

## Escaping the Energy Sanctions Tangle

### GAS NETWORKS & OFF-RAMPS FROM ESCALATION IN US-EU-RUSSIA RELATIONS

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Energy Sanctions and statecraft are mainstays of Western policy toward Russia and this looks unlikely to change. The passage of the Countering America's Adversaries Through Sanctions Act (CAATSA) by a veto-proof majority in the U.S. Congress specifically targeted broad new prohibitions on energy sector loans with maturity longer than 60 days and new partnerships in the oil sector (off-shore, deep-water, Arctic, and shale) outside of Russia. Yet, for all of the excitement about tightening pressure on the Kremlin and imposing bipartisan restraint on the White House's friendly overtures to Russian President Vladimir Putin, successive rounds of U.S. and EU sanctions since 2014 have failed to compel Moscow to withdraw from Crimea, cooperate fully to implement the Minsk II accords, or come clean on its foreign electoral intrusions. Prospects for indirect and long-term effects of Western sanctions also are dwindling, given the upward swing in global oil prices, signs of stabilization across the Russian economy, and widening internal divisions among American and European stakeholders in energy relations with Russia.

What can be done to navigate these rocky political shoals? The first step is for all parties to accept that sanctions will not be lifted anytime soon; mutual interests rest with demonstrating resolve to sustain sanctions while maintaining flexibility to reassure that future de-escalatory gestures will be reciprocated. Second, policymakers on all sides must recognize that the regional gas landscape is changing, but in more ways than shifts in unconventional supply and demand. The rise of LNG, interconnection of the transmission infrastructure, and entrenched corporate strategic partnerships, in particular, are converging to effect dense, interdependent, and multidimensional gas networks. These, in turn, are displacing the salience of point-to-point pipeline politics or the crude exercise of market power, generating new forms of leverage. If policymakers in the three capitals have the courage of leadership to arrest the downward spiral in

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political relations, this network transformation of the energy equation offers opportunity to ease the sanctions tangle, if not re-ground strategic ties across the former East-West divide.

### **Sanctions Upon Us!**

CAATSA empowered the U.S. president to sanction individuals and firms (both U.S. and non-U.S.) involved in the construction of Russian oil and gas export pipelines, as well as inserted Congress directly into the mandated review process. Although President Donald Trump begrudgingly signed the new Russian sanctions into law, he too doubled down on wielding America's newfound "energy dominance," featuring prospects for U.S. LNG exports to cut into Moscow's established European markets. While leaders across Europe questioned U.S. motives, as well as maintained an aversion to restricting interdependent gas ties with Russia, Brussels nonetheless renewed its current sanctions regime and its determination to liberalize the EU common energy space.

Ironically, the default to sanctions between the West and Russia is becoming more entrenched as the tangible effects seem more negligible, if not detrimental. In the energy sector alone, Russia hit post-Soviet highs in oil production by 2016 and its gas footprint in Europe expanded, all with Western sanctions in place. Although success is often elusive, contemporary U.S. and EU sanctions on Russia founder at multiple levels.

Specifically, successive rounds of sanctions are flagging due to unclear and open-ended objectives. While formally aimed at altering different elements of Russia's foreign behavior, Western decisionmakers remain divided over a focus on coercing reversal in Moscow's policy, deterring escalation, exacting economic versus political punishment, signaling protest, or imposing placeholders for more aggressive future action—each with different (and at times cross-cutting) requirements for success. Smart sanctions targeted at specific sectors, firms, and individuals lack clear metrics, as well as leave ambiguous the vulnerability of extra-territorial Russian entities. They also rest on conflicting assumptions about Kremlin politics and decisionmaking, thus are out of sync with the compensation and circulation of targeted Russian elites. Moreover, there is little incentive for the Russian leadership to comply, let alone overcome "Jackson-Vanik paranoia," as the Congressionally imposed sanctions do not specify pathways for relief or self-restraint on changing goal posts.

Moscow also has demonstrated remarkable dexterity at offsetting the financial and technological restrictions to maintain "business as usual." By practicing fiscal discipline, allowing the ruble to float, leveraging accumulated foreign capital, attracting foreign investment in non-strategic sectors, and curbing the outflow of capital, the Kremlin succeeded at riding out the combined pressures of sanctions and oil price shocks initially to stave off acute macroeconomic crisis and then to register modest growth

projected through 2018. Rising oil prices offer additional relief, albeit at the costs of perpetuating corruption and neglecting long-term productivity. Energy firms have adapted to the higher costs and restrictions on technology imports—selling off assets, soliciting available financing and capital from Russian Banks and investors in China and India, as well as exploiting marginal cost advantages to land more gas and preserve market share in Europe.

Western sanctions likewise produce collateral damage. By some calculations, U.S. and EU sanctions cost targeted Russian firms about one-third of their revenue and employees, and half of their asset value compared to non-sanctioned firms. But they carry reciprocal negative consequences for exchange rates, as well as for key European energy firms and strategic sectors. Protracted use also risks amplifying fundamental incompatibilities between American and EU approaches to the design and implementation of energy sanctions. As a recent RUSI [report](#) underscores, the unilateral imposition of U.S. secondary sanctions on European energy firms would put Washington on a collision course with the EU's strict interpretation of sanctions and grandfathering provisions that protect projects underway with Russian partners. Similarly, Timothy Frye [demonstrates](#) that although there is little evidence the sanctions have had a discrete rally around the flag effect in Russia—due to preexisting support for the annexation of Crimea—the Russian population tends to be more forgiving of the Kremlin's poor economic performance and harbors greater antipathy toward the United States and the EU in the face of Western sanctions. Accordingly, further extension of sanctions will likely perversely incite “de-risking” among American and foreign energy firms intent on reducing exposure to U.S. sanctions, while bolstering the Kremlin's political resilience.

Yet, sanctions persist. Irrespective of mounting limitations, U.S. policymakers perceive them as integral to demonstrating resolve. Despite complaints about Washington's high handedness, Brussels has few other viable tools to protest, if not challenge, Moscow's assault on Europe's common interests and values. The Kremlin, too, has little short-term incentive to relax reciprocal sanctions. It can rely on infusions from the sovereign wealth fund, obscure the costs of policies in Ukraine, and selectively target government-spending cuts as oil prices rise. The threat of tougher Western sanctions also generates incentives to accelerate construction of both Nord Stream II and Turkish Stream (notwithstanding uncertainty over final landfall in Europe), lay claim to contested reserves in the Black Sea, diversify contracts with EU companies, and invite non-Western investment in upstream development.

### **Networks & Social Capital in the Eurasian Gas Ecosystem**

Often overlooked in the sanctions calculus are emerging network forms of interaction among mature and new gas hubs across Europe. The integration of these hubs—which receive piped gas from Russia and other suppliers; import, store, and distribute LNG;

and concentrate vertical integration with other power and transportation sectors—effectively alters the prominence and prestige of respective actors within the network. The changing centrality of these emerging hubs—measured in terms of their position between pairs of important hubs or other prominent supply networks—adds resilience, optionality, and indirect effects to intra-European and external markets. These structural features open up opportunities for alternative supply both to and within EU sub-regional markets that carry different implications for diffusing extra-commercial power, vulnerability, and influence across the European-Eurasian gas network.

As elucidated elsewhere, the emergence of satellite hubs within the EU creates incremental competition with Russian imports. The Baltic States and Poland, for example, constitute a north-central European hub with development of related LNG facilities and interconnectors southward. Notwithstanding the 10%+ premium Lithuania is projected to pay for purchasing LNG from Norway, the opening of floating storage and regasification units, development of interconnectors with the other Baltic States and Finland, and promise of re-exports are estimated to reduce import requirements from Russia by one third, thus strengthening the sub-region’s bargaining position vis-à-vis Gazprom. Similarly, as Hungarian cross-border points are tied into Ukrainian, Central European, and Italian gas systems, they offer critical links for diffusing flow from multiple directions across the sub-region. This stands to reinforce development of the Southern Gas Corridor—complementing transit flows through Turkey—that otherwise can augment non-Russian deliveries from Azerbaijan (and possibly Turkmenistan, Iraq, and Iran) with connections to Greece, Albania, and the Adriatic Sea.

Deep and cross-cutting corporate strategic alliances complement these infrastructure networks. They constitute the grist for building trust and securing access to energy markets and resources across the network that transcend contracted flows of gas, spot trading, varying ownership types, and regulatory voids at the national and EU levels. The increasing quality of corporate relationships, reflected in the depth of foreign investment, can elevate the transfer of firm-specific assets while reducing exit mobility that strengthen inter-firm commitments. These new corporate hubs and clusters of exchange dampen incentives for coercive behavior and arbitrary disruption of established transnational business ties. As international tensions mounted and sanctions were imposed following the outbreak of the Ukraine conflict, some of the largest multinational energy stakeholders increased gas investments, staved off more stringent restrictions on existing projects, and forged closer business alliances with Gazprom. These social networks effectively constrain Russia’s market power while preserving its salience as a valued commercial partner.

Several trends stand out in this regard. Gazprom’s social capital across both northern and southern sub-regions of the EU gas market has steadily increased since 2006, notwithstanding successive gas wars and sanctions. But the quality of these ties varies significantly. Gazprom enjoys very strong corporate ties with leading German and

Finish gas companies that jibe with the high volume of contracted bilateral gas trade. Given that Germany is not import-dependent on Russia, the strong social ties may better account for the continued partnership and outspoken political support for sustaining ties with Gazprom by senior executives from respective German companies. Yet, Gazprom lacks trusted corporate relationships with the gas sectors across the Baltic States and Czech Republic, despite its market power and large contracted volumes of deliveries. Not surprisingly, reverse flow and threats of marginal imports of LNG into this sub-region curtailed Gazprom's bargaining leverage and compelled it to reduce the price of contracted deliveries to Lithuania by 23% since 2015.

Within the southern sub-region, Gazprom also enjoys very strong ties with the Italian firm ENI and Hungary's MOL that allow it to project influence indirectly over numerous smaller European entities. But here Gazprom's social capital is not unrivaled. Irrespective of the relatively small volumes of gas projected for delivery into the EU's Southern Gas Corridor from Azerbaijan, SOCAR's corporate affiliations are situated at the center of the sub-regional network, with especially trustworthy relationships emerging with prominent Italian firms. Furthermore, Gazprom does not enjoy rich corporate alliances with Turkish gas firms, notwithstanding the significant volumes of gas sold to Turkey. This effectively reduces the transaction costs for Ankara's pursuit of incremental non-Russian options.

### **Strategic Implications**

The United States, EU, and Russia now confront interlocking dilemmas with energy sanctions and statecraft that, if not deftly managed, can readily accelerate the downturn in strategic relations. For the Trump Administration, the main challenge rests with using discretion over enforcement of sanctions to sustain discriminating pressure on Russia, amid growing dissonance among allies with greater direct energy stakes with Moscow and mounting suspicions of the White House's leadership; all while signaling flexibility (mostly by omission) to reassure the Kremlin when it is ready to compromise. From a European policy perspective, the dilemma rests with maintaining a united front to leverage the institutional power and commercial allure of the single EU energy market to sustain pressure on the Kremlin—forging convergence across distinct energy security agendas among member states and the United States—while proffering policy “carrots” to embolden multiple stakeholders in Russia best served by participating in diverse, commercially competitive ventures. The Kremlin, in turn, faces daunting challenges of averting uncontrolled escalation of the current transatlantic stand-off, preserving the stature of Russian energy in established markets, and containing liquidity problems that can compound structural deficiencies in the economy, while upholding national security requirements and saving political face for its earlier foreign incursions. All parties must walk this tightrope as U.S. Congressional and Russian presidential elections heat up over 2018.

The changing gas landscape, however, may offer opportunities to “square these circles.” A key to averting sanctions fatigue rests with aligning Western national security and market incentives. One way to do so is by targeting political interventions to accentuate the density of emerging EU gas infrastructure networks, rather than by favoring specific gas supply routes. Promoting transparency and market reforms, as well as introducing targeted tax breaks and preferential lending terms/guarantees, should be the guiding principles. This could facilitate price correlation across European hubs that the ongoing recession and market itself may be slow to deliver. Such policies could “incentivize” flexible supply options to constrain Gazprom’s non-commercial exploits, while directing investment to bolster the resilience of critical hubs across the north-south and southern energy corridors, as well as the integration of the Ukrainian gas infrastructure. Although these actions could potentially create additional surplus capacity, they can strengthen the resolve behind Western sanctions in the face of Moscow’s opportunistic probing. Because they will not threaten Gazprom’s market share head on, they also can signal restraint to Russia, reassurance to EU allies, and a commitment to liberalization to Ukraine that politically directed U.S. LNG exports do not.

At the same time, policymakers should appreciate that corporate ties continue to bind, even across politically stark East-West borders. Accordingly, Western policymakers would be wise to realize that the challenges are not so much to rise above narrow commercial interests with their energy statecraft, as they are to recognize the boomerang effects of disrupting strategic corporate ties, and to make it clear that the door will be open for engaging commercially competitive Russian gas interests as tensions ease. Down the road as the Europe-Eurasian network gets built out, this can include working closer with Russia’s rising gas independents to extend reciprocal influence forged out of historical relationships working with Moscow. Different Russian firms and their local partners/subsidiaries could be invited to join in the development of diversity via new LNG and storage facilities, Southern Corridor, decoupled pricing, access to transmission lines, and shale exploration. Such broadening and deepening of social capital could limit Gazprom’s room to maneuver while elevating the stature of new Russian stakeholders in gas-on-gas competition. It also could facilitate, on the margins, the tough decisions needed in Moscow to reinvigorate liberalization of the gas industry at home. Ironically, these different facets of network diplomacy could take us “back to the future,” where the natural gas infrastructure and related ties constituted the bulwark for détente among “Cold War” Europe’s main rival camps.