

**29 November 2022**

## **The consequences of placing a price cap on Russian oil**

Abstract from *Macro Research, Oil Update*  
UniCredit Research

- European diplomats are negotiating a price cap on Russian oil once an EU ban takes effect, but there is substantial disagreement regarding a price target.
- The greatest challenge is to identify a price for Urals low enough to compromise Russia's public finances and war efforts but high enough to incentivize Moscow to keep pumping.
- Russia has several options to circumvent such a cap, and OPEC+ might feel compelled to adopt a more aggressive stance (cutting or threatening to cut production even further) to dissuade the West from regulating the price of other crude benchmarks in the future.

Brent prices have been on a rollercoaster throughout 2022. They started the year around USD 80/bbl before jumping to USD 127/bbl in March on the back of the Russia-Ukraine conflict, and since September, they have fluctuated within a wide trading range of USD 100/bbl and USD 80/bbl. In October, OPEC+ managed to put a floor under Brent prices at USD 90/bbl by announcing new output cuts to the tune of 2mb/d, but this floor was broken recently. Now, oil prices are roughly back to where they were at the beginning of the year.

Three factors are weighing on oil prices. First, new COVID-19-related restrictions in China in response to surging case numbers (with all their repercussions on mobility, economic activity and social tensions) are darkening the demand outlook for oil. Second, rumors that Saudi Arabia might push OPEC+ to reverse production and add 500,000 b/d have created expectations of abundant supply. Third, the attempt by the G-7 to set a price cap on Urals (the Russian benchmark) is putting downward price pressure on Brent as well. While the COVID-19 outlook in China remains the greatest unknown factor, in what follows, we discuss why placing a price cap on Russian oil, if successfully negotiated, might push OPEC+ to adopt a more-aggressive stance, pushing oil prices up.

### **The challenge of the price cap**

Last spring, the G-7 endorsed the introduction of a price cap on Russian oil. The measure was meant to keep Russian oil moving at a low price instead of removing it from the market, as an EU ban on Russian crude and on insurance on tankers would have implied (95% 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). 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 or North America, thus freeing Middle Eastern oil producers to redirect part of their Asian exports towards Western countries. In turn, the global oil market would be balanced despite sanctions. Prices would decline, while Moscow would take in fewer oil revenues.

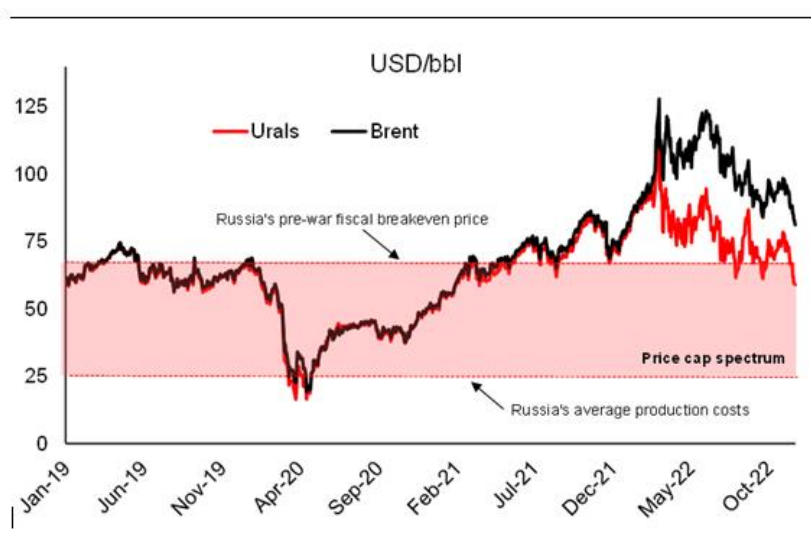
As we highlighted in our July Oil Update, the challenge is to identify a price for Urals low enough to compromise Russia's public finances and war efforts but high enough to incentivize Moscow to keep pumping. Chart 1 shows that, as a result of Western sanctions, Urals, which is trading at USD 58/bbl, is already selling at a discount of around USD 25/bbl over Brent. In that publication, we argued that the ideal price-cap spectrum would be between USD 30/bbl and USD 70/bbl. The rationale is the following. The average production cost for Russian oil is around USD 30/bbl, while its pre-war fiscal breakeven price 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, a price above USD 30/bbl would incentivize Russia to sell its oil, and a price below USD 70/bbl would hurt its public finances.

Negotiations are in play to agree on a cap ahead of 5 December, when Europe's embargo on Russian crude traveling by sea takes effect. For the last few days, European diplomats have struggled to find an agreement

on a widely supported price cap – that would apply to all importers of Russian oil using Western trade infrastructure, shipping, and insurance. Western European countries favor a cap of around USD 65-70/bbl – that is above where Urals is trading now and is at the high end of our spectrum. Eastern European countries, instead, think that a cap of this kind would be too generous for Moscow and would not have a meaningful impact on its public finances. They would rather set the ceiling around USD 45/bbl. Ukrainian President Volodymyr Zelenskyy, whose country is not part of the negotiations, went a step further last Saturday when he suggested setting the cap USD 30-40/bbl – the low end of our spectrum.

In our view, an easier solution would be to set a floating spread for Russian crude pegged to where Brent is trading, because oil prices are ultimately determined by global market forces. If demand and supply factors pushed Brent below the price cap, then the cap itself would be ineffective, as Urals prices would likely be close to those of the global benchmark. Instead, a floating spread might adjust automatically depending on where Brent is trading. If Brent prices decrease considerably, let's say towards USD 30/bbl, then the spread can be reduced in order to prevent Urals prices from moving below Russia's production costs (otherwise, Moscow would have little incentives to keep pumping). Equally, if Brent prices rise towards USD 100/bbl, for example, then the spread might be increased to levels similar to those recorded over the last six months.

**CHART 1. DECOUPLING BENCHMARKS**



Source: Bloomberg, UniCredit Research

### Implications for OPEC+

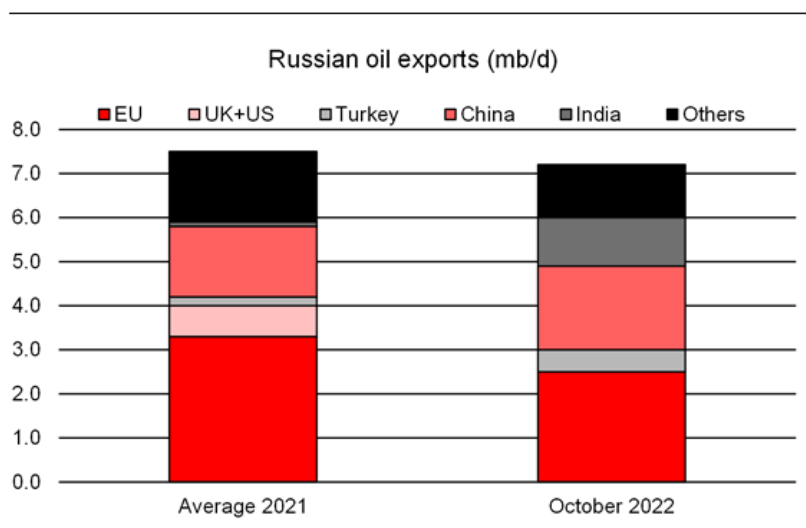
In the meantime, Russia has declared that it will not sell its crude to any country that is taking part in a price-cap scheme – meaning that if countries like China and India decided to comply with a cap (a big “if” given their ambiguous stance on the Russia-Ukraine conflict), they would no longer receive any Russian oil, thus compromising the whole rationale of the proposal. At the same time, Asian countries are already getting Russian crude at a sizable discount to Brent, and they have purchased barrels of Russian oil that once used to go to the West (Chart 2). For them, the incentive to comply with the cap is low if it comes at the cost of alienating Moscow. But the the price cap will give these remaining buyers of Russian oil even more monopsony power, as there will be even fewer alternative buyers above the price cap. The lower and more destabilizing the cap, the more likely it is to draw a harsh Russian response. Russia might still prefer to forgo some revenues instead of letting Western nations dictate its own selling strategy. Moscow could either react by fully removing its oil exports from the market or by setting a floor under the price of its crude, prohibiting exports at a price lower than that threshold.

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. In the long term, both Russia and China might have an incentive to develop more their own maritime insurance system in order to limit the impact of Western sanctions. 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 any difference between the capped price and market value. Finally, so-called shadow trade, including high-sea transshipments using “dark” tankers (with unclear ownership and records), is also likely to expand and could obstruct Russian trade analysis. According to the International Energy Agency (IEA), some 100,000 b/d of September loadings and 450,000 b/d of October loadings were missing destination information.

Russia might also retaliate by leveraging its influence within OPEC+ to push for more production cuts down the road, thus exacerbating the global energy crisis. In October, Saudi Arabia supported the decision to cut collective production by 2mn b/d out of discomfort that Western powers were trying to set a price cap on Russian oil. If they succeed, then, in the future, they might try to regulate the price of other crude benchmarks as well. For this reason, we deem it as unlikely that the cartel will announce a boost to production when it meets in Vienna on 4 December. Last Friday, Saudi Energy Minister Prince Abdulaziz bin Salman, while meeting with his Iraqi counterpart, stressed the importance of sticking to the OPEC+ decision to cut oil production. If anything, considering the sharp decline in prices recorded in recent weeks to below USD 90/bbl and given an increasingly uncertain outlook for the Chinese economy, we see the cartel as more likely to announce further cuts to restore a more-balanced market (given current demand weakness) or to signal its willingness to recalibrate output curbs if prices remain too weak. In turn, a more proactive OPEC+ is likely to put upward price pressure on Brent again. Otherwise, if OPEC+ does not react, the risk for the cartel is that Brent prices will move further down.

**CHART 2. REROUTING RUSSIAN OIL**



Source: IEA, UniCredit Research