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Gaming Out the Proposed Price Cap on Russian Oil

Colin Ward, Emre Hatipoglu, Majed Al Suwailem

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About KAPSARC

KAPSARC is an advisory think tank within global energy economics and sustainability providing advisory services to entities and authorities in the Saudi energy sector to advance Saudi Arabia's energy sector and inform global policies through evidence-based advice and applied research.

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In a June 29, 2022, communique, the G7 countries agreed to explore ways to impose a price cap on Russian oil exports. The main mechanism would be a ban on the provision of insurance, logistics and financial services by G7 nations for cargoes sold above the price ceiling. While there are some workarounds, the oil market is overwhelmingly served by G7 service providers, which could create a significant impediment to Russian exports. The G7 accounts for about 30% of the world's total oil consumption and has called on other countries to join this multilateral effort with the hope of bringing the Russian-Ukraine conflict to a peaceful resolution. While regulating Russian exports would impact all members of the G7 and the rest of the world, the European Union (EU) was by far the largest market for Russian energy before the current crisis, and their energy systems are designed for Russian grades, making it difficult to replace.

With the price cap policy, the western powers are trying to accomplish two goals at once: choke off funding to the ongoing conflict in Ukraine and preserve global access to energy, since pledges to ban Russian seaborne crude in the EU starting December 5 will have less impact if the price cap is successful. There is much debate as to the effectiveness of this plan. Like most economic coercion tools employed in interstate relations, the market is faced with a high level of uncertainty should this price cap be employed. More specifically, the uncertainty is directed toward the effectiveness of price cap enforcement and its consequences on the oil market. Accordingly, this insight strategically reviews three scenarios: a perfect price cap, an imperfect price cap, and Russian retaliation against the cap.

Before beginning, it is important to understand the current context. Once the Ukraine crisis began, many countries, especially in Europe, decreased and/or halted oil imports from Russia in solidarity with Ukraine. This affected Russian oil exports, with the country lowering its output by 800,000 barrels per day so far. In response, Russia sought other markets to sell its crude and refined oil products to. As of mid-November 2022, the price of Brent was hovering in the $90 per barrel (b) range, and Russia has been largely successful in exporting more liquids to India and China at about $70/b-$75/b, or a ~$20/b discount. This also caused a distortion to other major producers whose market shares have been partially affected by Russian oil exports to India and China. China and India have access to a larger global supply of crude, so their experienced market balance is less restricted, and the price paid is likely closer to what the market would pay if Russian supply was freely available. In a pre-crisis market analysis, KAPSARC forecast a mild supply surplus starting in H2 2022 (KOMO, Q1 2022). This serves as a reasonable counterfactual and indicates that prices would be close to the $70/b mark (barring OPEC+ intervention) if there were no restrictions on supply. The unconfirmed range for the price cap is somewhere in the $50/b-$70/b range, which could offer sufficient revenues to Russian oil producers. It would incentivize them to continue production and help fund major items in the Russian federal budget. However, it would make funding the estimated $1 billion in daily expenses needed for the "special operation" very costly for the Russian government.

Scenario 1: A perfect price cap with full compliance by all participants

Price caps do not allow for variable bids, or proper price discovery, so any ceiling below the international price would automatically be reached with no differentiation between buyers other than transport costs. As such, the buyers closest and easiest to reach are in Europe. Even with perfect enforcement of a Russian

supply ban, there are no rules against importing products refined by intermediaries. This would reduce the burden on Europe immediately, cutting energy prices and scoring domestic political wins.

Russia would be able to resume its full exports (~8 million barrels per day [MMb/d] in crude and crude products) and increase the global supply, which should, in turn, reduce market prices. The difficult part of implementing a cap is the price level and mechanism to select. There is no incentive to produce below $40/b due to breakeven concerns, and no real penalty for the Russian government above $70/b. For the mechanism, a fixed price risks needing revision (and more debate) when Brent prices fall, while a discount to Brent risks providing a worse alternative than a ban for Russia.

The main questions to assess the viability of a price cap are:

1. Securing multilateral support: If discounted crude is available on the open market and Europe is likely to be the indirect beneficiary, then developing nations are unlikely to support the price cap. Unless there is significant allocation of these supplies to struggling economies, or some commitment to pass the savings along in the form of aid, then the incentives to bypass the cap are relatively high.

2. Finding the right price: As discussed above, the right price could sweeten the deal for Russia by keeping its oil industry and federal budget afloat, while making it difficult to fund the war effort. If Russia's fiscal breakeven is ~$45/b (the floor), what ceiling would be attractive enough?

Scenario 2: An imperfect price cap with low compliance

As many multilateral efforts to implement economic sanctions have shown, rampant evasion and self interest make perfect policing of a price cap seem unlikely in the international arena. With some minor workarounds, the price cap could backfire significantly in Russia's favor.

What prevents full evasion by Russia is logistics. Currently, it needs to figure out how to ship liquids out and cash back in. The proposed price cap scheme would make both tasks easier. The limitations on shipping such as insurance would be removed, shipping costs would fall with more tankers available for hire, and the price cap compliant payments could use the SWIFT international payment system, leaving only the 'sweetener' payments to pass through alternate channels.

Non-financial concerns (arms transfers, votes in international bodies, and political favors) may be as important as financial ones in determining who Russia sells their oil to. There are too many methods available to Russia to financially game the system to list. Some examples are using intermediaries like China and others for non-United States dollar invoicing (likely growing the use of the Chinese remnimbi as a trade currency), sending tankers half full at full price, or paying for unrelated (and imaginary) services. The ease of bypassing the rules would therefore make a price cap policy an additional transaction cost, rather than an effective enforcement mechanism.

Russia has already stated that it would prefer not to sell its products to countries exerting pressure to instate this price cap. By providing liquids to India, China, and the developing world, Russia would maintain their influence in these spheres, while also forcing Europe to continue paying full market rates. There are also benefits to buyers of a 'leaky' price cap. India and China can gain favor with the West by pretending to

participate, and all recipients benefit from arbitrage by reselling on the free market. The service providers (tankers, etc.) are not held liable if they have plausible deniability, and there is little incentive for these providers to investigate if they are breaking the price cap. Lastly, Europe would benefit from a lowered global oil price to mitigate their domestic energy crisis.

Scenario 3: Russian Retaliation

Retaliating to the price cap and escalating the situation to a full crisis is another option Russia can pursue, especially if it believes it can outlast the West in a 'war of political attrition' and, hence, secure a negotiated settlement that is favorable to Russian priorities. For the price cap to function (even imperfectly), Russia must play along (e.g., restarting the grain ships was in Russia's interest to help developing allies). Contingencies for the worst-case outcomes (insurance, shipping, and payment obstacles) are already underway, so the issue is one of best alternatives for Russia. Russia must weigh the value of submitting to a price cap and drawing the conflict out further or increasing the pressure with a self-imposed export ban and trying to a achieve a faster negotiated settlement that could include the recognition of its territory and reduced sanctions.

Historically, winter has been Russia's greatest ally, so much so that they personify it as "General Frost" for its role in repelling invasions from their territory. The specter of a tough winter has been a significant driver for EU behavior so far, such as its increased imports prior to the December 5 ban on crude, proposing the Russian oil price cap, and seeking alternative suppliers. This conflict and the sanctions imposed have been conducted in frost free months so far, but December to February will be the real test. Increasingly bold actions from both sides, such as the attack on the Nordstream pipeline, increased mobilization of Russian troops, and plans for demand rationing and energy welfare payments from the EU indicate both sides are digging in.

The supply of gas will likely be a significant challenge this winter due to logistical constraints, but curtailing the supply of crude and crude products significantly increases the pressure on the EU as well as the global market. Reduced western strategic reserves from prior releases, and an impending ban on crude starting December 5 have increased Europe's Russian crude purchases in the meantime. Even by buying pricey crude from the international market over the winter, the EU could struggle to make their crude supplies last until spring.

Looking beyond this winter (where gas will be the major pressure point), it is possible that Russia could intentionally keep much of its supply offline next year as well. Recent Bank of Russia estimates show that its foreign reserves are back to $571 billion (frozen assets not included) and, with ~$1 billion/day in costs for its Ukraine operations and a sufficiently high oil price, Russia could hold out for two years on severely limited exports (<3 MMb/d) based on our estimates.

Conclusions

A price cap with perfect enforcement is almost impossible to implement, as there are many advantages and methods to circumvention. An imperfect price cap system would increase supply to the market and indirectly relieve supply security issues in the EU, but it would not provide the intended financial pressure on Russia. While the imperfect price cap may be financially attractive compared to a ban, it would only maintain the status-quo, while Russian leverage over an energy starved Europe could mean a faster end to the conflict. The determining factor is whether Russia believes its position is strong enough to push for a settlement, and if that is preferable to a drawn-out conflict of attrition.

Scenario	Perfect price cap	Imperfect price cap	Russian retaliation
Characteristics	All countries abide by the rules, and volumes go to the most convenient consumers (mostly EU)	Rules evasion is common with illicit payments, and Russia shuns the EU in favor of partners	Russia openly rejects the cap, only providing minimal volumes under sanctions
Price impact	Global price reduced	Global price reduced	Global price up sharply
Russian impact	Reduced revenues, reduced bargaining position	Increased revenues, reduced bargaining position	Severely reduced revenues, but improved negotiating position
EU impact	Reduced market rates, most pressure on Russia	Reduced market rates, least pressure on Russia	Much higher market rates, supply uncertainty
China/India impact	No arbitrage value, improved relations with the West	Some arbitrage, minor political issues	Increased arbitrage, significant political issues with the West
Other oil producers	Reduced prices, and a shift to more eastern buyers	Reduced prices, and a shift to more western buyers	Increased prices in a globally tight market

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