U.S. Sanctions on Russia: Geopolitics, Pipelines& U.S. Self-interest

By Mamdouh G. Salameh

Mamdouh Salameh is an international oil economist. He is also a visiting professor of energy economics at the ESCP Europe Business School in London. He may be reached at mgsalameh@btconnect.com

See footnotes at end of text.

In imposing new sanctions on Russia, the U.S. Congress aimed to punish Russia for its alleged meddling in the U.S. elections in 2016. Still, these sanctions were mostly motivated by U.S. self-interest and geopolitics.

There are indications that these sanctions will have very limited impact on Russia but could cause some collateral damage to others. They are virtually a restatement of the ones imposed by Barack Obama in 2014 after Russia annexed the Crimea. The biggest change, however, is that these sanctions are now codified into a law specifying that any move by U.S. President Trump (or a future president) to loosen the sanctions could be blocked by Congress.

The target of these sanctions as in the previous ones is Russian banks and companies as well as Russian oil and gas projects. The new law tightens some of those limits a bit – for instance, U.S. companies can't participate in any energy project in which Russian entities have a stake of 33% or more.[1] This certainly applies to the U.S. oil giant Exxon Mobil's involvement in the Russian Arctic with its Russian counterpart Rosneft.[2]

These sanctions have already been discounted by the markets as evidenced by the strengthening of Russian bonds, stocks and the ruble after Trump signed the sanctions legislation.

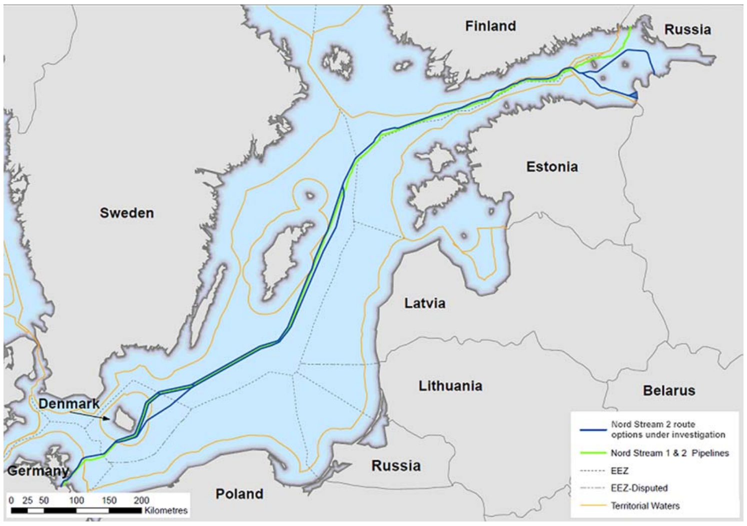
COLLATERAL DAMAGE

However, the European Union (EU) could suffer some collateral damage. The sanctions ban improvements including repair of Russian-owned pipelines into Europe. That provision could curb investment in the jointly European and Russian-financed Nord Stream II gas pipeline that would enable the Russian gas Giant Gazprom to divert gas supplies to the EU via Ukraine into a less controversial route under the Baltic Sea, to Germany (see Map 1).

The U.S. sanctions will also place additional restrictions on international companies participating in oil projects with Russian companies or facilitating or investing in Russian export pipelines.[3]

However, the most contentious issue could well be the sanctions on pipelines. Key projects such as Nord Stream II and the TurkStream pipeline which will carry gas from Russia to Turkey under the Black Sea, are threatened if investor companies or contractors could come under sanctions.

Two other European energy projects could be undermined by the sanctions. They are the Caspian Pipeline Consortium to carry Kazakh oil to the Black Sea via Russia and a prospective Baltic liquefied natural gas (LNG) plant.



Map 1. Nord Stream II Gas Pipeline

Nord Stream II construction will start in 2018 and will be finished by the end of 2019. The first pipes for the Nord Stream II were delivered in October 2016 to the German Logistics hub Mukran on the Island of Rugen.[4] The two "Nord Stream II" threads will transfer 27.5 billion cubic meters a year (bcm/y) of gas, doubling the capacity of the Nord Stream I.

The newly enacted sanctions are almost certain to create tension between the U.S. and Europe. "The U.S. bill could have unintended unilateral effects that impact the EU's energy security interests", Jean-Claude Juncker, the European Commission president, said in a statement." This is why the Commission concluded that if our concerns are not taken into account sufficiently, "we stand ready to act appropriately ".

The Financial times reported that the EU was drafting possible countermeasures against the U.S. including challenging the pipeline project sanctions through the World Trade Organization (WTO) should the U.S. start to enforce them.[5]

Some in the EU are claiming that the U.S. wants to displace Russia as a gas supplier to Europe. While there is some truth in this, U.S. LNG can't compete with Russian gas supplies to Europe. Russia has a fully integrated gas industry underpinned by the world's largest proven reserves of natural gas, the cheapest production costs , doesn't have to convert its gas to LNG to ship it to Europe and already has a network of export pipelines, even without Nord Stream II.

Moreover, Gazprom says it has other means of financing infrastructure if interest from Europe dries up.

GEOPOLITICS & U.S. SELF-INTEREST

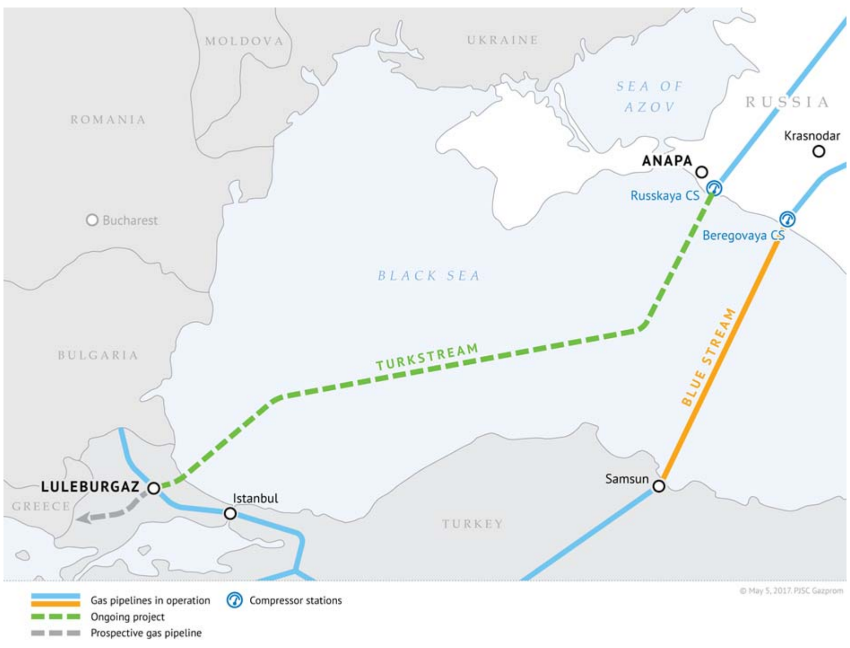
The U.S. has always been opposed to Nord Stream II, which it views as Russia's attempt to solidify its hold on Europe's energy supplies.

In fact, U.S. misgivings about the geopolitical implication of Nord Stream II are shared by eight European countries (perhaps instigated by the U.S.) – Poland, Hungary, Lithuania, Latvia, Estonia, the Czech Republic, Slovakia and Romania. They sent a letter dated the 7th of March 2016 to European Commission President Jean-Claude Juncker warning that Nord Stream II would have potentially destabilizing geopolitical consequences, undermine the energy security of Central and Eastern Europe, and detrimentally impact Ukraine.

On March 21, 2016 the prospective shareholders in the Nord Stream II consortium (Gazprom 50%; E.ON 10%; BASF/Wintershall 10%; Royal Dutch Shell 10%; OMV 10% and Engie 10%) issued a rebuttal. They argued that Nord Stream II would enhance Europe's long-term energy security by providing an alternative gas supply route that avoids the unreliable transit state of Ukraine. The rebuttal further asserted that the project will improve internal market competition by increasing liquidity in North-West European gas hubs with the delivery of additional gas supplies at a time when North Sea gas production is declining and European gas demand is rising.

Nord Stream II, with dual lines totaling 55 bcm/y capacity, would traverse the Baltic Sea along a route parallel to the existing Nord Stream I (also 55 bcm/y capacity) making landfall at the Lubminer Heide gas hub near Greifswald, Germany. It would provide up to 110 bcm/y of Russian gas supplies to the North-West European gas market.

PUTIN'S ENERGY MASTER PLAN



Map 2. The TurkStream Gas Pipeline

Putin's plan is to turn Russia into the world's energy superpower and it is working.

In the beginning of 2017, Gazprom projected that the demand for Russian natural gas in 2017 will increase by 2.7% to 430 bcm/y.

Russia has been building many pipelines to deliver its natural gas to every corner of Eurasia. Prominent among these pipelines is the Nord Stream II and TurkStream. By 2019 Turkish and European consumers will receive a new and reliable route for the import of the Russian natural gas (see Map 2).

TurkStream will have two parallel pipeline threads: one with the natural gas for Turkey and another one for European countries. Each thread will carry 15.75 bcm/y of Russian gas. The commissioning of both threads is planned for December 30, 2019.

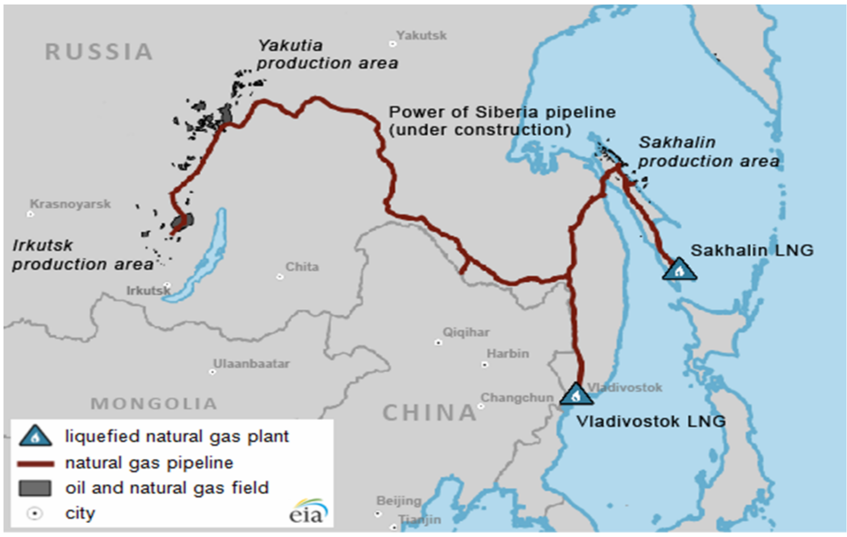
There is also the Power of Siberia gas pipeline which will deliver Russian gas to China (see Map 3). It will start operation by 2019 with the delivery of 38 bcm/y of Russian natural gas, which can be increased to 61bcm/y if Putin decides to cut the shipment of natural gas to Europe in favor of China.

Then, there is India. The delivery of 2.5 million tons of LNG to India by Gazprom (the equivalent of 3.4 bcm of natural gas) will start in 2018. The plans to build a pipeline to India as an extension to Power of Siberia are also under consideration.

And it does not stop there. Russia and Japan are actively discussing construction of a natural gas supply pipeline from Sakhalin (a Russian island in the Pacific Ocean) to Japan. The 1,500 km underwater pipeline will be able to provide Japan with 20 bcm/y of natural gas, which is 18% of Japan's LNG imports.[6]

European appetite for Russian natural gas has been growing despite political frictions. Since the beginning of 2017, deliveries to the European market have grown by 15% compared to the same period of the last year, or 8.6 bcm/y.

Collectively, the EU imports 53% of the energy it consumes. This includes 90% of its crude oil and 66% of its natural gas—a higher percentage than most other regions of the world, including North America, East Asia (but not Japan), and South Asia. All told, energy accounts for 20% of all EU imports.



Map 3. The Power of Siberia Gas Pipeline. Selected natural gas infrastructure in eastern Russia.

Most European countries import more than 30% of the energy they consume. Russia provides roughly 40%.[7] Germany, which boasts the largest economy in the EU, imports more than 60% of the energy it consumes, and France, which boasts the second-largest economy, imports about 45%. Currently, one-third of the natural gas consumed by Europe comes from Russia (see Table 1).

France and Germany illustrate how Russian energy can shape foreign policy. France may rely heavily on foreign energy, but most of its oil and natural gas comes from Algeria, Qatar, Saudi Arabia, and Libya—not Russia. France can, therefore, afford to be more aggressive and supportive of sanctions against Russia.

Not so with Germany, which receives 57% of its natural gas and 35% of its crude oil from Russia. Berlin must, therefore, tread lightly between its primary security benefactor, the U.S., and its primary source of energy, Russia.

This is one reason Germany has been an outspoken critic of the recent U.S. sanctions, which penalize businesses in any country that collaborate or participate in joint ventures with Russian energy firms. Germany supports the construction of Nord Stream II. The pipeline would help safeguard German energy security and needs.

Of course, Germany may try to diversify its energy sources from other countries like Libya, Nigeria, Kazakhstan and Norway, but it would struggle to do so. It relies heavily on pipelines for its energy, particularly Russian natural gas. But Germany has fewer options for natural gas and no major LNG facilities. Simply put, Germany is beholden to the countries with which its pipelines have a connection—something that makes it vulnerable to retaliation (see Map 4).

Cultivating this dependency is a conscious move by Russia. Russia has developed economic leverage that enables it to exert pressure over countries that could pose a danger to it by threatening their energy security. Is this just business for Putin? Of course not; geopolitical interests are intertwined.

Country	Dependency on Russia
Lithuania	75%
Hungary, Austria & Slovakia	60%-65%
Czech Republic	62%
Germany	57%
Poland	53%
France	45%
Latvia	45%
Bulgaria	37%
Romania	17%
Estonia	9%
The EU as a whole	**33%**

Source: BP Statistical Review of World Energy, June 2017 / OPEC Annual Statistical Bulletin 2017 / OilPrice.com accessed on the 9th of August, 2017.

Table 1.Europe's Dependency on Russian Gas Exports

First, China, Turkey and Russia are discussing ways to conduct their mutual trades using national currencies only, which will exclude the U.S. dollar from these deals.

Second, Turkey will become a European energy hub, which will increase the country's political weight on the continent. But this will happen as a result of energy cooperation with Russia.

Third, the ambitious plans to ship American LNG to Europe could be either delayed or put to rest for a long while.

The reality of the 21st century—as Putin sees it—is that energy is a political instrument. Political

Map 4. Major Gas Pipelines between Russia & Germany

alliances and the rise and fall of the international importance of particular countries will change in accordance with the energy supply routes.

Still, there is only so much Russia can do. Its geopolitical interests in Ukraine, for example, align with Germany's energy needs. Germany would benefit from Nord Stream II by getting a new and secure natural gas route, and Russia would benefit by gaining more leverage over Ukraine. But Washington wouldn't want Moscow to halt energy flows through Ukraine at its leisure. The U.S. needs to try to manage the Ukraine situation in a way that prevents a greater general German-Russian alignment.

U.S. Senator John McCain once called Russia a gas station masquerading as a country. While you can insult your gas station as you like, one still has to pay the bill.

GEOPOLITICAL FALLOUT FROM THE SANCTIONS

Russian Foreign Minister Sergei Lavrov was quoted saying after the sanctions were announced that while Russia has been doing everything possible to improve relations with the United States, recent events showed that U.S. policy was in the hands of Russophobic forces, pushing Washington to the path of confrontation.[8]

Many experts have warned that there are visible parallels between the current sanctions pressure over Russia and the situation in the 1980s when Washington also used sanctions and manipulated oil prices, resulting in the collapse of the Soviet economy and the subsequent political turmoil.[9]

"By imposing new sanctions, the U.S. risks losing global influence and uniting non-Western countries against it," according to Vladimir Lepekhin, a Russian political expert and director of the Eurasian Economic Institute (EEU) think tank.[10]

If the United States continues to up the ante with measures such as arming the Ukrainian government, then the Russians are likely to make life difficult for Washington in other parts of the world. For example, Russia could provide arms to Iran, North Korea or potentially other regimes.[11]

Energy sales are an important source of revenue, of course, but for Russia they are more than that: they are an instrument of geopolitical power. They give Moscow considerable influence over the countries whose energy needs are met by Russian exports. If Russia intends to retaliate further against the U.S., its energy supplies, especially those it sends to Europe, may be its best option. A policy of dividing the U.S. and Europe could be Putin's best bet.[12]

WINNERS & LOSERS

The Ukraine and ExxonMobil could be the biggest losers in the sanctions' saga.

The new pipelines will make the Ukrainian pipelines' role in the European economy and politics null and void. The contract between Gazprom and the Ukrainian pipeline company, Naftogaz, will expire at the end of 2019.

Last year, Gazprom sent about 82 bcm of natural gas through Ukrainian territory for its European customers. The construction of Nord Steam II and TurkStream pipelines would deprive Ukraine of $2 bn a year of transit fees that Ukraine collects from Russia. It will also lower the market capitalization of Ukrainian pipelines by 5 times—down from $30 bn to $5 bn.

Signs of despair in Kiev are obvious. Right after the start of the work on the TurkStream, Naftogaz "unofficially" let it be known that, starting 2020, it was ready to decrease the 10% transportation fee that Russia pays for the flow of natural gas through Ukrainian territory.

Gazprom says that it does not rule out sending gas through Ukrainian territory after 2019 to its customer countries that border Ukraine—but it will be a much smaller amount of probably 15 bcm/y and only if it makes economic sense.

The other potential loser could be ExxonMobil. In the run-up to 2014 sanctions, ExxonMobil and Russia's oil giant Rosneft invested $3.2 billion in a project for drilling for oil in the Russian sector of the Arctic — a region that Rosneft estimated could have more oil than the entire Gulf of Mexico. But the sanctions forced Exxon Mobil to halt drilling.[13]

ExxonMobil applied in 2015 and in June 2017 for a waiver from U.S. sanctions on Russia but the U.S. Department of the Treasury rejected both applications.[14]

Chart 1. Russia GDP Annual Growth Rate

Russia's economy could in the long term be the winner in the sanctions war. Since the oil price crash in 2014, the Russian economy has been diversifying away from reliance on oil and gas exports. As a result, growth reached an annual rate of 2.5% in the second quarter of 2017, the fastest in almost five years (see Chart 1).

The recovery is definitely taking place amid clear signs that economy has adjusted to lower oil prices and the sanctions imposed in 2014.[15]

Russia is now saying that its economy can now live forever with an oil price of $40 or less.[16] It is also signaling that neither low oil prices nor sanctions will deter it from Arctic drilling. Rosneft is getting its drilling activities underway in the Russian Arctic. By so doing, Putin's Russia is demonstrating that sanctions did not succeed in putting a crimp in Russia's oil sector.

The recent U.S. sanctions demonstrate how remote, difficult and protracted the process of normalizing U.S.-Russia relations is.

Footnotes

[1] Joel Parshall, "U.S. Sanctions Hit New Russian Projects, Add Uncertainty" Journal of Petroleum Technology (JPT), 8 August, 2017.

[2] Mamdouh G Salameh, "Is U.S. Oil Giant ExxonMobil Trying to Evade U.S. Sanctions on Russia" (An article posted by the Research Centre for Energy Management (RCEM) on the 11th of May, 2017).

[3] Joel Parshall, "U.S. Sanctions Hit New Russian Projects, Add Uncertainty".

[4] Ibid.,

[5] A Report by Jim Brunsden & Courtney Weaver published in the Financial times on the 23rd of July 2017.

[6] BP Statistical Review of World Energy, June 2017, p.29.

[7] "How U.S. Sanctions against Russia Could Backfire", a report by OilPrice.com posted on the 7th of August, 2017 and accessed on the 12th of August.

[8] Nicole Gaouette & Jeremy Herb, "White House: Trump Sign Russia Sanctions Bill" (A CNN Report on July 29, 2017).

[9] Vladimir Lepekhin, "Window of Opportunities: Why U.S. Sanctions Likely to Boost Russian Economy", a report published by Sputnik International on the 11th of August, 2017.

[10] Ibid.,

[11] Dave Majumdar, "America & Russia Will Square Off Over New Sanctions", the National Interest, August 15, 2017.

[12] Meghan O'Sullivan, "The One Big Problem with New Russia Sanctions", published by Bloomberg View on the 10th of August, 2017.

[13] Mamdouh G Salameh, "Is U.S. Oil Giant ExxonMobil Trying to Evade U.S. Sanctions on Russia".

[14] Ibid.,

[15] Kathrin Hille, "Russia's Recovering Economy Fears from U.S. Sanctions Chill", The Financial Times, the 11th of August 2017.

[16] A Bloomberg interview with the Russian economy minister, Maksim Oreshkin at the Petersburg International Economic Forum (SPIEF2017) as reported by Reuters on the 2nd of June 2017.