for the upcoming winter? What effect will new sanctions on Russia's oil sector have on the war, on Europe, and on global markets? Will the oil production cut announced by OPEC+ raise energy prices around the world? And, is COP27, the upcoming global climate conference in Egypt, expected to produce any major developments?

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DOLLAR: Hi, I'm David Dollar, host of the Brookings Trade podcast Dollar and Sense. Today, we're going to talk about energy markets. And my guest is Samantha Gross, director of the Energy Security and Climate Initiative at Brookings. Samantha will be hosting a new Brookings podcast, Climate Sense. So, before we start our conversation, Samantha, tell us a little bit about your new podcast.

GROSS: Yeah, thanks so much, David. I'm really excited about it. The podcast is called Climate Sense. And the idea is to bring some good information to the climate debate to people who care about climate, but may not think about it all day, every day like I do at work. I interview various people I know about all kinds of issues. The first two episodes are out now. The first episode focuses on climate science. What's a greenhouse gas? How does this happen? We have an episode that's focused on fossil fuels. How did we get here and how do we get away from fossil fuels? Later episodes will focus on the international negotiations process, on electricity, and transportation, on environmental justice. Just a really wide sampling of expertise on the climate issue designed for regular people who care, but don't think about this all the time.

DOLLAR: And as I understand it, this is a miniseries. It's going to go for, what, eight episodes?

GROSS: Something like that, yeah. We may do a final episode that focuses on questions from the audience. So, if you have questions for us, don't hesitate to tweet me.

DOLLAR: That sounds great, Samantha, So, how do we find the new show?

GROSS: You can find it at Brookings dot edu slash Climate Sense Podcast, or wherever you get your podcasts. Apple, Spotify, et cetera.

DOLLAR: Okay, great. So, let's turn now to our Dollar and Sense conversation about what's happening with energy markets. We want to start with the big picture of what's really happening with global supply and demand for energy. How would you characterize this situation right now?

GROSS: Energy markets right now are really uncertain. There are strong forces pulling in opposite directions. On the one hand, you have concerns about a global recession, and that is generally pulling prices downward amid concerns about falling demand.

But the flipside of that is that new sanctions on Russia will be beginning in early December, and we've already seen declines in Russian energy supply. And so that tends to push prices upward. So, there's just a lot of uncertainty about the future of global oil markets right now. Predicting oil prices is usually a fool's errand, but it's particularly so right now.

DOLLAR: So, in this environment that recently the OPEC+ group decided to cut its production quotas by 2 million barrels per day, which for me as a non-energy expert, that that sounds like a lot. So, what's going on there and what's the likely effect of that?

GROSS: Well, one of the important words you said in your question was cutting production quotas by 2 million barrels a day. And the actual cut is likely to be a lot less than that for the reason that quite a few OPEC producers were not meeting their earlier quotas. And so, that entire cut in quotas won't be real. I think we're likely to see an actual production cut of less than 1 million barrels per day. And I think they announced that big number somewhat for shock value.

The reason for this is unclear. There are a lot of potential reasons for this. The Saudis, I think, were concerned about softening demand in the potential lead up to a global recession. And we saw oil prices fall by about $20 a barrel between sometime in August and just before the decision was made. And so, there was a sign of softening demand.

It's also true that there's not a lot of love lost between Mohammed bin Salman, the de facto leader of Saudi Arabia, and President Biden. And so there may have been some disagreement there about the direction that they want oil markets to go. But there's no question that it was in the OPEC producers' interests to cut back somewhat. And so we saw them do that.

DOLLAR: You mentioned that there'll be some new sanctions on Russia going into effect. How do things stand at the moment? The Ukraine war has been going on for eight months now. We have fairly unprecedented energy sanctions against Russia. Is that really biting? How are those sanctions shaping world energy markets?

GROSS: The Ukraine war is playing out in energy markets in a couple of different ways, whether you're looking at oil or looking at natural gas.

On the oil side, there aren't that many sanctions in place just yet, specifically on oil. It's more that many countries don't want to buy Russian crude right now. And that crude is selling to people who do want to buy it at a discount. India and China, for instance.

But new sanctions are coming, particularly at the beginning of December, led by the European Union. Sanctions on Western shipping companies transporting Russian oil and on Western financing and also insurance on those shipments. And that's where things are really going to get interesting. That could really put a damper on shipments of Russian oil by water.

We've also heard about the U.S. proposing a price cap on Russian oil. This is something that's really never been tried before. The idea behind it is that the world wants Russian supply. Russia is the world's largest energy exporter if you combine oil, coal, and natural gas. And so, we don't want to lose their supply. It's too hard on the economy and could cause too much of a price rise. But we don't want is Russia to make money from selling that oil. And so the idea is to get the oil on the market, but at a reduced price, enough to make the Russians want to produce it, but not so much that they're making a ton of money to fund their war effort.

This has never been tried before. We're not sure how it's going to work. And the potential level of that price cap has not been announced. And so, this is another factor that's really keeping oil prices up in the air right now. Whether this will happen and at what price level.

The natural gas side is a different story. On this side, it's Russia that's withholding supply to Europe through its pipelines to try to soften European support for Ukraine in the war. Before the war, Russia supplied about 40% of Europe's natural gas. And Europe is really facing some challenges going into this winter because of that lack of Russian supply.

DOLLAR: But I've read that quite a few ships carrying liquefied natural gas have been diverted from going to Asia, for example, and are now heading to Europe. So, it's actually quite impressive the way that the actual kind of nitty gritty functioning of these energy markets is. Sometimes ships are out there on the ocean, you know, heading in one direction and then prices move in a certain way and the ship gets redirected and goes somewhere else where there's going to be a better price. So that, I think, seems to be helping a little bit, just that solid functioning of the world gas market.

GROSS: It is definitely helping. But the truth is that there's not enough LNG, or liquefied natural gas, on the water to replace all of the Russian supply. And so, it's resulted in a couple of things. One of them is that the crisis has spread. We're now seeing higher prices in Asia in addition to in Europe, because Europe is sucking in all the LNG and raising those prices.

Another thing that has been happening in Europe to try to deal with the crisis is that they've been filling their natural gas storage on the continent. It's full or close to it right now going into the winter heating season. But there's still a situation where they're praying for warm weather to deal with the crisis. A lot of natural gas in Europe goes into either home heating or into industry, and both of those uses are hard to replace, especially in the short term. And so they're asking people to conserve. They're filling their storage, doing everything that they can in advance of the winter. But you hate to think of your energy policy as praying for warm weather, but at least for this winter, that's something that's true in Europe.

DOLLAR: So, are these disruptions in oil and gas markets leading to something of a return to coal? I want to get to climate in a few moments, but this can be a useful transition. You know, are we going back to coal and is that going to interfere with our climate objectives?

GROSS: You're seeing that in some places, particularly in Europe. But I think this is really going to be a short-term phenomenon. You're seeing some coal assets producing more, are going back into production for electricity to make up for natural gas. But Europe has really committed to eliminating coal and to lowering the carbon emissions of its electricity system. So, I think this is a really temporary thing right now to make sure that the lights stay on rather than any kind of permanent trend.

DOLLAR: So, the next big climate conference is starting on November 6th in Egypt, the COP 27. What are the objectives here? What do we expect to get out of this?

GROSS: Expectations going into this upcoming COP in Egypt are a bit low. There are a lot of factors that are working against high ambition this year. Concerns about a global recession, global inflation, high interest rates, supply chain woes. All of these things make achieving climate goals and setting more ambitious ones at the upcoming summit in Egypt more difficult.

I wish this wasn't the case because this is Africa's COP, because it's taking place in Egypt. And so there were high hopes that we would make progress on climate financing and maybe even on loss and damage, compensating developing countries for some of the damage that they're already facing from climate change. And I hope to see some progress on this, particularly on climate finance. But it's unfortunate that this African COP is taking place in an environment where these kinds of actions are especially difficult.

DOLLAR: That's a really interesting issue about damages and compensation. Can you say a little bit more about the pros and cons of taking that kind of approach that the wealthy countries who belched most of this greenhouse gas into the atmosphere should be compensating for countries that are getting flooding and environmental change?

GROSS: Yeah, this is just an absolute stickler in climate negotiations and has been since the beginning. It is true that while emissions growth has slowed and largely stopped in the wealthy world, the wealthy world is overwhelmingly responsible for the greenhouse gases that are in the atmosphere today and that are causing today's level of warming. Even though China is by far the largest of today's emitters, the United States is actually responsible for the lion's share of emissions in the atmosphere today.

And so, as happens with most global problems, it's the poor and those in the developing world who feel the brunt of it. And so, it's a problem that the wealthy world is responsible for, but that we need the developing world to help us solve, but that they are dealing with the worst of the damages. So, it's not just that they have to deal with and finance their own energy transition, but also deal with the damages from the emissions that we've already caused.

But truthfully, the energy transition is expensive. Money is hard to come by. And this is just a really, really difficult issue to find financing for adaptation in these countries to the changes that have already occurred, in addition to any payment for damages that have already happened. This has been one of the thorniest issues in all of international climate negotiations, and we're unlikely to solve it this time around.

DOLLAR: As a non-expert, I read a lot about how the cost of solar generation has gone way down or cost of generating power from wind has gone way down. So, I don't really understand why it's so difficult to get financing for a lot of this energy transition in the developing world. You know, I read about that these things will pay for themselves. And if that's true, you should be able to get relatively commercial financing if it's actually true. So, so, can you tell us a little bit more about the obstacles there?

GROSS: Absolutely. And it's a great question. And you're 100% right that the cost of renewable electricity has come way down. Solar electricity, for instance, is down almost 90% in the last ten years. It's phenomenal. And honestly, a lot of these investments in developing countries, the underlying investments are profitable. But the concern is about various forms of risk, everything from regulatory risk, currency risk, recession risk. And so, they're often a bit risky for commercial banks to take on.

Something that I'm excited about and I think is going to be and has been an emphasis in climate financing talks is leveraging private financing. It's not that governments or the development banks need to entirely do this. What they need to do is buy down some of the risk to then make it attractive for commercial banks and use a small amount of money to leverage a much larger amount of money from commercial banks. That's really where the money is. And so, I think that's an area where I'm optimistic.

There are some areas where they may not be able to pay for themselves. But there are a lot of areas where I think these investments are largely commercial.

Another issue is that the price in these investments is all upfront. You spend all your money upfront, and then the electricity is close to free. And so, the cost structure is different than many past utility investments. And so that changes the structure of the investments a bit. But largely a lot of them are profitable. It's just a risk issue.

DOLLAR: An issue that's relevant for our podcast discussion, our podcast audience is that the external financing almost by definition is going to come in foreign currency, typically hard currency, most commonly U.S. dollars. And you're generating power and then you're selling it in the domestic market, in local currency. That's where the market is. And so, aside from the kind of quality of any individual project, there's also a macroeconomic issue. Has the country taken on overall so much debt that it's got a problem essentially servicing that? That kind of unsustainable debt will in the end show up as a big currency depreciation, and what looked like a sound financial situation you discover well actually what's owed in U.S. dollars is many times more costly in domestic currency. So, so I think that's an important issue.

And until recently that macroeconomic situation had been looking pretty good for many, many developing countries. They've really improved their macro stance. But with the pandemic and over the last couple of years, a lot of low-income countries are just in very high risk of debt distress. So, it's hard in those countries, it's really quite difficult to, you know, to take on new external debt for these kind of activities. That's where you really need more intervention from the IMF, probably more debt relief, including from countries like China, which have become major creditors. So, there are a lot of complicated just general economic, macroeconomic issues involved in this in kind of setting a foundation for that climate finance.

GROSS: Absolutely. And today's environment with concerns about recession and coming out of COVID, I think makes it even more challenging. But even before then, that currency risk over the lifetime of a long-lived project was one of the biggest challenges to financing renewable energy in developing countries, even though that energy has gotten downright cheap.

DOLLAR: And then when we talk about climate finance for developing countries, there are a lot of different things in play. As I understand it, one was simply supposed to be about $100 billion a year contribution from rich countries to help poor countries. And that just is not remotely materializing. Can you say a little bit about that?

GROSS: Yeah, that was promised several years ago that the wealthy world would achieve that level by 2020. And here we are in 2022 and we're still not there yet. Granted, the COVID crisis didn't help, but we weren't even close before COVID. That amount of money was intended to include all kinds of things, including private finance, concessional finance, grants, aid, et cetera. But yeah, we're not we're not there yet, and I don't think we're going to get there this year either.

DOLLAR: Is there is kind of one main trust fund rich countries are supposed to contribute money or just lots of different?

GROSS: Yeah, largely a lot of this is going through everything from individual countries' aid programs to through the various multilateral development banks and regional development banks to working to leverage private financing centers. So, there's a lot of different avenues through which this $100 billion could flow if we could ever get there.

DOLLAR: So, last question for you, Samantha. So, here we are in the autumn heading into the winter. And you already mentioned the Russian gas cut off to Europe and the somewhat difficult situation that's already developing. Could you tell us a little bit more about what's likely to happen in the European winter? And, what are some of the positive measures that can help deal with this situation?

GROSS: Well, this this winter may be a tough one in Europe, but Europe has showed remarkable resiliency so far. As I said before, they filled their gas storage in advance of the winter and that's fantastic. They're used to getting more supply, but still, they've gotten the best start on the winter that they possibly can.

You've seen them work to replace some gas-fired electricity with coal. It's not ideal over the long term, but sometimes you just have to get through the winter. Another thing that's happened is that they're asking individual homeowners to please cooperate by conserving gas in their homes, by keeping their thermostats a bit lower. And it is difficult to get cooperation from large numbers of people, but I think they're doing a good job of pitching that as part of the European contribution to the war effort in Ukraine. And one of the things that they can do is not use Russian gas. And so, that's an exciting thing.

The real question is if they have a cold winter, how things will play out in terms of just overall sufficiency of gas supply. There's concerns that if a lot of that gas goes to heating, that there may simply not be enough for industry. And so that's the great concern going into the winter. And so, the hope is that there is sufficient conservation among homeowners such that industry can continue to operate. But the worst case scenario is that they have a really cold winter and that impacts industrial production.

So, let's hope it doesn't go there. And over time you'll see the energy transition go forward more, you'll see more gas infrastructure to import LNG built in Europe, and the crisis will ease over time. But this winter may be a tough one.

DOLLAR: As I understand it, so far the autumn has been a little bit milder than usual or expected in Europe, and so that's a good start. But of course that doesn't guarantee what's going to be happening as we get into December and January and February.

GROSS: It doesn't, but so far, so good. In fact, this doesn't sound positive, but natural gas prices in Europe right now are only about twice the level they were last year, which sounds awful, but they've been a lot higher recently. So, for right now, things look good and we'll knock on wood that that continues.

DOLLAR: I'm David Dollar, and I've been talking to my colleague Samantha Gross about developments in energy markets. It's very complicated because demand seems to be going down with a slowing of the world economy and, worst case, recession. And on the other hand, we've got a lot of different issues on the supply side, including OPEC+ production cuts, and effects of sanctions on Russia, and just the general effect of the Ukraine war. So, thanks for elucidating all of that, Samantha, and we look forward to your new podcast series. And audiences can dig more deeply into many related energy and climate issues. So, thank you very much.

GROSS: Thank you. It's always a pleasure to be here with you.

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DOLLAR: Thank you all for listening. We release new episodes of Dollar and Sense every other week. So, if you haven't already, follow us wherever you get your podcasts and stay tuned.

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Until next time, I'm David Dollar and this has been Dollar and Sense.