

US sanctions on Russian energy sector: first results and side effects

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In the first half of 2014, after Crimea became part of Russia, the US and the EU have restricted the access of major Russian banks and companies to Western financing and imposed sectoral sanctions banning the transfer of technologies and equipment for the defense industry, the sanctioned oil and gas companies ("Gazprom", "Gazprom Neft", "LUKOIL", "Rosneft", "Surgutneftegas") and for fuel and energy complex of Crimea. Sectoral sanctions have been repeatedly supplemented and clarified since then. One of the latest laws on sanctions passed in July 2017 by Congress and was signed on August 2, 2017 by President Donald Trump, tightened existing sanctions and distributed them to the transport sector and oil and gas pipelines; it also increased the pressure on Russian officials.

Sanctions' impact on Russian energy sector

The current sanctions have obviously not yet achieved their goals. There were no significant political changes in Russia, neither changed the external course and rhetoric of Russian officials. The economy shows some signs of recovery and slight growth. Why do the sanctions seem ineffective and what can they achieve in a longer perspective?

All calculations show that the Russian capital market and the industry is largely dependent on energy prices than on sanctions. Nothing changed when the sanctions were first imposed in the beginning of 2014 and later, but the economy reacted immediately to the fall of oil prices in the late 2014. According to the assessment of the special rapporteur of the UN Human Rights Council, the economies of countries that imposed sanctions against Russia lost about \$ 100 billion, the Russian economy is half as much which amounts 1% of country's GDP¹.

The significant result is that in the first quarter of 2014, after the introduction of sanctions, the dependency between oil prices and capital inflows to Russia was highly disturbed for the first time: prices changed slightly, while capital outflow from the country amounted to \$20 billion –

¹ Спецдокладчик ООН оценил ущерб стран от санкций против России // Interfax.ru. 28.04.2017. URL: <http://www.interfax.ru/world/560420>

about 1.5% of GDP². Another indirect indicator of the losses from sanctions is the dynamics of external corporate debt. According to the Central Bank it decreased from 2014 to 1 June 2017 by almost 30%³.

Russian oil and gas industry was hit by technical sanctions which led to immediate losses and what is more important, will lead to increasing losses in the mid- and long term if the sanctions are not lifted. For example, about 90% of the key technologies of hydrocarbon production on the continental shelf come from the western partners. Sanctions affect 68% of imported equipment and 80% of the software used in the devices from the West; in the case of sub-seabed deposits, 80% of equipment and 90% of software must be imported⁴.

So a number of projects in this area were suspended. Among them are "Rosneft" and ExxonMobil offshore drilling projects on the Arctic shelf, Sakhalin Island and the Black sea.

Traditional production felt little impact from sanctions. At most shale projects Russian companies have also managed to adapt after the withdrawal of foreign partners and contractors, and continue their implementation. For example, "Surgutneftegaz" and "Gazprom Neft" continue the development of such deposits. Many foreign companies are also adjusting to the sanctions regime, they are trying to continue to do business out of politics, they intend to remain in the Russian market by any means.

Side-effects

Here we come to the first unintended side-effect of the sanctions: **business** (both Russian and Western) **goes into shadow**. The companies use third parties to avoid direct contacts, they exchange half-legal technologies without license, they do not declare their involvement in the projects and their benefits from it.

Another unintended result, which has shown itself not only in oil and gas industry, is so-called **"import substitution" by the Russian side**. If we speak about hydrocarbon extraction there is much evidence that Russian authorities and oil and gas companies began to more actively engage in import substitution, pay attention to Russian players and develop measures to

² The Central Bank of the Russian Federation. External Sector Statistics. URL: <http://www.cbr.ru/eng/statistics/Default.aspx?PrId=svs>

³ The Central Bank of the Russian Federation. External Sector Statistics. URL: <http://www.cbr.ru/eng/statistics/Default.aspx?PrId=svs>

⁴ Energy Minister of Russia Aleksandr Novak at the National Oil and Gas Forum. 03.2015. URL: <http://oilandgasforum.ru/data/files/Files%200315/Novak.pdf>

support qualitative development. For example, from January 1, 2017 the government introduced in the procurement by state-owned companies 15% priority for Russian goods and services⁵. There are already concrete examples of import substitution – both technologies and products: a telemetry system for inclined and horizontal drilling or one of the most notable initiatives in the field of technological import substitution: the project of "Gazprom oil" on creation of complex domestic technologies and high-tech equipment for the development of the reserves of the Bazhenov formation. The plans are to implement import substitution technologies on this project by 2025. The company has estimated the project cost at \$125 mln, of which 90% will be its own funds. In the case of successful implementation of all created technologies the level of "Gazprom oil" production from the Bazhenov formation deposits in 2025 could be around 2.5 million tonnes per year, reported the company⁶.

The next thing which seems to be a painful side-effect is **the reaction from the European states**, companies and some leaders. Despite the remaining focus of the EU on the Ukrainian crisis as a stumbling block towards restoration of the EU-Russia relations, the EU now clearly shows a much more sober and pragmatic attitude towards transatlantic solidarity wanted by the USA in terms of new anti-Russian sanctions. Senior European officials as well as leaders of major energy companies explicitly demonstrate serious concern about incoming US initiatives, for instance, against the Russian energy sector, which can damage the European energy supply.

The new sanctions that were adopted by the US in August 2017 mostly aimed at hitting Russian export pipelines by banning provision of financing, services, technology and information support to the Russian energy sector. That would almost surely damage Nord Stream 2 pipeline project, which concerns European companies involved.

Chairman of the European Commission Jean-Claude Juncker announced readiness of the EU to react to USA's actions in case the EU interests are not taken into account with European Commission extending a

⁵ Виноградова Е., Бурлакова Е., Никольский А. Почему санкции против России внешне неэффективны // Ведомости, 13.08.2017. URL: <https://www.vedomosti.ru/economics/articles/2017/08/14/729205-sanktsii-neeffectivni>

⁶ Проект «Газпром нефти» по изучению Баженовской свиты получил статус национального // Пресс-релиз «Газпром нефть». 17.05.2017. URL: <http://www.gazprom-neft.ru/press-center/news/1119467/>

requirement for Washington to publicly confirm that the new sanctions do not go against the European companies' interests⁷.

Germany's economy minister, Brigitte Zypries heavily criticized US saying that "the Americans cannot punish German companies because they are doing business in another country"⁸.

And finally, the widely discussed **Russian "Pivot to the East"**, particularly to China, has started to take a concrete shape. First attempts including the frame agreement with China signed in 2014 right after first serious sanctions were imposed, caused a wave of excitement and optimism in Russia but had little real filling and needed to be supported and continued by further steps: investments and technologies. They followed in 2016 when NOVATEK resolved the problem of attraction of financing under sanctions thanks to Chinese investors and banks entered its project "Yamal LNG": CNPC bought 20%, the Silk Road Fund – 9,9%. The LNG project received in total \$12 bln from China (partly in Yuans) and the conditions were quite acceptable, given the Western sanctions against NOVATEK and the inability to attract project financing in Western markets. In 2017 CEFC China Energy and Rosneft agreed about a \$9,1 bln deal for 14,16% stake in Rosneft. The upcoming NOVATEK project – "Arctic LNG" – will allegedly get the financing from the French company Total directly, without French banks; from Japanese companies and – most likely – Chinese funds. The investors are interested that the project is based on Russian technologies which looks like a further impetus for the development of import substitution in Russia. Importing equipment from the eastern countries like China or South Korea have increased but it is restricted as many devices contain Western made parts.

Conclusions and perspectives

The side effects mentioned here do not cancel the negative influence from the American sanctions on the Russian oil and gas industry and economy as a whole. What is more alarming, the more time passes the more effect will be shown. Difficulties with the development of oil fields in the Arctic shelf and in Eastern Siberia, problems with the building and renovation of pipelines, including strategic oil pipelines (such as "Eastern Siberia-Pacific Ocean" which

⁷ De Carbonnel A. EU warns U.S. it may respond swiftly to counter new sanctions on Russia // Reuters, 26.07.2017. URL: <https://www.reuters.com/article/us-usa-trump-russia-eu/eu-warns-u-s-it-may-respond-swiftly-to-counter-new-sanctions-on-russia-idUSKBN1AB1DP?il=0>

⁸ Germany calls for EU countermeasures against US following Russian sanctions // Deutsche Welle. URL: <http://www.dw.com/en/germany-calls-for-eu-countermeasures-against-us-following-russian-sanctions/a-39911686>

is necessary for a true Pivot to the East, or “Nord Stream 2” which is necessary for remaining a major player at the European market), as well as the decreasing quality of crude oil – all this may lead to Russia’s gradual shift from the leading positions at the world energy market. Another alarming issue is the environmental problem that can arise if oilfield service companies and transportation operators fail to properly renovate their assets and equipment. This scenario does not seem unlikely in the face of limited funding and a blocked flow of technology to the Russian hydrocarbon companies.

The broader long-term consequences for the Russian economy are hard to calculate – it depends on too much factors among which Russian domestic economic course, conjuncture of world markets, technological trends and their speed, the next US administration course and a number of other developments, but the serious deviations from the business as usual scenario are already inevitable.