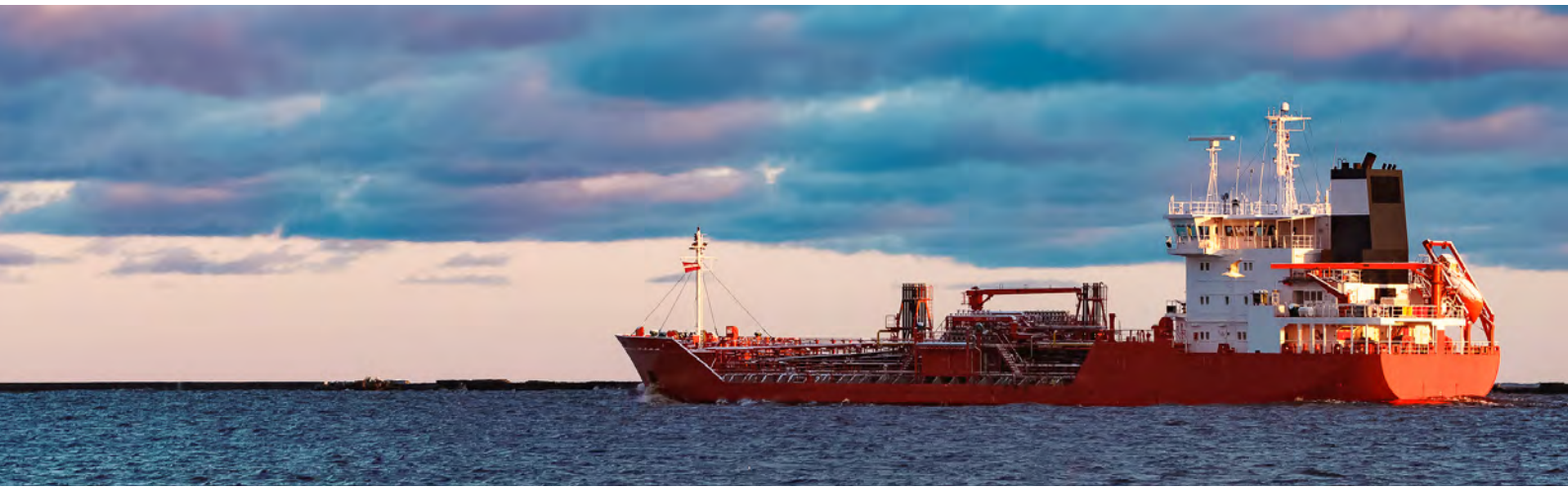
CENTRE FOR EUROPEAN REFORM
LONDON ★ BRUSSELS ★ BERLIN

Insight



A G7 energy tariff on Russia would be better than a price cap

by Elisabetta Cornago, 11 July 2022

A price cap on Russian oil would cut Russia's income, but a tariff would help governments support households and businesses dealing with high energy prices.

Following Russia's invasion of Ukraine on February 24th, G7 countries responded by rapidly approving a series of economic sanctions. Canada was the first to ban Russian oil imports (which were already zero) on February 28th, followed by the US embargoing Russian coal, oil and gas in early March. The UK vowed to phase out Russian oil imports by the end of 2022. EU member-states banned imports of Russian coal on April 8th, followed by oil delivered by sea on May 31st. In response, Russia has weaponised its gas exports, demanding payments in roubles and stopping or reducing flows to EU member-states. How have European energy markets reacted to this turmoil? How can European governments and G7 allies cut the revenues Russia gets from energy trade, while securing gas supplies?

What is the status of European energy markets?
A perfect storm of factors pushed up gas prices in autumn 2021, which in turn increased electricity prices: economic recovery after Covid-19 lockdowns raised energy consumption; and supply was reduced by unplanned maintenance of gas infrastructure, the deliberate slow-down of Russian gas supplies to Europe, and abnormally low wind power generation. At the time, the Commission insisted that the price spike would be temporary given the transient nature of most of these shocks.

After Russia's invasion of Ukraine, however, the outlook changed: imports of Russian coal and seaborne oil are on the way out, probably permanently. But the long lead times to full implementation of these sanctions, together with Russia's reduced gas exports, have only increased global energy prices. This is because markets prepare for possible shortages and the uncertainty around them: energy futures markets for coal, gas and oil point towards a prolonged period of high prices.

Economic sanctions on the energy sector are aimed at reducing Russian revenues, but so far they have primarily led to higher global energy prices, partly benefiting Russia.

The EU ban on coal imports from Russia only slightly reduced Russian revenues, because these imports are relatively modest, at €8 billion per year. The ban will start at the beginning of August. At the same

time, coal demand is having a revival, as several European countries, including Germany and the Netherlands, plan to delay the phase-out of coal power plants or to temporarily re-open closed plants, in order to fill in the gap in power generation left by lower gas imports from Russia. Many Asian economies are also turning to coal for power generation as the price of liquefied natural gas (LNG) increases. These factors have put pressure on coal prices too, which have increased over two fold since a year ago.

The EU's embargo on seaborne oil is more significant: in 2021, 32 per cent of crude oil imports to Europe came from Russia, and 39 per cent of refined products. EU imports of Russian crude and refined oil products were worth €48 billion and €23 billion respectively. Pipeline oil is exempt from the embargo because landlocked Czechia, Slovakia and Hungary rely on pipeline infrastructure for the vast majority of their oil imports, and cannot do without Russian oil in the short term. But most Russian crude oil imports into the EU in 2021 were seaborne, with only 25 per cent coming by pipeline.

Under the embargo, crude oil imports will be fully phased-out in December 2022, while refined products will be banned in February 2023. Additionally, while member-states could not agree on a ban on EU tankers transporting Russian crude, sanctions also involve a ban on EU firms providing insurance and financial services to cargoes transporting Russian oil products. The UK has committed to mirroring the insurance ban: this could prove to be hugely disruptive to Russia's exports, given the critical role that EU and UK firms play in insurance markets.

Oil exports are critical for Russia. Europe can replace oil from Russia with oil from elsewhere, but the partial embargo is having several effects on global oil markets. First, the price of oil has increased by 50 per cent since a year ago, which is partly offsetting the Kremlin's revenue losses as European imports reduce. Second, Russia has increased oil sales to other destinations, such as India and China, but at a discount. Third, EU member-states are already seeking alternative suppliers of crude and refined oil products, and this trend will accelerate in the coming months, as the embargo deadline gets closer.

Wholesale prices of natural gas have almost tripled in the past year, as geopolitical tensions have piled on top of gas market bottlenecks. Gazprom had already started reducing flows of gas to Europe prior to the February invasion, slowing down the refilling of gas storage facilities in the EU. After the invasion it has doubled down, including by reducing flows to Italy and Germany after entirely cutting off gas flows to Poland and Bulgaria earlier in spring. The official excuse was that some gas importers had not agreed to pay for gas in roubles, rather than in euros or dollars as contracts typically stipulate. With the rouble payment scheme, Putin is weaponising energy exports to split the unity of EU member-states. More recently, Gazprom has 'justified' export cuts by blaming Western sanctions for complicating the maintenance of pipelines.

Russia may play with gas supplies to put pressure on European governments, but with its REpowerEU plan, the EU has now committed to phase out Russian energy exports as quickly as possible, and to cut them by two-thirds by the end of 2022. But EU member-states are putting in place different strategies to achieve energy security. Germany and Italy, for example, have been on a gas-buying spree, rushing to secure floating LNG terminals and signing deals with gas producers such as Algeria, Angola, Congo, Qatar and the US. This suggests that the EU Energy Purchase Platform, launched by the European Commission to voluntarily aggregate and co-ordinate gas procurement in the EU, may only help smaller member-states, which may not have the ability to secure favourable gas contracts by themselves in a tight global market.

Turmoil on the gas market continues to affect the electricity market, too. Because gas is the price-setting source of electricity generation, high gas prices are driving up electricity prices, which have reached new all-time highs. The power market is under additional stress given unplanned maintenance needs in French nuclear power plants. This means that European consumers are facing increasing energy costs on all fronts.

How can Europe cut Russia's energy revenues?

With its average energy export prices 60 per cent higher than last year, Russia can retain and even grow its revenues from fossil fuels exports even if Western imports are falling. The International Energy Agency (IEA) estimates that, at current market prices, Russia earns $400 million per day from piped gas exports to the EU, and $700 million per day from global exports of crude oil and refined products: in January 2022, revenues from fossil fuel taxes and export tariffs made up 45 per cent of Russia's federal budget.

For this reason, policy-makers are thinking of ways to curb Russia's energy revenues. This is ironic because before the imposition of EU sanctions on oil, many analysts had encouraged EU governments to opt for a price-based approach, setting a tariff on oil and gas, which would have reduced Russian revenues. But this suggestion was not taken up, possibly because EU governments feared it would increase domestic oil prices. But in the short term, Europe has more flexibility in its choice of oil suppliers than Russia has in its choice of export destinations: for this reason, the tariff would not drive European prices up by its full amount. So how can the EU and its allies exploit this factor to stop Russia from benefiting from turmoil on energy markets, and mitigate energy price increases at home?

At its leaders' summit in Germany, the G7 agreed to explore a possible oil price cap to put a lid on global oil prices. With this approach, a group of oil importers would form a purchasing cartel agreeing not to buy Russian oil above a certain price. Ongoing discussions point to a set price between $40 and $60 a barrel: above Russian production costs, but substantially lower than the current world price. The cap could be designed as a waiver on the embargo and on the insurance ban: importers would be free to buy Russian oil, but only if they did so at a price beneath the cap.

Would this work? If the cartel is too small, it may simply entice Putin to cut oil supplies to these countries altogether. For this approach to destroy a substantial slice of Russian energy revenues, it would need to be applied by a large enough group of importers – otherwise, price cappers could be bypassed by bidders willing to pay even slightly more for precious oil. It is going to be difficult for Western advocates of the price cap idea to bring large importers of Russian oil on board, such as India and China.

The G7 countries are considering co-opting other countries by making access to Western insurance services for shipping conditional upon joining the cartel. This would drastically cut the number of ships transporting Russian oil – but the idea has shortcomings, too. First, it puts the burden on insurers, who would have to check whether the price cap is being respected by importers. Second, an insurance ban may prompt insurance providers from other countries to fill the void.

A tariff on Russian oil imports would be preferable to a complex price cap in multiple ways. First, a tariff raises revenues, while a price cap does not. Forcing the exporter to sell at a maximum price set by the cartel of buyers, the price cap destroys part of Russia's fossil fuel revenues. But with a tariff, the EU would extract at least some of those revenues, and could use them in the short term for income support for poorer households facing high energy bills, and in the long term for reconstruction efforts in Ukraine.

Second, enforcing a price cap would be difficult: importers willing to pay more than the price cap could try to offer a higher price 'behind doors' to obtain priority access to Russian oil. Third, if many countries applied a price cap, demand for Russian oil would spike. Because refiners of Russian oil would compete with refiners of higher-priced oil from elsewhere, retail prices of fuel at the pump would follow the higher global oil price instead of the capped purchase price of Russian oil. This means that consumers would not see any benefits in terms of lower prices at the pump.

What about the spike in gas prices? While the EU aims to cut imports of Russian oil into the EU by 90 per cent by the end of the year, Europe's dependence on Russian natural gas is still the elephant in the room: following the lengthy, difficult negotiations leading to the partial oil embargo, no EU leader is particularly keen to embark on gas sanctions. Further, given Russia is increasingly cutting its exports to Europe, some may wonder whether it is worth the EU attempting any sanctions on gas at all. But redirecting gas supplies away from Europe and towards other markets is even harder for Russia, and it would not be as profitable. For this reason, Russia would bear the brunt of a tariff on gas: European gas demand is more flexible than Russian gas supply. The EU should use this as an advantage.

Because EU-Russia gas trade is more reliant on pipeline infrastructure than oil trade, bypassing a European gas price cap may be impossible for Russia. This would make a gas price cap less subject to the shortcomings of an oil price cap, as it would be harder for other buyers to attract priority Russian gas deliveries with backdoor deals at higher prices. Nonetheless, considering that a tariff would allow the EU to extract revenues from Russia and use them for much-needed income support, it would be preferable to a price cap for gas as well as for oil.

Tariffs and price caps should not be understood as licenses to continue energy trade with Russia in the longer term: that is not politically or commercially credible. As EU member-states have agreed to phase-out Russian energy imports as fast as possible, a tariff is preferable to a price cap, which is in turn preferable to an embargo. The only reason to prefer a cap to a tariff is that the former would more easily coexist with an embargo, allowing the EU to save face by not backtracking on its approved sanctions. But if the EU can convince other G7 and G20 partners to adopt a tariff, this would be a double political success, increasing the pressure of economic sanctions on Russia, while limiting the price impacts of energy market jitters at home.

Elisabetta Cornago is a senior research fellow at the Centre for European Reform.