BRIEFING

Economic repercussions of Russia's war on Ukraine – Weekly Digest

This paper provides a summary of recent economic, financial and budgetary decisions and developments following President Vladimir Putin's decision of 24 February to start a military attack against Ukraine. It includes recent information relating to the EU sanctions regime, recent economic estimates, and policies supporting economic and financial resilience, including the coordination of national economic and fiscal measures. It also highlights policy recommendations made in the public domain to mitigate any adverse economic, financial and social effects and to support economic recovery in the EU and the Euro Area.

For a list of previous Weekly Digest on the economic repercussions of Russia's war on Ukraine see here.

Presidency conclusions following the energy Council meeting

At their **extraordinary Energy Council Meeting** of 9 September 2022, **Ministers** agreed that the current levels of electricity and gas prices put pressure on the inflation and the EU economy, threatening the competitiveness of European companies and creating social tensions. In view of the gravity of the situation, Ministers emphasised the **need for coordinated European action**, both in terms of short-term exceptional emergency measures, and medium/longer-term improvements to the market framework.

Ministers invited the Commission to propose by mid-September measures

- capping the revenues of electricity producers with low costs of production (that benefit from the current situation) and introducing a solidarity contribution from fossil fuel companies,
- limiting the impact of high gas prices on EU electricity markets and energy prices for customers (temporary intervention, including gas price cap),
- incentivising coordinated electricity demand-reduction across the EU,
- and supporting market participants to meet increased margin calls in volatile markets for (emergency liquidity instruments).

One may note in this context that in view of rising prices for electricity, **Eurelectric**, the sector association representing the wider European electricity industry, published an overview on 29 August that aims to outline the impact of high energy prices in different countries and that in particular lists different **mitigating support measures**. That overview illustrates that the measures taken in different Member States are quite **heterogeneous**, as retail customers in some but not all countries benefitted from a reduction of taxes and levies, discounts, price caps, and from one-time direct payments, sometimes only targeted at households in need, sometimes provided to all households irrespective of their financial situation.

Russian Gas Supplies

Indefinite Suspension of Nord Stream 1

The Russian gas producer Gazprom announced on 2 September that the "*main pipeline to Germany would remain closed indefinitely*" until a turbine is repaired, according to Reuters (Gazprom's website was lately not accessible; the Swiss-based consortium operating the pipeline, Nord Stream AG, has not issued a press release). Reuters, citing the news agency Interfax, also reports that Deputy Prime Minister Alexander Novak, in an interview with the Russian state television, put the blame for the suspension of operations on the manufacturer of the turbine, claiming that the terms of a maintenance contract have been violated. The Nord Stream 1 pipeline historically supplied about a third of Russia's gas exports to Europe, but was recently operating at only 20% of capacity. The decision to suspend deliveries indefinitely had little direct impact, if any, on current European gas prices that have spiked end of August but decreased since (see Figure 1).

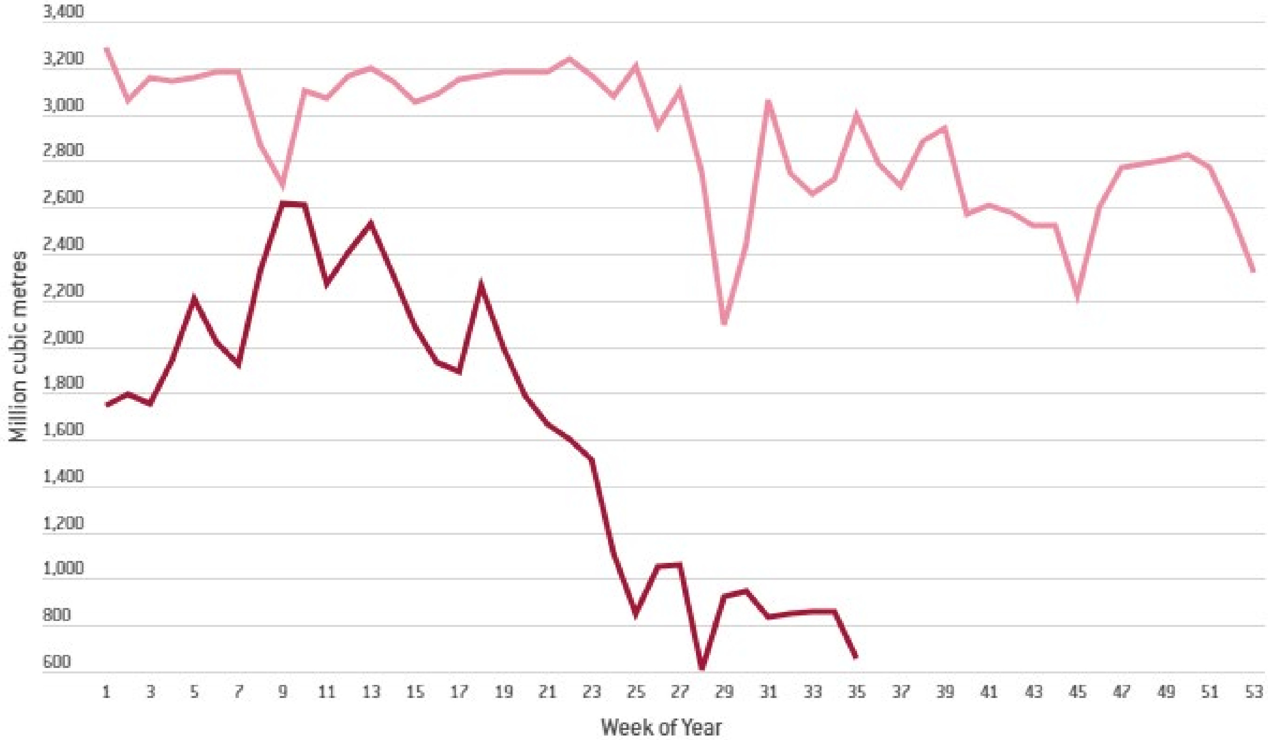
Figure 1: Price development of a European gas benchmark price [Dutch TTF (EUR/MWh), until 8 September]

Source: *Trading Economics*

Member States' Measures to Support Energy Companies

For a number of **reasons, energy companies got into difficulties** in the current environment. First, **Russian deliveries of fuel are not forthcoming** anymore. With the notable exception of Bulgaria and Hungary, Russian exports of pipeline gas to the EU have significantly dropped (see Figure 2). Most recently, as mentioned above, transport via the Nord Stream 1 pipeline has actually been suspended indefinitely. In order to supply end users or to generate electricity, energy companies therefore have to purchase gas from other sources at considerably higher costs. The ability to pass on price increases to end users of gas and electricity is often limited, in particular when retail prices have been fixed in advance, leading to financial losses and cash flow shortfalls.

Figure 2: EU Natural Gas Imports from Russia 2021 versus 2022



Legend: Upper line - 2021; lower line - 2022 (last data update as of 6 September 2022)
Source: Bruegel European natural gas imports data set, based on ENTSOG data

Second, a related problem hits energy companies that sell future electricity production in financial markets via **derivative contracts such as futures or forwards**. A number of electricity producers appear to have sought to fix future income from electricity sales through derivatives. The seller's position in such contracts, however, loses value if the price of electicity increases as, the seller owes the buyer the difference between the pre-agreed and the current price. However, such liability is not allowed to grow large, since it would expose one party to the risk of the other party defaulting. Instead, the parties regularly exchange so-called **variation margin collateral**, which can be thought of as a pre-payment of the final liability when the contract falls due. Therefore, the sharp price increases of this year have put electricity producers under **unexpected strains to put cash or securities forward** as collateral.

It is against this background that **European electricity companies have recently called for relief regarding their obligations to post collateral** according to a press report. The same report suggests European clearing houses think **bank guarantees to replace cash or securities collateral** "should not be far away" in order to alleviate liquidity pressures on energy companies. In fact, Regulation (EU) No 648/2012 ("EMIR") allows clearing houses to accept bank guarantees, however the technical standards implementing it require collateralisation of the guarantee. Consequently, it would need to be clarified **which banks would be willing to provide the service and at what cost and terms** - and how the costs and terms compare to the alternative of banks straightaway lending cash and securities to electricity firms so that the latter can fulfill their collateral obligations. Since such loans seem to be difficult to obtain in the market, so might be the guarantees. Ultimately, either way, **there will be a role for the public sector**, including public banks, to provide loans or guarantees. This appears also to be the Commission's thinking, since President von der Leyen announced in her speech of September 7 making it easier for Member States to support energy markets, "updating" the Temporary State aid Framework adopted in March 2020. In the following, we discuss selected public interventions that have already taken place.

ESMA Report on Trends, Risks and Vulnerabilities

Market volatility, yields and bond spreads have risen significantly due to the Russian invasion of Ukraine and subsequent sanctions against Russia, the European Securities and Markets Authority (ESMA) noted in its second Trends, Risks and Vulnerabilities Report 2022, published on Thursday 1 September. In addition, uncertainty remains very high, with the normalisation of monetary policy, the Russian invasion of Ukraine and the ongoing containment in China due to the Covid-19 pandemic. ESMA also noted that the value of equities has fallen while commodities have risen. Going forward, the convergence of risk sources will continue to create a very fragile market environment, ESMA warned. It therefore advises investors to prepare for further market corrections.

Some country examples:

Finland

On 6 September, Finland stated to provide bridge financing specifically for the energy company **Fortum**, to strengthen its liquidity reserves and thereby secure Finland's energy supply. The Finnish State holds a majority share in Fortum, Finland's biggest company by revenue. The **bridge financing** provides a liquidity backstop to cushion rising collateral requirements; according to Fortum's press statement, the company's collaterals tied up on the Nasdaq exchange lately amounted to approximately EUR 3.5 billion, yet were at their highest a fortnight earlier, amounting to approximately EUR 5 billion at that time.

The incremental liquidity facility of EUR 2.35 billion is made available in several tranches, matures in full within one year from signing, and comes at an effective annual interest rate of 14.2% for the whole amount and term. Moreover, a drawdown of the liquidity facility will spark a share issuance that increases the state's stake in the share capital by 1 percentage point, diluting the ownership of other shareholders, and lead to a cap of the management team's salaries and waiver of bonuses.

Sweden

On 6 September, the Swedish government announced a **general measure**, having given the Swedish National Debt Office a mandate to provide credit guarantees for loans to electricity producers that are cleared in the electricity derivatives market by Nasdaq Clearing, to allow those that trade in electricity derivatives to meet the increasingly higher collateral requirements.

The programme allows electricity producers (mainly those domiciled in Sweden) to apply for a loan via their bank, which in turn can get a credit guarantee from the Debt Office that covers 80 per cent of the credit risk, while 20 per cent thereof would stay with the bank. The credit guarantee with a maximum maturity of three years shall come at a market-based fee to be determined by the Debt Office. During the life of the loan, beneficiaries may not pay bonuses or other forms of variable remuneration.

Austria

On 31 August, the Federal Republic of Austria announced that it has concluded a loan agreement in the amount of EUR 2 billion with the Land Wien, one of its nine federal states, in order to provide liquidity to the energy provider **Wien Energie**, which is in ownership of Land Wien. According to a related statement of Wien Energie, two days before that announcement the company was required to provide collateral in the amount of EUR 1.75 billion in the context of trading energy derivatives; in that statement, Wien Energie also called for an sector-wide protection measure, arguing that the current situation in energy trading would affect other players as well.

The announcement of the Federal Republic of Austria does not set out details on the loan agreement with the federal state. However, in the press conference held Chancellor Nehammer and Minister of

Finance Brunner stressed that the loan was provided as an **emergency measure**, made available within 72 hours, and that the circumstances and exact liquidity needs of Wien Energie would have to be laid open and carefully assessed in an ex-post report.

Germany

Germany was already forced in July to **specifically prevent the insolvency of Uniper**, a company of systemic importance for the German energy market that was, as the largest importer, highly dependent on Russian gas supplies. Uniper has a power generating capacity of 33GW, approximately equal to that of the Netherlands.

The German government agreed on a rescue bailout amounting to EUR 15 billion, thereby taking a 30% stake in Uniper that reduces the majority stake of the Finnish energy company Fortum to 56%. The bail-out, subject to a State aid decision by the Commission, lead to a cap of the management team's salaries and waiver of bonuses. The intervention aiming to restore the company's viability is furthermore based on a cost-reallocation mechanism introduced under public law that becomes applicable as of 1 October ("Gasumlage"): a price surcharge paid by all consumers shall help gas importers to cope with the considerable replacement cost for Russia gas supplies.

On 17 August, Uniper presented its Half-Year Interim Report 2022, presenting a net loss of more than EUR 12 billion under IFRS, slightly more than half of that related to anticipated future impact from gas curtailments, nearly a quarter related to loan impairments for Nord Stream 2. The remaining part was said to be related to fair value valuation of hedge derivatives, which will later on be offset by positive gains on the underlying assets.

On 9 September, a second German gas supplier announced that it would need to seek a state bailout "due to unfulfilled supply obligations by upstream suppliers" - the lack of Russian gas supplies, which forces the company to procure gas at considerably higher prices on the energy markets to serve its customers.

Oil Price Developments and Russia's Revenues

Oil prices dropped from around USD 130 in March to below USD 95 at the beginning of September. This has happened as the increased demand, including for power production to replace gas, met with increased production, releases from stockpiles and a weakening global economic outlook.[1] OPEC countries and other producers ("OPEC+") noted against this background "*the adverse impact of volatility*", i.e. unhappiness about the recent decline of prices, and emphasised a "*readiness to make immediate adjustments to production*". The FT, citing sources from Saudi Arabia, suggests that OPEC+ is minded to keep the price somewhere around 100 USD.

Meanwhile, **Russian oil exports** in barrels per day have diminished by 7.5%. In July, Russian oil export revenues fell to USD 19bn, from USD 21bn in June, on both reduced volumes and lower oil prices (in comparison, according to Russian customs data, total revenues for the full year 2021 amounted to USD 111bn).

The Peterson Institute meanwhile points out that in August the discount that Russia has to accept when it sells its crude oil began to shrink. It was largest in early April, but **in the meantime Russia seems to be finding buyers and transport routes for its produce that allow it to improve its pricing power**. This

[1] For reference, see the IAE Oil Market report, latest issue of August: https://www.iea.org/reports/oil-market-report-august-2022

might suggest that Russian export volumes have also started to increase and have contributed to falling global crude prices.

To summarise, it appears that global oil prices, while substantially below their March highs, may well remain elevated but below their recent highs if OPEC+ succeeds, and Russia risks to continue benefitting from elevated prices, although on reduced, but increasing, volumes.

Against this background, the **G7 countries agreed on 2 September to "finalise and implement" a price cap on Russian oil exports**, to prevent Russia from benefitting from its war of aggression. The plan is to prohibit services enabling the maritime transport (say, insurance for tanker ships) of Russian crude and petroleum products unless the purchase price of the merchandise is below the cap.

In this context, we recall that the sixth package of sanctions includes a ban on services for transporting Russian oil from early 2023 on. The proposed price cap would, if implemented by the Council, replace this full ban. In principle, this might allow keeping Russian produce available to the world market with a potentially lowering impact on prices, while reducing the excessive revenues of Russia per unit sold. Since the planned EU embargo also concerns services for shipping Russian oil to non-EU countries, replacing it by such a price-cap mechanism provides relief to non-EU user of Russian oil that may have been discontent with the EU's approach - while at the same time **facilitating a broader political alignment of countries to diminish Russian oil revenue**. In fact, the G7 conclusions speak of a "broad coalition" of unnamed countries implementing the price cap going forward. The more countries ensure their domestic service providers adhere to the cap, the more difficult it will be to find shipment capacity for Russian oil priced above the cap. That makes the price cap potentially more effective than a more limited EU ban. However, a number of **implementation issues** remain.

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