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EU sanctions against Russia and potential problems with Serbia crude oil supplies

The sixth package of sanctions against Russia introduced by the European Union in connection with the attack on Ukraine will have consequences for Serbian Pančevo refinery, owned by Russian companies. Deliveries to the plant are taking place via the Adria pipeline and the Omišalj oil terminal in Croatia, and the new sanctions prevent the unloading of Russian crude oil in EU ports. Under these circumstances, Serbia is in a difficult position, and there are few potential scenarios for breaking out of this stalemate.

Impact of the sanctions on the Serbian oil sector. There is one refinery in Serbia, located in Pančevo with a processing capacity of 96,000 barrels/day and owned by NIS a.d., whose dominant role in the shareholding structure are Russian companies[1]. Crude oil is delivered to the plant through the Omišalj oil terminal (throughput capacity is 600,000 barrels/day) on the island of Krk in Croatia on the Adriatic Sea, and then via the Adria pipeline (throughput capacity is 400,000 barrels/day). The owner and operator of both the terminal and the pipeline in Croatia is JANAF Plc. company, while in Serbia, Transnafta a.d. In accordance with the current operating agreement, valid from January 1, 2022 to December 31, 2022, between NIS a.d. and JANAF Plc., the refinery is able to use the Adria pipeline for crude oil supplies at the level of 64,000 barrels/day in 2022 with the option to increase or decrease deliveries by 10% in the take-or-pay formula. The sixth package of sanctions introduced by EU countries on June 4, 2022, prevents the unloading of Russian crude oil in the ports of EU countries from November 1, 2022. Although a 6-month transition period has been introduced for previously concluded contracts, in practice this means that after December 5, 2022, the Pančevo refinery will not be able to import crude oil from Russia via the Omišalj oil terminal and the Adria pipeline.

Earlier, in 2021, the company NIS a.d. reduced the share of crude oil from Russia to 17% from 27% in 2020 (mainly Novy Port grade, which is produced by Gazprom Neft PJSC, and a small amount of Urals grade), increasing at that time the processing of crude oil from Iraq to 51% compared to 44% in 2020 (Kirkuk grade) and Iran (Iranian Heavy grade). The plant also processes crude oil from Norway (Johan Sverdrup grade) and crude oil extracted by NIS a.d. in Serbia, Romania, and Bosnia and Herzegovina.

The significance of this plant for the fuel market in Serbia is extremely important as 70% of the domestic fuel demand is covered by the Pančevo refinery. Additionally, the naphtha, which is produced at the refinery, is directed to the petrochemical plant HIP Petrohemija a.d., which is also owned by Gazprom Neft PJSC (20.86%). Importantly, at the end of 2021, Gazprom Neft PJSC and the Serbian government signed an agreement increasing the shareholding of the Russian company in HIP Petrohemija a.d. up to 90%.

Potential scenarios for solving the supply problem. The sixth package of sanctions imposed on Russia will hamper the operation of the Pančevo refinery and prevent further imports of crude oil from this direction via the Croatian oil infrastructure. This type of threat was considered earlier when Gazprom Neft PJSC was placed on the list of the fourth EU sanctions package. Under these circumstances, NIS a.d. after December 5, 2022, will be forced to increase shares of supplies other than Novy Port and Urals grades. Importantly, the spread between crude oil from Russia and Iraq or Norway is significant (over USD 30 / barrel), and thus the costs of purchasing other cargoes will be higher. As a result, the Serbian government and the company itself are considering taking several measures aimed at both increasing energy security and improving the conditions for the plant's operation.

[1] The company is owned by Gazprom Neft PJSC (50%), Gazprom PJSC (6.15% – from May 6, 2022, which was dictated by the desire to circumvent potential EU sanctions), the Serbian government (29.87%) and other shareholders (13.98%). Gazprom Neft PJSC has bought shares in NIS a.d. in 2009 (51%), and in 2010 it increased its share (56.2%).

Firstly, the company NIS a.d., due to its activity in the upstream segment, is considering increasing crude oil production mainly in Serbia (production in total is approx. 16,000 barrels/day), Romania (approx. 11,200 barrels/day), and Bosnia and Herzegovina. Nevertheless, these levels are not optimal for refinery and would only have a limited impact on the level of crude oil utilization from these directions at the plant.

Secondly, the option of building an alternative pipeline is being considered. Interestingly, on February 22, 2022, before Russia's invasion of Ukraine, the Serbian government considered extending the Druzhba (southern line) pipeline from Hungary to Serbia on the Szeged- Pančevo route (approx. 200 km). It is anticipated that the transport capacity of the pipeline would be around 20,000-50,000 barrels/day. Although this is a project in the preliminary stages (both NIS a.d. and MOL Group have not officially commented on the idea), it is realistically considered. The issue of this investment was discussed during the Russian-Romanian talks on May 20, 2022, in Belgrade. NIS a.d. is the owner of six blocks in the western part of Romania and has been extracting crude oil from the Teremia field since 2019 (in 2020-2021, the crude oil from Romania at the Pančevo refinery was used as a feedstock at the level of 7,000-8,000 barrels/day). It is expected that crude oil from this country would also be supplied through the new pipeline. Importantly, in the event of the construction of this type of infrastructure, it would be possible to continue, or even probably increase, crude oil supplies from Russia, as crude oil supplies via the Druzhba pipeline to refineries, among others in Slovakia and Hungary, are not covered by the sixth package of sanctions. The problem, however, is the time needed for construction of this pipeline, which would probably take several years.

Third, the government in Serbia is considering increasing the storage capacity (crude oil, fuels), mainly those under state control (stocks controlled by the Directorate for Energy Reserves and the state-owned company Transnafta a.d.). Such actions would be aimed at improving fuel availability and securing Serbia in the event of market disruptions. The commencement of such work also results from the provisions of the Council Directive 2009/119 / EC of September 14, 2009, imposing an obligation on Member States to maintain minimum stocks of crude oil and/or petroleum products, because Serbia, as a country with candidate status for EU membership, is obliged to implement the EU law to the national legal system and thus expand the storage capacity.

Fourth, Serbia is considering diversifying of sources and directions of crude oil supplies. Restricting the ability to purchase crude oil from Russia will force NIS a.d. to look for alternative suppliers. Earlier, it was assessed that the fourth package of sanctions would make it impossible to import crude oil to Serbia completely (the Russian company is the majority shareholder). In these circumstances, the possibility of importing crude oil from the United Arab Emirates via the Durrës port in Albania was pointed out. It is now known that deliveries can be made via the Adria pipeline, but the option of closer cooperation with the Middle East countries will probably still be considered.

Conclusions

- The sanctions imposed by EU countries on the import of crude oil from Russia will have an impact on the operation of the Pančevo refinery, as Gazprom Neft PJSC will not be able to import Russian oil to its plant in Serbia. Such a situation will mean that the refinery will not be able to process the crude oil that is sold on the market at a significant discount, which will consequently affect the financial results achieved by the plant. According to the Serbian authorities, the sanctions will cost USD 600 million, due to the emerging price difference between Urals and Kirkuk grades. Thus, Serbia will import cheap natural gas from Russia ("IEŚ Commentaries", no. 624), but not crude oil (after December 5, 2022). However, until the end of 2022, the plant will still benefit from lower crude oil purchase costs due to the decision of the Serbian government in March 2022 to exempt this commodity from customs duties.
- Under the new conditions, NIS a.d. will be forced to buy crude oil from places other than Russia. At the same time, it is difficult to indicate whether the actions of the Serbian government to expand the infrastructure, and thus the construction of the pipeline from Hungary, will materialize. The introduced sanctions make it possible to import crude oil to refineries, among others in Slovakia and Hungary, from Russia via the Druzhba pipeline, but probably not for long enough to guarantee the profitability

of extending this pipeline to Serbia. Thus, the pipeline construction project raised by the government can only remain in the conceptual phase. In that case, the only solution for NIS a.d. will be after December 5, 2022, to purchase non-Russian crude oil and an increase production in locations where the company has its assets. Nevertheless, it is highly probable that the Serbian government will accelerate efforts to expand storage capacity, which is in line with EU regulations, and will probably support the company in its efforts to search for alternative suppliers.