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Western Sanctions on Russian Hydrocarbons: Twofold Effects by A.V. Belyi

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Western Sanctions on Russian Hydrocarbons: Twofold Effects

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Introduction

February 2017 - The present text represents an update of my earlier analysis published in OGEL in 2014. The situation surrounding sanctions gained political interest, and additional complexities and opacities developed in regards to the business relations. The latest developments, including the Glencore's purchase of Rosneft's assets, prove that sanctions have not produced a uniform vision in the west - harmful effects on Russian oil and gas seem to persist.

In the globalised and highly interdependent world of today, any economic restrictions engender multifaceted effects. Societal and economic contexts become key factors leading to either the success or failure of sanctions deployed as diplomatic tools. For instance, import restrictions lead to the desired domestic transformation in South Africa earlier in twentieth century.[1] However, in many other cases such as those of Cuba, Iraq and Iran, sanctions co-existed over a period of time with the political stances of antagonizing states. Political tensions with the most industrialised countries often constituted an excuse for domestic economic difficulties.[2] Indirect effects of sanctions on economic flows have also been observed. Among others, direct economic restrictions on investment and trade frequently amplified transactions via some third states.[3] This leads to rising costs of sanctions and the ultimate reshaping of economic benefits from international economic activities. One of the most famous commodity traders and Glencore founder Mark Rich used sanctions on South Africa and Iran to promote commodity trade deals operated from Switzerland.

Political and economic contexts have thus been shown to strongly influence the effects of sanctions in each case. Against this background we should understand the complexities surrounding the current sanctions imposed by the EU and the US on Russia. To summarise, both the EU and the US addressed specific restrictions on financial flows and specific technologies. The most notable of these, Rosneft and Novatek, as well as to the leading Russian banks (Gazprombank, Sberbank and VEB) were listed among the targets. Financial sanctions aim at forbidding physical or legal persons from providing new long term financing for the sanctioned companies. Shorter term loans of 30 or 90 days are allowed but often engender unfavourable interest rates for the borrowers.[4] The US list is longer as it includes more Russian firms (e.g. Gazprom, Lukoil, and Surgutneftegaz),[5] while the EU adopted a

[1] P., Levy, "Sanctions On South Africa: what did they do?", Centre Discussion Paper 796, University of Yale, 1999

[2] see Petersen, S., "Iran's Deteriorating Economy: An Analysis of the Economic Impact of Western Sanctions", *International Affairs Review*, online journal, available on URL: http://www.iar-gwu.org/node/428

[3] N. Babat and B. Ro Kwon, "When Are Sanctions Effective? A Bargaining and Enforcement Framework", *International Organization*, Vol 69 (1): 131-162

[4] A summary of US sanctions can be read in Forbes, September 2014, available on URL: http://www.forbes.com/sites/francescoppola/2014/07/18/u-s-sanctions-on-russia-are-financial-warfare/#1f2d88c37934

[5] See US Treasury, available on URL: https://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20140912.aspx

softer approach.[6] In addition, sectorial sanctions imposed by the US on some oil and gas technologies have led to consequential effects upstream, especially in the Arctic seas operations. Despite the differences, the common western stance towards Moscow consists of changing Russia's recent policy approach towards Ukraine.

The targeted sanctions on Russia occurred *grosso modo* during domestic politico−economic transformations in the west. In many developed countries, societies currently live in a changing paradigm—market relations are often significantly impacted by a two-decade long economic stagnation, leading to difficulties in generating financial growth.[7] In this context, sanctions on Russia generate additional costs and concerns and thus provoke political debates domestically in some European countries and in the US.

Still, it would be misleading to suggest that sanctions do not produce any harmful effect on Russia's energy structures and development. Contrary to several political claims at Russia's domestic level,[8] consequences from economic restrictions on finance, technology and general business strategy constitute serious obstacles for the Russian hydrocarbon industry. To allow for a comprehensive overview of the situation, the effects of sanctions should be classified and assessed. A two-way impact may also be revealed: sanctions on Russia have obviously provoked significant political debate in the west.

1. Direct effects on financial flows

Restrictions on direct financial transactions arises as one of the most prominent challenges faced by the Russian economy. When contrasted with the pre-sanction period, a continuous decline in Gross Domestic Product's growth rate can be observed;

Year	Growth rate
Jan. 13	0.55
Jul. 13	0.42
Jan. 14	0.35
Jul. 14	-0,64
Jan. 15	-1,16
Jun. 15	-1,31
Jan. 16	-0,57

Source: Central Bank of Russia

In addition, Central Bank interest rates have increased and the value of Russian currency has halved from its pre-sanctions levels. The macro-economic figures reflect hurdles faced by financial and hydrocarbon sectors affected by the imposed sanctions. Most of Russian companies historically increased their over-reliance on western loans. The total corporate

[6] For a detailed legal analysis of sanctions and a comprehensive target list see Shearman & Sterling LLP, *Russia Sanctions: Impact on Financial Institutions in the US, EU and Japan*, Report of 25 April 2014

[7] A. Belyi and K. Talus, *States and Markets in Hydrocarbon Sectors* (London: Palgrave Macmillan, 2015)

[8] See Izvestia, 14.07.2014 available on URL: http://izvestia.ru/news/573960 and RIA Novosti, 12.10.2016 available on URL: https://ria.ru/world/20150623/1081984568.html

debt of Russian companies towards international banks is one of the world largest.[9] Credit has accelerated particularly since the early 2000s, when Russian oil and gas companies increased in terms of capitalization, investment activities and overseas operations. State owned Gazprom and Rosneft topped most of the hydrocarbon companies in terms of investment commitments. Subsequently, in the aftermath of sanctions, Russia's state-owned hydrocarbon companies experienced difficulties from the very beginning of the political troubles between Russia and the west - Rosneft was forced to renounce its ambitious target to increase oil production by 25% by 2020. The Russian government had initially aimed to privatise part of Rosneft in an attempt to fill some budgetary holes. Furthermore, a planned partial privatization of Rosneft has been postponed as a result of the low share price until a more optimistic period. This postponement provoked further difficulties in meeting budget obligations, between 10 and 20 billion dollars. Spring 2016 saw the suggestion of a partial privatization of Rosneft to mitigate financial troubles,[10] although subsequent tensions surrounding the Minister of Economy's arrest might further cast a shadow on the privatization plans. *Ceteris paribus*, a lack of possibilities to attract further credits in Europe and the US lead to Rosneft strengthening its ties with China. Subsequently, China's oil company CNPC obtained 20% of shares in Rosneft's Vankorskoe gas field in Eastern Siberia. Through this, China becomes both the investor and the buyer of Rosneft's crude oil and blue fuel commodities, which makes the negotiation positions of the latter difficult in leverage.

In this context, a surprising allocation of a stake of 19.5% in Rosneft's to the Swiss Glencore in December 2016 could be considered a face-saving event. Glencore has now became the main trader of Rosneft oil and its stakeholder interest is rather evident. However, this particular investment deal has been financed by Russian banks allowing the Central Bank to generate additional cash without creating inflationary spirals[11]. Glencore paid a marginal amount of USD 300 million for its acquisition of the Russia's giant shares. Qatar Investment Authority and an undisclosed firm registered in Cayman Islands are also participants in the new shareholder agreement dividing the 19,5% of the privatized Rosneft stakes. In addition, Qatar Investment Authority is one of the largest shareholders in Glencore itself. Thus, the deal demonstrates a difficulty to track financial flows and cross-ownerships[12]. In this context, one would guess that Rosneft has been able to get access to loans via its official annual bond offering outside the western financial structures and with a persistent opacity on the bonds' buyers.

Another company experiencing hurdles from financial market restrictions is privately-owned (albeit connected to Russia's political elite) Novatek. The company succeeds the independent gas producer Novafininvest, and has been famous for its liquefied natural gas (LNG) project in Yamal Peninsula. China's CNPC and the French Total are shareholders of the massive project of 20 million tons per annum of production capacity in the Kara Sea in the Arctic. To avoid significant delays in implementing the project, the State Reserve Fund[13] allocated USD

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[9] for more precise data, see Central Bank of Russia available on URL: www.cbr.ru; the evolution of the debt can be also observed in Trading Economics, available on URL: http://www.tradingeconomics.com/russia/external-debt

[10] Bloomberg, 19.06.2016, available on URL: http://www.bloomberg.com/news/articles/2016-06-19/putin-said-to-weigh-11-billion-rosneft-sale-to-china-and-india

[11] Kazakova, N., "Rosneft share deal more than meets the eye", *TradingFloor,* 21 December 2016, available on URL: https://www.tradingfloor.com/posts/rosneft-share-deal-more-than-meets-the-eye-8338358

[12] for details on the deal, see Reuters, 25.01.2017, available on URL: http://www.reuters.com/article/us-russia-rosneft-privatisation-insight-idUSKBN1582OH

[13] Sidorova, Y., "Oil Reserve Fund", in Encyclopeadia on Energy and Mineral Policies, Springer Publisher, available on URL: http://link.springer.com/referenceworkentry/10.1007/978-3-642-40871-7_118-1

50 billion to enable continuation. The Chinese bank agreed to allocate up to USD 10 billion to the project, after China cautiously considered any risks of confronting western legal penalties.[14]

Financial restrictions also concern major banks, including Gazprombank, VEB and Sberbank. However, their situation appeared to be less dramatic than the one initially projected by the expert community. Diversified domestic portfolios and a sharp devaluation of the domestic currency eased the balances. Added to that, financial flows from the west to Russia were redirected via third countries including Dubai, Hong Kong and Turkey. The latter contains Sberbank-owned bank Deniz which became one of the contact points for the Russian credit recipients. Its strategic position was not questioned by Ankara even during the Russia-Turkey crisis of late 2015-early 2016, although Sberbank attempted to negotiate a take-over of Deniz in June 2016[15]. This policy approach might demonstrate an eagerness of third countries (Turkey in this case) to benefit from the restrictions of direct transactions between the western and Russian economic undertakings.

In turn, a large market for profitable loans constitutes a crucial component for European banks, considering their current crisis in cash flows. The structure of loans reveals that French and German financial institutions have been the main creditors to Russian banks and state-owned energy companies. In retrospect, it could be noted that sanctions on Russia represent one of the core divisive factors in the domestic politics of both France and Germany.

2. Direct Effect on Access to Technologies

Unlike financial flows which are difficult to control, technology-related sanctions constituted a more serious barrier for Russia’s oil and gas development. Most of the upstream oil production technologies are patented in the US and therefore restrictions imposed by the State Department are relevant. Software programs used in oil and gas exploration (especially in deep water areas) are predominantly either EU or US-based technologies which remain vital for the industry. Since any technologies related to either deep water hydrocarbon exploration or to the Arctic sea specific oil and gas development were added to the banned list, Russian undertakings were forced to revise their ongoing plans. Additionally, the use of any software technology licensed to Russia for hydrocarbon fields development may be also be forbidden.

There are no direct links between sanctions on the existing oil extraction and exports. Russian oil production growth rates kept a positive dynamic, with a new record level of 11 billion barrels extracted in 2016. Nonetheless, a development of Greenfields remained slow, with the oil price staying below USD 60 per barrel. In addition, oil-indexed gas markets lost their attraction for exporters. Instead, Asian buyers of the blue fuel felt more confident with a price decline and gas glut in the market. In this context, Gazprom appeared unsuccessful in

[14] LNG World, 21.04.2016, available on URL: https://www.lngworldnews.com/report-chinese-banks-to-put-up-10-bln-for-yamal-lng/
[15] Reuters, 15 June 2016, available on URL : http://www.reuters.com/article/russia-sberbank-denizbank-idUSL8N19643A

securing a west-to-east export reorientation[16]. An example of the effects of the sanctions are seen in the pipeline projects in China's destination, agreed in 2014 but stalled since.

However, technology-related sanctions create a significant delay on any deep-water drilling projects and particularly affect Arctic sea hydrocarbon development. In the aftermath of the second wave of sanctions of July 2014, the Rosneft-ExxonMobil project in Arctic Kara Sea had to be delayed mostly because of the related technology bans[17]. ExxonMobil subsequently lobbied for a sanctions relief, however the efforts were rebuffed by the Democrat Administration of Barak Obama. Later, ExxonMobil as well as most of the US oil industry backed the Republican Party against the Democrats during the 2016 elections. However, one should not over-estimate a link, with Donald Trump and the US oil industry on the one hand, and Russia on the other. U.S. political and business interests may still diverge from Russian ones, the interest is in doing business *in* Russia rather than *with* Russia. In addition, the more reluctant approach to foreign policy of some Republican members may even further contribute to an escalation of relations with the Kremlin. The effects of Donald Trump's Presidency on Russia and sanctions remains to be seen. For instance, newly nominated Secretary of State, Rex Tillerson, former ExxonMobil CEO, reiterated a need of continuing sanctions policy tools towards Russia.[18]

A difficulty of controlling technology-related business transactions has also occurred. A questionable situation emerged with one of the leading oil service providers, Schlumberger, who decided to purchase a non-sanctioned Eurasia Drilling Group based in London but related to Rosneft's ownership.[19] Through this purchase, the large American energy service company did not formally violate the sanctions-related regulations, but still emerged in the market for technology supply. The deal was not sealed, and Eurasia Drilling Group is now delisted from the London Stock Exchange.

Overall, the direct effects of access to technologies did not create a widespread crisis in Russia's oil and gas sector in the short term. If sanctions on technologies are maintained, their long term effect might turn into a slowing down of new liquefaction and shale production technologies. Instead, even if successful, the Schlumberger deal would have remained an exception to the rule, whereas a number of projects, even operated by privately owned non-sanctioned companies, have been put on hold.

3. Long Term Indirect Effects

Arguably the long-term effects from sanctions may be most difficult to predict and to compute. This is as a result of their focus on a more long-term investment orientation and Western companies' cooperation with Russian industries. Among the most notorious examples is a development in the Russian LNG investments. US officials mentioned the possible inclusion of gas refrigeration technologies into the sanctions lists. US-based APCI technology remains the most widespread in the fast growing liquefied industry. If its

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[16] Belyi, A., "Russia's gas export reorientation from West to East: economic and political considerations", *Journal of World Energy Law and Business,* 2015, 8 (1): 76-86

[17] Bloomberg, 01.12.2014, available on URL: http://www.bloomberg.com/news/articles/2014-12-01/exxon-rosneft-scrap-arctic-contracts-as-russia-sanctions-bite

[18] See Platts, 03.02.2017, available on URL: http://www.platts.com/latest-news/oil/washington/fact-box-global-energy-implications-of-tillerson-21766883

[19] Financial Post, 20.01.2015 available on URL: http://business.financialpost.com/news/energy/schlumberger-bets-on-russian-oil-with-us1-7b-stake-in-eurasia-drilling?__lsa=1ffb-b02c

application becomes effective, then a joint LNG export plant operated by Rosneft and ExxonMobil in Sakhalin may be permanently stalled. Further expansion of sanctions to the liquefied industry may affect access to more modern and cost effective methods to refrigerate natural gas. Among others, American producers use ammonia-based refrigeration profitable for small-scale LNG production and transport. If applied, then Russian LNG producers may lag further behind international progress in the sector.

In addition, restrictions of access to technologies could provide US suppliers with access to European markets competing with Russian counterparts. In the meantime, international majors become increasingly keen to involve themselves with Russian companies in the development of LNG. Among illustrative examples, Gazprom regularly concluded Memoranda of Understanding with Royal Dutch Shell to build between 10 and 15 MTPA of liquefaction capacity in Ust Luga on the Russia's Baltic coast.[20] Gazprom also recently obtained a preliminary agreement to export liquefied natural gas to Belgian gas pipeline company, Fluxys, to export the product once the production plant becomes effective. Nevertheless, significant delays in the implementation of the agreements are indirectly affected by the sanctions. Gazprom's international partners are kept in "waiting mode" regarding political developments and therefore prefer not to concretise their commitments. The recent withdrawal of the chemical producer East Group from Ust Luga demonstrates a lukewarm reception for the refrigeration industry in the location.

It could be then argued that other Gazprom projects, including the controversial Nord Stream 2, could be subject to indirect effects from sanctions.[21] Although pipelines are not included in the sanctions regime, the political distrust negatively affects new export projects coming from Russia. Various European companies see the project as a path to sustain relations with Gazprom. Considering the mismatch with the political position expressed by Brussels and most of European capitals, subsequent pressure on easing sanctions on Russia could occur in domestic political interrelations of major European states. Western countries could grow extensively wary of the expansion of sanctions in both LNG and gas pipeline business, hence aversion to new deals with Russian companies remains high.

4. Conclusion

Consideration of sanctions and their multiple effects, usually beyond the initial objective, remains highly important. Each case of sanctions and their multifaceted consequences is particular and dependent upon the specific context of international and domestic politics. In the afore-mentioned case, sanctions against Russia have been addressed during important economic and political transformations in the US and Europe. Thus, the impacts have also been significant in domestic policy discussion, particularly in France, Germany and the US. Paradoxically, international business actors pressure their domestic political structures to ease relations with a country where political structures overwhelmingly dominate business relations. Their main concern consists of avoiding the reshaping of financial flows and business alliances. Instead, the complexity of international financial flows demonstrate a difficulty to track ownership of funds and shares especially outside the western financial structures. At the same time, the long-term effects of sanctions on Russia might result in a

[20] See Gazprom information on Baltic LNG, available on URL: http://www.gazprom.com/about/production/projects/lng/baltic-lng/

[21] See a discussion published at Centre for Global Interest, *Commercial Project or Geopolitical Threat,* June 17 2016, available at URL: , http://www.globalinterests.org/2016/06/17/nord-stream-2-commercial-project-or-geopolitical-threat/

serious leverage loss characterised by lagging behind in technological advances and persistent financial difficulties.