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US-Russia Policy Hits European Energy Supply

The Consequences of Unilateral Sanctions and Growing Market Competition

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Triggered by Russia's annexation of Crimea and military intervention in Ukraine in early 2014, the governments of the United States (US) and the Russian Federation have since been locked in a geopolitical confrontation, which is largely playing out on the economic stage. In addition to unilateral economic sanctions, the US government is focussing on the export of liquefied natural gas (LNG). In doing so, it wants to reduce not only Russian state revenues, but also European dependence on Russian energy imports. In this context, the US policy is aimed squarely at the German federal government, which was described by President Donald J. Trump as a "prisoner of Russia". The more the European-Russian energy trade is drawn into the conflict between Washington and Moscow, the more serious the consequences are likely to be for European energy supply.

The increased use of economic instruments of power in US policy towards Russia is negatively affecting European and German interests. The current discussion on the Nord Stream 2 pipeline, which is currently under construction, has lost sight of the fact that this sanctions policy has a considerable impact on energy relations between Europe and Russia. This project has not only been criticised in the European Union and Germany, but in Washington too. The US government is exploring ways and means to stop this project from being completed.

Back in the 1960s and 1980s, US administrations were trying to prevent the construction of Russian pipelines running through Ukraine today with a mix of incentives and pressure on their European allies. Since 2015, the Nord Stream 2 project, with its high political costs (see SWP Research Paper 3/2017), has presented the German government with the dilemma of how to reconcile legal principles, economic interests as well as foreign and European policy paradigms. At the same time, US sanctions severely restrict the ability of Germany and Europe to take autonomous action. This not only threatens EU cohesion on energy policy but also energy security in terms of providing a competitive, stable and flexible supply on demand.

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Unilateral Sanctions as a Tool of US Russia Policy

Even during the Cold War, the US government relied primarily on unilateral economic sanctions to weaken the Soviet leadership in this conflict of systems. This sanctions policy started out as a strict unilateral export control regime for dual-use and military goods which, in coordination with the Western allies, eventually became a multilateral embargo. Washington also denied the Soviet Union and its successor, the Russian Federation, Most Favoured Nation status in bilateral trade relations between 1951 and 1992. Once the Cold War was over, the US government imposed unilateral sanctions on the now Russian defence firms for their exports to Iran, thereby excluding them selectively and temporarily from the US market. Since the end of 2012, the US government has refused to issue visas to Russian officials accused of human rights abuses and corruption and has frozen their assets where they are under US jurisdiction.

The US government imposed far more extensive sanctions in March 2014 in response to the incorporation of the Black Sea peninsula of Crimea into the Russian Federation in contravention of international law, as well as to Moscow's destabilisation policy in eastern Ukraine. Initially, the US Departments of Commerce and State tightened export controls on dual-use and military goods, technology and services. At the same time, the Office of Foreign Assets Control (OFAC) within the US Department of the Treasury began listing Russian individuals and entities belonging to President Vladimir Putin's inner circle as Specially Designated Nationals (SDNs) and Blocked Persons. This measure allows any assets they own under US jurisdiction to be frozen. In addition, US persons are prohibited from entering into business relationships with those listed as SDNs. The prohibition is enforced under civil and criminal law and extends to entities that are more than 50 percent owned or controlled by listed Russian individuals or entities.

The reasons for being listed as an SDN are set out in four Executive Orders (E.O.) issued by President Obama between March and December 2014, and codified into law by Congress in August 2017. These include "asserting government authority over the Crimean region without the authorisation of the Ukrainian government, undermining democratic processes or institutions in Ukraine and threatening the peace, security, stability, sovereignty or territorial integrity of Ukraine; and also misappropriating the state assets of Ukraine or of an economically significant entity in Ukraine" (E.O. 13,660). High-ranking members of the Russian government and their supporters (particularly the so-called oligarchs), but also persons active in the Russian defence sector (E.O. 13,661; 13,662) or trading and investing in Crimea (E.O. 13,685) can also be listed as SDNs.

The more than 30 unilateral US sanctions regimes that address, inter alia, the proliferation of weapons of mass destruction, transnational crime and a series of state and non-state actors have repeatedly targeted Russian individuals, organisations and institutions. Current listings were based on Russian activities in relation to certain states such as Syria, Iran and North Korea, as well as in connection with alleged cyber attacks and meddling in the 2016 US presidential election campaign. Once the US Department of State had determined that the Kremlin was involved in the poisoning of former Russian intelligence officer Sergei Skripal in the UK, Washington imposed further trade sanctions on Russia, the first wave of which came into force in August 2018.

Consideration for European interests under Obama

President Barack H. Obama proceeded cautiously in imposing unilateral US sanctions against one of the world's largest energy exporters. Giving consideration to European allies' considerable energy imports from Russia, his administration did not target the ongoing production and exports of Russian

oil and natural gas. Instead, its punitive sanctions focused on the long-term development and exploitation of oil reserves in the Arctic and of shale oil. These steps were taken in close consultation with the Europeans who, in turn, coordinated their unilateral sanctions with Washington.

From July 2014, the Obama administration issued new measures, known as sectoral sanctions, which were specifically designed to raise the costs of long-term development of the Russian energy sector. Pursuant to E.O. 13,662, the OFAC then began to place Russian companies in the finance, defence and energy sectors on the Sectoral Sanctions Identification (SSI) list. Once the list had been published, new financing provided from US persons to those listed on it were restricted as follows: the current maturity of new debt or equity may not exceed 14 days for listed Russian financial institution (Directive 1), no more than 60 days for Russian energy companies (Directive 2) and no more than 30 days for Russian defence firms (Directive 3). Furthermore, US persons are prohibited from participating in the exploration and production of oil in Arctic, deep-sea and shale formations (Directive 4). Unlike persons listed as SDN, those placed on the SSI list are free to dispose of their assets under US jurisdiction and US persons may also continue to enter into any other transaction with them.

Targeting European-Russian energy trade

In August 2017, a bipartisan majority in Congress broadened existing sanctions against Russia in response to the Russian government's intervention in the Syrian civil war from September 2015, to Kremlin-controlled cyberattacks against US authorities and companies, and to evidence of Moscow's interference in the 2016 US presidential campaign. The *Countering America's Adversaries Through Sanctions Act of 2017* (CAATSA), which was also directed at Iran and North Korea, was passed against the explicit will of President Trump. The CAATSA curtailed presidential authority to ease primary sanctions imposed under the four executive orders. Furthermore, the statute required the administration to tighten both primary and secondary sanctions. The latter are not directed against US persons, but make certain activities by non-US persons 'sanctionable'. In doing so, Congress created the legal prerequisites for being able to impose even more stringent unilateral sanctions as a potentially powerful tool within a US Russia policy aimed at economic containment. If secondary sanctions were to be imposed, they would specifically target Russian energy exports.

The *Ukraine Freedom Support Act of 2014* (UFSA), amended by section 225 of the CAATSA, authorises the President to exclude those foreign persons from the vital US financial market who make "significant" investments in certain oil projects or financial institutions participating in "significant" transactions for those projects or for Russian SDNs. The UFSA now also mandates the adoption of primary sanctions against Gazprom by prohibiting any medium to long-term investment by US persons. However, these measures will not enter into force until the US administration determines that the company has been shown to have withheld significant quantities of natural gas supplies from Ukraine, Georgia, Moldova or NATO allies for political reasons.

Section 232 of the CAATSA is potentially the most serious for European energy supply. This is because it enables the President to impose secondary sanctions on non-US persons involved in the construction, modernization or repair of energy export pipelines if a single investment exceeds one million US dollars or if more than five million US dollars are invested within twelve months — a magnitude quickly achieved with capital investment in the energy sector. The list of pipelines potentially affected by this type of sanction not only includes the existing Nord Stream pipeline through the Baltic Sea, but also Blue Stream and Turkish Stream, both of which pass through the Black Sea to Turkey, as well as the politically controversial Nord Stream 2 gas pipeline. In addition, the provisions contained

in section 232 may also apply to pipelines passing through Belarus and Poland, or, paradoxically, even through Ukraine. The sanctions could also target LNG export terminal supplies to Europe and Asia.

Although the US State Department made it clear in late October 2017 that pipeline projects initiated before 2 August 2017, including any investments made so far, would not be affected by possible secondary sanctions under section 235, the US administration is free to amend the guidance at any time.

In any case, Nord Stream 2 has drawn condemnation from many sides. Since a Russian-European consortium decided to build the pipeline in the summer of 2015, the project has been criticised across party lines in the US, the EU and Germany. The German government took the view early on that this was a commercial project and would, therefore, be subject only to German law and was not a matter for EU regulation. This position has prompted a phalanx of opponents in Washington, Brussels and Warsaw to exploit legal remedies and political pressure to bring down the project. US sanctions could become part of the countermeasures.

Overall, the adoption of the CAATSA testified to the erosion of consensus on both sides of the Atlantic as to how to respond to Russian aggression. At congressional hearings in late summer 2018, members complained about the limited impact of the use of US unilateral sanctions imposed in close consultation with the EU, and criticised what they perceived to be a too lax implementation and enforcement by the Trump administration. After the Democrats have taken over the House of Representatives, the existing sanctions could soon be further tightened and extended. Events in the Kerch Strait in late November 2018 have provided new arguments for such a course of action. In fact, several bills are circulating in Congress, some of which provide for listing more Russian companies as SDNs. The resounding impact of such a move was evident in April 2018 when aluminium prices skyrocketed following the listing of Rusal, the world's second-largest aluminium producer. If the *Defending American Security from Kremlin Aggression Act of 2018* were adopted in the US Senate, an even greater number of energy projects could be threatened by US sanctions.

Economic Impact

Since the current US sanctions are designed to complicate future oil and gas exploration and extraction for Russian companies, their impact on Russia's current oil and natural gas production and energy exports has so far been rather minimal. However, they have dissuaded companies from investing in expensive projects and developing new large deposits, instead encouraging them to concentrate on boosting production from previously developed fields and re-opening small fields. As a result, current production and exports of crude oil and natural gas increased despite the sanctions.

The Yamal project, led by the Russian energy group Novatek and costing 27 billion US dollars, extracts natural gas, transforms it into LNG and then exports it via the Arctic port of Sabetta in the east of the Yamal peninsula. Novatek, the China National Petroleum Corporation, the Silk Road Fund and French company Total are all involved in this project. The project was launched at the end of 2013 and began exporting in 2017. It has an annual capacity of 16.5 million tonnes of LNG. In January 2018, it even supplied the US city of Everett in Massachusetts, demonstrating the competitiveness of Russian LNG. Despite the current sanctions against participants in the Russian project, the sale could legally be brokered by a French dealer and shipped on a French tanker.

Among the projects that are directly affected by the US sanctions is one in the Kara Sea initiated by Russian company Rosneft in conjunction with US company Exxon, a project in the Barents Sea with Italian company ENI and another in the Black Sea with Exxon and ENI. In addition,

the British-Dutch company Shell withdrew from the offshore production of natural gas on Sakhalin after the US Department of Commerce classified the enterprise as an oil production project. Overall, the impact of the sanctions on Russia's energy industry was far less significant than the halving of the oil price between mid-2014 and the end of 2016, which was followed by a sluggish recovery in 2017 and 2018. However, the impact of the oil price decline on the energy industry was largely mitigated by the devaluation of the ruble, as this reduced company losses.

Yet, it is uncertain whether Russia will be able to continue exporting the same volumes of oil and gas in the future. Hydraulic fracturing is considered an indispensable technology for keeping Russia's oil production at a stable level in the longer term. This technology is needed both for current brownfields and for the development of new non-conventional deposits. US sanctions on hydraulic fracturing and non-conventional production mainly affected joint ventures involving Shell and French firm Total (Bazhenov Formation in Western Siberia), but also Exxon.

The longer US sanctions persist, the faster and greater the decline in Russian oil production could be. The respective investment cycles are at least five to seven years, but more likely, depending on the size of deposits, 10 to 12 years. This means that after 2022—2025 there could well be a sharp fall in Russian oil (and natural gas) production, which could have a lasting impact on already very volatile markets.

The structural consequences from US sanctions also include restricting the global activities of Russian corporations and slowing down their internationalisation activities — as in the case of privately owned Lukoil. The state-dominated Russian corporations, on the other hand, benefit from direct recourse to public funds and were able to further expand their share in Russian exploration and production. The impact of the sanctions is counterproductive to the interests of the EU and the US government. Moreover and even more seriously, the US sanctions are creating a large legal grey area with high risks for Western companies. These risks have to be included into the cost-benefit considerations of companies doing business in and with Russia. The main focus here is on measures aimed at the financial sector. As energy relations between the United States and Russia have declined, the extraterritorial reach of US sanctions is particularly serious for third parties, especially for European companies. In fact, US sanctions are putting increasing pressure on European energy companies to stop engaging in the Russian market, thereby weakening their market positions.

The resulting vacuum allows competitors from China, India and also from the Middle East to expand their activities. The crux of the matter is that state-dominated oil and gas companies can expand their market shares in leaps and bounds, which could have an impact on liberal trade and pricing mechanisms in the medium term. The unilateral US sanctions against Russia, Iran and Venezuela result in state interventions gaining ground. Politicisation and the political instrumentalisation of the energy markets is increasing. All of this could have far-reaching consequences for Europe's energy security, which will then depend increasingly on supplies from these state-owned companies.

US LNG Exports to Europe

The Shale Revolution has made the United States a key player in world oil and gas markets. Between 2010 and 2017, domestic energy companies increased their daily oil production by 73 percent, according to data from energy company BP. Exports rose by 157 percent. Nearly 28 percent more natural gas was produced during the same period. In 2017, the United States was the world's largest producer of both crude oil and natural gas. Since Congress lifted the export ban on crude oil at the end of 2015, exports increased from 465,000 barrels a day to just under 1.2 million barrels a day in 2017, according to the US Energy Infor-

mation Administration. The International Energy Agency forecasts that the US will meet 80 percent of global demand growth for crude oil over the next decade.

As oil prices pick up, US oil production will continue to rise and, as a by-product, more natural gas will be produced. There are two terminals in operation in the US, Sabine Pass since 2016 and Corpus Christi since November 2018. The two plants have an export capacity of 35 billion cubic metres annually and another 55 billion cubic metres of capacity are to be added in 2019. This is roughly equivalent to Germany's annual gas consumption. By 2020, export capacity could reach around 100 billion cubic metres per year. In 2017, more than ten percent of US LNG exports went to Europe.

The availability of secure and competetive energy in the US shields it from developments on the energy markets. As a result, the US is now self-sufficient, meaning that the US government has achieved a major foreign policy goal and gained considerable clout in its international relations.

US-based production is so huge that bottlenecks exist in the processing and transport of crude oil and natural gas. In order to sustain the production boom, US companies are looking for foreign markets for their liquefied natural gas. Consequently, not only are US sanctions based on geopolitical considerations to reduce European dependence on Russian energy imports, they also fuel Washington's vested economic interests, such as reducing the US trade deficit and creating domestic jobs. For President Trump's policy of 'America First', energy dominance is both the means and the end. With him in the White House, the thought has become entrenched that the main aim should be the pursuit of profit and pure profit maximisation and that balancing the interests of long-time partners and allies in the field of energy and (climate) policy is no longer relevant. Germany's export surplus is a thorn in his side. If Berlin had to import more LNG from the US, the balance sheet would shift in Washington's favour. This would also cement the energy price spread between the US and Europe, with negative implications for Europe as an industrial location and for European competitiveness. It would also have considerable effect on energy prices as a whole for private households.

In the trade dispute between the US and the EU, LNG imports from the US have become a negotiating item, as the meeting in July 2018 between President Trump and the President of the European Commission, Jean-Claude Juncker, demonstrated. In any case and irrespective of the political noise, LNG has become an increasingly important component of the portfolio management and trading business of European importers. LNG is one of those commodities where political and business interests coincide. For example, in 2013, the German government guaranteed a loan for an LNG terminal in Goldboro, Canada. In Germany, the construction of LNG terminal(s) is currently under discussion with potential sites in Stade, Brunsbüttel and Wilhelmshaven.

There are presently no indications that US LNG will be able to undercut the short-term and long-term marginal costs of Russian pipeline gas in the European market. US LNG is still too expensive to be really competitive. The European gas market is currently the market that absorbs quantities not purchased elsewhere because other customers are more attractive since they pay higher prices. The price differences between the Far East and Europe are still significant. LNG in Asia is priced at 9.8 US dollars per MmBtu (million British Thermal Units, average for 2018) and at only 7.7 US dollars per MmBtu on the British exchange. In addition, major buyers are all located in the northern hemisphere and, therefore, consumption follows the same seasonal curve. European LNG terminals can handle a capacity of 150 billion cubic metres per annum, but are currently operating at less than a quarter of their capacity. However, if Russian supplies are to be replaced on a large scale, the terminals could reach their limits.

European gas consumers have benefited from competition in the gas markets result-

ing from the shale gas boom in the US and the surplus of LNG on the markets. Prices fell, even though long-term contracts with minimum purchase obligations (take-or-pay) with European companies will secure Gazprom's sales in the medium term. Gazprom's market share in the EU of around 35 percent is the result of long-term contracts and price signals.

But pressure is likely to continue to rise on Europe to import more US LNG. For example, a cross-party majority in Congress is pushing to prevent the construction and operation of Russian gas pipelines. In addition, in the current trade dispute with Washington, the Chinese government recently imposed a ten percent tariff on US imports of LNG.

The increasing focus of US sanctions policy on Russian natural gas supplies is remarkable. Since oil exports contribute far more to the Russian budget, limiting the budgetary scope of the Russian government in this area would be far more effective. Nevertheless, in December 2018, the Trump administration insisted that production levels not be significantly reduced in the run-up to the OPEC+ meeting. In doing so, the Trump administration had in mind its own electorate and its re-imposed sanctions against Iran. If it were to target Russian gas exports and their market share in the EU instead, it would not only receive applause from Poland, but it would also give US companies an advantage in the face of intense competition for market share. What would be detrimental to European import options from a market point of view would be advantageous to the Trump administration.

Conclusions

The geopolitical dispute between the US and the Russian Federation threatens the stability of European and German energy supplies. If the US government were to target Russian gas exports in the future, this would seriously impact Europe's industrial base and its competitiveness. Considering the rapidly declining production of natural gas in the EU itself, the need for imports is already higher than was forecasted just a few years ago. Demand for gas has recovered in Europe since 2017, and e.g. the phase-out of coal in Germany will have an effect here as well. Thus, it is safe to assume from a market perspective that Russian natural gas will cover the EU's 'base load' well into the 2020s. After Gazprom supplied a record 194 billion cubic metres to Europe in 2017, exports are likely to have increased in 2018. There are three economic reasons for this: not only does Russian natural gas come from the largest reservoir in terms of volume, it is also currently the most cost-effective. The fields in Western Siberia and on the Yamal Peninsula have excess supplies of between 130 and 150 billion cubic metres per year. Moreover, Gazprom has the necessary and diversified export infrastructure which allows the company to react flexibly to competitors. But Russia is also increasingly orienting itself towards Asia. This will further change the setting and the dynamics of the gas markets, also making diversification an imperative for the EU.

Nevertheless, pressure will continue to come from Washington, especially with regard to Nord Stream 2. If this project were hit with secondary sanctions from the US, the EU would have to rely more on a functioning Ukrainian transit corridor and buy LNG. Russia's export pipelines were running at almost full capacity during the period of cold weather in February and March 2018. A strong signal that sufficient import capacity will be needed in future.

In any case, US secondary sanctions would severely curtail Europe's ability to act autonomously. It should, therefore, be possible to build a consensus in the EU. No matter where Brussels or the Member States stand on Nord Stream 2, the decision about what to do should be a sovereign one for Europeans. The impact on EU-based companies described above, or on specialist European companies laying pipelines for offshore and subsea construction, is serious. Not only are private economic interests affected by unilateral US sanctions, but also

skills and technical know-how that are strategically important for Europe.

In order to guarantee not only their energy supply in the long term but also their strategic autonomy in this important policy area, Europeans need to find a common response to Washington and Moscow. As a first step in this direction, the European Council should swiftly add all the relevant US legal bases to the annex of the EU "blocking legislation". As a precautionary measure, the Instrument in Support of Trade Exchanges (INSTEX) to facilitate payments outside the dollar area should, in addition to Iran, also include business with Russia. Finally, the EU and Germany should continue to focus on diversification, including higher LNG imports, not least as a political signal to Washington and Moscow.

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