Russian oil: Walking a tightrope

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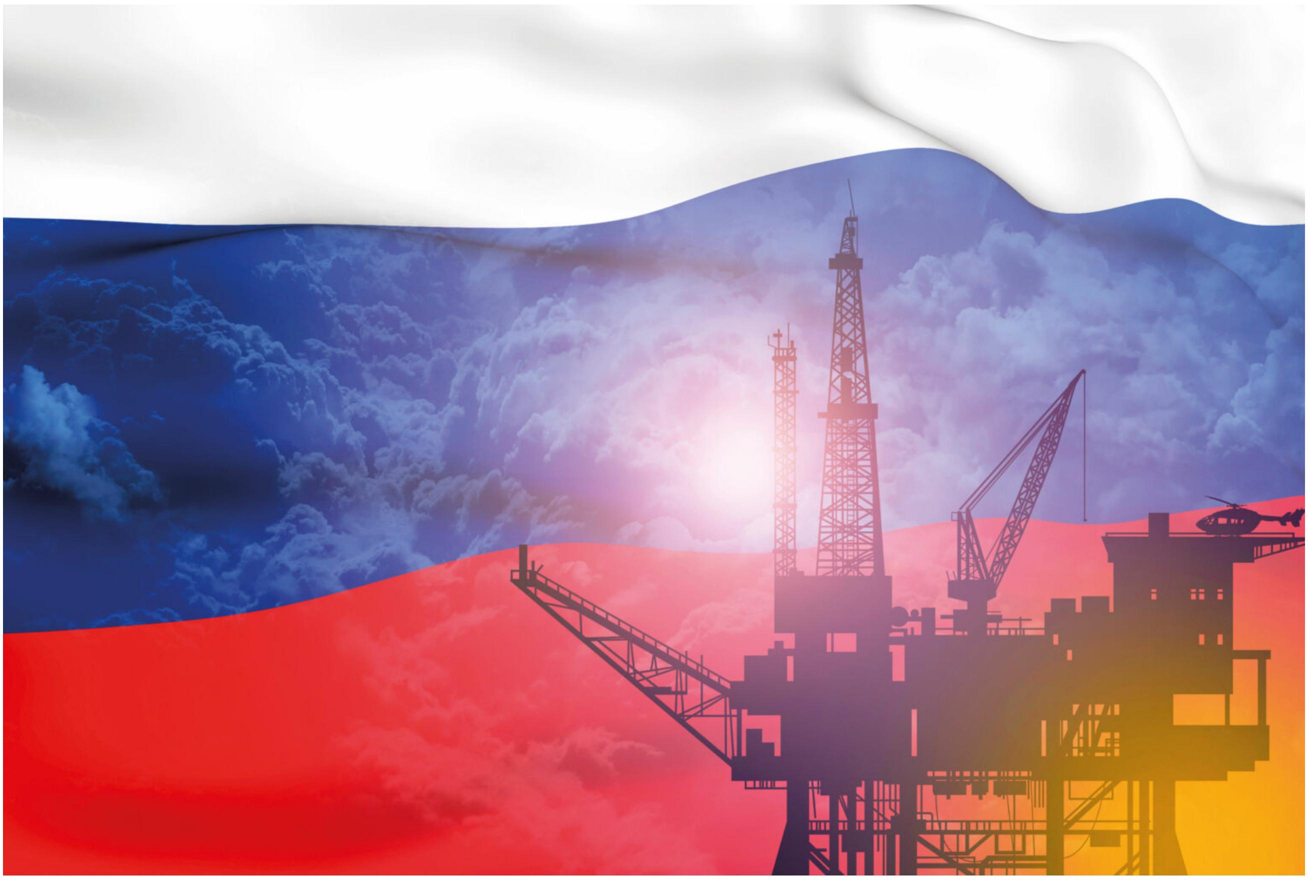

The price cap on Russian oil exports is a first-of-its-kind sanctions tool. By allowing purchases below a certain price, governments across the G7, EU and Australia hope to starve Russia's war effort of funding while securing energy supplies and costs. The question is whether banks, insurers and shipping companies will be able to put this vision into practice. *John Basquill* reports.

Western sanctions have historically sought to take a sledgehammer to the countries on the receiving end. In the case of US restrictions on Iran and North Korea, for example, companies are totally prohibited from facilitating the trade of goods and services, with only occasional carve-outs, for example for humanitarian purposes.

The ambition is to cut enemy nations' access to the US financial system, including the dollar, and ultimately apply enough economic pressure to bring about policy or regime change.

Sanctions against Russia are different. The eventual aim is to force the Kremlin to cease hostilities in Ukraine, after it launched a full-scale invasion in February last year, but many governments – particularly in Europe – have a strategic dependency on Russia for key commodities, not least oil and gas.

With energy prices already unstable, blocking trade overnight could have been disastrous for consumers. The International Energy Agency (IEA) says in a December 2022 report that prior to 2020, Russian oil accounted for the majority of consumption in 10 EU member states, including Belgium, the Netherlands and Sweden.

Germany imported nearly 43 billion cubic metres of natural gas from Russia in 2020, equivalent to around two-thirds of the country's gas imports. The next-largest buyer of Russian gas in 2020 was Italy, with imports totalling 29 billion cubic metres, the IEA says.

Against that backdrop, the response from western governments – specifically the G7, European Union and Australia – has been to craft a sanctions regime from scratch that aims to dent Russia's economy and weaken its military efforts, while ensuring energy supplies remain robust.

The solution they struck upon was to impose a price cap on oil transactions, introduced from December 5 onwards. The regime allows banks, insurers and shipping companies to continue facilitating trade in Russian oil, but only if the price remains below a certain level. As of press time, the cap has been set at US$60 per barrel, with a second threshold for petroleum products yet to be established.

"This is walking a tightrope," says Washington, DC-based Matthew Thomas, a partner in the international trade practice at law firm Blank Rome. "Western governments can't go after Russian energy with a sledgehammer, like with Iran, because they have a huge interest in maintaining the relative stability of energy prices – especially with high inflation globally."

"These really are among the most innovative sanctions we've seen," adds Anthony Rapa, a partner at the same firm and head of its national security practice. "We've never experienced anything quite like this mechanism."

Bloomberg data suggests the cap may have had an immediate effect on Russian oil exports. In the week leading up to the end of December, crude oil export duties fell by US$108mn, or 12%, with seaborne oil exports dropping by around 117,000 barrels a day based on a four-week average.

But for commodity traders and financiers, there remains a huge amount of uncertainty. The cap exists alongside other sanctions on Russian oil, adding to regulatory costs and complexity. Market incentives and risks differ greatly between traders and banks, and for many institutions, the opportunities presented by the cap may be outweighed by the challenges.

challenges.

Traders cautious but opportunities emerge

Larger traders have so far been cautious on the prospect of lifting Russian oil in keeping with the price cap. **GTR** revealed in late November that Shell and Glencore had no plans to enter new trading business in Russian-origin oil, while Gunvor said it had ceased trading with relevant Russian counterparties.

Trafigura said it had "substantially reduced the volume of petroleum products we are offtaking" and in May stopped purchasing crude oil from Russian state-owned Rosneft. Vitol added it had lifted no Russian-origin crude since April but planned to lift "a small amount" of Russian petroleum products in compliance with all relevant sanctions regimes.

However, purely in economic terms, there is a clear incentive for traders to re-enter the Russian market, argues commodities trade and financing expert Jean-François Lambert, chief executive of Lambert Commodities.

"It will be very tempting to step into these deals," he tells **GTR**. "They are more complicated, and whenever there are complications, there are usually better margins. Traders know how to take advantage of a volatile market, bringing a solution to a customer or a supplier when those solutions are not obvious – and as a result, they can claim a bit more of a commercial margin."

What those transactions would actually look like remains uncertain.

Separately to the price cap, the EU has slapped a ban on all seaborne imports of Russian oil, except in exceptional cases such as unexpected disruption to pipelines. At the same time, EU-flagged, owned or operated vessels are prohibited from carrying Russian oil, including to non-EU countries.

The US and UK each banned imports of Russian-origin crude oil and petroleum products in March 2022, with Australia following suit with similar measures a month later. The US has also extended the ban to liquified natural gas and coal.

Russia has also hit back at the introduction of the cap. A decree signed by President Vladimir Putin in late December bans the sale of crude oil and petroleum products to any nation that imposes the cap, starting on February 1 this year. It will initially last for five months.

An analysis by legal intelligence provider JD Supra says the decree appears to mean traders can sell Russian oil below US$60 per barrel, supported by insurers and shipping companies from the G7, EU or Australia, but only if the buyer is in a country that has not imposed the price cap itself.

Theoretically, that would mean a Swiss trader could sell a cargo of crude oil to a buyer in India, insured in the UK and with a shipping company based in Greece, below US$60 per barrel – without falling foul of any of the various restrictions in place. Payment to the Russian seller or its bank would have to be protected under licensing arrangements.

Banks remain wary

Industry insiders believe financing trades in Russian oil will likely lie beyond the risk appetites of many western banks. Even prior to the war in Ukraine, much of the trade finance sector had undergone a substantial de-risking exercise since the start of the Covid-19 pandemic, which prompted a squeeze on liquidity and drove numerous smaller traders out of business.

In a string of high-profile cases, a tightening on liquidity resulted in fraudulent activity being exposed and banks suffering billions of dollars in losses. Several lenders cut exposure or withdrew entirely from financing commodity trades. An anxious climate around commodities is only going to be worsened by the fear of breaching sanctions or appearing to be supportive of Putin's regime.

"Banks are going to be very cautious," says Lambert. "The compliance risk is massive, and banks are obsessed by the reputational risk as well."

He notes that a similar pattern has emerged in agri and non-ferrous metals transactions, where traders have struggled to obtain financing even where deals are not subject to sanctions.

"If you take one Russian-related deal, the bank will be asking, 'do I have the proper information?

Am I dealing with the right party, or might I be caught in a transit trade situation?' They are probably going to keep erring on the side of caution and telling their customer they are not equipped," he says.

Sean Edwards, chairman of the International Trade and Forfaiting Association (ITFA), tells **GTR**: "I don't think any banks see this as an opportunity, rather as additional due diligence that will need to be carried out in conjunction with their clients."

That due diligence burden on banks could be heightened further by the potential use of deceptive shipping practices by entities involved in trading Russian oil, Edwards adds.

"Given the destination of a lot of Russian crude to certain Asian countries since the start of the conflict, and the subterfuge used by Russia to export a lot of its cargoes, including ship-to-ship transfers to vessels that have switched off their AIS [automatic identification system], I suspect that there will need to be greater scrutiny of the origin of the crude sold by certain traders," he says.

"As always, those traders with robust compliance mechanisms will benefit and it's possible that some of the weaker ones will find it harder to get funding."

There are other potential complications around shipping and insurance. In a December oil market note, Rystad Energy says Russia is expected to face a shortage of tankers maintaining crude oil exports from western ports.

"The threat of losing protection and indemnity insurance will limit Russia's access to the tanker market, reducing crude exports to 2.4 million barrels per day – 500,000 bpd lower than levels seen before Russia invaded Ukraine in late February [2022]," say analyst Viktor Kurilov and senior vice-president Jorge Leon.

Will the cap prove effective?

Enticing banks, traders and insurers to make use of the price cap mechanism is only one measure of its effectiveness. Governments will be keenly watching for attempts to circumvent the controls, although Blank Rome's Thomas and Rapa suggest doing so is unlikely to be easy.

"The concept behind this is that even if you have a Russian seller and a buyer in China or India, you would struggle logistically to move that from one place to the other without bumping into western finance, shipping or insurance," says Thomas.

"There is also the ubiquity of dollars in energy trade."

Rapa adds that non-oil price countries "probably don't see trade in Russian oil as enough of a strategic issue that they need to build an entire ecosystem, completely firewalled, to facilitate it".

Beyond the operational aspects of the price cap, there are more fundamental questions around how the effectiveness of the restrictions will be measured.

"The ultimate objective of sanctions effectiveness is to see whether or not they actually alter behaviour or conduct of the sanctioned persons or institutions," says trade veteran Harry Broadman, managing director and chair of the emerging markets practice at Berkeley Research Group.

"That's a really important point, and that's what makes sanctions generally a tricky tool," he tells **GTR**. "Whether or not sanctions are effective will not show up immediately, and making hypotheses around how certain players will react is very complicated."

A more pressing question, Broadman suggests, is whether the oil price cap could end up an international trade version of a Rube Goldberg machine. Goldberg, an early 20th-century US cartoonist, was known for depicting elaborate contraptions designed to perform simple or everyday tasks.

"Generally, in economic policy, a golden rule is that the simpler the policy – that is, the more clearly that you can express how and why it works – the better that policymakers and the public can assess whether it's effective or not. That is not easy when you have a large number of complexly related variables that they hope will operate in synch, in an overly complex fashion, and in my mind, the particular design of this oil price cap may be another Rube Goldberg mechanism."

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