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Europe's new energy map

Since the start of the war in Ukraine, the EU has transformed its energy strategy. The Middle East is likely to benefit most from these adjustments

The war in Ukraine is transforming Europe's energy map. With Europeans increasingly purchasing liquefied natural gas (LNG) from Norway, Qatar, and the United States, as well as natural gas from North African and Central Asian producers, Russia is no longer the key supplier. The composition of European oil imports is also changing now that EU bans on Russian crude and petroleum products are in force, targeting around 2.5 million barrels per day (b/d).

The Middle East is likely to benefit most from these adjustments, allowing it to reclaim the prominent market position that it partly lost with the US shale revolution and the global transition to cleaner energy sources over the past decade.

The issue of oil variability

In theory, redrawing the oil map is easier than redrawing the gas map. The oil market is globally integrated and largely free of major barriers to the international flow of crude shipments. By contrast, the natural-gas market is more regionally fragmented, because gas has traditionally been transported through pipelines. A massive global proliferation of liquefaction and regasification facilities would be required to make the LNG market as wide-ranging and efficient as the oil market.

In practice, however, the variability of oil from one country to another tends to limit substitutability. The two primary qualities that differentiate one type of oil from another are weight and 'sweetness.' Heavy oil evaporates slowly and contains material used to make industrial products like asphalt. Light oil requires less processing and accounts for a greater percentage of gasoline and diesel than does heavy oil.

Urals crude, the flagship Sweetness refers to crude oil'ssulphur content.

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Midstream companies and refiners that transport, store, and process 'sour' oil need extra capabilities to remove the sulphur from their product. Urals crude, the flagship Russian product that used to be shipped to Europe, is a blend that can be both sweet and light, making it especially suitable for producing diesel and jet fuel. Among the largest Middle Eastern producers, Saudi Arabian oil comes the closest to Urals in quality. As such, some of the 5.5 million b/d that the Kingdom ships to Asia may now be redirected to Europe, while commensurately more Russian oil will go to China and India.

This scenario is in keeping with the aim of the European Union's price cap, which is meant not to remove Russian crude from the market (which would be economically disruptive), but rather to limit the amount of oil revenues that the Kremlin can generate. Getting more oil from the Middle East, instead of from the US, also would spare European refineries from some of the costs of switching over, because US shale oil is generally too light to substitute for Russian crude on a large scale.

The increasing role of the Middle East

But there are obstacles to diverting trade away from Asia. Chief among these are the long-term contracts that tie Asian customers to Middle Eastern producers, and the greater appeal of the Asian market relative to Europe, owing to Europe's stricter environmental standards and lower growth potential. Moreover, as the global competition to secure Middle Eastern oil intensifies, OPEC's pricing power will increase.

The Middle East's growing role in supplying oil to Europe is already visible. Europe used to be a net importer of Russian petroleum products, particularly the diesel used to power cars, trucks, ships, construction and manufacturing equipment and more. Hence, by early 2023, investors had become quite concerned that the continent would experience a debilitating diesel shortage once the EU ban on Russian products went into force in February. But, so far, Europe's supply-diversification strategy has proven effective.

The strategy has many moving parts. For example, last year, Germany signed a contract with Abu Dhabi to receive diesel in quantities equivalent to around two-thirds of its previous imports from Russia. But, according to the Energy Information Administration, the largest

increase in diesel imports to Europe has come from Saudi Arabia. As of February, shipments had risen to 202,000 b/d, up from an average of 68,000 b/d between October 2021 and September 2022. Turkey's role is also likely to grow. Since it is not an EU member, it is still allowed to import Russian diesel within the price-cap framework. These imports could be used to satisfy domestic demand while Turkish diesel is exported to Europe.

And in the future, if the green transition truly picks up and leads to a reduction in global oil consumption, Middle Eastern producers' market share and pricing power will increase. Because their production costs are among the lowest in the world, a drop in oil demand would imply that the least cost-efficient producers, such as North American suppliers, would be priced out.

A delicate balancing act

These changes to Europe's oil map mark a significant geopolitical shift. In some ways, they represent a return to the situation four decades ago. Europe became a major consumer of natural gas in the 1980s precisely because it wanted to reduce its exposure to the Middle East, following the instability from the 1970s oil shocks. That is why Middle Eastern oil still represents less than 20 per cent of total European oil imports.

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By the same token, increased reliance on Middle Eastern oil will make Europe much more vulnerable to geopolitical tensions in the region. In addition to adopting appropriate hedging strategies – both in terms of supply diversification and diplomatic engagement – Europeans also must prepare to deal with the rise of Chinese influence in the region. China brokered a diplomatic rapprochement between Iran and Saudi Arabia just last month; and as a major importer of Middle Eastern oil, it will try to leverage its new geopolitical role to steer market dynamics in its favour.

Europe's changing energy map thus will have global implications. When America announced its strategic 'pivot to Asia' in 2011 and became more energy independent by exploiting shale oil and gas, the Middle East's relevance was vastly reduced. While OPEC was forced into the uncomfortable OPEC+ alliance with Russia, climate concerns forced Middle Eastern countries to start rethinking their economic models, with enormous social and political consequences. Now, the region is likely to

return to the center of the energy map, at least in the short to medium run. Whether it will use the opportunity to lay a foundation for long-term stability remains to be seen.

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