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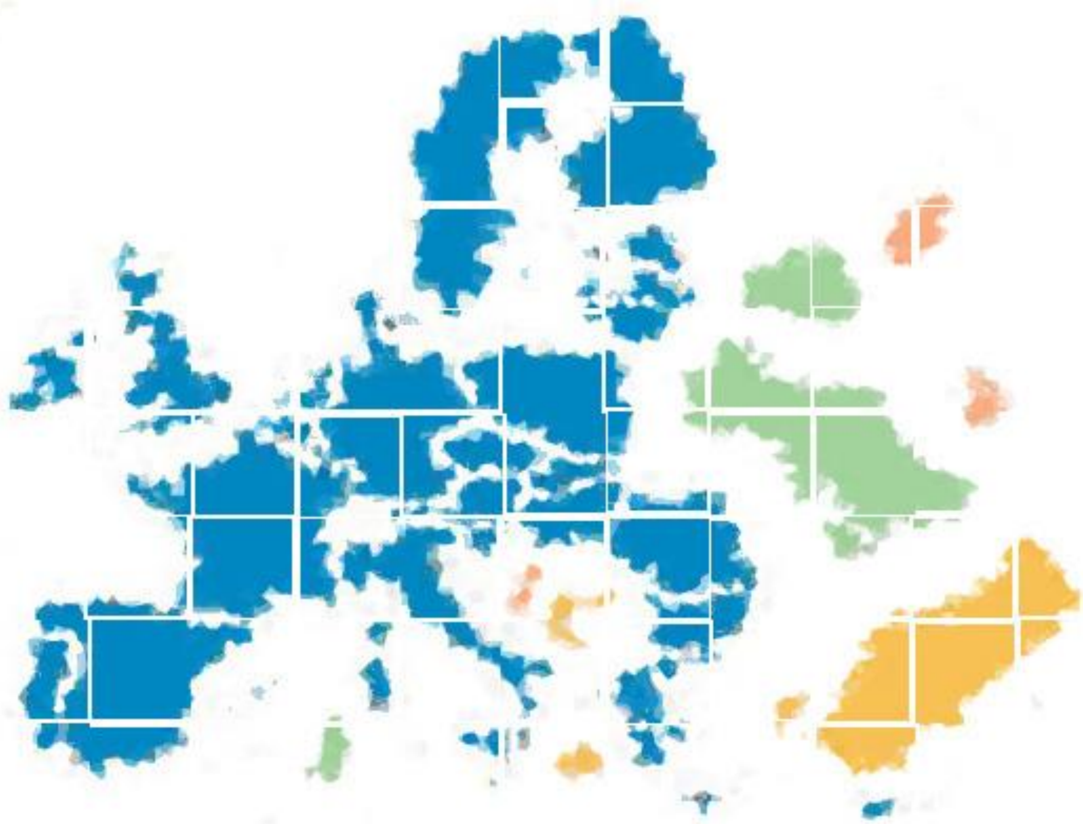
The Two-Way Street Effect of Sanctions

Challenges for the oil and gas business and political pressures

Andrei Belyi



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The Two-Way Street Effect of Sanctions
Challenges for the oil and gas business and political pressures

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In the globalised and highly interdependent world, any economic restrictions engender multifaceted effects. Societal and economic contexts become the key factors leading either to success or failure of using sanctions as a diplomatic tool. For instance, import restrictions stimulated a desired domestic transformation in South Africa earlier in twentieth century.[1] By contrast, in many other cases, comprising Cuba, Iraq and Iran, sanctions long time co-existed with the political stances of antagonizing states. Even more, political tensions with the most industrialised countries oftentimes 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 to reshaping the economic benefits from international economic activities. Quite curiously, one of the most famous commodity traders and Glencore founder Mark Rich used sanctions on South Africa and on Iran to promote short-term oil deals operated from Switzerland.

Thus, political and economic contexts influence significantly the effects of sanctions in each particular situation. On these grounds and considerations, we should understand complexities surrounding the current sanctions imposed by the EU and the US on Russia. For a brief background, both the EU and the US addressed specific restrictions on financial flows and specific technologies. Notably, Rosneft and Novatek, as well as to the leading Russian banks (Gazprombank, Sberbank and VEB) were listed among the targets. Sanctions regulation forbids physical or legal person from providing new long term financing of over than 30 days period. Shorter term loans are allowed but with obviously higher interest rates.[4] The US list is longer as it comprises

[1] Levy, P., "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

more Russian firms (eg. Gazprom, Lukoil, and Surgutneftegaz),[5] while the EU adopted a softer approach.[6] Despite the differences, the common western stance towards Moscow consists in 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 a changing paradigm of states—market relations, significantly provoked by a two-decade long economic stagnation, and difficulties in generating significant financial growth.[7] In this context, sanctions on Russia generate additional costs and concerns and thus provoke political debates domestically in some European states and in the US.

Still, it would be misleading to stipulate that sanctions do not produce any harmful effect on Russia's energy structures and development. Contrary to a number of political claims at Russia's domestic level,[8] consequences from economic restrictions on finance, technology and, even more, on general business strategy, constitute a serious pitfall for the Russian hydrocarbon industry still aspired for globalisation. In order to have a more comprehensive look at the situation, effects of sanctions should be classified and then possible ways of mitigating sanctions effects in each particular classified category may be briefly assessed. In turn, a two-ways street impact may also be revealed: sanctions on Russia have provoked significant political debate in the west.

Direct effects on financial flows

An imposition of restrictions on direct financial transactions constitute a significant challenge for Russian economy. The core difficulty for the Russian sanctioned companies consists in their over-reliance on western loans. The total corporate debt of Russian companies towards international banks is one of the world largest.[9] Credits 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

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

[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

[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

beginning of the political troubles between Russia and the west. More particularly, Rosneft renounced to its ambitious target to increase oil production by 25% by 2020. Noteworthy, the Russian government aimed at privatizing part of Rosneft in order to fill some budgetary holes. Even more, a planned partial privatization of Rosneft has been postponed till better times because of the low share price. The postponement provoked further difficulties in meeting budget obligations would be between 10 and 20 billion dollars. Even later, in spring 2016, a partial privatization of Rosneft was put on the table to mitigate financial troubles of the budget,[10] although current tensions surrounding Minister of Economy 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 leads Rosneft to tighten ties with China. Subsequently, China's oil company CNPC obtained 20% of shares in Rosneft's Vankorskoe gas field in Eastern Siberia. Subsequently, 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 very difficult in leverage.

Another company experiencing hurdles from financial market restrictions is privately-owned (albeit connected to Russia's political elite) Novatek. The company succeeding an independent gas producer Novafininvest 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 Arctic. In order to avoid significant delays in project implementation, the State Reserve Fund[11] allocated USD 50 billion to enable the continuation of its implementation. Chinese bank agreed to allocate up to USD 10 billion to the project, after China cautiously considered any risks of confronting western legal penalties.[12]

Financial restrictions also concern major banks, comprising Gazprombank, VEB and Sberbank. However, their situation appeared to be less dramatic than the one initially projected by expert community. Diversified domestic portfolios and a sharp devaluation of the domestic currency eased the balances. Adding 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 Russia-Turkey crisis of late 2015-early 2016. This policy approach might then 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.

[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] 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
[12] LNG World, 21.04.2016, available on URL: https://www.lngworldnews.com/report-chinese-banks-to-put-up-10-bln-for-yamal-lng/

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. Without pretending to determinist assumptions, it could be noted that sanctions on Russia represent one of the core divisive factor in the domestic politics in both France and Germany.

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. Among others, most of the upstream oil production technologies are patented in the US and therefore restrictions imposed by the State Department may not be ignored. Most often, software programmes used in oil and gas exploration (especially in deep water areas) are 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 ban list, Russian undertakings were forced to revise their ongoing plans. Adding to that, any software technology licensed to Russia for unclear purposes may be also be forbidden to use. Consequences for Russian oil and gas projects have been important especially for new sophisticated areas of development. Right in the aftermath of the second wave of sanctions of July 2014, Rosneft-ExxonMobil project in Arctic Kara Sea had to be delayed mostly because of the related technology bans[13]. ExxonMobil then subsequently lobbied for a sanctions relief, however the efforts were then rebuffed by Democrat Administration of Barak Obama. Later on, ExxonMobil as well as most of the US oil industry backed Republican Party against Democrats during the 2016 elections. However, one should not over-estimate a link between Donald Trump and US oil industry on one hand and Russia on the other. US political and business interest may still diverge from the Russian ones, the interest is in doing business *in* Russia rather than *with* Russia. Adding to that, a more reluctant approach to foreign policy of some Republican members may even further contribute to an escalation of relations with Kremlin. Thus, effects of Donald Trump election on Russia and sanctions remain to be seen.

A difficulty of controlling technology-related business transactions also occurred. An interesting situation emerged with one of the leading oil service provider Schlumberger, who decided to purchase a non-sanctioned Eurasia Group based in London but related to Rosneft ownership.[14] This way, the large American energy service company did not formally violate the

[13] 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
[14]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

sanctions-related regulations, but still emerged in the market for technology supply. 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 run. If sanctions on technologies are now maintained, their long term effect might turn into a slowing down of new liquefaction and shale production technologies. Instead, Schlumberger deal rather remains an exception to the rule, whereas a number of projects, even operated by privately owned non-sanctioned companies, have been put on hold.

Long term indirect effects

It could be argued that the long term effects from sanctions may be most difficult to predict and to compute. These are related to more long term investment orientation and Western companies' cooperation with Russian industries. Among the most notorious examples we may see a development in the Russian LNG investments. In fact, the US officials oftentimes mentioned a 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 their application becomes effective, then a joint LNG export plant operated by Rosneft and ExxonMobil in Sakhalin might certainly be stalled for good. Further expansion of sanctions to the liquefied industry may affect an access to more modern and cost effective methods to refrigerate the 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 take a further step behind the international progress in the sector.

Even more, restrictions of access to technologies could ease US suppliers an access to European markets competing with Russian counterparts. However, this hypothesis needs to be still verified as Europe does not represent the favoured destination for US gas suppliers. Even more indirectly, international majors become increasingly perplex to involve themselves with Russian counterparts in the development of LNG. Among the illustrative examples, Gazprom regularly concluded Memorandums 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.[15] In addition, Gazprom 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 effected by the sanctions. Gazprom's international partners are kept in "waiting mode" regarding political developments and therefore prefer not to concretise their commitments. Recent withdrawal of the chemical producer East Group from Ust Luga rather demonstrates a lukewarm perspective for the refrigeration

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

industry in the location. It could be then argued that other Gazprom projects, including the controversial Nord Stream 2 could be subject of indirect sanctions effect. [16] Here again, some European companies see the project as a path to sustain relations with Gazprom. Considering a mismatch with the political position expressed by Brussels and most of European capitals, a subsequent pressure on easing sanctions on Russia could then further occur in domestic political interrelations of major European states.

Conclusion

It remains important to consider sanctions effects in multiple way and usually beyond the initial objective set by the use of economics in diplomatic purposes. Each case of sanctions and their multifaceted consequences is particular and dependent upon 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 impact have also been significant in the domestic policy discussion, particularly in France, Germany and the US. Paradoxically enough, international business actors pressure their domestic political structures on easing relations with a country where political structures overwhelmingly dominate business relations. Their main concern consists to avoid reshaping financial flows and business alliances. At the same time, long-term effects of sanctions on Russia might result in a serious leverage loss characterised by a technological lagging and persisting financial difficulties.

[16] 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/

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