

## International Sanctions and the Energy Sector – Part 2: Russia

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In the [first part](#) of this three part series we considered the impact of President Trump's decision to re-impose sanctions on Iran's energy sector with effect from 5 November 2018.

However, Iran is not unique. Other nations whose economic strength is founded on their energy sector have also found themselves the target of similar sectoral sanctions.

In the second part of this series we explore the EU and the US sanctions that have been imposed against the Russian energy sector.

### RUSSIA

#### Background

The sanctions regimes against Russia were imposed in response to actual or alleged actions by the Russian government. These included the annexation of Crimea and the destabilisation of Ukraine in 2014, plus the alleged malicious cyber activities aimed at interfering with or undermining the 2016 US presidential election.

They initially targeted a number of individuals and companies alleged to be involved in these actions or those close to the Russian government. However, they have since been expanded to include sanctions prohibiting activity in certain sectors of Russia's economy (in particular its energy industry) and have also targeted a number of the so-called '*Oligarchs*' and the companies in their control.

More recently, sanctions have been imposed in the wake of the Novichok nerve agent attack in Salisbury, UK.

This article concentrates on the sanctions directly targeting the Russian energy sector.

#### The EU Sectoral Sanctions

The EU sanctions targeting the Russian energy sector are primarily contained in Council

Regulation (EU) No 833/2014 (as amended) (the “**EU Regulation**”). They seek to inhibit oil exploration and production projects in Russia:

1. in waters deeper than 150 meters;
2. in the offshore area north of the Arctic Circle; or
3. which exploit shale formations by way of hydraulic fracturing.

(the “**Targeted Projects**”)

The sanctions operate in two key ways. First, by preventing the sale, supply, transfer or export of the items listed in Annex II of the EU Regulation (which includes a number of items that can be used in the exploration or production of oil, for example, drill pipe and casing) by EU persons or from the EU for use in the Targeted Projects.<sup>1</sup> Second, by prohibiting the direct or indirect provision of associated services necessary for the Targeted Projects, including: drilling, well testing, logging and completion services; and supply of specialised floating vessels.<sup>2</sup>

The EU Regulation also prohibits:

1. certain dealings, directly or indirectly, with transferable securities and money-market instruments with a maturity exceeding 30 days and issued after 12 September 2014 by, or
2. the making of loans or credit with a maturity over 30 days to,

certain Russian companies involved in the sale or transportation of crude oil or petroleum products, any non-EU subsidiaries owned 50% or more by them and any person acting on their behalf or at their direction.<sup>3</sup> The companies currently listed in the EU Regulation are Rosneft, Transneft and Gazprom Neft.

Finally, the EU Regulation states that prior authorisation is required in respect of the provision of certain assistance or financing related to the items listed in Annex II of the EU Regulation to individuals or entities in Russia or if the items are to be used in Russia.<sup>4</sup>

A separate EU regulation prohibits the sale, supply, transfer or export of certain goods and technology suited for use in the energy sector and for the exploration of oil, gas and mineral resources to Crimea or Sevastopol and any associated assistance of financing.<sup>5</sup>

The EU sanctions apply to anyone within the EU, any EU national or company incorporated in the EU (wherever they may be physically located), and to any business done in whole or in part in the EU.

### **The US Sectoral Sanctions**

The US sanctions targeting the Russian energy sector are primarily contained in Executive Order

13662 (as amended) (the “**Order**”) and in the Countering America’s Adversaries Through Sanctions Act (“**CAATSA**”).

The Order applies to “United States persons”.<sup>6</sup> However, it could also apply to non-US persons in respect of any transaction that causes a US person to violate the Order or causes a violation of the Order to occur in the US.

In similar fashion to the EU Regulation, Directive 4 of the Order seeks to inhibit oil exploration and production from the Targeted Projects. It does this by preventing goods, services (other than financial services), or technology in support of exploration or production from being provided to certain restricted entities and their 50% or more subsidiaries.

However, following the introduction of CAATSA in August 2017, the US sectoral sanctions went a step further than their EU counterparts. In particular, CAATSA extended Directive 4 to include oil projects outside Russia in which the restricted Russian entities have a 33% or greater ownership interest or own the majority of the voting rights. The US sectoral sanctions can therefore impact projects located far from Russian borders.

The Order also attacks the ability of key companies in the Russian energy sector to access the international debt markets. Directive 2 of the Order prohibits new debt with a maturity of more than 60 days being issued to certain entities and their 50% or greater subsidiaries.

CAATSA contains various additional provisions impacting the Russian Energy Sector. In particular, it provides for the:

1. mandatory imposition of sanctions on non-US persons who knowingly<sup>7</sup> make a significant investment<sup>8</sup> in a project intended to extract crude oil from deepwater, Arctic offshore or shale projects in Russia (section 225); and
2. discretionary imposition of sanctions on a person (not limited to US persons) who knowingly:
  1. makes an investment of \$1 million or more (or an aggregate value of \$5 million or more over a 12-month period), which directly and significantly contributes to the enhancement of the ability of Russia to construct energy export pipelines; or
  2. provides goods, services, technology, information or support to Russia, which could directly and significantly facilitate the maintenance or expansion of the construction, modernisation or repair of energy export pipelines. (section 232)

That section 232 refers to “energy export pipelines” is significant. Unlike the previous sanctions targeting the oil sector, section 232 could be applied to pipelines carrying Russian gas, large amounts of which are imported by the EU.

These additional provisions purport to have extraterritorial effect, which means they are of concern to non-US persons who are otherwise outside the US jurisdiction. Any non-US persons breaching these provisions may become subject to secondary sanctions that would severely restrict their ability to do business with the US and to access the US financial system, and therefore the international financial system.

### **The Reaction of Energy Companies**

The sanctions imposed on the Russian energy sector have received mixed reactions among energy companies. The differences between the EU and US sanctions, most especially the manner in which they are enforced, has led to the perception that US companies are more affected than their European counterparts.

Mostly, however, energy companies have been able to progress their projects unimpeded by the sanctions. This likely reflects the types of projects being progressed in Russia since the sanctions came into force.

The EU and US sectoral sanctions target oil exploration and production from deepwater, Arctic offshore or shale projects in Russia. Such projects are complicated and require the adoption of advanced techniques and technologies. Accordingly, they are typically more expensive than, for example, conventional shallow water or onshore drilling operations. Projects of this nature therefore tend to be uneconomic in periods of lower oil prices, such as those experienced since 2014. For these reasons, it is possible that such projects might not have been pursued since 2014 even in the absence of sanctions.

In fact, Russian oil production has increased from 10.86 million barrels per day in 2014 to 11.23 million barrels per day in 2017, making it the world's third largest producer in 2017 behind the US and Saudi Arabia.<sup>9</sup> This is a clear indication that the sanctions have not had a significant impact on the Russian energy sector's ability to produce crude.

### **Looking Forward**

It is questionable whether the sanctions imposed on Russia's energy sector have been effective. They have not, it seems, prevented Russia from increasing its production of oil. Neither have they prevented all deepwater, Arctic or shale projects from being progressed. However, with higher oil prices than when the sanctions first took effect, the economics of such projects should become more palatable and Russia may begin to feel the impact of the sanctions to greater extents.

Furthermore, the extraterritorial aspects of CAATSA are likely to begin affecting the appetite of non-US persons to make significant investments in Russian energy export pipelines or in Russian deepwater, Arctic offshore or shale projects. There is also the risk of further sanctions. The US Energy Secretary, Rick Perry, recently indicated that sanctions on the Nord Stream 2 pipeline are possible and that further energy-related sanctions are planned.<sup>10</sup> In addition, further sanctions on Russia in relation to the Novichok nerve agent attack in Salisbury, UK are expected, although it is not yet clear what form they will take and whether they will target

Russia's energy sector.<sup>11</sup>

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<sup>1</sup> Article 3 of the EU Regulation.

<sup>2</sup> Article 3a of the EU Regulation.

<sup>3</sup> Articles 5(2) and 5(3) of the EU Regulation.

<sup>4</sup> Article 4.3(a) of the EU Regulation.

<sup>5</sup> Article 2(b) of Regulation EU No 692/2014.

<sup>6</sup> United States persons is defined as “any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction within the United States (including foreign branches), or any person in the United States” (Section 6(c) of Executive Order 13662).

<sup>7</sup> “Knowingly” for these purposes means a person who had actual knowledge, or who should have known, of the conduct, circumstance or result.

<sup>8</sup> Guidance from the US Department of State that whether or not an investment is “significant” will be determined on a case by case basis taking into account *inter alia* the nature and magnitude of the investment and its relation and significance to the Russian Energy Sector.

<sup>9</sup> <https://www.bp.com/content/dam/bp/en/corporate/pdf/energy-economics/statistical-review/bp-stats-review-2018-full-report.pdf>.

<sup>10</sup> <https://www.nytimes.com/aponline/2018/09/13/world/europe/ap-eu-russia-energy.html>.

<sup>11</sup> <https://www.reuters.com/article/us-usa-russia-sanctions/u-s-says-to-issue-chemical-weapons-related-sanctions-against-russia-idUSKCN1NB2M7>.