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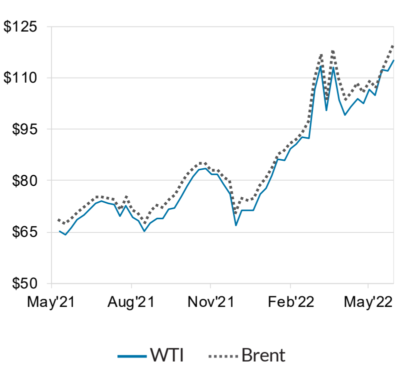

Source: CME, ICE

THE BIG PICTURE

EU Escalates Energy War Against Russia

- *New EU oil sanctions look to be targeting lasting damage to Russia's economy.*
- *The pace and timing of sanctions implementation will be critical, with ample scope for unintended consequences.*
- *Europe needs to start thinking strategically about its postwar relationship with Russia.*

EU efforts to isolate Russia over its war in Ukraine are testing the bloc to its very limits. An alliance created on the premise that trade begets peace is being threatened by its trade dependency with Russia, a power that calculated that its energy market muscle would somehow immunize it from any negative consequences of invading Ukraine. The EU is responding. It had little choice. For one, its own energy security was clearly at stake, as seen in the EU plan to cut Russian gas imports by two-thirds this year and end them by 2027. But as the biggest buyer of Russian hydrocarbons, Europe has essentially been funding Russian President Vladimir Putin's war. To retain credibility, this had to change.

The EU's continued unity, economic well-being, energy transition and geopolitical status all depend on getting its response right. Opposition from Hungary that delayed publication of the oil embargo agreement highlights the issue's capacity to undermine European unity.

The dangers of taking on an energy superpower via oil and gas sanctions are clear. The threat to Russian supply spikes prices. This limits the revenue impact of targeted sanctions on Moscow, even if sales volumes are hit. Russia's central bank reported a current account surplus of nearly $96 billion over January-April 2022, up from just under $26 billion over the same period in 2021, although Russia's war-related costs are also on the rise.

In the medium to long term, Russia will on balance suffer economically as a result of sanctions. But its revenue hit could be dwarfed by the increase in the EU's oil and gas import bill in the near term. Europe's energy reliance on Russia has put it "in a situation where it has to inflict pain on itself," notes sanctions expert Maria Shagina at the International Institute for Strategic Studies.

To avoid a Pyrrhic victory, the EU has to carefully calibrate policy implementation and be prepared to respond dynamically and creatively in the months ahead, should the cost trajectory of its energy war with Moscow prove overly burdensome. And since walking back sanctions is probably not viable politically, that puts the onus on other policy options, including: accelerating efficiency measures and the energy transition, providing financial support for vulnerable members of society and intensifying producer outreach (p2). Also on the cards are emergency measures in the event of supply disruptions.

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Compromise Solution

This sixth wave of economic measures could appear underwhelming. For one, the EU has already cut seaborne crude imports from Russia to one-third prewar levels. And only seaborne purchases are being targeted — not pipeline volumes — while a full ban won't come into effect before year's end, when Germany and Poland will also be cutting their Russian pipeline imports. Last, Hungary, Slovakia and the Czech Republic get pipeline exemptions, and Bulgaria a blanket import exemption. Products, however, will be the bigger hurdle, with the EU in May still receiving about 90% of its prewar imports of Russian refined products, or 1 million barrels per day.

So far, Russian crude exports have held up well, but the anecdotal evidence is that now it is harder to place cargoes, with trade involving more ship-to-ship transfers, long-haul sales, stockpiling on water and increasingly obscure traders. An EU ban on insurance for tankers taking Russian crude could also start to bite. Inevitably, already-steep discounts will have to get steeper to entice buyers.

High-Stakes Endgame

This new EU sanctions push comes as US President Joe Biden announced he is willing to send more advanced rockets to Ukraine, in a double-barreled signaling of intent. But this unity of purpose as to how to confront Putin masks some mixed messaging as to what postwar aims really are. On the US side, views about a need to degrade Russia's status as a hydrocarbons powerhouse are prevailing. But in Europe consensus is more fragile. The Baltic states and Poland are pretty much in line with Washington's hawks, but Hungary has fought sanctions against Russia every step of the way.

However the war ends and whoever is in power in Moscow, it is hard, if not impossible, to see a future Europe being so dependent on Russia for its energy supplies. Within a week of Russia's invasion, EU officials and leaders were directly tying energy independence from Russia and an accelerated energy transition to Europe's security architecture. That drumbeat has continued: for the West, "the long-term target should be the independence of the European energy sector," Lithuanian President Gitanas Nauseda reiterated in Brussels this week.

There has been no public discussion of what a defanged Russian energy sector will mean for the world on either side of the Atlantic, but there are strong arguments to suggest policy caution here would be advisable. A Russia that cannot have Europe as its prime market for energy exports will be an economically emasculated state. Russian energy export infrastructure is largely geared for European sales. There is potential for switching some volumes to the east, but a major shift will take time and require tens of billions of dollars of investment — an unappealing prospect for Moscow amid the energy transition.

A New Versailles?

The current trajectory has echoes of the onerous Treaty of Versailles imposed on Germany after World War I. It is hard to envisage a stable and democratic Russia emerging from the imposition of such conditions now. Russia, a nuclear superpower no less, could provide an early taste of the political upheavals likely to shake producer countries once the energy transition really begins to bite.

A Europe without cheap Russian oil and gas, and before its pivot to a faster energy transition bears fruit, also has its vulnerabilities. An overly precipitous transition from Russian hydrocarbons risks making some members' economies structurally uncompetitive just as a recession threatens. But the olive branch of compromise could be just as thorny a path as hard-line confrontation — undermining group unity and sanctions policy, while at the same time emboldening Russia.

This is a conflict where deft messaging, policy timing and strategic ambiguity are at a premium, and all need to be played in concert. Stakes are high. Moscow's invasion of Ukraine has galvanized EU purpose and unity like never before. But it has also further exposed rifts among its members. How Europe meets this challenge could be nearly as consequential for its economic, energy transition and political destinies as it is for Russia's.

Rafiq Latta, Nicosia

OPEC-PLUS

Producer Group Reveals Summer Surprise

- *Opec-plus oil ministers overturned pre-meeting expectations to green-light a bigger supply increase than scheduled — of 648,000 barrels per day versus 432,000 b/d.*

- *The move follows months of consumer calls for more oil amid eye-wateringly high prices and weeks of intense US diplomatic outreach to Saudi Arabia — but also reflects Riyadh's strong desire to keep Moscow on board.*

- *The increase, while modest, may be just the first in a series of moves as Opec-plus responds to the massive market and geopolitical changes generated by Russia's invasion of Ukraine, which may include revived US-Saudi ties.*

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Opec-plus' bigger monthly increase marks a minor supply pivot but a major policy shift. The group's underproduction problem means it will significantly undershoot the specific target to add 648,000 b/d in each of July and August. But the decision to increase after nine months of rollover decisions that rebuffed mounting consumer pressure for more oil, not least from the administration of US President Joe Biden, should not be underplayed. Baby steps these might have been, but nevertheless they were welcomed by a White House that had been unable to wring even the smallest supply concession from the Gulf. "We recognize the role of Saudi Arabia as the chair of Opec-plus and its largest producer in achieving this consensus amongst the group members," read a White House statement.

Thursday's decision could yet be the first of a series of market management moves as Opec-plus' big Mideast Gulf producers struggle to manage the massive oil industry changes unleashed by Russia's decision to invade Ukraine — including the EU oil embargo agreed this week and the US' broader aim of degrading Russia's energy powerhouse status (p1). Some of these changes are throwing up potential challenges to Opec-plus' hard-earned unity, including the strategic Riyadh-Moscow energy partnership.

Opec-plus' Gulf leaders Saudi Arabia and the United Arab Emirates are now walking the fine line of satisfying US demands, keeping Moscow on board and maintaining some control over oil markets roiled by geopolitical turmoil.

There was no obvious crack this week in the steely producer solidarity that has characterized Russia's relations with its Opec-plus partners. Russian Foreign Minister Sergei Lavrov's visit to Riyadh ahead of Thursday's meeting underlines that the increase was agreed in close coordination with Moscow. After the very brief meeting, Russian Deputy Prime Minister Alexander Novak made comments to the effect that the decision was made to meet growing seasonal demand. But the move also follows a period of intense US diplomacy vis-à-vis the kingdom, along with reports that Biden is finally planning to meet with Saudi Crown Prince Mohammed bin Salman in the coming month or so, ending Biden's freeze on personal relations under his presidency (p4).

Twin Challenges

What Opec-plus has essentially agreed to do is squeeze the three months remaining in its supply agreement to two. The agreement will now end in August, as opposed to September. Assuming Saudi Arabia and the UAE are the only ones that can actually make good on their higher target, actual increases are only 57,000 b/d (Saudi Arabia) and 18,000 b/d (UAE) above what they would have produced under the usual rollover.

In the context of Opec's massive underproduction of 3 million b/d in May, the move seems entirely inadequate. More will be needed to satisfy consumers, but Opec-plus' move marks a modest first step to address the twin challenges of growing demand and supply shortfalls. On the supply side, the problem is largely internal. Russia's conflict-induced production challenges aside, a whole raft of Opec-plus producers — among them Nigeria, Angola, Malaysia, Azerbaijan, Congo (Brazzaville) and Equatorial Guinea — have been unable to hit their targets for months. With this new 648,000 b/d staggered increase, the underproduction gap will almost certainly widen.

The shortfalls reflect a failure to invest on the part of the majority of Opec-plus members. A combination of energy transition concerns and faulty oil governance have stifled the standard producer response to what appears a major upward shift in prices. However, one producer that is studying an additional capacity push is the UAE. Abu Dhabi's state-owned Adnoc is now looking both at bringing its drive to 5 million b/d of capacity forward by three years to 2027 and then hitting 6 million b/d by 2030, sources have told Energy Intelligence. Saudi Aramco is meanwhile channeling record spending into the kingdom's own capacity expansion.

All Eyes East

No doubt sanctions on Russia and the war are helping to support prices. Russia's woes are also boosting Mideast Gulf producers' geopolitical clout, with consumers beating a path to their door to request more supply and strike energy deals. Nevertheless, the risks from this war probably outweigh the positives for Opec's traditional Gulf heavyweights.

First, high oil and gas prices, combined with concerns over security of supply, threaten to add momentum to the energy transition. The war in Ukraine is also reshaping global oil flows. Discounted Russian crude is now set to challenge Mideast Gulf producers in their core Asia-Pacific market.

It is hard to overstate the importance of Asia, especially China, for Gulf producers. China has been the safest of ports in a stormy market. It has delivered two decades of virtually uninterrupted growth, boosting sales even at times of low demand, such as during the pandemic in 2020. Like others, Beijing also has big renewables plans, while growth has slowed. But China at least still offers growth at at time when other economies are seeing structural demand slippage, making China a market of paramount strategic importance for the Gulf.

In 2015, Mideast crude made up just 24% of China's crude import mix; last year it was 50%; and so far this year it is 54%. For Moscow, too, China has been an increasingly important market, with Russia even usurping Saudi Arabia's crown as China's top supplier in 2017-18.

But US and European sanctions now make the Asia-Pacific, and China and India in particular, the primary option for large-scale Russian crude sales. To shift volumes, Russia is offering steep discounts that could grow steeper still as the EU oil embargo takes hold. If Gulf market share in these core markets is seriously eroded, this opens up the prospect of a market share stand-off between Russia and Gulf medium, sour producers.

Rafiq Latta, Nicosia

GEOPOLITICS

Russia's 'Friends' Engaged in Tricky Balancing Act

Moscow has reached out to the Middle East, China and India as sanctions pressures on it have increased. These so-called friendly countries have their limits, however. While willing to capitalize on either rising prices (Mideast Gulf producers) or huge discounts for Russian crude (India and China), they will not violate Western sanctions and are avoiding taking sides in the war. More substantial support to Moscow hinges on the outcome in Ukraine.

• In light of the EU's new embargo on Russian oil, Russia sees the position of Mideast producers as key — but US-Mideast ties are showing signs of a revival.

High-level diplomatic and commercial relations between Mideast Gulf states (particularly Saudi Arabia and the United Arab Emirates) and Moscow have improved since the formation of the Opec-plus alliance in 2016. Gulf producers view the participation of Russia in Opec-plus as necessary for the success of long-term market management. So far, Gulf governments have been treading carefully around Moscow's war in Ukraine, wishing to avoid any fallout that could prompt Russia's exit. During a visit by Russian Foreign Minister Sergei Lavrov to Riyadh this week to meet his Saudi counterpart, Prince Faisal bin Farhan al-Saud, both officials praised the work of the producer group. Lavrov said that commitment to the Opec-plus pact was also confirmed during consultations with his counterparts at this week's Gulf Cooperation Council meeting.

Wider investment and commercial ties between the two sides are lagging, however. In recent years, Russia has signed a number of high-level cooperation deals with both Saudi Arabia and the UAE in various sectors — including energy, technology, agriculture and infrastructure. Few actual projects have been realized, although Russia-related businesses have multiplied in the UAE of late. Russian Deputy Prime Minister Alexander Novak last month discussed barter deals and possible oil swaps with Iran — but the latter have long failed to gain real traction.

Such deals and discussions are in any case a sideshow to the main event — that is, the future of Russia's role in Opec-plus as its output slips to around 1 million barrels per day below its quota. Indeed, one issue Lavrov raised during his recent trips to Algeria and Oman was the ability of other Opec producers to replace Russian oil and gas volumes on Western markets. And Moscow will also likely be closely watching how Opec responds to ongoing US diplomatic outreach and pressure to increase production (p2).

Top White House Middle East Adviser Brett McGurk and State Department Energy Envoy Amos Hochstein visited Riyadh last week. That trip followed Saudi Defense Minister Prince Khalid bin Salman's recent visit to Washington, and a report of a possible meeting between US President Joe Biden and Saudi Crown Prince Mohammed bin Salman. US Secretary of State Antony Blinken and Prince Faisal likewise this week discussed Saudi efforts to extend a truce in Yemen, along with Iran's nuclear program and the Ukraine war. The US is also mediating between the kingdom, Egypt and Israel to finalize an agreement that would restore Saudi control over the strategic islands of Sarafin and Tiran at the mouth of the Gulf of Aqaba. But further improvement of strained US-Saudi relations could yet require some concessions from the kingdom in terms of its relations with Russia.

• India is trying to balance its ties with Russia and the West.

India has become one of the major buyers of Russia's discounted oil in order to meet internal demand and help refiners salvage their margins amid government price controls. Russian crude arriving at Indian ports spiked to 850,000 b/d in May from 360,000 b/d in April, according to Serena Huang, head of Asia-Pacific analysis at data analytics firm Vortexa. "Semi-term" contracts are also emerging. In comparison, India imported an annual average of less than 50,000 b/d of Russian crude in 2021. India also relies on Russia for fertilizers.

India's oil ministry is likewise encouraging state-controlled companies to look at acquisition opportunities created by the departure of Western oil majors from Russia. But this proposal has been met with caution. Indian firms point to a number of obstacles, including tightening sanctions, Russia's ban on dollar repatriation and the need to raise billions of dollars for such acquisitions. State-owned explorer Oil and Natural Gas Corp., which gets over half of its production from Russian assets, also said none of the Western majors had approached it over the positions they are vacating.

Underscoring India's struggle for balance, Prime Minister Narendra Modi last week met with fellow Quad leaders in Tokyo — Biden, Japanese Prime Minister Fumio Kishida and new Australian Prime Minister Anthony Albanese. The joint statement out of the meeting did not mention Russia, underlining consideration of India's interests, and Modi will participate in an online meeting of Brics (Brazil, Russia, India, China and South Africa) leaders this month.

Broadly, India's economic relations with Russia are marginal. In the fiscal year ended Mar. 31, the US was India's top trade partner at $119 billion, while Russia's $13 billion in trade put it 25th, with Russian arms sales to India also in decline. India is also worried that as the dust settles over Russia's invasion on Ukraine, Russia will be more closely aligned with China, which presents a strategic challenge for India.

• **China is providing political rather than economic support.**

Chinese Foreign Minister Wang Yi in March described the China-Russia relationship as "rock-solid" and said "there is a bright prospect for cooperation between the two sides." But beyond increasing purchases of discounted Russian crude, Chinese companies and financial institutions are largely putting their relations with Russia on hold. Chinese state majors are not in any hurry to pick up assets from Western oil companies exiting Russia, either. Keen to avoid secondary sanctions, firms are waiting for the situation to become clearer, analysts say, although meaningless MOUs could emerge.

Beijing's political support for Moscow — despite China's close economic ties with Ukraine — is also about resisting the pressure and influence of the US and Nato. Beijing's broad understanding is that a loss by Russia could embolden the West when it comes to any possible future clash over Taiwan.

Staff Reports

POLICY

The US' Boycott Fight Over Energy Finance

- *US states with oil and gas investments are pushing back on corporate and investor initiatives aimed at the energy transition.*
- *The state-level maneuvers are at odds with federal initiatives to enhance climate disclosure risk and nudge dollars toward lower-carbon investments.*
- *The fight over financial flows is yet another example of US energy policies fracturing along political lines.*

The Issue

US President Joe Biden came into office pledging to "supercharge" a US plan to fight the "existential threat of climate change." Legislation has slowed, but the Biden administration has wide latitude to direct foreign assistance flows to clean investments and is moving to require corporate climate risk disclosure. Seeing a threat, fossil fuel-producing states are trying to slow the flow of dollars away from oil and gas with new legislation threatening disinvestment from banks or asset managers believed to be boycotting the sector.

Origin Story

Last Tune, Texas became the first state to pass legislation aimed at pulling state-managed money away from firms that "boycott" oil and gas companies. More than a dozen US states have picked up the torch. West Virginia's Board of Treasury Investments, which manages $8 billion in state operating funds, dropped BlackRock from its portfolio. Oklahoma Gov. Kevin Stitt, a Republican, last month signed legislation mirroring that of Texas by requiring the state comptroller to catalog financial firms that have "boycotted" — i.e. curbed or limited investments in — companies involved in fossil-based energy. State agencies will need to divest from any flagged companies within a year.

The American Legislative Exchange Council (Alec), a group of conservative state legislators and private companies that drafts bills to advocate at the state level, seemed to emerge early on as a driving force behind the legislative efforts. The group has since backed away from publicly pushing the so-named "boycott" model. But the approach — targeting companies with corporate cultures that vocalize a more liberal position on politically charged issues such as LGBTQ rights and gun sales — has become a favorite among Republican statehouses. Climate change and energy transition policy have increasingly drawn Republican ire in "culture war" clashes, making financial firms that look to shrink certain oil and gas investments an attractive target for the right.

The approach is not entirely new. The former Donald Trump administration in 2020 finalized a rule that would bar banks from "discriminating" against sectors outright and tried to codify something similar at the World Bank. Both were bids to insulate oil and gas companies from banks' transition goals. The tactic also echoes the anti-boycott movement related to Israeli settlements in the West Bank, in which individual US states targeted companies refusing to do business with settlements.

Target Practice

Firms that have joined onto emissions-focused shareholder groups — such as the Net-Zero Asset Managers Initiative, or Climate Action 100+ — may be the biggest target. The conservative Texas Public Policy Foundation, which advocated for the Texas law and wants strong enforcement, is keeping an especially close watch on firms touting membership in those groups, says Brent Bennett, who runs the foundation's energy program. To that end, BlackRock is and remains a primary target, no matter the fund giant's recent announcement that it would not support "prescriptive" shareholder proposals that force a hard line on companies' transition strategies. Bennett said there will likely be "political pressure to keep certain companies like BlackRock on the list and divest from them if possible," absent very clear changes in policy like withdrawing from groups like Climate Action 100+.

The laws will test the appetite state officials have for potentially pushing large businesses out of state lines, and that of companies for maintaining robust, public climate goals in the face of divestment threats. The conundrum was underscored when Texas regulators engaged consultancy MSCI to come up with a list of companies with oil and gas boycotts, NPR reported in April, before realizing that MSCI's own policies might violate the law: MSCI has committed to a goal of net zero before 2040.

Banks have been forced to respond. Most of the two dozen companies replying to the Texas Comptroller's Office as of May 16 reported they do not have specific policies around oil and gas investments. JPMorgan Chase was among the few to note specific restrictions around coal mining and new Arctic oil and gas development, which Republican lawmakers have criticized for years. All but one boutique firm with a heavy renewables footprint said they do not boycott oil and gas.

A handful of companies reported membership in the climate-focused investment groups. BlackRock detailed its participation in the Net-Zero Asset Managers Initiative, Climate Action 100+ and the Task Force for Climate-Related Financial Disclosures but stressed that it does not retain sector-specific investment policies. BlackRock Senior Manager Dalia Blass added in the firm's response that its investment decisions "are governed strictly by our fiduciary duty to clients." And Aberdeen Standard Alternative Funds Ltd. said "client request" and increasing regulations surrounding carbon disclosure drove its commitment to the Net-Zero Asset Managers Initiative.

Tricky Enforcement

Enforcement is likely complicated. There is a fair amount of flexibility baked into the law, such as exemptions for companies with contract values of less than $100,000, and what some observers characterize as broad legal protections for firms to safeguard against risk. Tom Sanzillo of the Institute for Energy Economics and Financial Analysis said state regulators are going to find it tricky to distinguish between divesting from oil and gas companies to guard against climate risk and an actual "boycott." Sanzillo, who was deputy New York comptroller when Albany backed divesting state pension funds from oil and gas assets, noted that "many of the investment houses are responding with 'we don't boycott,' which is accurate. They don't."

State officials will have to demonstrate companies intentionally boycotted the sector — a high hurdle, Sanzillo said, adding that none of these cases have yet to be challenged in court. The win may be in passing the legislation, at least for Texas Republicans, said Mark Jones, a senior political fellow at Rice University's Baker Institute. "Enforcing it is not exactly a top priority," Jones said. But he acknowledged that if there is considerable public pressure, high-profile companies seen as engaging in climate "activism," such as BlackRock, could be singled out.

Bridget DiCosmo and Emily Meredith, Washington

POLICY

UK Tries to Navigate Producer-Consumer Politics

Inflation driven by skyrocketing energy prices is forcing governments around the world to address the cost-of-living crisis. For producer governments like the UK, that means balancing support for consumers with the impact on domestic energy sectors. Revenues generated from the UK's temporary windfall profits tax on North Sea oil and gas producers, announced last month, will help fund a support package for households struggling with high energy bills. But some argue the tax could slow North Sea hydrocarbon investment in a supply-strained world in the short term, while negatively impacting the UK's energy transition longer term.

• The UK has joined other European producers in launching a windfall tax on its oil and gas sector to underpin consumer relief.

A temporary increase in the UK's headline tax rate on profits from 40% to 65% is seen as raising some £5 billion in the next 12 months to help fund some £15 billion ($19 billion) of assistance for consumers. UK Chancellor Rishi Sunak insists that the windfall profits levy will be phased out when oil and gas prices return to historically normal levels. A new investment allowance has also been built into the tax, allowing oil and gas companies to get over £90 back in tax relief for every £100 they invest. But one industry source describes this as simply "sweetening a bitter pill on the extra 25% tax" the government expects to raise.

Parliament had already voted against a windfall profits tax for oil and gas producers. But the government was facing mounting pressure to act — with UK consumers expected to see household energy bills more than double inside a year — and it's not alone. This month, Italy said it would finance a €14 billion ($15 billion) economic support package by increasing tax on energy companies' windfall profits to 25%, up from the 10% it first considered in March. Hungary also announced a windfall profits tax that will apply to banks, insurers, big retail chains, energy and trading companies, telecom companies and airlines.

The UK may yet introduce a similar tax for electricity generation companies in the autumn, which could weigh on the shares of exposed companies such as SSE, RWE, Iberdrola and Orsted, as well as Centrica and Drax. The government is talking to the power generation sector and investors about energy market reforms to ensure the price paid for electricity is more reflective of the cost of production; right now, gas is the price-setter.

• Some argue the ripple effects of the windfall tax — including tax relief for fossil fuel projects but not renewables projects — could undermine investment in the UK energy transition.

Steep tax relief for investment could give a boost to projects previously considered uneconomic, while also undermining environmental targets. The London-based Institute for Fiscal Studies (IFS) believes the 91% tax relief will see North Sea investment heavily subsidized. "The new super-deduction means that investing £100 in the North Sea will cost companies only £8.75, with the remaining cost paid by the government. So, a massively loss-making investment could still be profitable after tax," argues Senior IFS Economist Stuart Adam. The UK and other governments pledged to phase out "inefficient" fossil fuel subsidies at last year's COP26 climate conference in Glasgow. Shell noted the tax relief does not extend to transition investments.

Investment bank RBC last month said any implementation of a possible windfall tax on electricity generators would be "highly complicated and potentially damaging to the government's green agenda" by reducing investor confidence and increasing the cost of capital for new projects — noting that the UK wants to spur renewables and nuclear investment.

UK oil, gas and renewables lobby group Offshore Energies UK has meanwhile cautioned about the climate of uncertainty the windfall tax creates for energy investment across the board. "In particular it pushes up the cost of borrowing for new projects, making it more difficult to raise the money needed to maintain existing energy supplies and build the low-carbon energy systems of the future," Offshore Energies UK CEO Deirdre Michie said in late May.

Industry experts also say the windfall tax will hit the UK supply chain and its thousands of employees — and could threaten the sector's capacity to handle transition projects down the line. "I think this is a blow to investor sentiment and raises doubts over the significant investments needed for the North Sea energy transition with these additional costs expected to flow down the supply chain. In six to seven years' time everyone may ask: Where are all these large capex projects on [carbon capture and storage], hydrogen or offshore wind?" Derek Lang, EY's global oil and tax leader, told Energy Intelligence.

• Investors in the oil majors have largely shrugged off the impact, as the levy is dwarfed by the revenues from soaring oil and gas prices, but smaller North Sea-dependent players saw share prices dive on the news.

The global oil majors have stepped back from their previously massive exposure to the mature North Sea Basin. France's TotalEnergies, Shell and BP each report between 5%-6% of their production from the UK offshore sector. But after netting out the effect of the investment credits, analysts at investment bank Jefferies see the tax costing these companies just 2%-4% of net income in 2023. Those figures would fall significantly if the credits were expanded to transition investments. Total is the most exposed, with an estimated $900 million tax hit next year.

Share prices for the European majors have generally traded flat since the announcement, reflecting their diversified portfolios. Investors have been more worried about independents that rely on the North Sea. Shares of the North Sea's top producer Harbour Energy are off almost 13% since the tax was unveiled. But analysts note that smaller companies may be best placed to benefit as they bring forward modest offshore projects to take advantage of available write-offs.

The overall impact on North Sea supply looks negligible. New projects linking smaller reservoirs to existing infrastructure could not keep pace with existing declines. "The move is unlikely to render new or existing projects uneconomic and it could even accelerate 'ready to go' developments, such as Rosebank and Cambo," said Neivan Boroujerdi, research director for North Sea upstream at consultancy Wood Mackenzie.

Tom Pepper and Noah Brenner, London

CLOSING ARGUMENTS

Turkey's Syria Move, Israel-Saudi Island Politics

Turkey: Nato's 'Double Standard' Prompts Push for Syria Buffer Zone

Turkish President Recep Tayyip Erdogan appears to be taking advantage of Russia's invasion of Ukraine to seek a solution to Ankara's own long-time problem with Kurdish separatist forces in northern Syria. Erdogan recently announced that Turkish forces would undertake a cross-border incursion into Syria to create a 30 kilometer-deep buffer zone — free of the presence of forces affiliated with the Syrian-Kurdish People's Protection Units, or YPG. Turkey had been threatening to forcibly create such a zone since 2019 but had been prevented from doing so by Russia, culminating in a series of military clashes that left scores of Turkish troops dead. With Russia focused on Ukraine, Erdogan, sensing opportunity, appears prepared to finish the job.

Erdogan discussed his threatened incursion in a recent phone call with Russian President Vladimir Putin, in which he also raised the possibility of Turkey playing a larger role in mediating a resolution to the Ukraine war. Turkey, a Nato member, has criticized the Russian invasion of Ukraine and expressed its support for the territorial integrity of Ukraine. But it has not signed up to Western-led Russia sanctions. Moreover, Erdogan views the Ukraine war as distracting from Turkey's own geopolitical priority of confronting regional terrorism in the form of Islamic State and the Kurds, points he recently expressed in an *Economist* article.

Turkey has been fighting a decades-long war with the Turkish-Kurdish militant group the PKK, and Ankara considers the YPG a PKK offshoot. Complicating the Turkish posture is the YPG's role in the ongoing US campaign against Islamic State in Syria. YPG fighters are the backbone of the US-backed Syrian Democratic Forces in Syria's largely Kurdish northeast. The US has cautioned Erdogan against undertaking his threatened operation, saying a new offensive could undermine regional stability and put US forces in Syria at risk. US objections, however, appear to be falling on deaf ears.

Turkey's threatened military incursion into northern Syria is part and parcel of an ongoing military and political campaign waged against the PKK and YPG, which has seen Turkey launch four military incursions into Syria since 2016, as well as carrying out ongoing operations in northern Iraq targeting the PKK. Erdogan has condemned the support provided by the US, Nato and the EU to the YPG, and has used this stance to block the membership applications of both Sweden and Finland to join Nato, citing what he called Nato's "double standards" in fighting terrorism.

Israel-Saudi Arabia: Egypt Island Deal Signals New Era

The final touches are in the process of being applied to Egypt and Saudi Arabia's 2016 agreement for the transfer of control of two strategically situated Red Sea islands, Sanafir and Tiran, from Egypt to Saudi Arabia. Sanafir and Tiran are located on the Strait of Tiran at the mouth of the Gulf of Aqaba, Israel's only Red Sea gateway to its southern port of Eilat, and the 2016 deal was linked to Saudi aid to and investment in Egypt. But what makes this deal resonate geopolitically is that it requires the agreement of Israel: Finalization would crack open the door to Israel and Saudi Arabia normalizing ties.

Egypt has largely controlled the islands since 1950, when Saudi Arabia ceded management in a bid to strengthen Arab military positioning against Israel. Egypt used its presence on the islands to restrict Israeli shipping through the Strait of Tiran, contributing to the outbreak of the 1967 Arab-Israeli War. Israeli forces captured the islands during that conflict, and again during the Yom Kippur War of 1973. But the islands were returned to Egypt as part of the two countries' 1979 peace agreement, under which Egypt agreed to guarantee the safety of Israeli shipping transiting the Strait of Tiran and keep the islands demilitarized.

It is this treaty obligation that makes Egypt's transfer of the islands back to Saudi control a geopolitical event — with Saudi Arabia becoming the effective guarantor for Israeli shipping through the strait. Saudi Arabia has no diplomatic relations with Israel, despite quiet Israeli-Saudi cooperation on matters of mutual security concern, such as Iraq's nuclear program in the 1980s and Iran's ongoing muscle-flexing in the Mideast Gulf.

The lack of any formal ties between Israel and Saudi Arabia was a key complicating factor in the deal's finalization — even as Egypt endured a political backlash at home against the transfer, with the government accused of selling Egyptian sovereignty to Saudi Arabia. But Egypt's parliament approved the deal in 2017, and its top court in 2018. This final obstacle may now be overcome, in part via US mediation among Israel, Saudi Arabia and Egypt. Israel has made great strides in normalizing relations with other Gulf Arab states: Notably, Israel and the United Arab Emirates signed a free trade deal this week, after normalizing ties in 2020. Saudi Arabia — its identity tied to its religious leadership — has been more cautious, but the Sanafir and Tiran deal represents a step in that direction.