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Impending EU sanctions could badly hit Russia's oil revenues

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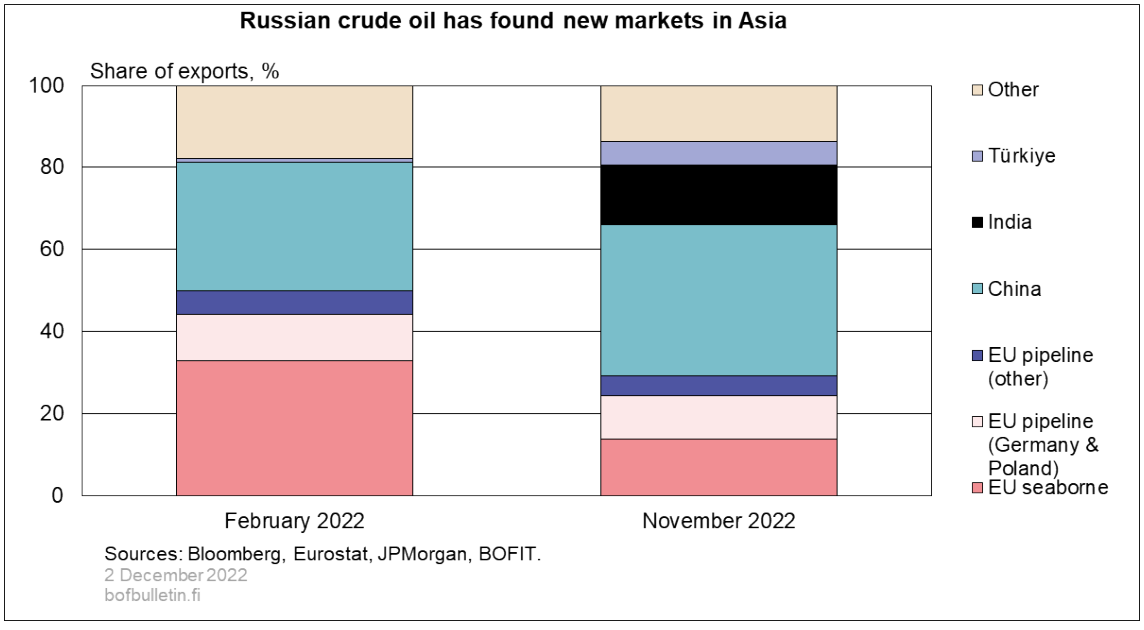
Russia's oil exports have decreased only marginally in volume since it began the war in Ukraine. The International Energy Agency (IEA) estimates that the export volume of Russian crude oil and oil products in October was only 4% down on the pre-war level. While the export volume to

countries of the European Union has fallen somewhat, Russia has found new markets in India, China and Türkiye. Its revenue from oil exports has also been boosted by high oil prices, despite having to sell at a discount in relation to other oil grades.

The EU's import prohibition on Russian crude oil will apply from 5 December 2022, and on Russian oil products from 5 February 2023. The ban will apply to seaborne imports to EU countries. While the EU's imports of Russian oil products have mostly been by sea, imports of Russian crude oil have been partly by sea but also via the Druzhba pipeline. The biggest buyers of Russian pipeline crude – Germany and Poland – have announced they will also terminate their pipeline imports in December, even though this is not required by the sanctions.

Russia is therefore set to lose almost a quarter of its crude oil export market in December (Chart 1). It will have to find new buyers for approximately 1.1 million barrels per day (mbd) of crude oil. This equates to nearly the same volume as the combined increase in Russia's exports to China, India and Türkiye since the start of the war. It will not necessarily be easy for Russia to boost its exports again to these countries by a similar amount. Russia is already the biggest source of imported oil in all three of these countries, and the growth in their Russian imports has levelled off in recent months. Russia has not so far discovered any other significant alternative markets for its oil.

Chart 1.



In parallel with the EU's import bans, a price cap mechanism applying to Russian oil imports agreed by the Group of Seven (G7) countries should also take effect simultaneously. Under this mechanism, the EU and the United Kingdom will permit the provision of shipping, financing and

insurance services for Russian oil shipments to any country only if the price paid for the oil does not exceed the price cap. The EU's original intention was to prohibit the provision of financing and insurance services entirely, but the United States favoured an alternative price cap mechanism. It was feared that a complete ban would lead to too steep a fall in oil supplies on world markets and therefore a sharp rise in oil prices. With the price cap mechanism, the aim is to allow Russian oil to flow into world markets but to limit the export revenues that Russia receives from this.

Few details have yet emerged about the price cap mechanism, and the actual cap has not been determined either. According to the media, the price cap will be fixed, but it could be revised periodically depending on the market situation. The most recent discussions have centred on a price of about USD 60 per barrel. The average price per barrel for Urals crude this year has been about USD 80, but in recent weeks the price has dropped to around USD 60. The intention is not to apply the price cap to re-exports of Russian oil or to oil products refined from Russian crude in third countries. In the absence of further details the plan has generated uncertainty among market participants and economists as to the price cap's practical implementation and impact. In most assessments Russia's export revenues are expected to decline, but there are still no projections as to the scale of the drop.

Russia has announced that it does not intend to observe the price cap or to sell oil to countries that sign up to the mechanism. Most countries have not committed themselves to the price cap, and India, for example, has stated it intends to continue purchasing Russian oil. If Russia wishes to sell its oil outside the price cap system, it must find sufficient shipping capacity for this, and the relevant financing and insurance services must be obtained outside Europe. That will not be easy, as European entities dominate the market. Shipping data analyses suggest that European vessels have been used for most of the seaborne transportation of Russian oil exports this autumn. Russia's largest shipping company, Sovcomflot, became subject to Western sanctions after the invasion of Ukraine.

Many analysts are of the view that Russian-owned (and Russian-insured) tankers could transport some – but not all – of the country's exported crude oil after the price cap mechanism comes into force. There are enough Russian vessels to cope with about one third of the exports. If Russia were also to purchase tankers that are waiting to be scrapped and use 'shadow' tankers (which transport e.g. Iranian and Venezuelan oil), these could raise the share to around half. To transport the other half, vessels from elsewhere, such as China and India, would be needed. According to estimates by JP Morgan, this would require, for instance, India's entire crude oil shipping capacity and about one third of China's. Recent Russian media reports indicate that China is not going to accept insurance policies provided by Russian companies.

The EU's import prohibition on Russian oil products enters into force in February 2023. Exports of

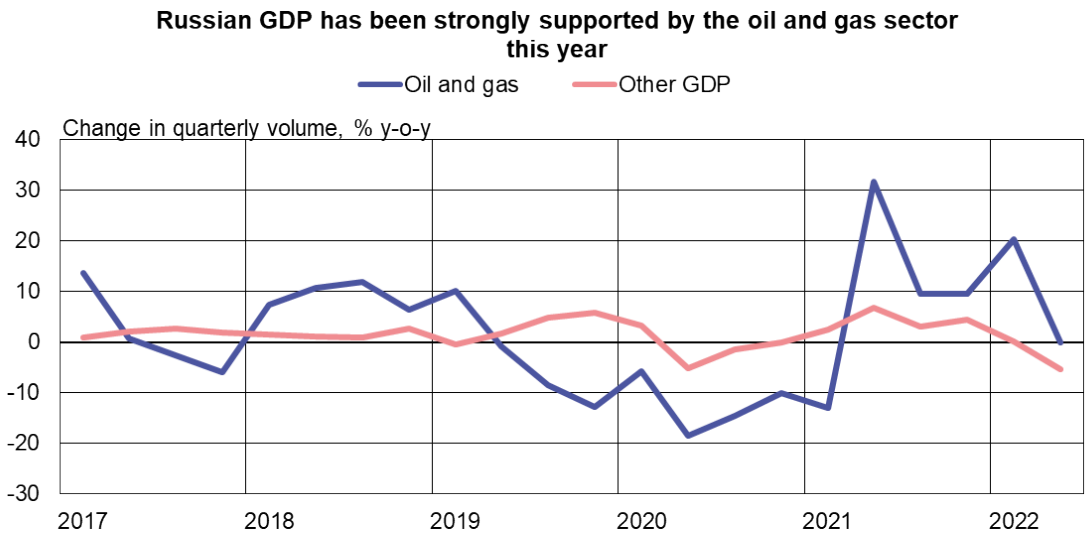
Russia's oil products to EU countries have fallen since the start of the Ukraine war, but in the autumn the EU still accounted for one third of these exports. The IEA estimates that Russian exports of oil products to EU countries in October amounted to about 1 mbd. New buyers will have to be found for this by February. China, India and Türkiye have barely increased their imports of Russian oil products. They have plenty of refining capacity of their own, which means they are more interested in crude oil. Russia has managed nevertheless to increase its exports of oil products to Singapore, for example, which acts as a raw materials brokerage hub in Asia.

A similar price cap to that for crude oil is planned for Russian oil products in February. The details are as yet even less clear than for crude oil. It is considered that finding the shipping capacity for circumventing the price cap will be considerably more challenging for Russia in the case of oil products than for crude oil. Russia's own shipping capacity is very small. Even if it could gain the use of all the capacity from the sources mentioned above, it is estimated that this would be enough to cover only 15% of its oil product exports. Assembling sufficient transportation capacity could therefore take a long time.

Most experts believe that Russia will be able to find only partial alternative markets for its exports. In total, about 70%–75% of Russia's crude oil production has been exported as crude oil or oil products. Russia's oil production is therefore expected to decrease in 2023. The official forecast of the Russian Ministry of Finance shows a contraction in oil production of about 5% next year. Forecasts made by energy organisations outside Russia [1] are more pessimistic, with the most recent production forecasts indicating a decrease in the range of -8% to -15%.

According to Russia's Federal Service for State Statistics (Rosstat), it is specifically the oil and gas sector that has maintained the country's gross domestic product (GDP) this year. The share of GDP produced by the oil and gas sector did not even dip downwards in April–June (Chart 2). By contrast, the non-oil GDP contracted by more than 5% from the previous year, and this was even a slightly steeper decline than in spring 2020 during the pandemic. No detailed GDP figures for July–September have yet been published, but preliminary data for the extractive industry suggests that production remained unchanged from a year earlier. According to Rosstat, the oil and gas sector's share of Russia's GDP in 2022 has been about 20%. A rough calculation suggests that a drop of about 10% in the Russian oil and gas sector [2] in 2023 could reduce Russia's GDP by around 2%.

Chart 2.



Sources: Rosstat, BOFIT.
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A contraction in Russia's oil production and exports also means a cut in the country's budget revenues. In Russia's budget framework for 2023, crude oil production is projected to fall by 5% and the average oil price is expected to be USD 70 per barrel. On the basis of these assumptions, the oil and natural gas revenues in Russia's federal budget are estimated to be approximately RUB 8,900 billion (USD 150 billion at the Russian central bank's current official exchange rate). The budget framework also contains risk scenarios for different levels of production and at different oil prices. If production were to fall to about the average level expected by the international organisations referred to above (about 9.5 mbd), and assuming the oil price is USD 60 per barrel, Russia's oil and gas revenues would be about RUB 1,500 billion below the budgeted amount.

If other factors remain unchanged, Russia's federal budget deficit under this risk scenario would grow by around 1 percentage point in relation to GDP, bringing it to 3% of the Russian Ministry of Finance's forecast level of GDP. Russia would probably still be able to finance such a deficit without too much difficulty. A greater contraction in oil revenues than expected would nevertheless require Russia to tighten its belt even more. It is difficult, however, to estimate the extent to which revenues will tumble, as there are still many unknowns about the practical implementation of the price cap mechanism.

Notes

1. The International Energy Agency (IEA), the U.S. Energy Information Administration (EIA) and the Organization of the Petroleum Exporting Countries (OPEC). ↑

2. Production of natural gas is also expected to decrease in 2023. Russia has almost completely stopped its exports of pipeline gas to EU countries. This export volume cannot be quickly redirected to new markets due to the shortage of transportation options. ↑

Keywords

BOFIT, oil, Russia, sanctions, Ukraine