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CONSTANT THREAT BUT LIMITED ACTIONS TOWARDS RUSSIA

The Effect of the US Sanctions on the Central and Eastern European Energy Sector

The US sanction bill enacted in 2017 targets Russian energy export projects, and creates significant risk for any person or company seeking to do business with designated Russian person or in Russian frontier energy projects.

As the Act highlights the US’ opposition against the Nord Stream 2 project, it can be interpreted also as choosing side in the debate on the planned extension of the actual German-Russian cooperation in natural gas trade. The action has created some tension as the Commission manages the Nord Stream 2 issue as an internal matter to be solved within the existing legal and regulatory framework.

The implementation guidance defines a restricted focus for the application of sanctions reflective of the cautious attitude of the US administration towards the Congress-initiated Act. The guidance attempts to ease concerns of the European Commission and the EU Member States and preserve transatlantic sanctions unity, emphasizing that the sanctions are discretionary, and implementation will be coordinated with allies of the United States.

The Act indicates the attempt to ensure that US foreign policy remains focused on countering Russian aggression and to establish a presence in the region and beyond. This could lead to constant threat and emerging risks in relation to Russian energy projects, but the guidance and the communication suggests limited actual implementation in case of projects which affects Europe directly.

In our view, the CEE region, which already expressed joint opposition to the Nord Stream 2 project and shares growing concern for Russian dominance in general, received a boost with the new Act. The threat of sanctions should slow momentum for the major Russian export pipeline project to Europe and serve as an important tool to maintain the Ukrainian transit route. The act supports the Hungarian diversification strategy by allowing the primary projects of interest (RO-HU corridor, Croatian LNG terminal) more time while rival Russian-backed energy projects fall into further uncertainty.

The authors would like to thank Carson Thal for his valuable comments.
THE US SANCTIONS ON RUSSIA EXTEND TO DEVELOPMENT OF ENERGY EXPORT PIPELINES

The US sanctions law, Countering America’s Adversaries through Sanctions Act (CAATSA), which was signed by President Trump on 2 August 2017 imposes fresh sanctions on Iran, Russia, and North Korea. The Russian related sanctions are placed in the title cited as “Countering Russian Influence in Europe and Eurasia Act of 2017”, whereof section 232 defines the sanctions with respect to the development of pipelines in the Russian Federation described in detail in section 235.

According to section 232, the President, in coordination with allies of the United States, may impose five or more of the sanctions described in section 235 with respect to a person if the President determines that the person knowingly, or on after the date of the enactment of the act:

- makes an investment that directly and significantly contributes to the enhancement of the ability of the Russian Federation to construct energy export pipelines; or
- sells, leases, or provides to the Russian Federation, for the construction of Russian energy export pipelines, goods, services, technology, information, or support that could directly and significantly facilitate the maintenance or expansion of the construction, modernization, or repair of energy export pipelines by the Russian Federation.

The sanctions target the business conduct which has a fair market value of $1,000,000 or more, or that, during a 12-month period, have an aggregate fair market value of $5,000,000 or more.

Section 235 lists and describes twelve different sanctions, out of which at least five may be imposed based on the decision of the President. The possible sanctions can be classified as follows:

- sanctions related to export (exclusion from export-import bank assistance, denying export permission if approval of the United States Government is required for the export of goods or services);
- sanctions related to loans and financial markets (including the prohibition of any United States financial institution from making loans or providing credits to the sanctioned person and the prohibition of banking transactions that are subject to the jurisdiction of the United States and involve any interest of the sanctioned person);
- sanctions related to property transactions (prohibition from acquiring, using, transferring, transporting, importing, exporting any property that is subject to the jurisdiction of the United States; or conducting any transaction involving such property);
- sanctions related to procurement (the United States Government may not procure, or enter into any contract for the procurement of, any goods or services from the sanctioned person);
- sanctions on the corporate officers and principal executive officers of the sanctioned person (exclusion of corporate officers, imposition of the above listed sanctions on the principal executive officers).

Regarding the energy sector-specific motivation for the elaborated sanctions, section 257 (titled as “Ukrainian energy security”) contains some hint. According to the last three points of the section, it is the policy of the United States to promote energy security through developing diversified and liberalized energy markets that provide diversified sources, suppliers, and routes; to continue to oppose the Nord Stream 2 pipeline given its detrimental impacts on the European Union’s energy security, gas market development in Central and Eastern Europe, and energy reforms in Ukraine; and that the United States Government should prioritize the export of United States energy resources.

THE BROADER CONTEXT – US INTERNAL POLITICS

Article I of the US Constitution enumerates several of Congress’s foreign affairs powers, including those to “regulate commerce with foreign nations”. Recently, Congress took active steps to reassert its authority on the international stage and maintain the US commitments to NATO and CEE allies. The near unanimous passage of Countering America’s Adversaries Through Sanctions Act, passed the House 419 – 3 and passed the Senate 98-2, sending a clear bipartisan message to the President that any attempt unilaterally ease Russian sanctions would be unacceptable. At this time, Republican and Democrat foreign policy lawmakers are leading the fight to keep US foreign policy intact and they believed that this bill was a positive step to reigning in Russian aggression. While the CAATSA appears to be an attempt by Congress to step in and fill the void of US foreign policy left by the Trump administration, in reality, it is just an example of US foreign policy on Capitol Hill - simply keep the train on the tracks rather than attempt to lay new tracks. In lawmaker’s eyes, the CAATSA was not a revolutionary bill in nature, but simply an attempt to ensure that US foreign policy remains focused at countering Russian aggression. Both Republican and a Democrats continue to be united in this goal with the foreign policy subcommittee heads serving notice as to the current defunct state of US foreign policy and the dangers of lacking clear objectives.
DIVERSE OPINIONS ON THE INTENT AND EFFECTS OF THE SANCTIONS

Major controversy continues to swirl around the main motivation behind the Act, whether it is simply to punish Russia for several recent actions specified therein (e.g. aggression in Ukraine, hacking the US presidential elections), to ease the dependency of (Central and Eastern) European countries on Russia and Kremlin influence, or rather beholden to commercial interests, that is promoting US energy exports to Europe by constraining the export abilities of the actual main supplier, Russia.

Although the commercial intent is clearly stated in the section 257, CEPS argues that this sentence merely upholds the export policy of the United States throughout the Obama era rather than attempt to secure new opportunities for US business via sanctions. Moreover, CEPS also debates the commercial interest regarding the opposition of Nord Stream 2, which is the only concrete pipeline mentioned in the law. CEPS states that since the Nord Stream 2 is a diversionary pipeline, which means that it will primarily serve to reroute volumes from the existing Yamal and Brotherhood Pipelines, then in its absence gas will simply continue to flow through the existing pipelines. Thus, it is unlikely that any sanctions against Nord Stream 2 would provide US LNG companies with new opportunities in European markets. CEPS also emphasizes the discretionary nature of the sanctions and concludes that the law provides opportunities for the US and the EU to cooperate to enhance European supply security.2

However, this view is not shared by all sides. According to Clingendael, the bill raise tensions between the US and the EU (including the Commission, Germany and other Member States), especially with its potential application to Nord Stream 2. Clingendael argues that while Russia does not shy away from extracting political benefits from its energy exports, the Commission challenges Gazprom on legal and regulatory grounds, not political ones. US sanctions drag Nord Stream 2 further into the geopolitical realm, and can be interpreted as interfering in the Commission’s internal matters, thus creating rift among transatlantic allies that serves Vladimir Putin’s purposes.3

Nevertheless, the effect of the sanctions on specific infrastructure and on the EU gas market as a whole is far from clear, and this uncertainty were even larger before the guidance came public. The overarching view is that the uncertainty itself leads to higher costs and delays for any project, but some experts believe Gazprom’s main pipeline projects (Nord Stream 2 and TurkStream) are likely to be built regardless. Gazprom reacted to the sanctions by ramping up nascent construction efforts for TurkStream under the Black Sea, but longer-term projects in earlier stages will likely face tangible setbacks. In particular, the deep-sea, arctic, and slate projects that require the use of foreign technologies would suffer most.4

MEANWHILE IN EUROPE: THE DISPUTE OVER NORD STREAM 2 CULMINATED IN PROPOSED EXTENSION OF EU GAS RULES TO IMPORT AND OFFSHORE PIPELINES

‘Controversial’ became almost an epithet for Nord Stream 2, referring to the debate among EU Member States on the necessity and the – market and geopolitical – effects of the planned extension of the actual German-Russian cooperation in natural gas trade. Central-Eastern European and Baltic countries have criticized the project in the European Council, and members of the European Parliament sent letters to the European Commission objecting to the project. While the Commission felt that pressure to take measures against the project was growing, and declared also its own critiques, the requisite legal steps for preventing construction remain unclear.5

In line with Clingendael’s diagnosis, the European Commission is keen to demonstrate its willingness and ability to solve the issues of the internal energy markets within the existing legal and regulatory framework, but for the moment it is powerless. The Commission requested from the European Council (the Member States) a “mandate” to negotiate an Intergovernmental Agreement (IGA) with Russia over Nord Stream 2, but the Council’s legal service found no legal basis for such a request according to its assessment released on 27 September 2017, and the Council has not made a formal decision.6

The proposal for amending the Gas Directive (2009/73/EC) was announced in October and issued on 8th November 2017. It contains the extension of the entire regulatory framework (e.g. the provisions on third-party access, tariff regulation, ownership unbundling and transparency) to gas pipelines to and from third countries, including existing and future pipelines, up to the border of EU jurisdiction. The proposal also clarifies that under the Directive the territorial waters and exclusive economic zones of Member States would be applicable to offshore pipelines. Since Nord Stream 2 crosses the terrestrial water of Denmark and Germany, and the exclusive economic zones of all country around the Baltic sea, the amended Directive would be clearly applicable for the pipeline in question.7

In its Q&A factsheet, the Commission asserted that the aim of the proposal is to fill a legal void for gas pipelines to and from third countries which can be detrimental to the functioning of the EU internal energy market and security of supply. The Commission articulated that the proposal is complementary to the Nord Stream 2 mandate, but denied seeking to prevent the construction of any new gas pipelines.8

The new sanctions bill, specifically identifying Nord Stream 2, can be interpreted to represent the US position in the debate, however, as Clingendale pointed out, this assertion was not greeted kindly by the Commission and could even backfire if it disrupts the anti-Nord Stream 2 coalition by offering stronger solution for the claiming Member States’ problem.
THE PUBLIC GUIDANCE PROVIDED SOME CLARIFICATION, BUT UNCERTAINTY REMAINS

The US Treasury’s Office of Foreign Assets Control (OFAC) and the US State Department released the guidance on implementation of the CAATSA on 31st October 2017. The one-page document does not detail the rules of implementation, rather it highlights and clarifies some feature of the act as follows:

- The main message of the guidance is that the section 232 sanctions are discretionary, not mandatory, and imposing these sanctions requires coordination with allies of the United States.
- The guidance emphasizes the energy security and diversification goal, but has no reference to the other specified policy goals from section 257 (like opposition against Nord Stream 2).
- The guidance states that the focus of implementation would be on energy export pipelines that originate in the Russian Federation, not pipelines that originate outside Russia and transit through the country.
- Most importantly, the guidance states that the focus of implementation would be on investments and other business activities mentioned made on or after August 2, 2017, and related to a Russian energy export pipeline project initiated on or after August 2, 2017. The document also defines a project to be considered initiated upon its signing, adding that investments and loan agreements made prior to August 2, 2017 would not be subject to Section 232 sanctions.
- The guidance also declares that the sanctions would not target investments or other activities related to the standard repair and maintenance of pipelines in existence and capable of transporting commercial quantities of hydrocarbons, as of August 2, 2017.

CONCLUSIONS

Estimating the impact of the act on CEE energy markets would be highly speculative at this point, but some general interpretations and assessments can be made based on the above.

We must distinguish the two main actors to detect the US’ motivation, Congress and the White House. The act was initiated and passed with nearly full bi-partisan support, while the implementation falls to the President and his administration, which seems less enthusiastic about the sanctions and more risk-averse. This is clearly visible in the soft tone of the guidance, which is restrictive compared to the act, especially by removing ongoing projects from the focus of the implementation. The administration wants to avoid the controversial aspects of the CAATSA and is reluctant to implement the US sanctions as Congress originally intended. The public guidance announcements and the list of targeted individuals illustrated the administration’s restraint from escalating US-Russia tensions by actively targeting Russian pipeline projects. However, Congress remains unified in its goal to punish the Russian government, and top lawmakers believe that active steps need to be taken to stop Russian aggression in Eastern Europe. Based on this, more back and forth between Congress and the administration is expected, which will lead to more threatening words than implementation action.

The applicability of the act on specific pipeline projects is also not obvious based on the guidance. The contracts for TurkStream had been signed before the enactment of the CAATSA and construction is underway, meaning the first string will likely be unaffected, while the widely discussed second string (to Bulgaria) would fall under the bill. Construction of the Nord Stream 2 has not begun (pipe laying is tentatively scheduled to start in Q2 2018) and it is unknown what kind of agreements were concluded before the date outlined in the act. As the guidance does not define precisely what type of contracts are considered to ‘initiate’ a project in the first place, the applicability of the act cannot be ruled out. However, with its special mention in the text, it would be difficult to argue that it is not within the scope. At the same time, it should be emphasized that the guidance establishes focus of the implementation, without restricting the legal applicability of the act which has a broader extent. The guidance shows the attitude of the administration in relation to sanctions, but the actual implementation is more a matter of political realities than purely benign legal considerations.

Furthermore, the most emphasized feature of the sanctions is that they are discretionary and that implementation will take place in coordination with allies of the United States. The administration took serious efforts to assuage concerns of the European Commission and to preserve sanctions unity with the European Union, arguably the most critical factor in the current sanctions regime.

However, the European Union’s institutions (Parliament, Commission) and Member States are united only in the general aim of taking steps against the Russian aggression in Ukraine and to counter the increasing Russian influence in Central and Eastern Europe (several strategic documents point out this goal, e.g. Energy Union, Energy Security Strategy), but they are fragmented in approach and have divergent interest in relation to pipeline projects, particularly Nord Stream 2. European promoters of the project and Gazprom are lobbying at all possible levels to attempt to convince stakeholders that Nord Stream 2 is based purely on commercial considerations, which is not the case. Therefore, it is hard to imagine joint EU-US decision-making can effectively carry out implementation of the act. We assume that the US administration won’t take the risk to impose sanctions unilaterally on European energy incumbents, but still, the US Congress has now interjected itself into the equation.
The debate in Europe has now shifted to the extension of EU law over external pipelines. If adopted, it would give the Commission some control over the Nord Stream 2. Although within the EC’s legal/ regulatory approach, the primary objective is not to prevent construction but to mitigate its potential adverse effects, it can discourage and slow Gazprom from building it. Introducing third-party access and unbundling requirements at the first sight may seem to have limited added value for pipelines originating in producer countries with monopolistic upstream markets. Nevertheless, considering the Gazprom’s tenacity with infrastructure ownership or at least legal exclusivity (including the case of the terminated South Stream project), such consequence is more plausible.

The sanctions package, even with restricted focus and limited implementation, adds risk and creates an unfavorable climate for any investment or business in relation to new Russian energy projects (shale, Arctic offshore or deep-sea oil). While the guidance does not mention plans for enacting section 232 or 235 to cordon off financial markets from Russian backed energy projects, there is a rising concern in the financial community that this might happen in the future. This fear comes from the open, loose language of the CAATSA and the authority it grants the administration to impact Russian energy enterprises. If individuals associated with energy projects are sanctioned and excluded from accessing investors or financial loans, then inevitably the costs of the projects will increase - just the pure possibility of such actions can have similar effects.

The CEE region sent a clear message in November 2015 when 7 countries signed a joint letter addressed to the Commission against Nord Stream 2. (The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia signed. Romania, Bulgaria and Slovenia refused to sign.) In our view, the region now got a powerful ally to counter Russian dominance, with the threat of sanctions alone able to slow down the Russian initiative. It can be an important tool to maintain the Ukrainian transit route as well, affecting the economic implication of the whole modernization process of the Ukrainian energy sector.

From the Hungarian perspective, in our view, the act supports the Hungarian diversification strategy, since the prime projects (RO-HU interconnector, Croatian LNG terminal) will have some breathing room against rival Russian-backed energy projects.

NOTES


3 Clingendael: Nord Stream 2 will divide EU, new US sanctions will do more harm https://www.clingendael.org/publication/nord-stream-2-will-divide-eu-new-us-sanctions-will-do-more-harm


9 https://www.state.gov/o/enr/275195.htm


11 http://www.atlanticcouncil.org/?view=article&id=37695.trump-administrations-solid-guidance-on-russia-sanctions
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