Special Bulletin

A Japanese Perspective on the International Energy Landscape (613)

December 5, 2022

Western Agreement on Russian Oil Price Cap at $60/bbl

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On December 2, the European Union announced that it agreed to set a cap at $60 per barrel on prices of Russian crude oil for marine transportation. The Group of Seven industrial democracies and Australia have also agreed on the Russian oil price cap as an additional sanction on Russia for its invasion of Ukraine. If Russian crude oil priced above the cap is subjected to marine transportation, the Western countries will prohibit their insurance companies from accepting marine hull insurance policies for such transportation. As insurance companies in the United Kingdom and Europe underwrite most marine hull insurance policies, the price cap is designed to affect Russian oil imports into non-Western countries.

The Russian oil price cap began to be considered under the leadership of the United States at a G7 summit in Germany last June. The United States initiated a Russian energy embargo including oil in March, followed by Canada and the United Kingdom. The G7 announced a Russian oil embargo in early May and the EU (with some exceptions) followed suit in late May. In a bid to increase pressure on Russia engaging in military aggression in Ukraine by reducing energy revenue that is the biggest foreign currency earner for Russia and the most important for the Russian economy, Western oil-consuming countries launched the Russian oil embargo even at the cost of oil imports from Russia. Given that oil exports are far more important than other Russian energy exports, Western countries had no choice but to implement the Russian oil embargo.

However, the Western Bloc's Russian oil embargo triggered various international oil market reactions and failed to achieve a cut in Russian oil export revenue as its major objective. First, the embargo led to international oil market price spikes in a manner to inflate Russian oil revenue. Second, Europe, the biggest destination of Russian oil exports, retained their Russian oil imports until they began to cut such imports in the second half of 2022 towards the year-end. Third, India, China and some other countries increased Russian oil imports without joining the embargo. They have imported Russian oil at discount prices due to Russian oil's difficult position in the market. However, market prices shot up under the Western embargo, preventing even discount prices from falling so much. As a result, Russian oil export revenue reflecting price hikes and maintained volume is expected to increase this year from the previous year, instead of declining.

As this issue has been understood, the Russian oil price cap has been devised to hold down Russian oil revenue anyway. Since the cap was discussed and proposed at the G7 summit in June, relevant countries have considered a specific cap level, a mechanism to implement the cap and how to operate the cap in view of complex business realities for the international oil market. How to operate the price cap in the international oil market where various and complex business deals are done has been a difficult issue. More difficult has been how to prevent any sharp fall in Russian oil exports and maintain Russian oil exports at a certain level to avoid the further destabilization of the international

oil market and price hikes while achieving the essential objective of holding down Russian oil revenue. Even the United States that initiated the Russian oil price cap proposal wanted to prevent crude oil and gasoline prices from shooting up at least until the midterm congressional election in November. Western countries have been required to strike a balance between the two objectives that trade off with each other: cutting Russian oil revenue and avoiding any sharp fall in Russian oil exports that would trigger oil price spikes.

The price cap at $60/bbl is viewed as striking a balance between the two objectives. East European countries within the EU have reportedly called for a lower cap, reflecting their hardline attitude against Russia. Greece known for its prosperous shipping industry has sought a higher cap. Before the agreement on the cap at $60/bbl, speculators were talking about cap levels between $65/bbl and $70/bbl. Final coordination might have gone in the direction of lowering the cap to hold down Russian oil revenue.

While the price cap has been set, how its effects should be viewed is still uncertain. Up to date, Russian Urals crude oil, a benchmark crude for Europe, has been priced roughly at the cap level. In this sense, the cap level meets the status quo. Even if the price cap is strictly enforced for third countries, Russian oil revenue may not decline so much. Whether India and China would comply with the price cap or how they would respond to the cap are uncertain. After British and other European insurance companies withdraw their marine hull insurance policies, whether any substitute insurers would emerge or what would happen next will have to be watched. Businesspeople familiar with the oil market predict that various countermeasures and loopholes may be devised. In such case, however, Russian oil will remain available in the international oil market, making it difficult for any upward pressure on oil prices to emerge. Meanwhile, the agreed price cap at $60/bbl may naturally have to be adjusted to market realities. If crude oil prices fall, the price cap at $60/bbl may become meaningless. The cap may then have to be lowered in line with the market trend. This kind of adjustment will be a future challenge.

On the other hand, Russia's reaction to the agreed price cap is the most uncertain factor. As a matter of course, Russia has raised strong opposition to the price cap. In response to the Western attempt to affect the Russian economy, Russia has threatened to stop oil supply to countries that introduce the price cap. Russia is expected to continue and enhance negotiations with India, China and other countries that have not participated in the Russian oil embargo. However, a central Russian response may be to exert pressure on oil-consuming countries by indicating the potential oil supply stoppage. Any partial oil supply stoppage may trigger market responses, exerting upward pressure on crude oil prices. A major focus of attention may be how the OPEC-plus group of oil-producing countries including Russia would respond to the price cap. On December 4, the group decided to maintain a production cut of 2 million barrels per day. In the future, it may flexibly respond to relevant developments.

Potentially, Russia may not only exert direct influence on oil supply but also take measures against the oil price cap in natural gas and other areas to enhance pressure on the Western Bloc including Europe. While the oil price cap has been set to roughly meet market realities, the international oil market is likely to become turbulent depending on whether Russia would take a wait-and-see attitude or some reaction to the oil price cap system. We will have to closely watch future Russian actions.

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