On Friday, the EU agreed to a price cap on Russian crude oil at $60 per barrel as part of a sanctions regime spurred by Russia’s invasion of Ukraine. The proposal, first proposed by the US, was initiated by the G7 as an alternative to sanctions that threatened greater economic disruption and comes days ahead of a December 5th deadline when major EU sanctions are scheduled to go into effect. These additional EU sanctions include an EU ban on Russian maritime oil imports, one of Russia’s largest markets. Non-European G7 countries and Australia, having supported a version of this proposal, quickly approved the agreement on Friday. The cap comes in addition to direct bans on crude imports by participating countries. It is intended to bring down the price of Russian oil broadly on global markets, curbing Russian revenues while still ultimately allowing the oil to be sold in order to not destabilize the global energy markets.

It is a gamble with risks—most importantly of supply shortages, rising prices, and deepening global economic downturns—which will largely be determined by Russia’s response. But even if the price cap achieves its two-fold goals of curbing Russian profits while not disrupting the oil supply, these sanctions will markedly and perhaps permanently alter the global energy markets, particularly in this case, the tanker insurance and reinsurance industry. These markets have been largely dominated by British and EU firms. Similar to the SWIFT sanctions and the technology sanctions, which have accelerated efforts, particularly on the part of Russia and China, to find alternatives to US and western dominance, the oil price cap will upend western dominance in the insurance and reinsurance business.

HOW THE PRICE CAP OPERATES

The cap operates indirectly, through the regulation of maritime services such as tanker insurance and reinsurance and puts the onus of compliance on the private sector, particularly global shipping and insurance companies. The insurance and reinsurance services, mostly based in Europe, are critical for tankers because the transport of oil products can result in expensive accidents. Ports, therefore, require tankers to have insurance in order to dock. Uninsured ships, for example, are not allowed to sail through the Suez Canal. The price cap agreement would authorize this industry to provide services to the transport of Russian oil, but only if the oil is purchased at a price at or below the cap.

The cap is not likely to apply to oil imports by the participating countries. The US has prohibited the importation of Russian oil by Executive Order 14066, issued by President Biden in March. And the EU Monday will stop purchasing seaborne Russian crude oil, per an agreement made in June. Instead, the cap effectively applies to other countries that import Russian crude but happen to make use of maritime services from participating countries. China, India and a number of other Asian countries have effectively replaced Russia’s European markets, but would not be penalized if the oil was shipped or insured by non-participating countries. Russia, China and India are possible alternatives for insurance, although they do not have the confidence and credibility at this point as western sources. The price cap and import ban concern seaborne Russian crude and does not apply to some land-based modes of trade, such as the Soviet-era Druzhba pipeline.
Guidance for businesses in the US illustrates how enforcement would work at the business level, encouraging businesses to include in their contracts provisions for attestation that the price cap is being adhered to. This would allow US agencies the authority to pursue those who are not abiding by their attestations. More specifically, the Treasury’s Office of Foreign Asset Control outlines provisions to afford US service providers safe harbor, shielded from strict liability for breaching sanctions if complying with a prescribed recordkeeping and attestation process in good faith. Those services providers are split into 3 tiers of services, with commodity traders and brokers required to comply with the “Tier 1” highest levels of due diligence, given their direct access to pricing information. Financial institutions, ship agents, and customs brokers are responsible for requesting and retaining price information from primary Tier 1 actors or their counterparties. And finally, ship owners and insurance firms responsible for collecting attestation from involved parties in Tier 1, Tier 2, or their counterparties.

The US Treasury has also issued guidance that has stated that Russian oil that had been sold under the pricing mechanism but then substantially transformed or refined outside of Russia, would not be subject to sanctions.

NEGOTIATION HISTORY

The sixth round of sanctions agreed upon by the EU initially in June would have banned maritime services businesses from facilitating the transportation of Russian crude entirely, a harsher measure. This agreement was scheduled to go into effect six months later, on December 5th. The price cap, a US led initiative, is an alternative that is intended to soften the blow to consumers, who might suffer from an extreme oil price shock if Russian exports become effectively impossible to ship globally; some oil analysts earlier this year predicted that disruption of Russian seaborne exports could drive prices to $200 a barrel. But the policy also lightens the force of the sanctions on Russia relative to an outright ban.

The proposal follows weeks of US/G7-led negotiations among EU countries, aimed at maintaining a reliable supply of oil to the global market while limiting Moscow’s revenue as the war in Ukraine continues. In recent weeks negotiations had led to disagreement among members over the price. Some critics have argued that Russian oil is already selling at a steep discount, limiting the effect of proposed caps. Baltic countries, led by Poland, were strong proponents for lowering the cap, and had rejected the EU’s earlier proposals as being too soft on Moscow. Greece, Malta, Cyprus, countries with large shipping industries, led the push back for a price of $70 or more per barrel. Countries interested in protecting their consumers from oil disruption also favored a higher price. As recently as a week ago, discussions were in the $65 to $70 range. However the lower cap now adopted is a move towards the position of Poland and other members who sought heavier restrictions.

In order to help bridge the gap with Poland and other countries seeking a higher price cap, the final agreement included language to review the price cap every two months, or sooner if needed, and to aim to keep the price cap at least 5% below the Russian crude oil export price.

RESPONSE

Russia responded to the final agreement saying it would not accept the price cap and is analyzing how to respond. Leading up to the decision, Russia has threatened consequences for participants in the regime, such as a cut-off of exports. In a speech in Vladivostok in September, Russian President Vladimir Putin
called the provision “stupid” and said Russia “will not supply anything at all if it contradicts our interests ... We will not supply gas, oil, coal, heating oil – we will not supply anything.” Russia has also said that it will not use tankers that are part of the price oil cap and that its state owned insurance company will provide reinsurance the UK and Europe will not provide. It remains to be seen whether the major ports and canals will be willing to accept it.

Many countries, India and China most important among them, will likely continue purchasing Russian crude. This is intended under the policy. Treasury Secretary Janet Yellen has stated that Russian oil "is going to be selling at bargain prices and we’re happy to have India get that bargain or Africa or China. It’s fine."

ANALYSIS

Sanctions policy during the War in Ukraine has attempted to balance two goals that have often been in tension. The first goal is to reduce Russia’s ability to make war by curbing its trade. The second goal is to minimize the disruptions to global trade that might harm everyday people. The price cap regime on the energy trade—Russia’s lifeline—is the latest attempt to optimize across these conflicting priorities.

The price cap is also an attempt to address a weakness in many commodity embargos. For a fungible global commodity like oil, a boycott may have no impact on price if there are other market participants who do not participate in that boycott. By leveraging a supply chain bottleneck, the EU and its G7 allies are attempting to enforce a global discount, reducing Russia’s leverage even among those countries still willing to trade with Russia.

The price of $60 per barrel by any measure exceeds Russian production costs, whether one takes a low-end estimate of $20 per barrel or a high-end estimate of $44 per barrel. Under these conditions, Russia may still be willing to sell, even under the price cap. This will in turn ensure that Russian exports continue to put downward pressure on the global price of oil, protecting consumers. But the $60 number fought for by Baltic countries is low enough that it is likely to take a bite out of Russian revenues at times.

Consequently, the Russian response is the wildcard. It will determine whether the worse case scenarios projected by some energy analysts are realized with the price cap resulting in Russian retaliation causing supply shortages as western countries head into winter with economies very vulnerable to price shocks.

Russian politics fractured by the war in Ukraine with pressures on the right and the left of the political spectrum, will play an important role in how this authoritarian regime responds. Equally important are the projections for the Russian economy. According to some analysts, Russia’s budgets for 2023 are reportedly already forecasting a budget deficit of 2.4% for 2023 and the price cap may fall below their budget expectations for their oil exports. Furthermore, Russia is a global disruptor and has already repeatedly demonstrated with its Ukraine policy that it is willing to take actions that exceed expectations and violate the norms of an international rules based order.

The OPEC+ meeting this weekend will be an important first indicator of not only Russia’s response to the price cap agreement but also the reaction of other major oil producers. It comes at a time of increasing uncertainty with weakening energy demand in China and looming recession. Some analysts are projecting that the meeting could result in possible deeper oil output cuts. Whether Russia decides to
respond speaking loudly but continuing to find alternative markets in China, India and other Asian countries without upending the global energy markets remains to be seen.

Noncompliance is also expected to be part of the global response. The potential for noncompliance strengthens the case for a relatively moderate price cap. If the regime were too restrictive, traders would be more incentivized to circumvent it rather than complying. But, what is in question is how much it will become a deeper part of energy markets.

Most straightforwardly, firms trading in Russian crude could falsify purchase prices. But more subtle means of evading the restriction are possible as well: for example, a buyer could purchase Russian crude at the $60 per barrel price, while simultaneously agreeing to pay above-market rates for some other good or service. This is exactly what happened in the Oil for Food Program imposed on Iraq in the 1990s. Meant to constrain the amount of oil Iraq could sell and to enforce that those revenues were spent on humanitarian needs of the Iraqi people, Iraq overpriced other commodities to make up for the shortfalls in oil revenue.

Russian oil is also expected by industry analysts to follow the same trajectory of Iranian and Venezuelan oil trade with an increased use of a shadow fleet or the “dark fleet” of tankers that keep their oil trading. While this will most likely increase the time and cost to Russia’s oil trade, it will also increase the role of the black market and corruption in this global sector, undermining confidence and efficiency in the global economy.

Finally, as mentioned at the outset, the price cap agreement will markedly and perhaps permanently alter the global energy markets, particularly in this case, the tanker insurance and reinsurance industry. These markets have been largely dominated by British and EU firms. Similar to the SWIFT sanctions and the technology sanctions, which have accelerated efforts, particularly on the part of Russia and China, to find alternatives to US and western dominance, the oil price cap will upend western dominace in the insurance and reinsurance business.