CIDOB **opinion**

E-ISSN 2014-0843

PLAYING THE OIL LEVER: The EU and US together can strip Moscow of its oil revenues

Alan Riley, Senior Fellow, Atlantic Council

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MARCH 2022

The EU and US has more leverage that first appears to deny or strip Moscow of its oil revenues. And it can take such steps knowing that there will be only a limited economic impact on European consumers. Russian oil exports to the European Union are approximately 3 million barrels per day(mbd). Total Russian oil exports are around 5mbd which provide 40% of all Russian tax revenues. The oil sold into the EU is heavy Urals crude, which European refineries are fitted out to take. As a result of the nature of Russian oil sold to Europe, Moscow would face heavy switching costs to sell that oil anywhere else. At the same time the EU and US, together allied states in the IEA have 1.5 billion barrels in the Strategic Petroleum Reserve (SPR). It would be possible therefore to shut off Russian oil exports to the EU, and thereby closing access to 3/5th of Russian tax revenues from its oil exports. Such a decisive step would rapidly undermine the capacity of the Russian state to wage war without imposing enormous costs on the EU or the US.

Clearly there is a danger that if we seek to strip Moscow of its oil revenues it will try to manipulate the price of natural gas to obtain additional revenues. Hence in any deal with Moscow over oil revenues there would have to be also a parallel deal on gas. In some respects, it is easier to control natural gas flows because almost all of Russian exports to the EU come via pipeline (in 2021 140 billion cubic metres (bcm) of a total of Russian exports of 155bcm). There are no pipelines in Gazprom's Western Siberian fields to take that gas anywhere else than Europe. In order to limit market distortions, the Union could for instance impose a fixed price for natural gas (perhaps linked to a non-Gazprom contaminated benchmark such as the US Henry Hub) and impose an agency which would act as the sole purchaser of Russian natural gas. The agency would then feed gas into the spot and long term contract markets.

At the same time the EU and US with other Western allies could decide to replace Russian oil exports to Europe with a mix of alternative supplies. Part of the alternative supply source could be taken from the Strategic Petroleum Reserve (SPR). The members of the International Energy Agency (IEA), consisting of the EU states, the US and other Western allies maintain a reserve of 1.5 billion barrels. They could decide to draw upon the reserves to replace some of the Russian oil exports to the EU. A second source of oil flows for the EU would involve drawing upon extra production from Saudi Arabia, the Gulf States and the US. The aim would eventually for oil producing states to produce all the additional oil that the EU would need.

It is unlikely that Moscow can survive a loss of 3/5ths of its oil revenues for very long. With the rolling sanctions that have been imposed by the EU and the US, including the withdrawal of SWIFT access, and the freezing of approximately 50% of Russian foreign reserves, Moscow is desperately short of foreign exchange. This is clear from the recent decision of the Russian Central Bank to forcibly convert domestically held dollars and euros into roubles. For the EU and the US to now stop the flow of dollars into Moscow from Russian oil exports would have a severe impact of the financing of the Russian state and its military. The impact is likely to be so severe that the EU and US could offer Moscow an alternative.

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This would be to accept EU control over Russian oil and gas revenues. The EU would impose an oil levy on Russian oil stripping a significant part of the revenues from Moscow. This would deprive it of much of its capacity to pay for the war, while providing the EU funds to pay for the war cost that fall upon the EU and Ukraine. While Moscow will also clearly object to this proposition it is a better proposition than to face a cut off of 3/5ths of its oil revenues.

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Moscow could of course seek to evade any total EU/US organised cut off of exports to the EU. It would however be difficult to move huge quantities of oil in the face of sanctions on tanker fleets and insurance companies. Even if some Russian oil was sold despite sanctions, given the release of oil from the SPR and additional oil production, the effect would be to increase market liquidity and thereby push oil prices lower. Already without sanctions Russian oil is having to be discounted by 20-30% to find any buyers. So even with evasion, Moscow would face the double discounting of 20-30% off a price which would itself have fallen because of its own attempts to push additional supplies into global markets.

The EU and US together have more capacity than first appears to be inflict heavy costs on Moscow for waging aggressive war against Ukraine. We can take steps to either deny Moscow directly a large chunk of its oil revenues or strip those revenues from the Kremlin. Either way we sought to act. While there may be some initial disruption from either step, the overall costs that would fall upon European businesses and consumers would be limited.