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The challenge of capping the price of Russian oil

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■ G-7 leaders recently decided to explore the adoption of a price cap on Russian oil prices in order to mitigate the negative spillovers of the insurance ban announced by the EU that implies, de facto, the removal of Russian oil exports from the market.

■ The challenge is to find a price for Urals that is low enough to compromise Russia's public finances and its war efforts but high enough to incentivize Moscow to keep pumping. An ideal cap should be set between Russia's average production costs (around USD 30/bbl) and its pre-war fiscal breakeven price (around USD 70/bbl).

■ Even if an adequate price that does not trigger a sharp depreciation of the RUB is found, the implementation of the cap will be rather challenging, and Moscow has several ways to circumvent it. Such a measure risks to further escalate tensions between Russia and the West and could unintentionally boost oil prices via a higher geopolitical risk premium.

Fears of a global recession are weighing on oil prices. After moving close to USD 125/bbl in early June, Brent is now trading at around USD 100/bbl. Concerns about declining demand being triggered by the erosion of real household income, tighter monetary policy and rising COVID-19 cases are offsetting worries about an undersupplied oil market. Another source of price relief is the expectation that Russian oil will keep flowing globally thanks to the introduction of a price cap that will circumvent the insurance ban recently approved by the EU, thus easing the problems associated with the undersupply that characterizes the market. In our view, this optimism is misplaced. The implementation and enforcement costs of any such measure are extremely elevated, and Moscow is unlikely to accept the price of its own oil being set artificially without retaliating – and this sort of uncertainty will contribute to keeping Brent prices elevated going forward.

How tough on Russian oil should the West be?

With its latest package of sanctions, the EU went beyond an import ban on Russian crude (as originally expected) and imposed a ban, along with the UK, on insurance for tankers carrying Russian crude anywhere in the world. Ninety-five percent of the world's tanker liability cover is arranged through a London-based insurance organization called the International Group of Protection and Indemnity Clubs, which heeds European law. Without such insurance coverage, Russia and its customers would have to find alternatives for covering third-party liability claims, including environmental damage and injury such as that associated with oil spills and accidents at sea, which can cost billions of dollars when they happen.

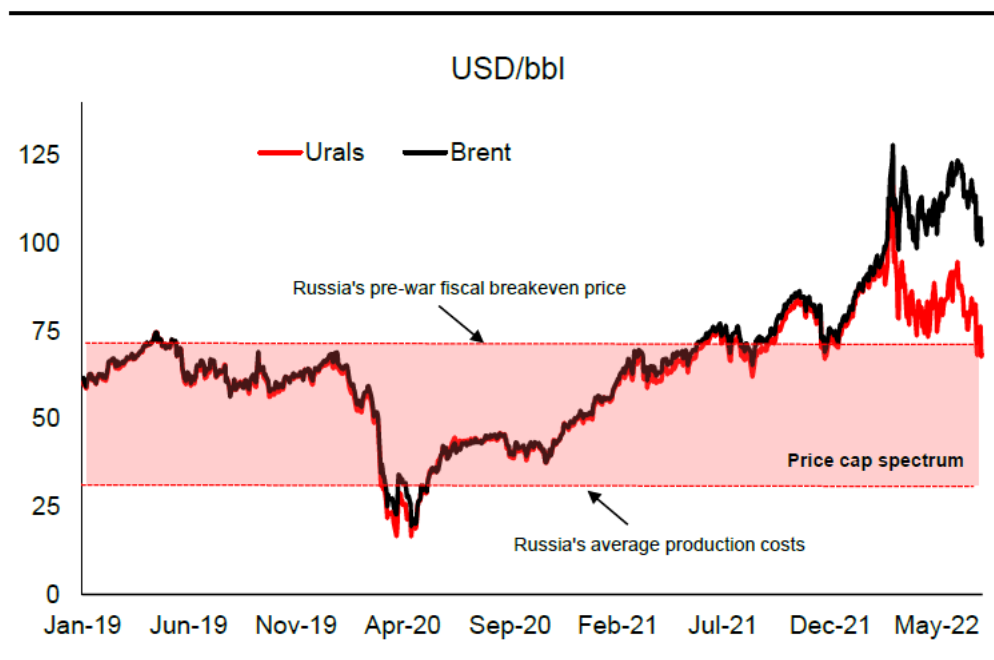
This measure implies that Russian oil exports will be de facto removed from the market when the insurance ban kicks in in six months. Russia exports around 5mn b/d of oil around the world, with roughly 3mn b/d just going to Europe. As a result of sanctions and self-sanctions imposed by the West, Russian oil production is already expected to be down by 3mn b/d in July. By the end of the year, also the roughly 2mn b/d of Russian exports to Asia might be compromised by the insurance ban. Overall, around 5% of pre-pandemic global supply will be removed from the market as OPEC+ and the US lack the spare capacity necessary to step in and replace these missing barrels. Hence, market tightness, which is already high, is expected to intensify further, pushing oil prices higher.

For this reason, the Biden administration has proposed the introduction of a price cap on Russian oil, a measure endorsed at the latest G-7 meeting. The rationale is to keep Russian oil moving at a low price instead of removing it from the market. Moscow will earn less oil revenues, while global oil supply will be less tight. On paper, the mechanism looks straightforward. Once a price cap is set, buyers of Russian oil would be offered a waiver from the ban on European shipping insurance. Thanks to this exemption, countries like India or China, which have abstained from sanctioning Russia, would be allowed to buy from Moscow not just the barrels that they usually buy but also those that no longer go to Europe and North America, thus freeing up oil from Middle Eastern producers that could redirect part of their Asian exports

towards Western countries. In turn, the global oil market would be balanced despite sanctions and prices would decline.

In putting such policy into practice, the challenge is to find a price for Urals that is low enough to compromise Russia’s public finances and its war efforts but high enough to incentivize Moscow to keep pumping. Chart 1 shows that, as a result of Western sanctions, Urals is already selling at a discount of around USD 30/bbl over Brent. A cap on Urals would likely imply a much bigger gap. The average production cost for Russian oil is around USD 30/bbl, while its pre-war fiscal breakeven was around USD 70/bbl (which is probably higher now as a result of higher spending related to the Russia-Ukraine crisis and a fall in non-energy-related tax revenue due to the current slump in economic activity). Thus, any price above USD 30/bbl would incentivize Russia to sell its oil and any price below USD 70/bbl would hurt its public finances. This means that the factors that usually determine the price of oil will have to be ignored: production costs of marginal producers, demand momentum, overall spare capacity, inventory levels and a geopolitical risk premium.

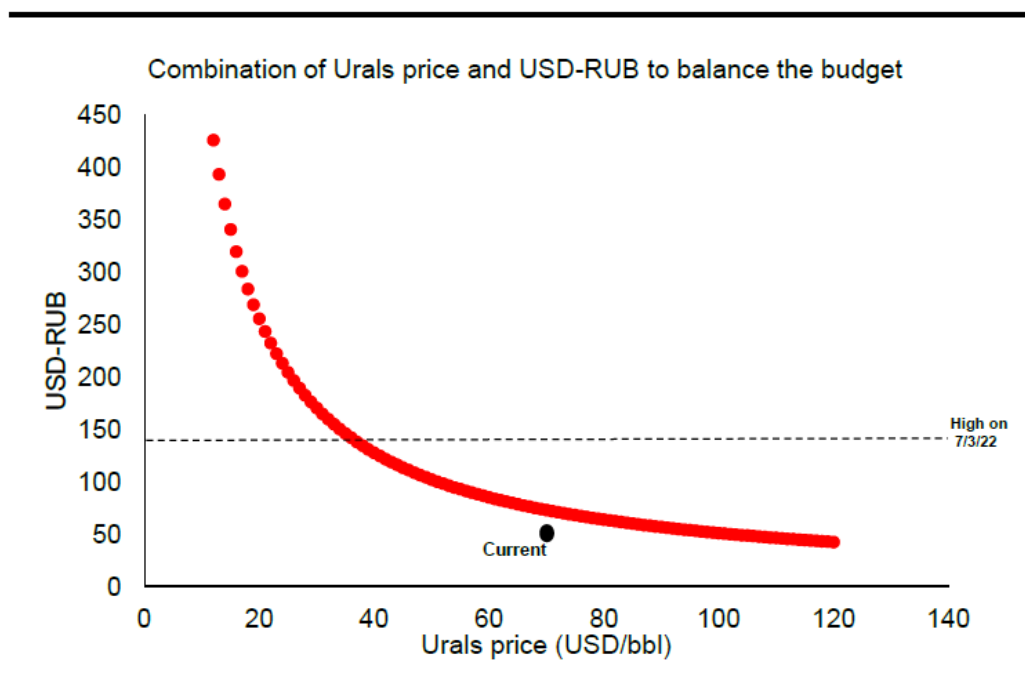
CHART 1. THE PRICE CAP SPECTRUM



Source: Platt, Energy Aspects, UniCredit Research

Western powers need to be careful in not setting a price cap that is so low to completely destabilize the Russian economy, further escalating geopolitical tensions with Moscow. From Russia’s point of view, what matters is the amount of RUB that its USD-denominated oil revenues would convert into. If the price of Urals is too low, then the RUB will have to sharply depreciate in order to ensure that oil revenues denominated in domestic currency remain unaffected. Chart 2 shows the combinations of USD-RUB and the prices of Urals that are necessary to balance the government’s budget.¹ The current price and FX combination is below the downward-sloping red line – meaning that the RUB is too strong to allow the balancing of the budget through the current oil revenues. For capped prices between USD 40/bbl and USD 60/bbl, the RUB would enter a stress range where it should depreciate substantially, up to levels similar to those recorded at the beginning of the Russia-Ukraine conflict. For prices below USD 40/bbl, the depreciation required would likely be unsustainable for the Russian economy, triggering a major crisis, with skyrocketing inflation and a further slump in GDP that would likely induce Russia to retaliate.

CHART 2. A DIFFICULT BALANCING ACT



Source: Bloomberg, UniCredit Research

How will Moscow react?

A price cap would pose several implementation problems. First, at least in the short term, Russia could cope with the price cap through its National Wealth Fund which could deploy up to USD 200bn to smooth the pain of the measure. Second, even if a cap is set at a decently high level (close to the upper bound identified in chart 1), Russia might still prefer to forgo some revenues instead of letting Western powers dictate its own selling strategy. Moscow could either react by fully removing its oil exports from the market or by setting a price floor for its crude, prohibiting exports at a price lower than that threshold. This way, the West will be forced to choose between going without Russian oil (and accepting higher global oil prices as a result of a tighter market) or paying what Moscow requests.

Third, Moscow is already working on circumventing the ban on insurance by providing its own insurance to potential clients through its state-controlled Russian National Reinsurance Company, but the insurance coverage that it will offer is unlikely to be as wide-ranging as that provided by European companies. For this reason, we think that buyers in Asia might be reluctant to accept it out of concerns that shipments will not be fully covered or that they could be found in violation of secondary sanctions if they are implemented. The provision of alternative insurance is only one way to circumvent a price cap. Russian companies may resort to bundling oil together with other goods, selling oil at the capped price and other goods or services at a highly inflated price to make up for the difference between the capped price and the market value. Finally, the price cap presumes the collaboration of countries, such as China and India, that so far have avoided siding against Russia, which is an important economic and geopolitical partner for them.

A price cap on Russian oil prices is an appealing idea, but one that would face several implementation problems and would risk escalating tensions between Russia and the West. Imposing a price cap on Urals could ultimately push prices higher as a result of a higher geopolitical premium. The alternative could be to rethink the terms of the EU's insurance ban in order to ease the tightness of the market, while the market keeps spontaneously discounting Russian oil as a result of sanctions and self-sanctions. The implementation of a cap on natural gas prices, instead, would be slightly less challenging for a number of reasons. Unlike the oil market that is internationally integrated, the natural gas one is regionally fragmented. Therefore, the price cap on gas would require a coordination only at the European level, and not globally. Second, and precisely for this feature, Russia would have more limited options to react to a cap. It could either accept it and sell its gas to Europe or it would halt its production entirely, without the option of leaking its gas to third parties (at least in substantial amounts). Therefore, when it comes to

artificially managing the price of a commodity, it is important to carefully consider the features of the underlying market.

1 The chart is based on three assumptions. First, the fiscal revenues per barrel are equal to pre-war fiscal breakeven prices multiplied by the USD-RUB rate that prevailed in the months before the Russia-Ukraine conflict began (73). Second, Russian exports remain unchanged. Third, the price of oil sold domestically would have to be equally affected by the cap, as it would become difficult to differentiate between domestic and foreign consumers.