February 1, 2023

The International Working Group on Russian Sanctions Calls for Introducing a Low Price Cap on Russian Oil Products

In December 2022, the International Working Group on Russian Sanctions called for energy sanctions with the objective of reducing Russia's revenues from oil and gas exports to $100-120 billion in 2023 from an estimated $357 billion in 2022.

Russia's invasion of Ukraine is a violation of international law and order, which has inflicted inhumane violence and suffering on the Ukrainian people. Ending the war on Ukraine's terms is the only sustainable solution to the multiple challenges - food security, inflation, refugees, and economic slowdown - caused by Russia's aggression. We see a squeeze on Russian energy export revenues as the most effective economic tool to constrain Russia and hasten a decision in Moscow to end the invasion. And our assessment of Russia's vulnerability to lower oil revenues has been reinforced both by historical experience and by multiple recent signs of economic strain as oil revenues fell in the fourth quarter of 2022 – including a wider budget deficit, a surge in domestic borrowing, and greater reliance on the oil fund.

However, G7 governments have decided to postpone a decision on the crude oil price cap until March in order to collect more data on the cap's initial impact before making further adjustments. Thus, the key decision to be made now concerns the level of the product price caps, which will come into force on February 5.

We believe that the G7 governments should set a low-price cap on Russian oil products, specifically, more aggressive than crude price cap level, for several reasons. First, it will have a major impact, since oil products account for a third of Russia's total oil exports. Second, Russia is in a weaker position with products than crude, since they are much harder to redirect, and have higher logistic costs. In particular, India and China – now the main sinks for Russian crude - have their own refining capacities and, therefore, less interest in buying refined Russian oil products. Third, stopping production would disrupt refineries. In addition, there is weak demand for some oil products – like naphta and fuel oil – giving the G7 greater leverage against Russia. Ultimately, we assess that Russia is likely to keep supplying oil products even under a more aggressive price cap. Moreover, governments and businesses, especially in the United States and EU member states, have the toolkit to balance market prices should they fluctuate.

Therefore, we call on G7 countries to set the low product price caps for products such as naphta and fuel oil which are in less demand, and where Russian has least leverage. Specifically, we propose the February 5 product price caps be set at a level consistent with crude prices clearly above Russia`s average cost of production and the market spread between crude and product prices. Using a $30/barrel benchmark[1] crude price and average 2019-22 product spread over crude for lower price oil products (naptha, fuel oil) vs. 4Q-22 product spread over crude for the higher price oil products (diesel, jet/kero. Gasoling), we would recommend the following price per barrel of product: Diesel: $50-80, Jet/Kero: $45-75, Gasolina: $40; Naphtha: $25; LSFO[2]: $40, HSFO: $15.

The Proposed Level of the Price Cap for Oil Products

	1	2	3	4	5	6	7	8
		Product spread over Dated Brent, $/bbl				Proposed product price cap, $/bbl (30$ banchmark oil)		Verification
	Market prices (Dec 2022), $/bbl	Average 2019-21	Average 2022	Average 2019-22	Q4 2022	based on average 2019-22 product spread over crude	based on average 4Q-22 product spread over crude	Market price discounted for 43% (Urals vs Brent
Gasoline	85	6	16	9	11	39	41	48
Diesel	121	10	41	18	51	48	81	69
Jet/Kero	121	9	39	16	43	46	73	69
Naptha	67	-3	-15	-6	-16	24	14	38
High Sulphur Fuel Oil	57	-11	-24	-14	-29	16	1	32
0.5% Fuel Oil	78	10	6	9	-1	39	29	44

	1	2	3	4	5	6	7	8	9
		Product spread over Dated Brent, $/tonnes				Product price cap, $/tonnes (30$ banchmark oil)		Verification	
	Market prices (Dec 2022), $/tonnes	Average 2019-21	Average 2022	Average 2019-22	Q4 2022	based on average 2019-22 product spread over crude	based on average 4Q-22 product spread over crude	Market price discounted for 43% (Urals vs Brent	Conversion factors
Gasoline	714	54	137	75	92	328	346	407	8,5
Diesel	904	76	310	134	384	359	609	515	7,5
Jet/Kero	945	69	304	128	332	362	566	538	7,8
Naptha	594	-25	-129	-51	-140	216	127	339	8,9
High Sulphur Fuel Oil	381	-71	-163	-94	-192	107	9	217	6,7
0.5% Fuel Oil	522	64	41	58	-8	259	193	298	6,7

Memo: Prices are quoted in $/tonne, which is the market standard for products. We estimated these prices using IEA prices quoted in $/bbl. Conversion factors = Tonnes to barrels equivalent. Grey reflects our preferred choice of the scenario.

Over time, we call for:

1. The price cap on crude oil to be progressively lowered in steps over time ("a ratchet"), ultimately aligning the crude price cap – and the price caps on diesel and other oil products - with the lower naptha and fuel oil price caps. We specifically call for agreement on a further decrease at the March price cap review.

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[1] The crude oil benchmark is used for the purposes of analytical illustration and reflect dependencies between the price for oil products and oil, of which products are produced.

[2] Low sulfur fuel oil/0.5% Fuel Oil

2. Increased investment in monitoring and enforcement to prevent both Russian oil sales above the price cap and smuggling operations back into EU/G7 markets. Monitoring and enforcement should include frequent audits of pricing attestations obtained by tier-2 and tier-3 actors to determine whether the tier-1 parties providing them meet the safe-harbor guidelines of reasonable reliability. Monitoring and enforcement should also track efforts to smuggle Russian crude and product back into EU/G7 markets by disguising their origins through ship-to-ship transfers in the Mediterranean and East of Suez as well as blending operations utilizing floating and on-shore storage facilities in the trading hubs around Fujairah and Singapore.

3. Full sanctions on Gazprom, Russian oil companies, and Gazprombank, with limited exemptions for oil price cap-related transactions.

At the same time, we recognize that many supporters of Ukraine are cautious about an aggressive stance on the price cap. Along with the objective of depriving Russia of energy export revenues to finance the war, they have a strong and legitimate interest in stable energy markets and reducing inflation. We agree that it is critical to design the sanctions to have a significant effect on Russia while minimizing negative consequences for the citizens of partner and third countries, which include some of the most vulnerable.

However, we argue that a lower price cap will not lead to market turbulence, such as a supply shock, for two key reasons:

First, it would remain profitable and rational at this level for Russia to continue supplying oil products to the global market.

Our contention is that Russia has, on average, very low oil production costs - under $5/barrel cash lifting costs and under $10/barrel capital and exploration expenditure costs - as reported by Russia's largest oil company, Rosneft, in its 2021 annual report. If anything, these costs - which are domestic costs in rubles - are likely to fall as the ruble weakens in response to lower oil earnings. At product prices aligned with crude prices above Russia`s average cost of production[3] and the average market spread between crude and products prices, oil refining – and crude exports - will remain financially profitable and sustainable for Russia. As long as Russia continues to supply, there will be no shortage and, thus, no price surge.

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[3] According to our analysis, the price of 30-35$ is higher than Russia`s average marginal production cost of crude oil.

In addition, Russia is boxed in. Oil storage within Russia is small relative to production, meaning it cannot continue production at normal levels without exports. And shutting down production in older Russian fields is risky, since Russia may lose reserves and production permanently.

Second, the US and EU have a toolkit to help balance the market in case of price fluctuations, including:

- Oil emergency reserves: The release of 240 million barrels of emergency reserves by IEA countries - 1.5 million barrels a day (mbd) for 6 months - would make a material difference to supply. And there is scope to do more: for example, when Allied forces started their air campaign against Iraq in 1991, the IEA activated a pre-agreed upon plan to release 2.5 mbd. Altogether, IEA member countries hold 1.5 billion barrels in public reserves and about 575 million barrels through obligations with the private sector; thus, releases since the start of Russia's invasion only amount to 9% of total reserves.
- Potential for increase in production. The United States may be able to increase production by 0.7-0.8 mbd within six months. In addition, Saudi Arabia and the UAE have 3 mbd in spare capacity.

The EU and G7 countries should now impose a low price cap on Russian naptha and fuel oil exports, consistent with a $30/bbl crude price. Over time, we believe that the G7 should aim to lower the price cap on Russia's crude and other product exports in steps to align with the lower naptha and fuel oil product price caps. We see price caps at this level as rapidly constraining Russia's economy, and helping to end the war, while maintaining Russia's incentive to supply.

Note: The inclusion of affiliations is for identification purposes only and does not represent an endorsement of shared views with the co-signer.

Dr. Anders Åslund, Senior Fellow, Stockholm Free World Forum.

Tania Babina, Assistant Professor of Finance, Columbia Business School, Columbia University; Co-organizer of the Economists for Ukraine group.

Torbjörn Becker, Director of Stockholm Institute of Transition Economics, Stockholm School of Economics.

Dr. Andriy Boytsun, Founder and Editor of the Ukrainian SOE Weekly; Independent Corporate Governance Consultant; Former Member of the Strategic Advisory Group for Supporting Ukrainian Reforms.

Edward C. Chow, Senior Associate, Center for Strategic and International Studies.

Anne L. Clunan, Associate Professor of National Security Affairs, Naval Postgraduate School; Faculty Affiliate, Center for International Security and Cooperation (CISAC), Stanford University. *The views here are my own, and not those of the U.S. Navy, Department of Defense, or Government.*

Borys Dodonov, Head of the Center for Energy and Climate Studies, Kyiv School of Economics.

Anastassia Fedyk, Assistant Professor of Finance, the Haas School of Business, University of California - Berkeley; Co-organizer of the Economists for Ukraine group.

Edward Fishman, Senior Research Scholar, Columbia University's Center for Global Energy Policy.

Yuriy Gorodnichenko, Quantedge Presidential Professor of Economics, Department of Economics, University of California - Berkeley; Co-organizer of the Economists for Ukraine group.

Sergei Guriev, Professor of Economics, Sciences Po, Paris, and Former Chief Economist, European Bank for Reconstruction and Development.

Denis Gutenko, Ukrainian Emerging Leaders Program Fellow, Stanford University; Former Head of the State Fiscal Service of Ukraine.

Benjamin Hilgenstock, Senior Economist, Kyiv School of Economics.

James Hodson, Director and Chief Executive Officer, AI for Good Foundation; Co-organizer of the Economists for Ukraine group.

Eric Johnson, Former Managing Director, Cambridge Associates; Former National Security Council Staff, White House Situation Room.

Bronte Kass, Program Manager, Freeman Spogli Institute for International Studies (FSI), Stanford University; Assistant Coordinator, International Working Group on Russian Sanctions.

Dr. Craig Kennedy, Center Associate, Davis Center for Russian and Eurasian Studies, Harvard University, and Former Vice Chairman, Bank of America Merrill Lynch.

Tyler Kustra, Assistant Professor of Politics and International Relations, University of Nottingham.

Michael McFaul, Director, Freeman Spogli Institute for International Studies (FSI), Professor of Political Science, and Hoover Institution Senior Fellow, Stanford University; Coordinator, International Working Group on Russian Sanctions.

Benjamin Moll, Professor, London School of Economics and Political Science.

Richard Morningstar, Former Ambassador to the European Union, Ambassador to Azerbaijan, and Special Envoy for Eurasian Energy.

Tymofiy Mylovanov, President of the Kyiv School of Economics; Associate Professor, University of Pittsburgh.

Jacob Nell, Senior Research Fellow, Kyiv School of Economics; Former Chief Russia Economist, Morgan Stanley.

Steven Pifer, Affiliate, Center for International Security and Cooperation (CISAC), Stanford University; Former U.S. Ambassador to Ukraine.

Lukasz Rachel, Assistant Professor of Economics, University College London.

Elina Ribakova, Deputy Chief Economist, Institute of International Finance.

Dr. Benjamin L. Schmitt, Senior Fellow, Kleinman Center for Energy Policy, University of Pennsylvania; Associate, Harvard-Ukrainian Research Institute; Senior Fellow, Center for European Policy Analysis (CEPA); Rethinking Diplomacy Fellow and Space Diplomacy Lab Co-Founder, Duke University.

Moritz Schularick, Professor, Sciences Po Paris, and University of Bonn.

Stephen Sestanovich, Professor, Columbia University School of International and Public Affairs; Senior Fellow, Council on Foreign Relations.

Natalia Shapoval, Vice President for Policy Research, Kyiv School of Economics.

Dr. Kathryn Stoner, Mosbacher Director and Senior Fellow, Center for Democracy, Development and Rule of Law (CDDRL), and Professor, Freeman Spogli Institute for International Studies (FSI), Stanford University.

William B. Taylor, Former U.S. Ambassador to Ukraine; Vice President, Russia and Europe, United States Institute of Peace.

Vladyslav Vlasiuk, Assistant Coordinator, International Working Group on Russian Sanctions.

Denys Yatsyshyn, Director, Corporate Relations, U.S.-Ukraine Business Council (USUBC).