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BULLETIN

U.S. Hits Russia's Energy Sector with New Sanctions

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The latest U.S. sanctions on Russia's energy sector could significantly reduce that country's budget revenues, making it more difficult to continue the war with Ukraine. The announcement of sanctions by President Joe Biden in his final days in office and their sustainment so far by President Donald Trump strengthens the U.S. negotiating position ahead of possible talks with Russia on the terms of a halt to military action in Ukraine. The impact on the Russian economy will be reinforced by the extension of restrictions on the energy sector in the next EU sanctions packages.

On 10 January, the U.S. Department of State and the Treasury Department's Office of Foreign Assets Control (OFAC) announced another package of sanctions targeting Russia's energy sector. This is the strongest blow to the Russian industry since the G7 adopted the price cap mechanism. The new sanctions, coming into force on 27 February, are a response to Russian efforts to circumvent the restrictions. They target energy companies and related industries (e.g. insurance, technology, and mining), blocking a record number of "shadow fleet" vessels, restricting energy expansion in the Arctic, and raising the cost of LNG and oil exports, particularly to China and India. At the same time, the United Kingdom adopted similar restrictions.

Consequences for Russia. The largest players in the oil sector affected by the restrictions account for about a quarter of Russia's oil processing and exports, namely Gazprom Neft and Surgutneftegaz, as well as all upstream, processing, and logistics subsidiaries The new sanctions will worsen Gazprom's financial situation, as Gazprom Neft has recently been the most profitable part of the group, and hamper its upstream operations and exports of oil raw materials (e.g., fuels, lubricants). The sanctions will also limit Russia's influence in Central Asian countries (including Gazprom Neft Asia, Munai Myrza, and Gazpromneft-Tajikistan) and Luxembourg, where Gazprom Neft International is based. Most importantly, they hit operations in Serbia where the company owns more than 50% of that country's largest oil company, NIS, which includes, for example, the Pančevo refinery. Although Lukoil and Rosneft were not directly included in the sanctions list, the restrictions affect their upstream and technology projects, including Rosneft's flagship Vostok oil development on the Arctic shelf. The technology sanctions introduced will limit the involvement of Western companies in investments in Russia. This will reduce export revenues, significantly hamper logistics, and slow ongoing upstream and technology projects.

The U.S. has targeted Russia's entire offshore oil-transportation system used to evade the price cap mechanism. The number of vessels in the sanctioned "shadow fleet" has quadrupled, from 54 to 237, representing about a third of the suspected "fleet". Two of Russia's three largest insurance companies (AlfaStrakhovanie and Ingosstrakh) are also affected by the restrictions, as are foreign shipowners and trade operators (e.g., from India, Hong Kong, and the UAE). The effects are already being observed, with some oil customers from China or India giving up on receiving the crude. According to estimates, up to half of the sea transport of oil from Russia to China is at risk.

The sanctions will also limit Russia's LNG exports, particularly to Europe. The package blocks the Vysotsk-LNG and Protovaya-LNG Baltic terminals (about 2.2 million tonnes of LNG exports per year) and deepens the restrictions on the Arctic LNG-2 terminal, which was partially launched last year, pulling Chinese and Indian companies suspected of supporting the project onto the sanctions list. Methane carriers and icebreakers involved in LNG transportation have been added to the sanctions list as well.

Also groundbreaking is the scope of the package, which affects the mining and export industries for coal, coking coal, and lithium. Of significance is the imposition of sanctions on the operator of Russia's largest lithium deposit, Polar Lithium (a joint venture between Norilsk Nickel and Rosatom), which has been planning the mass processing of lithium at a plant under construction in the Königsberg oblast. This will slow the development of Russia's battery and electromobility industry and undermine cooperation in this area with China. The U.S. first hit Rosatom with individual sanctions against the company's management, but the effect of these restrictions on nuclear power plant construction projects in Turkey or Hungary is not clear.

In response to the sanctions, Russia announced it would have an "appropriate" but unspecified response. Representatives of Russia's Foreign Ministry claimed the restrictions are ineffective, arguing they are only destabilising global markets.

Biden Administration's Calculations. The energy sanctions package is another tool of U.S. pressure on Russia in the wake of its invasion of Ukraine. Such a strong slap on the Russian energy sector by the U.S. authorities had not been implemented earlier due to concerns about a global spike in commodity prices, which would most likely have translated into a renewed rise in inflation, and about harming the Democrats' chances in the presidential and congressional elections, which in the end did not matter. The stable price of oil below $80 per barrel in the third and fourth quarters of last year reduced the risk of destabilisation of the global market and higher energy costs, including in the U.S. The imposition of sanctions at the end of the Biden administration did not carry political risks, rather reaffirmed the firmness of his approach to Russia as part of his political legacy, while strengthening the new administration's negotiating position. This decision means that the U.S. can still show "goodwill" in its approach to the negotiations and extends the range of sanctions concessions that it could make in connection with a possible Russia-Ukraine agreement, but not necessarily a complete relaxation of pressure on all sectors of the Russian economy. It is likely that the scope of these sanctions was consulted between Biden and Trump advisors.

The Trump Administration's Approach to Sanctions. The will to sustain the existing sanctions has been indirectly reaffirmed by the new president with the announcement of further restrictions that could be imposed on Russia in the event that it continues its war and is unwilling to negotiate. Any attempts by the Trump administration to lift the energy sanctions would mostly require informing Congress, which can block the president's decision. This is because of regulations adopted in the Countering America's Adversaries Through Sanctions Act, which is the legal basis for the latest sanctions package. However, the effectiveness of the sanctions will depend on their enforcement by the new U.S. administration, including against third countries that import Russian raw materials. Lifting or loosening them, however, is unlikely. Limiting the availability of Russian raw materials is in line with the announced energy policy, which aims to dominate global markets and lower oil and gas prices by increasing their production in the U.S. and increasing exports. In addition, Trump has called on OPEC countries, led by Saudi Arabia, to increase oil production and drive the price of oil down in order to reduce Russia's income from its sale and make it more difficult to finance the war.

Conclusions and Outlook. For Russia, the package means further impediments to the export of energy resources, contributing to a decline in export tax revenues, an important part of the revenues to local and federal budgets needed to finance the costly war. In the long term, it could mean the collapse of LNG exports, the importance of which to state revenues and the power elites over the next decade was expected to replace declining revenues from pipeline exports to Europe. The sanctions weaken Russia's economic and technical capacity for further expansion in the Arctic. Russia will certainly take steps to circumvent the sanctions while negotiating with the new U.S. administration to lift them.

Despite the strong blow to Russia's energy sector, the potential for further significant restrictions in this area remains. The U.S. could hit the Russian nuclear power industry with sanctions on Rosatom or tighten the regime on the oil sector, extending sanctions to Rosneft and Lukoil. Given the delayed effect of any economic sanction, it may also be necessary for the U.S. to use pressure via military support for Ukraine to force Russia into negotiations.

Maintaining consistency in U.S. sanctions policy, despite the change in power, should send a clear signal to partners in Europe and Asia (including India, Japan, and South Korea) to further reduce cooperation with Russia in the area of energy and turn to increasing U.S. imports. An additional incentive for such actions is expected to be Trump's call for more balanced trade in bilateral relations, with partners' surpluses viewed negatively by Trump and providing him with an argument for imposing tariffs.

In the next sanctions packages, EU countries should strengthen their own sanctions on the Russian energy sector, especially improve enforcement, introduce an embargo on Russian LNG, lower the price cap on oil, and tighten measures against Russia's "shadow fleet". In view of the failure to include sanctions on LNG from Russia in the EU's 16th sanctions package, getting countries to agree to these restrictions would be a tangible success for the Polish presidency of the EU Council in the area of energy security.