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SANCTIONS EVASION AND DEROGATION ON RUSSIAN OIL

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The oil embargo on Russia presents a critical challenge for European and US authorities seeking to curtail Russian crude and oil product exports. While the sanctions are designed to restrict these exports, several factors are hindering their effective implementation, leaving room for evasion. This analysis highlights key issues related to sanctions evasion and the strategic decoupling from Russian oil, with a particular focus on the case of Lukoil.

Financing Kremlin's war

The European Union (EU) has granted exemptions to Bulgaria and landlocked Central European nations such as Hungary, Slovakia, and Czechia, allowing them to continue importing Russian oil until the end of 2024. This presents a significant risk, as it enables the backdoor entry of Russian oil into the broader European market.

The current oil price cap, set at $60 per barrel, has been breached. The Russian Urals blend trades now at around $75 per barrel. Russian exports have continued to rise, reaching a record high of 3.72 million barrels per day in early October. Approximately 20-25% of Europe's imports of crude oil and refined products still originate from Russia, often indirectly through third countries like Turkey, the UAE, Morocco, Egypt, and India.[1]

The derogation and beyond: Bulgaria has been a typical case-study for the ineffectiveness of current sanctions. The derogation to the EU embargo has provided Lukoil with an enormous surplus profit, estimated at around $3 billion since the Russian invasion, on the back of the steep discount the company gets on Russian crude imports (around $20 per barrel). Lukoil's business operations in Bulgaria have made up around 4% of the total Russian oil budget revenues in 2023.

[1] According to analysis of import data from Eurostat's COMEXT and Russia crude oil shipments to third countries such as Turkey, the UAE, India and North Africa.

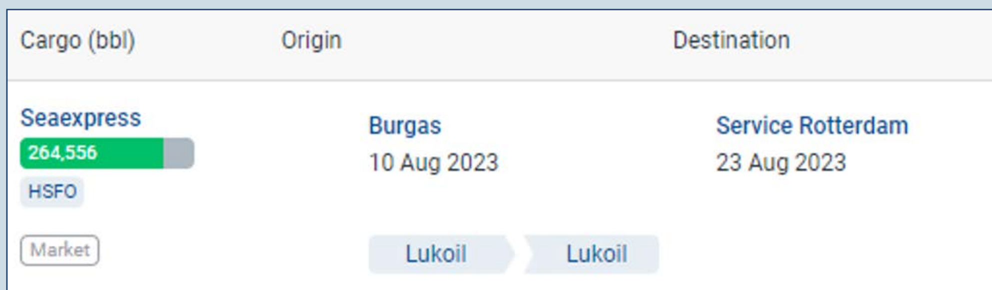
KEY POINTS

- Between **20-25% of Europe's imports of refined products** still originate from Russia, often indirectly through third countries like Turkey, the UAE, Morocco, Egypt, and India.
- The exemptions granted to Bulgaria and landlocked Central European nations such as Hungary, Slovakia, and Czechia to continue importing Russian crude oil **enables the backdoor entry** of Russian oil into the broader European market.
- The derogation to the EU embargo has provided Lukoil's Bulgarian business with **a surplus profit of around $3 billion** since the Russian invasion, or around 4% of the total Russian oil budget
- The analysis shows that Lukoil exported EUR **930 million worth of oil products** in 2023, a major loophole allowing Russia to use the EU to preserve its global oil market share.
- Lukoil Neftohim may have also violated the **conditions of Bulgaria's sanctions exemption**, by directly transferring oil products made from processing Russian crude oil to the Netherlands.
- There is an urgent need to strengthen the implementation and enforcement of the oil sanctions by **banning the transshipments of Russian oil products** that arrive in EU ports which are then transported onwards to non-EU destinations.
- The **price cap** institutionalizes the discount at which Russian companies are currently selling on the global market. A more robust oil price cap should be at or slightly below **$40 per barrel**.

Box 1. An STS Laundromat for Russian Oil

The analysis of ship-tracking data uncovers evidence that Neftohim may have also directly violated the conditions of Bulgaria's sanctions exemption, which prohibits the nation's companies from selling or transferring refined products derived from Russian oil to other EU member states. On August 8th, the Seaexpress, a vessel managed by the Greek company Thenamaris Ship Management, arrived at the Burgas port. Here, it loaded a substantial cargo of 40,000 tons of fuel oil from the refinery. Tracking data reveals that the vessel embarked on a 15-day journey across the Mediterranean, ultimately offloading its cargo at the Dutch port of Rotterdam. It's noteworthy that before the Seaexpress received its cargo, the Burgas refinery had not received any non-Russian crude for a period of 21 days. During this same timeframe, the port received four shipments of Russian crude oil, totaling over 340,000 tonnes. Consequently, it's highly probable that the fuel loaded onto the Seaexpress contained a significant component derived from Russian crude oil.

Figure 1. Example of a cargo owned by Lukoil shipped to the Netherlands during August, 2023 a month with 100% Russian crude oil deliveries to Bulgaria

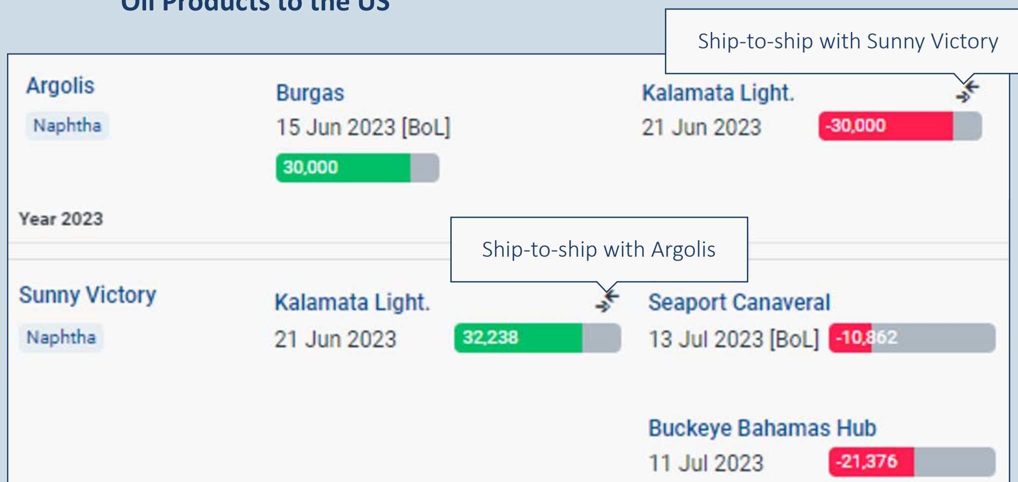


Source: *KPLER based on assessment by CREA*

Burgas is not just providing an alternative gateway for Russian oil into the EU; the refinery is also exporting its products to other regions subject to oil embargoes, such as the United States. Shipping data reveals that this year, the United States imported more than 70,000 tons of refined products from Burgas. The below screenshots are taken from the Kpler platform showing a shipment (vessel named Argolis) that loaded 30,000 MMbbl of naphtha from Burgas Rosenets Oil Terminal. The vessels then traveled to Kalamata Lighthouse (Greece) where it undertook a ship-to-ship transfer with the vessel Sunny Victory, transferring the 30,000 MMbbl of naphtha. The vessel named Sunny Victory then traveled from Kalamata Lighthouse off the Greek coast to the Bahamas on the 11th July where it unloaded 21,376 MMbbl of naphtha. Interestingly, this vessel then offloaded a further 10,862 MMbbl of naphtha in Florida USA at the Seaport Canaveral. This means that the 10,862 MMbbl of refined oil products that entered the USA were of almost entirely Russian origin, refined in the Lukoil owned refinery in Burgas.

This situation mirrors a pattern of a refining loophole within Western sanctions. This loophole allows for crude oil, once transported outside of Russia and refined into products like diesel or gasoline, to be legally imported by countries subject to sanctions.

Figure 2. A Ship-to-Ship Transfer of Russia-made Oil Products to the US



Source: *KPLER based on assessment by CREA*

In 2023, alone, after the derogation came into force, new analysis by Global Witness, CSD and the Centre for Research on Energy and Clean Air (CREA) reveals that the Neftohim refinery in Burgas processed 4.5 million tons of Russian crude in the first 9 months of the year (95% of all crude processed by the Lukoil refinery was of Russian origin) generating an estimated EUR 1 billion to the Kremlin's budget in direct tax revenues, enough to operate the Wagner mercenary group for one year.

Bulgaria is currently the fourth largest importer of Russian oil trailing only India, China, and Turkey. When the European Union imposed sanctions on Russian crude oil in December 2022, Bulgaria secured a special exemption to "safeguard domestic supply" and enable the sale of fuel to Ukraine. This exemption was explicitly granted to prevent Bulgaria from gaining an unfair economic advantage over other EU member states, which were prohibited from importing Russian crude oil by sea. A spokesperson for the European Commission clarified the purpose of this exception last year, stating that it was intended for Bulgaria to procure supplies for its domestic needs and not for the resale of imported Russian oil to other countries. However, the assessment reveals that, instead of solely meeting Bulgaria's internal demand, the refinery, primarily owned and operated by the Russian fossil fuel giant Lukoil, is naturally taking advantage of this exemption.

Potential Sanctions Evasion: The analysis shows that Lukoil exported EUR 930 million worth of oil products in 2023, a major loophole allowing Russia to use the EU to preserve its global oil market share. Although exports to EU countries have dwindled in 2023, Lukoil has used EU ports and key hubs in international waters (Kalamata Lighthouse, Malta and Ceuta, among others) for ship-to-ship transfers and onward exports to non-EU countries. Between March and July 2023, a further 239,000 tons of refined product left Bulgarian ports on voyages where the ultimate destination country could be obscured through a series of ship-to-ship (STS) transfers.

The derogation explicitly states that exports of oil products to third countries are allowed only when there are environmental concerns linked to storage constraints. Yet, Lukoil has roughly maintained average annual production levels at the Neftohim refinery even in 2023 (just 10% down from pre-COVID levels) even as total exports have shrunk by more than a quarter year-on-year in February-September 2023. This shows that Lukoil has taken advantage of the derogation to increase its wholesale market share domestically to over 90% in 2023, and simultaneously redirect exports of final products to alternative destinations including Turkey, Egypt and the UAE (for possible transshipment to the EU).

Neftochim appears to be on a trajectory that could lead to a violation of the conditions stipulated in Bulgaria's exemption. Recent Eurostat data provides insights into the situation. Between March and July 2023, which marks the first full month of data availability following the implementation of the export prohibition, Bulgaria managed to export 304,000 tons of refined petroleum products to the European Union. During this same period, the refinery was actively engaged in importing 2.1 million tons of Russian crude oil, along with 216,000 tons of non-Russian crude. This suggests a potential deviation from the intended use of the exemption and raises questions about the refinery's compliance.

What's next

There is an urgent need to strengthen the implementation and enforcement of the oil sanctions to ensure that crude oil and fuel products are not delivered to customers by Russia-linked third parties such as newly registered oil trading companies with unclear ultimate beneficial ownership and existing global commodity traders exploiting loopholes that mask the origin of their oil and oil products.

Recent developments have increased safety, environmental, economic, reputational, financial, logistical, and legal risks for industry stakeholders. Changing trade routes and evolving geoeconomic ties have created a "shadow trade" that involves **irregular and high-risk shipping practices** often associated with countries and persons under sanctions, or linked to illicit activities. These heightened risks include:

Financial: Russia has relied on unproven and fraudulent insurance providers, which lack capital, reinsurance arrangements, and expertise, which could lead to large financial risks for oil consumers.

Environmental and marine safety: The difficulty in holding vessels accountable for environmental damage costs could wreak havoc on global ocean governance. The use of older vessels operating beyond their lifespans, irregular flag states, falsified registrations, fabricated or neglected surveys and inspections, and crews pressured to disregard safety practices have increased the risk of marine casualties.

Russia-linked state capture networks: The concealment of ownership structures and cargo origin, the manipulation of AIS systems, and the loss of access to reputable service providers, financing, and ports have led to reputational, logistical, and financial risks. The additional profit from servicing the illicit supply of Russian oil and fuel products has entrenched Russia-linked state capture networks in a number of EU countries including Greece, Malta, Bulgaria, the Netherlands, Spain and Italy, among others. Still, between 30 and 40% of Russian crude oil is shipped by

Western companies, including primarily Greek shippers, who have taken advantage of their enormous fleet and traditionally good ties with Russian oil companies.

The EU should **lift the derogations on the import of Russian crude oil** provided to landlocked Central European countries and Bulgaria as there are no technical or economic justifications for the exemptions. The refineries in all of these countries can process non-Russian crude oil and can access relatively easily alternative supply from the Baltic, Adriatic and Black seas.

The derogation has been used as a **backdoor for additional crude sales to the EU** and the illegal shipment of final products to the rest of the member-states, Turkey and North Africa. Vulnerable countries, including Turkey, Egypt, Greece, Italy, Hungary, Slovakia, Czechia, Bulgaria, and the Western Balkans, require stricter external monitoring of oil to prevent potential sanctions evasion. To enhance **transparency and compliance**, the EU should amend the Commission Implementing Regulation (EU) 2015/2447, ensuring that the customs declaration includes **the true origin of oil products** exported from an EU port, confirming they were not produced with Russian crude oil.

Bulgaria should **increase the fines** (currently less than EUR 50,000 per infringement) imposed for violating the rules of the derogation **to 10% of the company's annual revenues**, which is in line with similar anti-trust legislation.

The EU should **ban the transshipments of Russian oil products that arrive in EU ports** which are then transported onwards to non-EU destinations. Russia is reliant on the few locations that it can use to move oil product exports to the global market. Prohibiting Russia from using EU ports would make logistics harder for Russia and lower their ability to export current oil product volumes to non-EU countries.

Tankers with falsified statements of the fuels' origin should be treated as **smuggling with all the related legal consequences**. This includes the arrest of ships at sea, their confiscation, and a penalty worth the difference between the oil price cap and the price of Brent crude if the latter's price is higher than $60 per barrel imposed on the shipping company.

The price cap **institutionalizes the discount** at which Russian companies are currently selling on the global market. It has also failed in significantly lowering global oil prices. A more robust **oil price cap should be at or slightly below $40 per barrel**. This would stimulate Russia to keep selling oil to the global market but would significantly squeeze the country's budget revenues and deprive it from resources to maintain the war effort in Ukraine.

Although insurance companies outside the G7/EU/OECD are risking sanctions, they have seen this as an opportunity to boost their global insurance market share. If the example of Iran and Venezuela are to guide the assessment of the secondary sanctions impact, Russia has already been able to find enough service providers for its oil exports. Oil clients should insist on continuous and appropriate **maritime insurance coverage** for vessels. This coverage should be provided by legitimate insurance providers with sufficient coverage for CLC liabilities.

The inflation of shipping and ancillary costs or the bundling of such costs should be viewed as a sign of **potential price cap evasion**. The customs authorities in the Russian oil trade should require an itemized breakdown of all costs to determine the price paid for oil or petroleum products.

The planned measures to prevent European shipping companies from servicing non-compliant crude are hardly effective. Vessels that have handled non-compliant crude will regain access to EU insurance services just 90 days after unloading their last non-compliant cargo. **Increasing the ban** for ships handling non-compliant crude from 90 days to 1 year is a critical deterrence measure. To ensure vessels are fit for their intended services, industry stakeholders should also insist that sellers receive classification from IACS member classification societies.

Port authorities and customs agencies should promote the continuous broadcasting of AIS throughout the lifetime of a voyage. If a ship needs to disable its AIS for safety reasons, the ship should document the circumstances necessitating disablement. The irregular AIS patterns should be vigilantly monitored for **data inconsistencies with actual ship locations**. Enhanced ue diligence should be conducted in the context of STS transfers, especially in areas at higher risk for illicit trading activity or AIS manipulation. Port authorities should also verify oil record logs to hold accountable records of cargo movements aboard vessels.

Both oil clients and government authorities should carry out appropriate due diligence, especially for ships that have undergone numerous administrative changes. **Due diligence should be calibrated** according to the specificities of business and related risk exposure. If an industry participant is aware of potentially illicit or unsafe maritime oil trade, including suspected breaches of the oil price cap, they should report this to relevant authorities.

Regulatory authorities must also ensure that Russian companies do not use **transfer pricing schemes** to tap into lucrative spreads of crude oil prices and refined product prices, and especially ensure that the proceeds from such transfer pricing cannot reach the Russian government.