Russian oil: sanctions and self-sanctions start to be felt

- In March, embargoes and boycotting of Russian oil had a limited impact on exports of Urals due to a number of technical factors.
- More-severe oil-supply losses in Russia have materialized in April, and, by May, Russian oil output is expected to have fallen by 3mn b/d (around 30% of total production).
- Even if there are several mitigating factors at play, Brent prices are likely to move close to USD 115/bbl for the remainder of the quarter.

The West has marshalled remarkable unity in response to the Russia-Ukraine crisis. In the timespan of a few weeks, Western nations cut off several Russian banks from the SWIFT interbank payment system; froze the FX reserves of the Russian central bank; banned exports of dual-use goods and imposed asset freezes, travel bans and other curbs on Russian individuals. The speed, scale and scope of these sanctions have been unprecedented. While the EU (unlike the US, the UK, Canada, or Australia) is still pondering whether or not to sanction Russian oil and gas exports, several European energy companies have announced their intention to suspend purchases of Russian oil. This self-sanctioning involves the market, not governments, penalizing a country for its wrongdoings either for reputational reasons or fear of secondary sanctions.

Preliminary data on Russia's oil production and exports in March and early April show that, so far, the combination of official and unofficial sanctions has been effective but only to some extent. Moscow has found alternative buyers for its oil, particularly in Asia, thanks to generous discounts. However, we think this situation is likely to change soon. Financial sanctions are making it increasingly difficult for Russia to process oil-related transactions, and more-severe oil-supply losses in Russia are likely to materialize in the next few weeks – as windows that are still open to oil traders to finalize certain transactions with Russian counterparts close. With OPEC+ struggling to meet its production quota and the peak in demand associated with the summer driving season approaching, we think the drop in Russian oil output could push Brent prices close to USD 115/bbl for the rest of 2Q22. The only mitigating factor is a decline in Chinese demand triggered by outbreaks of COVID-19.

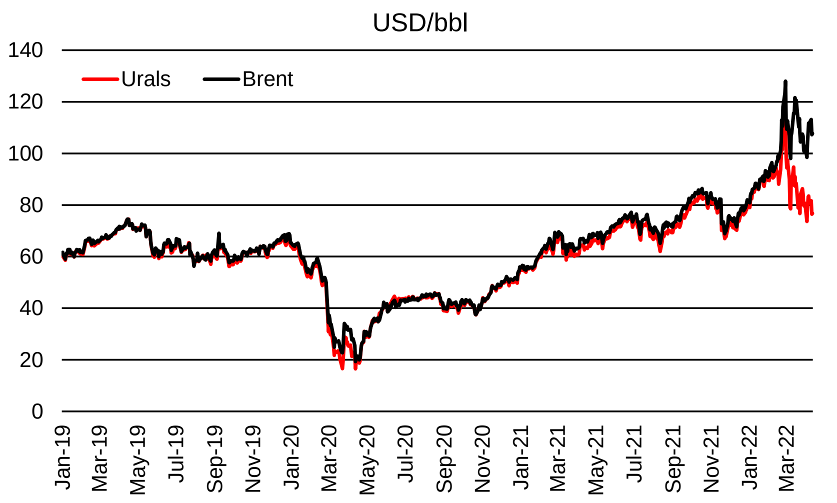
The impact of sanctions: contained so far, strong soon

Economic sanctions, whether government-imposed or self-imposed, must strike a balance between two competing goals: **1.** to respond to misconduct by inflicting trade or financial losses on an offender; **2.** to minimize the costs faced by the entity imposing sanctions. If the goal of oil sanctions is to freeze Moscow's oil exports and affect revenues that sustain military efforts, at least in theory, self-sanctions might achieve this at a lower cost – meaning they could have a more-contained impact on global oil prices. The reasoning behind this is simple. The price of oil is roughly a function of two variables: market fundamentals (demand, supply, and inventories) and geopolitical risk. Government sanctions and self-sanctions affect market fundamentals in the same way as long as they target the same amount of oil. What differs is their impact on the geopolitical risk premium, which might be more contained when self-sanctions are imposed, as they would not be perceived as causing an escalation in inter-governmental tensions that might lead to a wider conflict or might trigger retaliation (by cutting off natural-gas supplies, for example).

When, in mid-March, the EU appeared to be ready to impose sanctions on Russian energy in concert with the US, Brent prices almost reached USD 140/bbl. Then, when the EU put a decision on hold, they dropped to around USD 110/bbl, where they have since stabilized (with large swings in both directions) despite the boycotting of Russian oil by some of the world's major energy companies. The stabilization of Brent prices at lower levels is partly due to a more-contained geopolitical premium associated with self-sanctions and partly due to the fact that stopping purchases of Russian oil will, in most cases, be phased in gradually, in order to allow companies to find alternatives to Russian oil – a difficult task at a time when there is a shortage of very large crude carriers to reroute some of the demand to farther providers. Moscow exports around 5mn b/d of oil worldwide (roughly 5% of the global supply), with Europe and China being its two major buyers (they buy around 2.3mn b/d and 1.4mn b/d, respectively).

A different picture characterizes the Russian oil benchmark. So far, embargoes and private boycotting have weighed on Urals prices. As shown in Chart 1, Urals and Brent prices, which usually move in sync, have sharply decoupled since the beginning of the Russia-Ukraine conflict. Urals is currently selling at a discount of around USD 30/bbl to Brent. Despite this huge spread, in absolute terms, Russia is selling its own crude for roughly the same price it was selling it for at the beginning of the conflict. Given that the RUB, after a massive initial depreciation, is now roughly back to pre-conflict levels, the amount of revenues per barrel that Moscow is bringing in has not been significantly affected so far (the production cost of a barrel of Urals crude is USD 5.7).

CHART 1: URALS IS SELLING AT A DISCOUNT



Source: Bloomberg, UniCredit Research

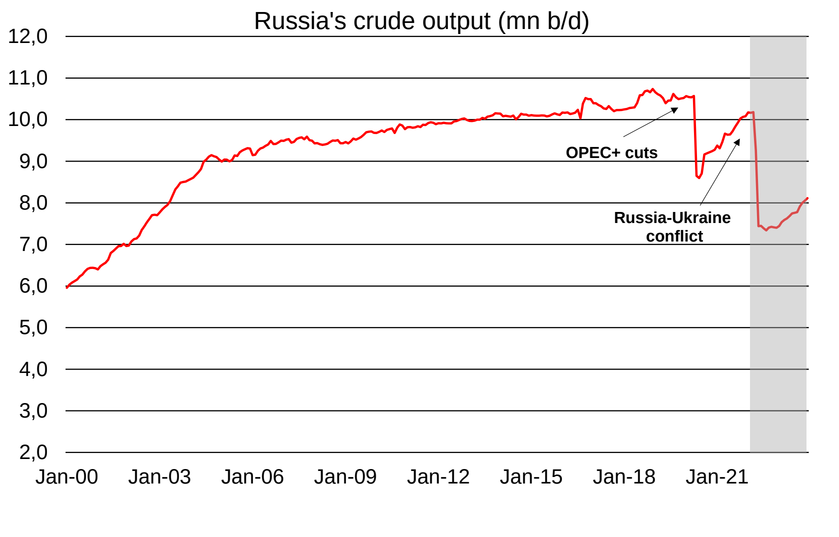
Thanks to these discounts, Moscow has so far managed to contain the resulting drop in oil exports by sea (crude and petroleum products). These had fallen by around 330,000 b/d (to 5.7mn b/d) in March – primarily as a result of government-imposed and self-sanctioning (before the Russian-Ukraine crisis, the US imported around 240,000 b/d from Russia). What is changing is the composition of the buyers of Russian oil. In March, loadings to India rose from almost nothing in February to 310,000 b/d on average, whereas seaborne exports to China were up by 70,000 b/d (a more-contained increase than expected due to recent COVID-19 outbreaks, which are curbing oil demand). This is possible because of a lack of secondary sanctions (i.e. the targeting of commercial activity involving a party under primary sanctions but occurring outside the US's legal jurisdiction), and it has helped curb oil-price spikes.

More tellingly, the share of Russian oil exports destined for unreported destinations rose by 250,000 b/d in March. This indicates that oil is being taken to large ships at sea and mixed with oil from other destinations, thereby obscuring its origin. This is a long-running practice first used by other sanctioned countries, including Iran and Venezuela. According to a report published by the *Wall Street Journal)*, a "Latvian blend" and a "Turkmenistani blend" are being offered on the market with the understanding they are mixed with substantial amounts of Russian oil, and their primary destination is Europe. In addition, according to maritime risk-management company Windward, the practice by vessels of turning off their transponders for several hours has increased by 600% since the intensification of the Russia-Ukraine crisis on 24 February.

The March figures looked relatively favorable for another reason. In most cases, cargoes purchased before restrictions were imposed have been loaded. Moreover, trade with holders of longer-term contracts continues to provide a boost to exports of Russian crude and products in line with contractual obligations. However, going forward, the flexibility that sanctions allowed in their initial phase will rapidly fade, and many oil-related financial transactions will become increasingly difficult to carry out. There might not be enough Asian buyers to replace Western ones, especially given the elevated insurance costs associated with shipping Russian oil. These have more than tripled since the beginning of the conflict.

In turn, Russian oil production will be negatively affected. Russian refiners have already had to halt operations at some units due to a lack of outlets (domestic or international) for their product. As boycotts and embargoes consolidate and storage fills up, crude-oil exports will face steeper declines in the coming weeks. According to Russian Deputy Prime Minister Alexander Novak, Russian oil production may decline by 4% to 5% (or around 500,000 b/d) in April from March due to problems with insurance and the usage of vessels. According to the International Energy Agency and several market participants, instead, Russian production will likely drop by about 3mn b/d by the end of May – without formal EU sanctions, which, if imposed, would roughly replace part of the self-sanctioning that is in the pipeline but they will have a larger impact on prices via a geopolitical premium – and could hit levels not seen in 20 years (see Chart 2). In the second week of April, and even after the volatility that characterizes weekly figures is taken into account, satellite information indicates that Russian oil exports were down by 25% (or around 1.6mn b/d) and that the number of completely loaded cargoes of Russian crude was down by a similar percentage.

CHART 2: IN FREE FALL



Source: PIRA, UniCredit Research

Implications for oil prices

As we argued in the past, the Russian-Ukraine conflict is taking place at a time when the oil market is extremely tight. The effects of this conflict will add to this tightness as sanctions start to be felt. A lack of secondary sanctions might partly mitigate this by allowing Russian oil to reach other destinations at a discount and by enabling more-expensive barrels of oil to reach those countries that have imposed sanctions. Other mitigating factors are the release of strategic reserves by oil-consuming nations, decreases in global demand (both in China due to COVID-19 outbreaks and in advanced economies due to the Russia-Ukraine crisis) and increasing production in the US. OPEC+ is unlikely to provide much relief unless producers with ample spare capacity, such as Saudi Arabia and the UAE, are allowed to exceed production quotas. However, the resulting disruption to Russian oil supply, estimated to amount to 3mn b/d, will be hard for the market to absorb without there being a significant impact on prices, and we expect such disruption will move Brent close to USD 115/bbl for the rest of 2Q22.

Edoardo Campanella, Economist (UniCredit Bank, Milan)
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: https://www.unicreditresearch.eu/index.php?id=glossary

Disclaimer

This report was completed and first published on 26 April 2022 at 16:27.

Responsibility for the content of this publication lies with:

UniCredit Group and its subsidiaries are subject to regulation by the European Central Bank

a) UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), Arabellastraße 12, 81925 Munich, Germany, (also responsible for the distribution pursuant to §85 WpHG). Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch (UniCredit Bank, London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: “Bank of Italy”, Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

d) UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.

e) UniCredit Bank Austria AG (Bank Austria), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria

f) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria. Regulatory authority: Financial Supervision Commission (FSC), 16 Budapeshta str., 1000 Sofia, Bulgaria

g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia

h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

Further details regarding our regulatory status are available on request.

ANALYST DECLARATION

The analyst’s remuneration has not been, and will not be, geared to the recommendations or views expressed in this report, neither directly nor indirectly.

All of the views expressed accurately reflect the analyst’s views, which have not been influenced by considerations of UniCredit Bank’s business or client relationships.

POTENTIAL CONFLICTS OF INTERESTS

You will find a list of keys for company specific regulatory disclosures on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

You will find the history of rating regarding recommendation changes as well as an overview of the breakdown in absolute and relative terms of our investment ratings, and a note on the evaluation basis for interest-bearing securities on our website https://www.unicreditresearch.eu/index.php?id=disclaimer and https://www.unicreditresearch.eu/index.php?id=legalnotices.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

You will find a list of further additional required disclosures under the laws and regulations of the jurisdictions indicated on our website
https://www.unicreditresearch.eu/index.php?id=disclaimer.

E 20/1

UniCredit Research*

Macro Research

Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

International Economics Research

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head, Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

MR 22/1

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), UniCredit Bank AG London Branch (UniCredit Bank, London), UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), UniCredit Bank Austria AG (Bank Austria), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Romania.