The Next Russian Energy Sanction

Just Like Old Times

As the partisan tug-of-war continues over whether Russian influence extended to the Trump team or had an impact on the recent American election, an earlier sanction suggestion I made has resurfaced.

This move, if Congress ever agreed to act on it, would freeze U.S.-Russian relations, intensify the resurgence of a Cold War, and make portions of the global playing field look like a mine field.

Yet given the possible disclosures likely to come out in the near term, it may come to pass anyway. The Trump White House may not want it; parts of the Republican caucus may not either. Neither may make any difference.

Given my previous involvement in the "Great Game," and my continuing contact with players in the intelligence community, the scuttlebutt is deafening. Whether it is Congressional committees or a special prosecutor, the revelations are going to make for some nasty headlines.

Before this is over, I think is quite likely that Congress will move back to revisit – and toughen – sanctions against Moscow. And the current occupant of the Oval Office will have little means to prevent it.

And this leads me back to themes I addressed in a series of writings over the past 18 months.

First, a little background. I spend decades as a university professor and global energy analyst. But these were in large measure my "day jobs." Because almost 47 years ago I also signed an agreement with Uncle Sam…

The government essentially said it understood my soul may belong to God, but the rest of the anatomy was going to be theirs until further notice. That was what brought me into a sometimes-ill-defined segment of public service. It's a job you never really have the option of leaving – at least easily and preferably while still drawing breath.

But over time age takes its toll. That meant I finally got to the point where I could use the memorable Danny Glover line from the Lethal Weapon movies: "I'm too old for this s***."

Eventually, I was shot at less often.

But my role in the Great Game was hardly over, because – Shazam! I was transformed into an operational consultant and under that rubric, likely to be drawn into just about anything.

My bailiwick during my operational life was in counter-intelligence and in those days the primary object of my attention was Moscow.

Some of the pieces and much of the strategy in the current situation have felt very reminiscent of the Cold War, and I found myself all too easily assuming a familiar mantle of a previous age. The Cold War was an unnerving time. Yet at least you got up in the morning knowing what your purpose was going to be that day. The cause and the enemy were well defined.

You also recognized there were folks on the other side doing the same thing. An uneasy balance ensued, making the exercise strangely predictable.

But being brought "back into play" always means that I become aware of – or have a hand in fashioning – aspects of policy development exercised by others. Of course, this exercise comes with a certain prime directive. Appropriately enough, it is the same one I occasionally must practice when writing about energy matters.

It's simple. If I have access to "inside information" on what a company is about to do in the energy sphere, I must wait until it appears in public – any report, newspaper article, or blog post will do. The same holds true for what may or may not happen shortly in foreign policy. Guys like me need to sit on information and button it until there is an initial release via other means.

Gazproblems

Well, it is beginning to unravel this week. And that means, as in all matters relating to Russian energy policy, the West's target is once again Gazprom.

This is Russia's dominant corporation and the largest natural gas company on the face of the earth. It is always a main cog in Russian foreign policy. It does not speak on behalf of a Board of Directors, but for the Kremlin itself.

Gazprom is a behemoth, but not a very well-run one. It is bloated, containing far too many unproductive assets having little to do with the gas business (newspapers, a TV station, sports arenas, a food canning enterprise, textiles, an airline, chemicals, timber rights, and so on).

Even at home, Gazprom has major problems. It has an outmoded domestic infrastructure extending from depleting field drilling, through the largest pipeline network in the world (where there are numerous leaks daily), to processing and distribution.

It oversees rapidly declining traditional gas fields and has eschewed developing shale gas (but has been moving on another unconventional source, coal bed methane). It also has an increasing problem with budgeting for the huge expenses of moving into Eastern Siberia, above the Arctic Circle, and out onto the continental shelf (which Moscow argues goes all the way to the North Pole) to offset what by 2020 is probably going to be an 8% annual decline in production at maturing fields.

For both politically astute CEO Alexei Miller and his real boss, Russian President Vladimir Putin, expanding Gazprom and balancing the budget can only happen with increased outside sales of gas.

The most important element here is straight forward: Without increasing the annual sale of gas abroad, both Gazprom and the Kremlin are in deep trouble.

And while the recent accord with China has been ballyhooed by Russian media (and officials) as a major step in that direction, two things need to fall into place. Otherwise, the agreement will more likely turn into a decades-long millstone around Gazprom's neck, rather than a lifeline.

First, both parties must conclude essential elements of pricing and volume, take or pay provisions (requiring the end user accept a certain amount each month or pay as if it has), and the basket of crude oil and oil products used to determine pricing adjustments. Second, the Chinese contract is not a breakthrough for the Russians unless it leads to a significant increase in overall exports. That, in turn, cannot take place unless Gazprom continues to improve its market position where it currently sells most of its exports – Europe.

There, the Ukrainian crisis and Russia's continuing refusal to follow the provisions of the Energy Charter Treaty (ECT) and the Transport Protocol (TP) have combined to create a major problem for Gazprom.

ECT requires that all signatory nations separate their domestic companies producing gas from those transporting it. Further, TP obliges that each nation make its domestic gas pipeline system open to outside third parties. Despite having signed the treaty, Russia flatly refuses to either break up Gazprom or allow outside access to its pipelines (administered on behalf of the state by Gazprom on a monopoly basis).

Several months ago, an article appeared in Newsweek entitled “To Deter Putin, How about a Total Ban in Russian Energy?” It is written by Chris Hartwell and Andreas Umland and had previously appeared on the Atlantic Council website. The piece is now resurfacing in the latest policy discussions.

The authors initially number off the now familiar litany of Russian offenses to international sensibilities – Ukraine, the shooting down of MH 17 (the Malaysian airline), the Aleppo human tragedy in Syria, and an exit from the Nuclear Security Pact with the U.S. All of these affronts, they suggest, cause Russia to “diverge further from the rules-based consensus of the post-Cold War world.”

The Western sanctions introduced in 2014 seem to have little effect, leaving the authors to conclude that the measures should be increased to include an embargo of Russian energy exports to the outside world.

Now I happen to know something about economic sanctions, having experience in designing and advising on such measures. There is one overarching reality in crafting effective sanctions. It makes no difference whether we are considering the U.S. policy against Japan prior to World War II (an energy initiative, by the way) or against Cuba, the UN and Western sanctions against Iran, those intent on deterring a North Koran nuclear weapon, or the current U.S./European limitations on Russia.

To work, sanctions must have limited and defined diplomatic objectives with clearly proscribed range and application. They also must be used in tandem with other initiatives that also have a foreign policy purpose. Sanctions are not a surrogate weapon for military invasion. Getting even is neither a sufficient nor an acceptable objective.

An Energy Embargo Won’t Solve the Problem

There are always unrealistic expectations about either or both of two assumptions: the effectiveness of the sanctions; and/or how many nations are likely to participate (freely or under diplomatic compulsion).

Unfortunately, Hartwell and Umland fail on both counts. Yes, Moscow certainly and heavily relies on export revenues from oil and natural gas. But recipient countries also need the energy. By simply advocating a blanket embargo of Russian exports, the suggestion harms a far greater part of the world than the intended target.

It would also require a fine line between penalizing and incapacitating a nation. Move too far in the latter direction and Russia starts moving tanks someplace. If you are strangling a lifeline, a government will retaliate.

Embargos are difficult to implement in practice because they require enforceable agreements among so many affected players. In the case of embargos restricting where a country's oil or natural gas exports can go, there would need to be a broad consensus among primary importers, all of whom must meet their own domestic (and essential) energy needs.

In the case of Russia, an expansive embargo would fail. As Washington learned only too clearly in attempting to enforce sanctions against Iranian sales, global regional requirements allow for leverage even in the face of concerted outside opposition.

There will not be anything beyond partial compliance. And then there are the ongoing multi-year contracts already in force, for which legal strictures require compliance. A general energy embargo would not even apply here.

A further complication involves what such an embargo would do inside a country. Effects of a successful economic sanction should not extend to paralyzing a population or making life miserable to average people. That merely plays into a guaranteed rise in nationalism and further policy intransigence, especially in the case of Russia.

An across-the-board energy embargo will not work and will be counterproductive.

Yet, energy is still Russia's weak link. The objective in orchestrating an energy sanction against Moscow is to target that which allows outside compliance and still increases the screws. That is found not in oil but in natural gas.

Threading the Needle

Sanctions preventing Gazprom from selling its natural gas abroad will certainly fail. Multi-year (usually twenty-year) contracts are already in force and would be defended legally. Moreover, an attempt to close Gazprom exports outright would ratchet up animosity beyond the worst times during the Cold War.

Instead, the focus should be to make any new contracts more expensive for the Kremlin to engineer. It just happens that there is a way to do this without impacting existing contracts, where the target is not simply outside Russia but located in nations that already support the current sanctions against Moscow.

The plan calls for an initial round of sanctions against Gazprom Marketing & Trading (GM&T), Gazprom's main avenue for financing exports. These sanctions would limit GM&T's access to financing only existing contracts, not new ones.

This could be applied immediately against the GM&T office in Houston. The main location is in London (20 Triton Street), a location I've been to several times in the past. Others are in Manchester, Paris, Singapore, and Zug (Switzerland).

Both the UK and France would support such a move, since it does not impair existing delivery contracts. Those contracts are multi-year, requiring the pre-financing of each monthly delivery. Under this plan, those would continue.

This is the gist of the recommendation I made after the Ukrainian crisis emerged some two years ago.

The intent of these sanctions is to hurt Moscow financially, not destroy Gazprom. That said, the inability of Gazprom's international trading arm (GM&T) to access working capital would put several major projects in jeopardy – including the building of the new Chinese pipeline.

That pipeline project was the "big news" a while back. But the parties have yet to finalize cost (or for that matter what the gas pricing will be or even how that price will be determined).

Here is the most important point to remember in all of this: Moscow must sell additional gas abroad, otherwise its budget will collapse. To do that Gazprom must have the ability to operate freely.

Simply maintaining current contract volumes is not enough. Sanctioning GM&T would hit Russia where it hurts most economically, while it insulates current European import agreements from attack.

Of course, it is true that other GM&T offices internationally could pick up some of the slack, especially via Singapore with Chinese assistance. But this would still make the process considerably more expensive.

The sanctions would still prevent Gazprom from having access to dollar-denominated banking internationally when it comes to financing new projects.

Remember, the gas trade (like oil) is denominated in dollars globally. It's possible to bypass this with other currencies, but it costs more. Just ask the Iranians.

One factor is becoming more obvious.

Putting the screws to Gazprom is no longer off the table.

This remains the only energy sanction against the Kremlin I can see that has any chance of success. Maybe that's why, after a request for options, I recommended it to policy makers over two years ago.

About the Author

Dr. Kent Moors is an internationally recognized expert in oil and natural gas policy, risk management, emerging market economic development, and market risk assessment.

He serves as an advisor to the highest levels of 27 countries, including the U.S., Russian, Kazakh, Chinese, Iraqi, and Kurdish governments, to the governors of several U.S. states, and to the premiers of two Canadian provinces. He's served as a consultant to private companies, financial institutions and law firms in 29 countries, and has appeared more than 2,300 times as a featured radio-and-television commentator. He appears regularly on ABC, BBC, Bloomberg TV, CBS, CNBC, CNN, NBC, Russian RTV, and the Fox Business Network.

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