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IMPACT OF SANCTIONS ON RUSSIAN BUSINESS

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ANALYSIS

Five Years of Financial Market and Banking Sector Sanctions—A "New Equilibrium" Locally and Internationally

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Abstract
After adjustments following their introduction in 2014, the Western financial market and banking sector sanctions against Russia have produced hardly any lasting negative market effects in the last 12–24 months. This outcome has to do with some win-win constellations between international investors and the Russian state. These deals work as long as the US does not seek harsh escalations in economic and financial market sanctions. In addition, Western sanctions even support some of Russia's national economic policy goals indirectly, including consolidation of the banking sector.

Sanctions Have Little Impact
Personal and sectoral sanctions against Russia, which also materially affect the banking sector, the state banks and the financial markets, have been in place for five years now. At the beginning of the sectoral sanctions in 2014, initially coordinated between the EU, the USA and other Western countries, Russian financial markets and the national currency came under considerable pressure. At that time, the European regulator (ECB) demanded weekly updates from the major Western European banks operating in Russia. The cross-border claims of Western banks on Russia fell from almost 260 billion US dollars at their peak value in 2014 to just over 100 billion dollars at year-end 2016. These declines were almost as steep as the cross-border funding reductions in the context of the euro zone crisis against countries of the so-called "periphery," which posed massive challenges to the European markets and ECB. However, in the case of Russia, this adjustment could be achieved without massive disruptions through professional crisis management with the active participation of the Russian central bank and including currency swaps.

In the meantime, there is no longer any noticeable pressure on the local currency and international bank exposures to Russia. In 2014, important foundations were laid for the current stability, such as the turn to a free-floating ruble exchange rate and the high interest rate policy of the central bank. Despite occasional short-term market volatility driven by selective sanctions tightening in the USA and legislative projects discussed in Europe, economic catastrophe scenarios have failed to materialise. Of course, temporary setbacks in the exchange rate, on the government bond market and also on the Russian stock market have occurred. But, only a few Russian companies whose owners are or could be targets of sanctions suffer disadvantages on international markets, such as higher interest rates on capital market financing compared to otherwise comparable companies.

The overall low impact to date of Western financial market sanctions against Russia is mainly attributable to four factors: The lack of a complete escalation (especially on the part of the USA) on the sanctions front so far, gradual adjustments towards a "new equilibrium" of Russia's international financial embedding, a focused economic policy that wants to preserve the so-called "new equilibrium," and habituation effects among investors in combination with precautionary measures. These four aspects are discussed in more detail below. Moreover, despite Western sanctions, some win-win agreements between the Russian state and international investors are currently discernible, which may reduce the effects of Western sanctions and sanction threats.

Limited US Sanctions
To date, the US has never really implemented unilateral sanctions that pose systemic challenges to the Russian banking and financial system. Such steps were discernible in spring 2018, particularly with efforts to sanction Rusal and then later with the first phase of the Defending American Security from Kremlin Aggression (DASKA) legislation, which stipulated the potential exclusion of state-owned or state-related Russian banks from US dollar payment transactions. However, such harsh measures are currently no longer part of the sanctions efforts or, in the case of Rusal, the US has taken a pragmatic approach to sanctions once they have been announced. International investors currently assume that the USA will not further sanction large and internationally integrated Russian companies without additional political escalations.

In addition, after a first unilateral rush by the USA, consideration for European and/or international interests began to emerge. In this context, it should be stressed that European banks in particular have a special relevance for Russia's business. In addition, Russian companies or the state still enjoy international market access. In some cases, it seems that the Russian state is deliberately placing long-term international government bonds in dollars and euros (particularly following escalations in the sanctions debate) in order to communicate its international embedding in the financial market. These transactions create long-term dependencies. Financing on the global capital markets and with international investors is important, because Chinese investors purchase international Russian bonds on a large scale almost only when they are issued in offshore Renmimbi, but they do not invest heavily in Russian bonds denominated in USD or EUR.

The international debt market financing volumes for Russia are currently of a limited nature; their purpose is more to cultivate the market than to rely on them. Nevertheless, in recent years at least 10 to 25 billion US dollars a year have been raised in long-term bond financing with the participation of international investors. Some of these transactions even took place in US dollars, while others deliberately chose the euro as the issuing currency. However, the financing volumes are not so large that they should immediately trigger international suspicion. In fact, the volumes are small enough that there is solid investor interest in these rather scarce assets. In this respect, there is even a "win-win" situation with regard to Russian interests and international investor interests.

A "New Equilibrium"

In the absence of a complete escalation, the international banking and financial markets have also reached a stable equilibrium, benefitting both Russia and foreign investors. Foreign banks reduced their Russian exposures decisively from 2014 to 2016 (from 250–260 billion US dollars to about 110 billion US dollars). Since then cross-border bank financing to Russia has been stable for about two years at a level of just over 100 billion US dollars. However, the underlying interdependencies have shifted substantially. Only three Western European countries (France, Italy and Austria) now account for more than half of the Russian exposure to international banks. A few years ago relations were different. At that time German, American and British banks had substantial shares in Russia's business, at the level of the French, Italian and Austrian banks. At present foreign banks make up only 17% of the Russian market, while before 2014, the market share was over 30%.

This shift provides some security to Russia: since the banking sectors in France, Italy and Austria have a long-term interest in their commitments to Russia, they cannot withdraw quickly. They have local subsidiary banks with considerable balance sheet volumes and, of course, they aim to stabilize the value of these assets. This goal can only be achieved by a further active presence in Russian business. The major remaining European foreign banks in Russia are recognized by the central bank as important systemic players for the banking system and have not been subject to any regulatory or operational discrimination to date. As a result of these connections, it is not surprising that bank and, in some cases, political representatives from Italy and Austria are rather critical of sanctions. German banks (possibly also supported by the strong Italian UniCredit presence in Germany) have also been accused of lobbying activities in the USA in recent months.

Some international capital market investors with a Russian focus are also continuing to invest in the country, especially in Russian government bonds denominated in rubles. This happens primarily on the basis of orthodox-restrictive monetary and fiscal policies. Any declines in the market share of foreign investors in ruble government bonds, usually linked to news stories about the sanctions, was temporary up to now. The foreign commitment on this market, as a percentage share, has not once fallen sustainably during recent years and is now again close to 30 percent. The latter is quite an impressive figure in the emerging markets space (even vis-à-vis non-sanctioned countries). In absolute terms, there are currently even significantly more rouble government bonds in foreign hands than in 2014, i.e. before the banking sanctions of the EU and USA and the threat by the USA to sanction the new acquisition of Russian government bonds.

In the course of the first part of 2019, some market observers had the impression that many investors even wanted to cover themselves as extensively as possible with Russian rouble government bonds before US sanctions could be imposed. This excess demand has led to a sharp drop in yields and the Russian Finance Ministry has partly exploited this situation to hold large bond auctions. International investors and Russian authorities assume that even the sanctioning of the new acquisition of Russian government bonds by the US would certainly not plunge Russia into a comprehensive financial crisis in the coming 12–36 months.

Monetary Policy and Banking Sector Restructuring

Above all, the high-interest policy, implemented by a central bank that is reasonably independent and considered credible internationally, makes Russia attractive in the international investment universe, while fiscal consolidation is also taking place via high-dividend payments on shares of state-owned companies, which makes them interesting for foreign (minority) shareholders (see, for example, the recent dividend increase at Gazprom in May 2019).

At the same time, restrictive monetary and fiscal policies protect the ruble directly and indirectly from massive market distortions. In recent years, the rouble has performed significantly better than most emerging market currencies in terms of exchange rate stability against the US dollar. Moreover, conservative monetary and fiscal policy has also led to Russia once again being rated by all three internationally relevant agencies as worthy of investment in principle (investment-grade). For opportunistic financial investors and international banks, this is a relevant factor in their return and risk calculation and here too there is a win-win constellation for the Russian state and international investors.

The high interest rate policy also favors the local banking sector, which is once again making solid profits. In 2018, the return on equity was almost 14% (the highest figure since 2013). In addition, the banking sector has been able to strengthen its refinancing base in recent years on aggregate, also helped by the absence of major shocks—the ratio of deposits to loans is 81%, in 2014 this figure was 95%, and in 2008 112%. Banks also stabilized non-performing loans (currently 6%) and gradually reduced the share of foreign currency loans in the total loan portfolio. At present, these account for only 20% of the total loan portfolio. Nevertheless, the recessionary shocks of 2014–2015 have certainly led to certain distortions in the banking sector and some previously over-expanding players had to be nationalized in 2017.

However, this adjustment process also helped to achieve a long-term economic policy goal—including that of the central bank: the consolidation of the banking sector to "only" 484 banks (in 2014 there were 834, in 2008 1108). Fewer banks and the elimination of banks with an unsound business model will increase the resilience of the Russian banking and finance system or make it easier to manage potential crises. In addition, the share of state-owned banks in the banking market has continued to rise (to just under 70% in 2018 compared with 56% in 2014). However, the leading foreign (Western European) banks in the country are also benefiting from the market shakeout. In this respect, it is not surprising that the market share of foreign banks has stabilised again in the last 12–18 months—after years of decline—or that win-win possibilities are discernible here as well. The foreign banks are also generating considerable earnings from their Russian business.

Getting Used to Sanctions

After initial adjustments, international investors have now acclimated, while the steps gradually taken in recent years have helped to minimize Russia's vulnerability and give dedicated Russian investors a degree of security. Furthermore, preparations for further sanctions have also become standard practice in economic relations. In many treaties, for example, there are now sanctions and currency exchange clauses. Companies that continue to operate in Russia have also invested substantial resources in monitoring the sanctions issue, and an industry for such services has even established itself in Russia. In this respect, at least in the short to medium term, there is some predictability and perhaps even feelings of security. On the Russian side, too, there are quite a few contingency plans (e.g. in the event of harsh sanctions with regard to US dollar transactions) at private commercial banks, in cooperation with the central bank and the Finance Ministry.

Conclusion

Overall, Russian economic policy is aimed at maintaining the current equilibrium with its various win-win constellations outlined here and at minimizing Russia's vulnerability to external shocks, particularly new sanctions. To date, this economic policy has been quite successful. The existing balance among local and international banking and financial markets outlined above could thus be maintained for years to come.

However, there are clear signs of moral hazard. International investors with a dedicated appetite for Russia's commitments will generate excess returns. The latter are partly based on the latent sanction risks (above all unilateral sanctions by the USA), which have not yet materialized. But it is precisely this fact that could well attract the suspicion of relevant US players. This effect should also be seen in the context of a certain adverse selection. The investors and banks (mostly selected European banks) still active in Russian business are benefiting from the withdrawal of other players and see their previous strategy as successful, which may result in a unhealthy market bias towards Russia in some countries.

In addition, the slow growth in the Russian economy, the low level of investment and the resulting—as well as sanctioned—limited international financing mean that Russian assets are becoming increasingly insignificant on international markets or in international portfolios.

However, these developments also make further sanctioning at least more realistic. In this respect, it should be noted that medium to long-term risks may currently be underestimated by investors still active in Russia and in international banking and financial market relations. Thus, the stability of the last five years should not simply be projected onto the next five years, especially since the Western sanctions against Russia are based on a fundamental dispute about international aggression and at the same time the degree of predictability in Russian, and partly also Western, politics has substantially decreased.

Furthermore, it should be noted that the USA in particular could use unilateral sanctions against Russia in the economic sphere as an example to other aspiring geopolitical rivals. And the sluggish progress of the EU in its attempt to continue trading with Iran without touching the US dollar makes it clear that the US has considerable unilateral influence on the global financial market. Moreover, there is a rather broad majority in the political establishment and legislative branch in Washington for continued sanctions on Russia and thus the purchase of Russian government bonds for US investors and at least the selective sanctioning of "smaller" Russian state banks in 2019 is not unlikely (the largest Russian banks Sberbank and VTB are currently specifically mentioned again in certain legislative projects).

About the Author
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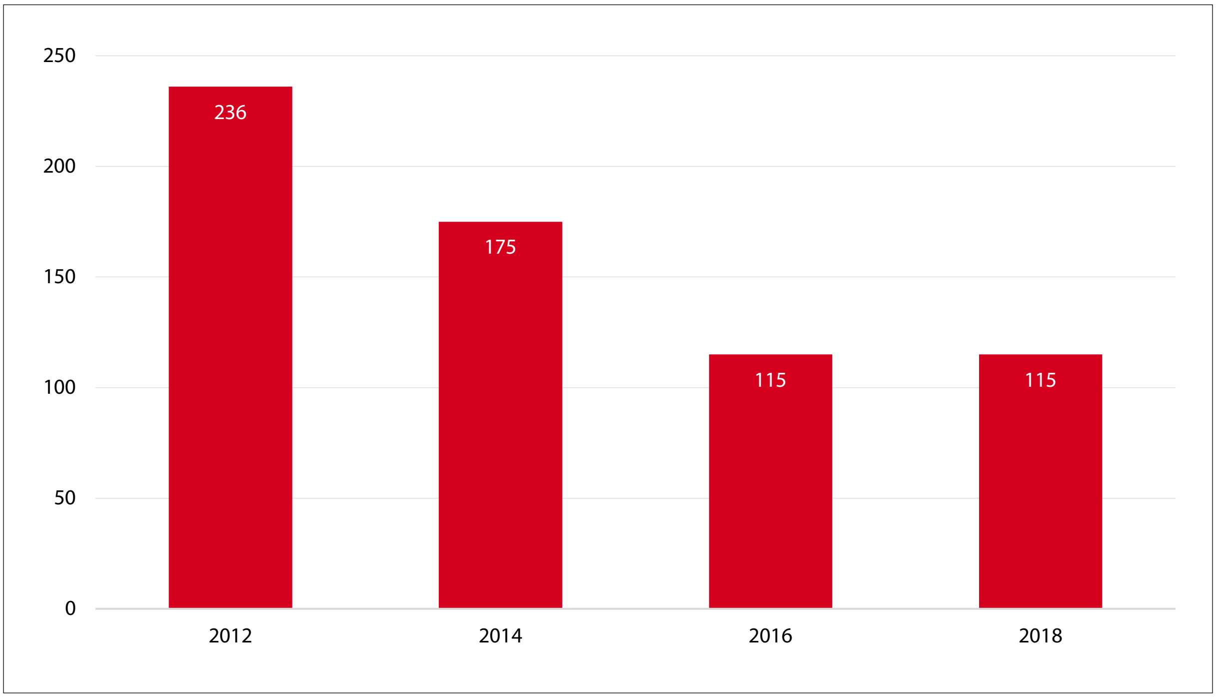
STATISTICS

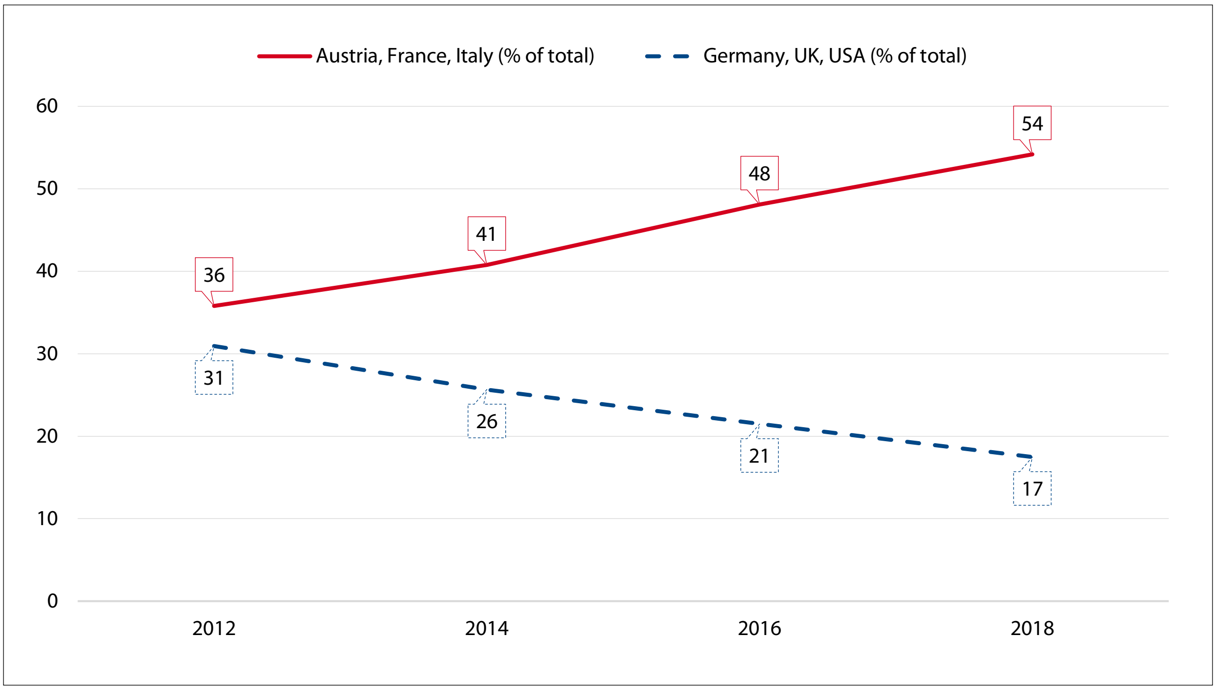
Foreign Banks in Russia

Figure 1: Cross-Border Banking Claims on Russia (USD bn)



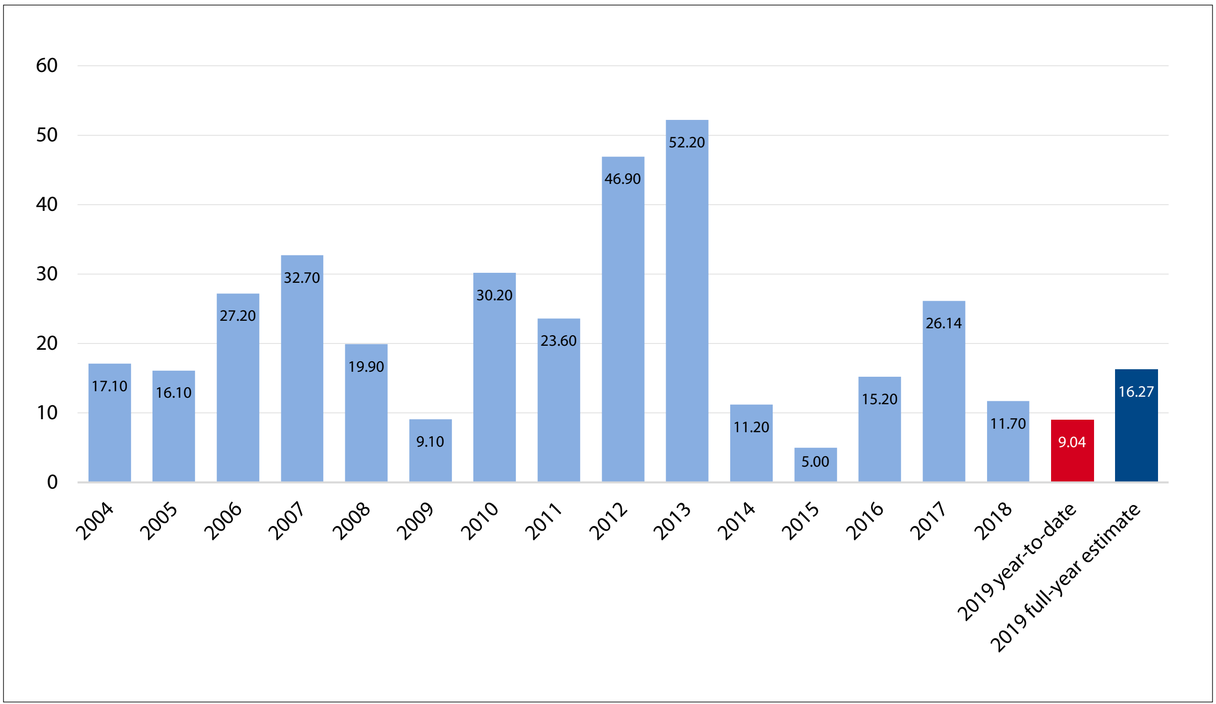
Source: BIS

Figure 2: Shares Cross-Border Banking Claims Russia



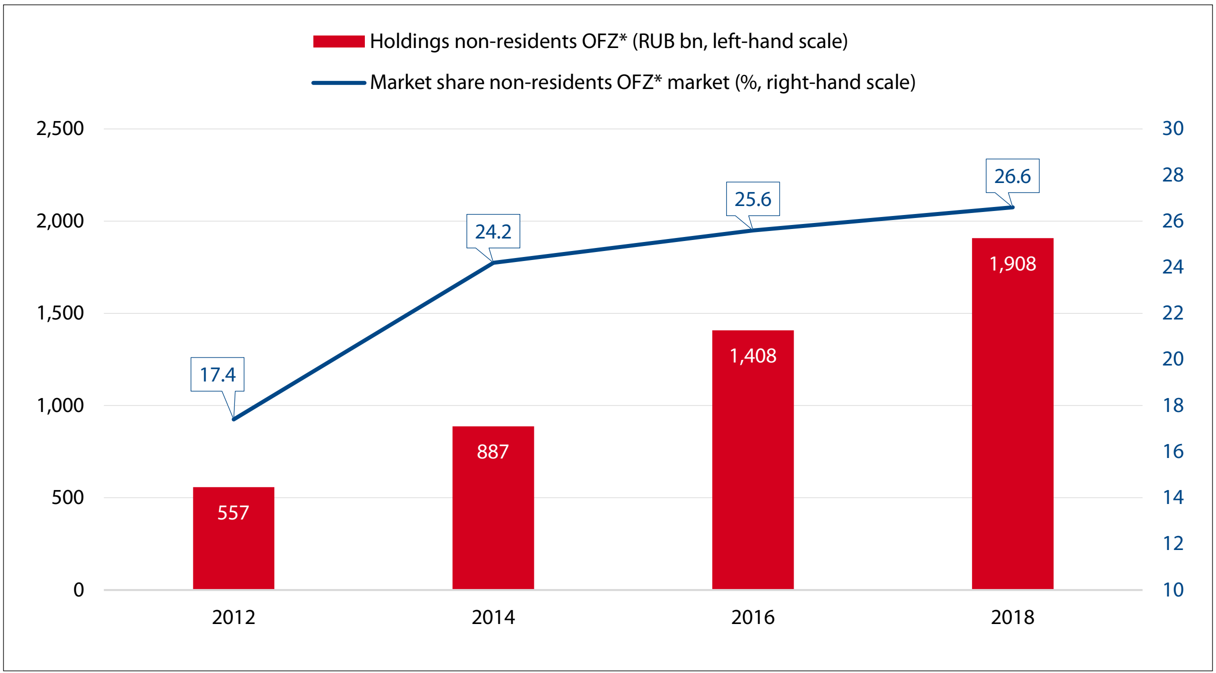
Source: BIS

Figure 3: International Bond Market Placements Out of Russia (USD bn)



Note: Full-year estimated based on year-to-date developments (until May 2019) and the assumption of no further major sanction escalation in 2019
Source: Bloomberg

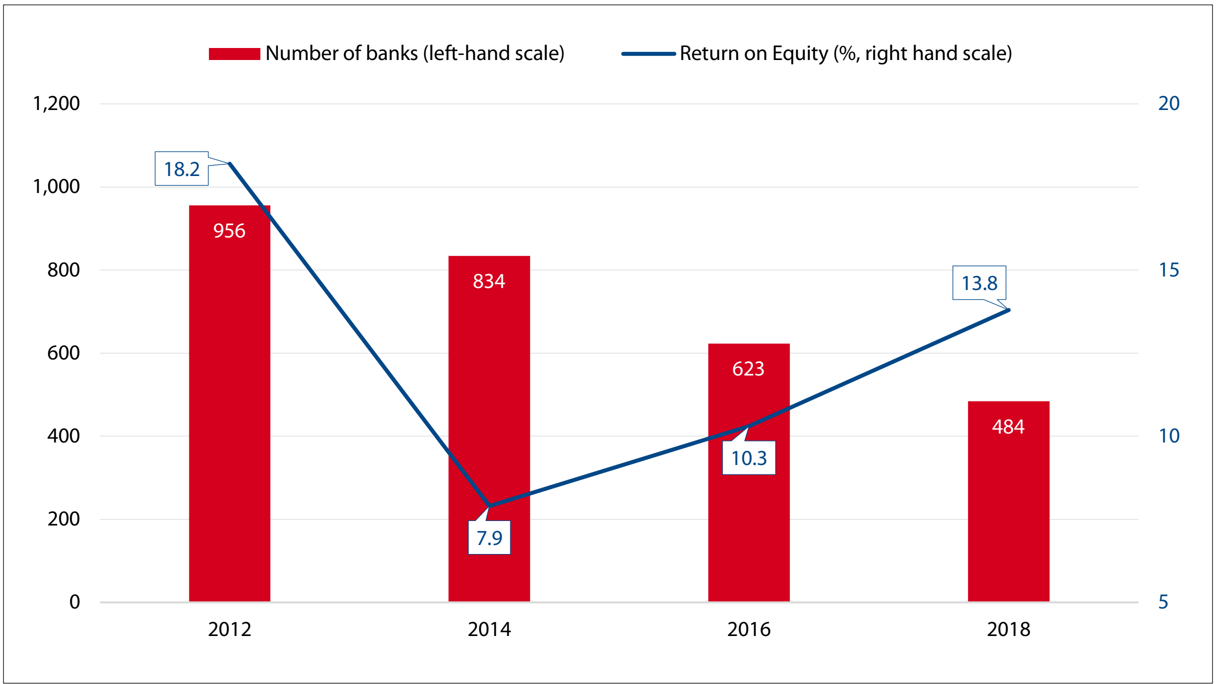
Figure 4: Non-Resident Engagement OFZ* Market



** Obligatsii Federal'nogo Zaima (Federal Loan Obligations): federal loan bonds issued by the Russian government*

Source: CBR

Figure 5: Key Banking Sector Ratios



Source: CBR

ANALYSIS

The Impact of EU Regulations and Western Sanctions on the Nord Stream 2 Project

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Abstract

The Nord Stream 2 project, signed by the Russian state-owned energy company Gazprom and several Western energy companies in 2015, will offer additional supply capacities for Russian natural gas deliveries to Europe and has the potential to bring Ukraine's role as a transit country to an end. EU competition regulation, Western sanctions and opposition from national governments challenge the completion of the project. This contribution analyses the perspectives of the Nord Stream 2 pipeline project in the light of EU regulations and Western sanctions and evaluates to what extent they impact on its progress so far.

A Deal Inked

In September 2015, the Russian state-owned energy company Gazprom signed an agreement with Western energy companies on the construction of the Nord Stream 2 pipeline (NS2). The NS2 pipeline will enable Gazprom to supply gas to the whole European energy market as a single consumer via the German gas pipeline network instead of providing individual deliveries to each national market inside the EU, cutting out Ukraine, Belarus, Poland and Slovakia as transit countries.

In light of the Ukraine crisis and the EU opposition to Gazprom's other pipeline project South Stream, the NS2 gas pipeline was as a logical step in Russia's export strategy. Gazprom currently exports almost half of its gas to Europe through Ukraine and pays approximately $2 billion in transit fees to Ukraine each year. The supply contract between Russia and Ukraine expires at the end of 2019. By launching NS2, Gazprom hopes that its gas will not flow through Ukraine any more. At the same time, Germany would become the largest gas distributor in Europe.

Since the annexation of Crimea in 2014 the EU and the USA have been periodically imposing sanctions against individuals, business sectors and officials from Russia. The sanctions intend to change Russia's international behavior and its geostrategic intention. And they apply to many strategic industries in Russia, including the energy sector and trade. This article gives an overview of the current situation surrounding the NS2 pipeline project and addresses the question of what impact western sanctions have on the development of the NS2 project so far.

The Nord Stream 2 Pipeline Project—A Short Overview

Once constructed, the more than 1200 km NS2 pipeline will transport 55 billion cubic meters of gas from Russia through the Baltic Sea to Germany annually. It will complement the Nord Steam pipeline in operation since 2011 and double its capacity. Construction costs will amount to 9.5 billion euros. Half will come from Gazprom and the other half from the European energy companies involved in the project—Anglo-Dutch Shell, OMV of Austria, Engie of France, Uniper and Wintershall of Germany. Gazprom will own the entire NS2 pipeline, and Nord Stream 2 AG (NS2 AG), a subsidiary of Gazprom, is the pipeline's operator. According to NS2 AG, more than 200 companies from 17 countries worldwide are involved in the construction. So far, 44 percent of the pipelines needed for Nord Stream 2 are already in place. The NS2 project is due to be completed by the end of this year. The NS2 project has been controversial ever since its inception, dividing Europe and overshadowing relations between the USA and Europe.

EU Criticism and Countermeasures

From the beginning, the NS2 project met with considerable outrage from Central and South European countries. As with the implementation of the Nord Stream 1 pipeline, Poland and the Baltic countries strongly criticized the project, arguing that NS2 posed a threat to EU energy security and the political security of EU member states. In addition, they argued, it could contribute to the further economic destabilization of Ukraine. Ukraine would lose about two billion US dollars in transit fees if the NS2 pipeline replaced the transit pipeline used in Ukraine by Gazprom now. In the words of the Polish foreign minister, Jacek Czaputowicz, "Nord Stream 2 is killing Ukraine"; "If the Russian gas transit through Ukraine ends, the country doesn't just lose significant income, it also loses the guarantee of protection against further Russian aggression."[1]

1 Nord Stream 2 killt die Ukraine – Polens Außenminister im Interview, Handelsblatt, January 3, 2019, https://www.handelsblatt.com/politik/international/jacek-czaputowicz-nord-stream-2-killt-die-ukraine-polens-aussenminister-im-interview/23820652.

In addition, Polish officials regularly expressed their concern that the competitiveness of new terminals for LNG in Poland and Lithuania would be impaired by the project. In July 2016 Gazprom and its five European partners in the NS2 applied to Poland's Office for Competition and Consumer Protection (UOKiK) for approval of their joint venture. UOKiK did express concern arguing that the new pipeline would enable Gazprom and its partners to dominate the Polish gas market, undermining local competition. Hence, Gazprom withdrew the application without waiting for UOKiK approval. And instead of a joint venture, Gazprom and its five partners signed a deal which regulates the financing for the pipeline construction. Consequently, the Polish competition authority filed charges against Gazprom and its partners in May 2018 for alleged violation of Polish competition law.

Furthermore, Poland is pushing ahead with its own energy projects to ensure its energy security and establish its position as an energy distributor in Europe. It plans to construct a 275 km Baltic Pipeline running from Denmark to Poland with an annual capacity of 10 billion cubic meters carrying Norwegian gas. In addition, the Polish government has decided to boost the LNG Terminal in Świnoujście, allowing it to import up to 7.5 billion cubic meters of gas annually. In this way, Poland would cease to rely on Gazprom's supplies entirely and become independent from Russian gas imports. Furthermore, the Polish government plans to emerge as a regional gas hub for Central and Eastern Europe through the expansion of the LNG terminal, the increase in LNG imports mostly from the USA, and the development of pipeline infrastructure to transport LNG imports to Ukraine, Slovakia and Hungary.

Ever since its initiation, NS2 has been controversial in Germany itself. The proponents of the new pipeline argue that Russian gas could make the phase-out of nuclear energy more cost-effective and allow the country to achieve CO2 targets more efficiently. Russian gas delivered by the NS2 pipeline would also be cheaper for German consumers than LNG from the USA. Moreover, the Russian gas deliveries would strengthen Germany's position as a transit state, meaning German companies would be better positioned on the EU market.

Against this, critics point out that the NS2 project would jeopardize the common European energy policy, undermine the formation of an European energy union and harm energy relations with Central and East European countries. The critics also maintain that the volume of gas imported from Russia could increase significantly, meaning Russia would dominate the German market.

So far, Germany, Finland and Sweden have approved the NS2 construction in their territorial waters in the Baltic Sea. However, the completion of NS2 is being prevented by a missing building permit from Denmark. The country requires an environmental assessment for the planned NS2 route in its territorial waters. The implementation of this permission could take many months, and potentially delay the project for an indefinite period.

In 2014, the EU imposed Ukraine-related sanctions in coordination with the USA and extended them many times. Most recently, the EU extended the sanctions until September 2019 in reaction to the escalation at the Kerch Strait and the Sea of Azov in March 2019. The EU sectoral restrictions include lending and investment restrictions and restrictions on the sale of energy exploration equipment, technology and services to development projects. However, the EU applied them only to the Russian oil sector. The Russian gas sector is excluded from the sanctions.

Apart from this, the NS2 project faces major problems arising the ongoing changes in the legal and institutional framework for foreign suppliers in the EU. On April 15, 2019 the Council of the EU adopted a gas directive amendment which demands that offshore pipelines from third countries which supply gas to Europe obey the same rules as onshore pipelines. The main measures of this amendment are based on the so-called gas directive from 2009 and include 1) ownership unbundling, 2) third-party access, 3) non-discriminatory tariffs and 4) transparency. The NS2 project does not meet any of these requirements yet. To fulfill them, Gazprom must first create an independent operator. The German national regulator (Federal Network Agency) will check whether this operator works independently of Gazprom. Moreover, the European Commission will monitor compliance with certification rules. Second, NS2 AG must guarantee access to the pipeline for third parties. Third, the German regulator must set competitive gas transportation tariffs. Fourth, NS2 AG must operate transparently, particularly in terms of security of supply.

In reaction to the new EU gas amendment, NS2 AG is thinking about turning the last 50 km of the pipeline into a separate company. The new company would own and manage the NS2 pipeline under EU jurisdiction. The rest of NS2 pipeline—about 1150 km—would operate outside EU rules. The board of NS2 AG hopes that in this way it can limit the EU's jurisdiction and maintain control of its own pipeline. Such a decision would help NS2 AG meet the first requirement of the EU gas directive, ownership unbundling. However, it would be difficult to meet the second requirement, i.e. third-

html?ticket=ST-8373277-5cL6ZpL0dIOdeMWHHdzx-ap5 party access to the pipeline, because only Gazprom has the right to export Russian gas via pipeline.

However, in response to German efforts, the new EU gas directive includes exceptions for the NS2. They stipulate that Germany will have the right to be the only country to regulate the NS2 pipeline and decide whether the NS2 project will qualify for exceptions to the EU rules. However, Germany would still have to get permission from the European Commission, which remains skeptical of Russian gas exports. Therefore, the decision-making process on the exceptions for NS2 could take a long time. In the case of Nord Steam 1 and its German connection to the existing grid OPAL, it took about six years. As a result, the EU gas directive complicates NS2, potentially undermining the attractiveness of the project to investors.

Gazprom is preparing for a worst-case scenario that foresees a potential delay to the NS2 project. The company has postponed the NS2's pipeline commissioning beyond 2019, signaling that it is considering potential restrictions and it is developing alternative routes to Western Europe for Russian gas. A new export gas pipeline TurkStream 2 with a capacity of 32 billion cubic meters is already planned. It might reach Western Europe through Bulgaria, Serbia and Hungary or through Greece and Italy to bypass Ukraine as a transit country.

US Sanctions

Most US sanctions related to the Russian energy sector or Gazprom were introduced in response to the Russian annexation of Crimea in 2014. These sanctions are mostly based on two acts of law, namely the Support for the Sovereignty, Integrity, Democracy, and Economic Stability of Ukraine Act of 2014 (SSIDES; P.L. 113-95/H.R. 4152) and the Ukraine Freedom Support Act of 2014 (UFSA; P.L. 113-272/H.R. 5859). According to the Ukraine Freedom Support Act of 2014, sanctions against Gazprom can be implemented, if "Gazprom is withholding significant natural gas from member countries of NATO member states, or further withholds significant natural gas supplies from countries such as Ukraine, Georgia, and Moldova" (UFSA 2014, Sec.4).[2]

Remarkably, until today, neither the EU nor the US has applied sectoral sanctions on Russian gas imports. According to media reports, in 2014 during the preparatory work on the sanctions, the US and the EU agreed to exclude measures that could damage their economic interests, including with regard to Russian gas imports and Europe's biggest supplier Gazprom. This approach applied particularly to the EU member states with a high dependence on Russian gas supplies. As a result, the US and the EU decided not to apply wider sectoral sanctions, but imposed financial restrictions only on two Gazprom subsidiaries, Gazpromneft (its oil production and refining subsidiary) and Gazprombank (its financial institution), while the US put restrictions on Gazprom's offshore projects in the Arctic and on its shale oil projects. Meanwhile, Gazprom has found a way to minimize the sanctions' impact by reaching several bilateral agreements with Chinese and Saudi companies and financial institutions.

Since 2017, high-ranking American politicians have actively criticized the German–Russian pipeline project, including President Donald Trump. During the meeting with NATO representatives in July 2018, he accused Germany of being a "captive of Russia" due to its energy reliance and "billions of dollars" in energy payments to Moscow. He stressed that "Germany is totally controlled by Russia".[3] Senior US officials and diplomats have been arguing in favor of tightening existing U.S. sanctions and speaking about establishing new secondary sanctions, known as extraterritorial sanctions. They could be imposed on individuals or entities that engage in trade or make investments that enhance Russia's ability to construct energy export pipelines. European energy companies involved in the construction of the pipeline or financing the project are threatened by the secondary sanctions. The German government is concerned about the possible effects of provision sanctions. It sees the secondary sanctions mostly as unacceptable interference in the European decision-making process. In the words of German Foreign Minister Heiko Maas "Questions relating to European energy policy must be decided in Europe, nowhere else" and to impose unilateral sanctions on NS2 "is not the correct course".[4]

In reaction to the potential US secondary sanctions, Gazprom and the Russian government have said that in the case of US sanctions against European partners, Russia would be able to finance the NS2 project on its own, without Western investment.

In the opinion of the critics of the US secondary sanctions, the real motivation of the US is to force European countries to buy US LNG instead of Russian gas. Here one should note that in the last two years LNG supplies from the US to the EU energy market have

2 https://www.congress.gov/113/bills/hr5859/BILLS-113hr5859enr.xml#toc-HDDB8F121F05949578798B16F2378E6F4

3 NATO summit: Trump accuses Germany of being a "captive of Russia", CNN, July 11, 2018, https://edition.cnn.com/2018/07/11/politics/trump-germany-russia-captive-nato/index.html

4 Speech by Foreign Minister Heiko Maas at the the New Year reception of the German Eastern Business Association (OAOEV), January 10, 2019, https://www.auswaertiges-amt.de/en/newsroom/news/new-year-reception-german-eastern-business-association/2177446

grown continuously. The EU Commission announced at the beginning of May 2019 that since signing the Joint Statement between the US and the EU in July 2018, cumulative European LNG imports from the US have risen by 272%, a total of 10.4 billion cubic meters of natural gas. They represent 12.6% of the EU's total LNG imports in 2019 so far. Currently, the US is the third biggest LNG supplier in Europe.

Conclusion

As this study indicates, the US and the EU sanctions have had little significant impact on the NS2 project so far, because none of them have been implemented in a manner that hinders the construction of the NS2 pipeline. If applied, the sanctions could have a negative impact in one or the other way on the companies involved. This may postpone the commissioning process of the pipeline, but it would be difficult to stop the construction entirely.

The missing construction permit from Denmark and the new EU gas directive are major challenges which Gazprom currently faces on the European market and which will ultimately decide whether NS2 will go into operation as planned. As things stand now, Gazprom and Russia would not be able to realize its export plans without a new gas transport contract with Ukraine in the medium term, because the NS2 pipeline will go into full operation later than planned and the combined capacity of the NS2 and TurkStream pipelines will not be enough to transport additional export volumes to the European market.

Moreover, the European diversification policy has also had a significant influence on Gazprom's export strategies. In accordance with it, the EU has effectively implemented a series of regulations which open the door to new gas suppliers from around the world, so that they can successfully strengthen their position as reliable gas suppliers on the EU energy market. Currently, the delivery contracts between Gazprom and the EU member states ensure Gazprom's position as the main European gas supplier. However, it is questionable whether these supply contracts will be renewed after their expiration and, if they are, whether the contract conditions and amount of gas exported will also meet the expectations of Gazprom or be in its favor.

Gazprom's gas export strategy must also be considered in the context of Russia's current weak economic situation, including the one-sided orientation of the Russian economy towards oil and gas revenues. There is a lack of technology and investment for the large-scale exploration of new gas fields. Without export revenues and Western investment, these problems cannot be easily solved. Gazprom serves the foreign and domestic policy objectives of the Kremlin; it does not act as an independent actor according to free-market principles. Therefore, the Russian government will use all possible opportunities to strengthen Gazprom's position on the EU energy market, despite its high political, economic and social costs. We cannot assess now whether the strategy followed by Russia and Gazprom will succeed.

The market entry of LNG suppliers could also aggravate Gazprom's future position on the EU market. In the coming years, the EU plans to expand its current LNG reserve capacity and build new LNG capacity. The plans include investments in the expansion of the Liquefied Petroleum Terminal in Świnoujście on the Baltic coast of Poland, construction of an LNG terminal on the island of Krk in Croatia and various LNG capacity development projects in Greece, Spain, Ireland, Sweden and Cyprus. German Economy Minister Peter Altmaier has also confirmed that Germany would build the infrastructure to import LNG. The EU expects that by using these measures 23 EU member states will have access to the global LNG market by 2020. According to the prognoses of the International Energy Agency, the EU will buy 84 billion cubic meters of LNG by 2040, whereas the volume of gas imported from Russia will drop to up to 150 billion cubic meters of gas.

Other factors include worldwide oil and gas prices, geopolitical and economic developments in the affected countries and regions, as well as the willingness of the countries involved in the project to comply with Russian interests. Russian reliance on the European energy market and the interdependence of both sides will remain in the short and medium term.

The realization of NS2 has also showed how deep the differences among EU member states on energy issues are and how difficult it is to follow a common EU policy and reach European solidarity in the field of energy security. In the future, as the example of Poland shows, the Central and East European countries will focus even more on their own national interests in the energy field rather than "speaking with one voice". Consequently, divisions over the issue of energy supply in the EU will continue to deepen.

About the Author

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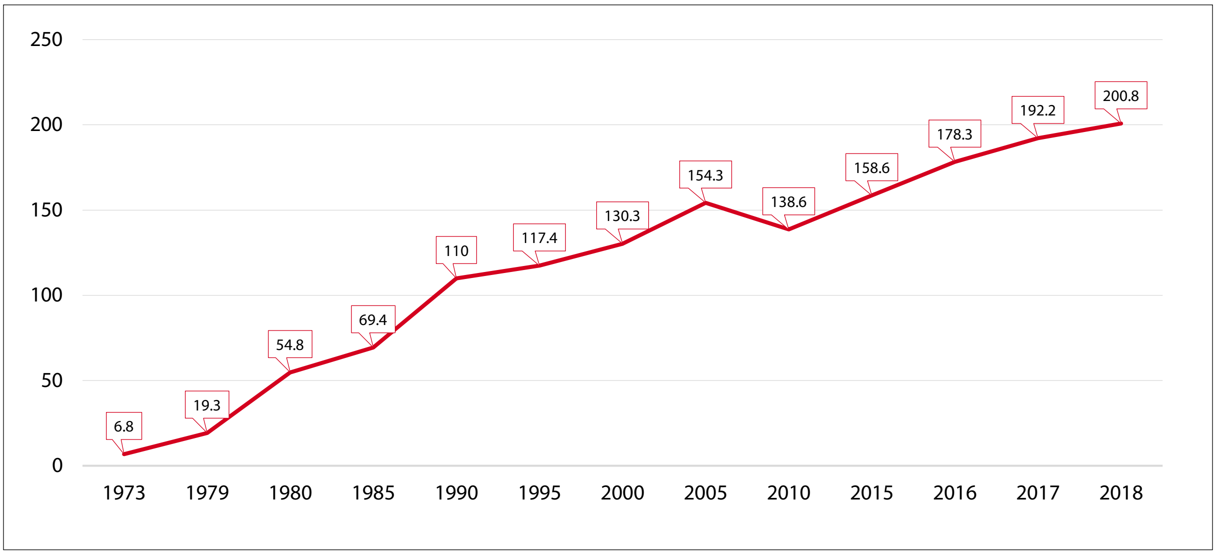
STATISTICS

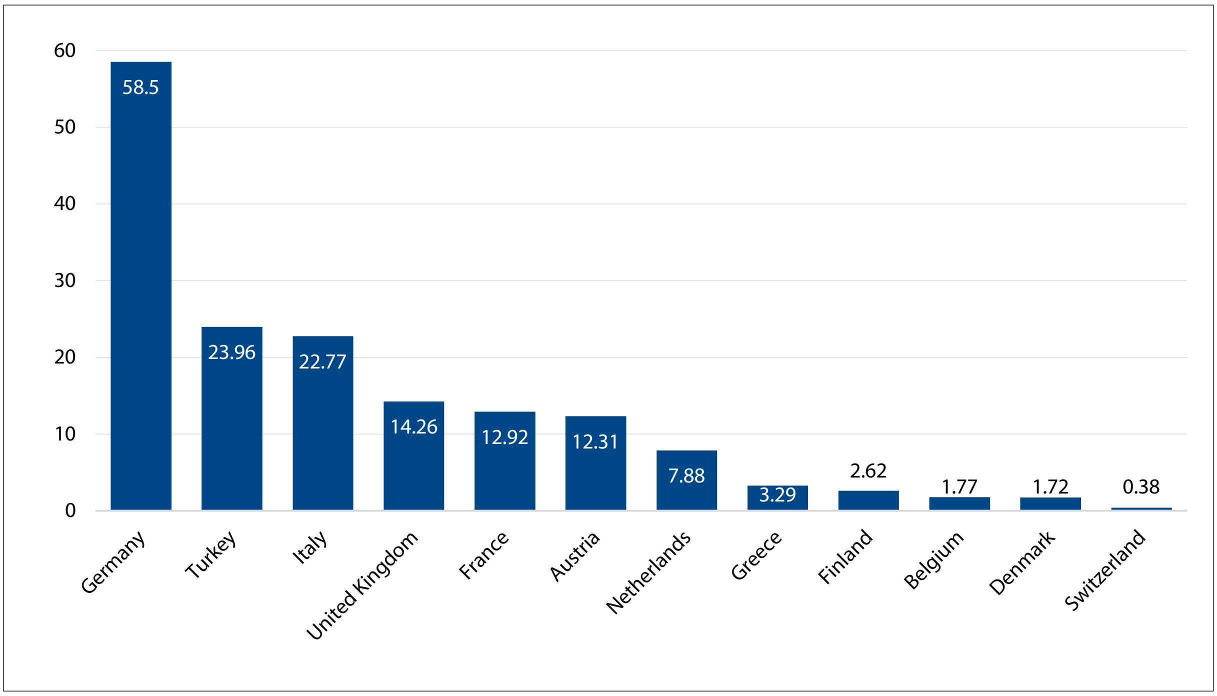
Gazprom Exports

Figure 1: Natural Gas Exports to Countries Outside the Former Soviet Union by Gazprom Export (billion cubic meters)



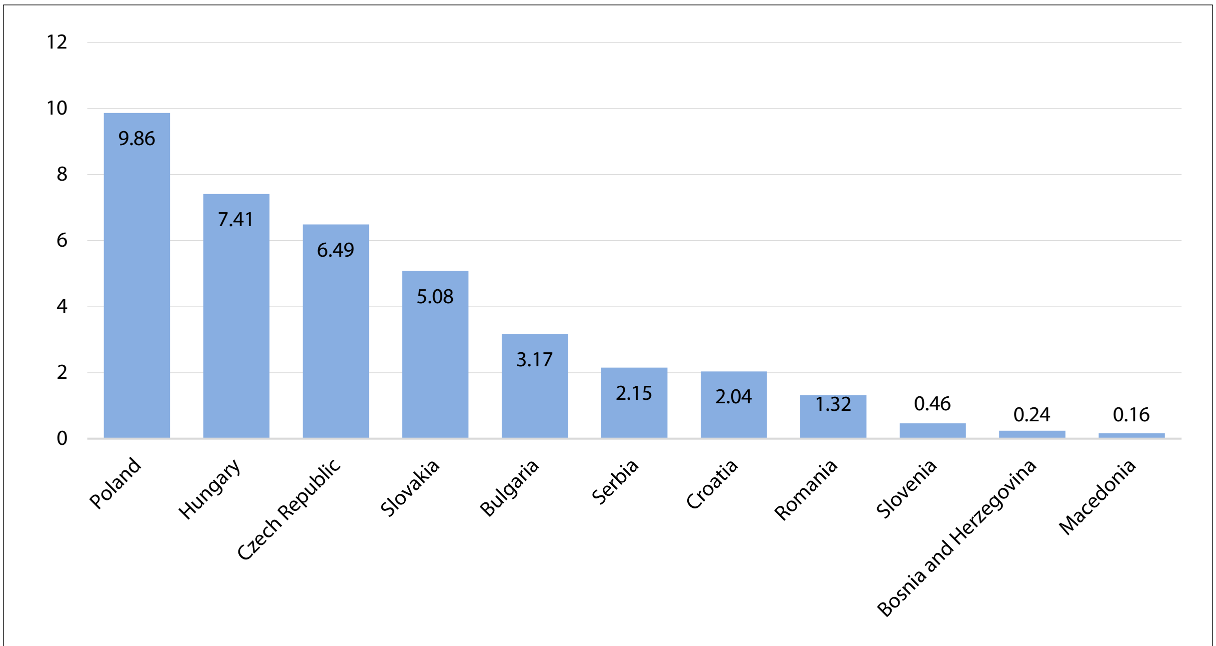
Source: http://www.gazpromexport.ru/en/statistics/

Figure 2: Gazprom's exports to Western Europe (plus Turkey) in 2018 (in bcm)



Source: http://www.gazpromexport.ru/en/statistics/

Figure 3: Gazprom's Exports to Central and Southeastern Europe in 2018 (in bcm)



Source: http://www.gazpromexport.ru/en/statistics/

ANALYSIS

Battle of the Crabs: Birth of a National Bourgeoisie?

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Abstract

To cut losses imposed by Western sanctions, an oligarch-connected company has used its access to the Russian state to gain control of the lucrative crabbing industry. This article lays out the details of the process for the take-over. Going forward, the question is whether Russian business as whole will seek to better defend its interests against this kind of encroachment.

An Oligarch's Family Seeks to Expand

From the beginning of November 2017 to May 1, 2019, first unnoticed, and then with increasing resonance, Russia witnessed a struggle to redistribute the market for crab production. Most of the media accounts link this initiative to Gleb Frank, the owner of the "Russian Fishery Company" (http://www.catching.ru) and the son-in-law of the oligarch Gennady Timchenko, who has long been seen as a member of President Putin's inner circle. According to some fishery industry insiders, the Timchenko family seemed to use its money, which it had already moved from the West into Russia, to cut the losses incurred by sanctions. In the current Russian political landscape, such an initiative seemed to be guaranteed speedy success. However, the majority of the fishing industry was able to organize a remarkable public campaign and "hold the door open" for almost a year and a half.

Russia's Fishing Industry

The fishing industry in the new Russia has always been an exception. Established in the Soviet era, it was even then a global player—regulation of ship navigation is international and part of the high-profit catch was exported. The industry is overwhelmingly masculine and has a traditional "sailor" culture inherited from the Navy. Fishing waters, as a rule, are associated with the Russian frontier—from Murmansk and Arkhangelsk regions to Primorsky Krai and Kamchatka. Residents of the dozen sparsely populated "coastal regions" are either descendants of people who never knew serfdom (in the North), or descendants of Cossacks, landmigrants and settlers (in the Far East).

The peculiarity of the fishing business is that the state owns the aquatic biological resources (the fish and other seafood), and if a fishing company has not received (or lost) the right to catch, it is effectively excluded from the market—trawlers, sailors and warehouses become "redundant" if the industry regulator, Rosrybolovstvo, (http://fish.gov.ru/), denies them quotas and permits. There are hard currency quotas for crabs, Pollock, and other seafood which are mainly for export, and quotas for more "democratic" fish, usually destined for the domestic market. The physical volume of quotas is adjusted at the end of each year and depends on scientific forecasts, ensuring the sustainability of the resource and avoiding "overfishing" and poaching. The taxes for harvesting seafood were established long ago and their sizes are insignificant—a fact long acknowledged by both fishermen and regulators.

In the 1990s and early 2000s, the Russian fishery industry passed through a "perfect storm": economic restructuring and the flourishing of violent entrepreneurship imposed a decline in official catches and the growth of poaching. The quotas for the annual auctions of 2001–2003 forced most companies to borrow from banks or informally negotiate with foreign "investors" (and they were only able to settle these debts by 2014–2015). The annual auctions were quickly recognized as being so unsuccessful, that the Russian Government has since 2004 switched to the so-called "historical catch" approach, essentially allowing each company to catch the same number of fish that it did in the previous year, first for 5 years, then from 2008, extended up to 10 years, and from 2019, for 15 years. The fishing industry achieved the last extension, adopted by the State Council in November 2015, in exchange for the so-called "quotas under keel"—the obligation to build new fishing vessels in Russian shipyards and domestic processing plants on the coast. Of course, the modernization of the old foreign ships and the construction of new foreign ones was more advantageous for the fishing industry from the point of view of "price and quality", but the Russian government decided to support the Russian shipbuilding industry in this way.

A New Fishing Bourgeoisie

With hindsight, it is possible to assert, that in the years following the transition from auctions to the historical catch principle, a Russian fishing bourgeoisie developed with the following characteristics:

- Willingness to "whitewash" the business, which soon led to its consolidation. However, there is still a reasonable level of competition—small and medium-sized businesses make up 68% of the total number of enterprises and catch 35% of the quota volumes. The share of small and medium business in the fishing sector exceeds their share in the Russian Economy as a whole, which is approximately 22%;
- Absence of foreign minority shareholders (distinguishing it from other export-oriented industries such as metallurgy or oil);
- The need for building contacts at the top of the executive branch, among ministers and relevant deputy prime minister;
- Nomination of representatives from the fishing sector to legislatures at the national and regional levels, including representatives in the State Duma and several senators in the upper chamber Federation Council—not only from United Russia, but opposition parties as well;
- Highly trained government relations specialists, who actively participate in all in all aspects of rule-making (particularly measuring of regulatory impact);

The presence not only of regional and industry business associations, but also such "umbrella" associations as the All-Russian Association of Fish Industry Enterprises, Entrepreneurs, and Exporters (http://varpe.org/), which includes businesses covering 80% of the Russian catch. De facto representatives of these associations constitute a controlling majority in the Public Council by the regulator Rosrybolovstvo.

Putin Takes Action

In recent years, only the Federal Antimonopoly Service (which criticizes all types of grandfather clauses) opposed the historical catch principle, but a letter of unknown authorship sent to President Putin in November 2017 became a trigger for change. The quota owners immediately pointed to a "new major player, the Russian Fishery Company, with substantial financial resources who wants to enter the market and displace small companies…" (Kommersant, November 20, 2017, https://www.kommersant.ru/doc/3473023). According to the fishermen, the management of this company allegedly sent this letter to Putin, who instructed presidential assistant Andrey Belousov to deal with the matter.

Whoever initiated this letter knew exactly how to pull the right bureaucratic levers—he had analyzed the financial balances of several crabbers for the three previous, profitable years, their investments in buying less successful competitors and modernizing old ships (but not investing in building new ones!), and their fragmented spending on corporate social responsibility. Most importantly, the letter informed the Russian leadership about the windfall profits the fishermen were making as a result of the devaluation of the ruble in 2015–2017, and from which the current crab kings, supposedly, could pay handsomely for participating in new auctions. Typically, governments transfer such excessive profits to the public treasury by temporarily increasing taxes or other fees, but auctions make it possible for a new player to enter the market who, in turn, is not interested in a sharp increase in fees for access to the ocean's resources.

The crabbers repulsed the first onslaught at the end of 2017, deploying a noisy media campaign, open letters to the authorities, and a meeting that brought together all fishing interests since the abolition of the "historical catch principle" would be a threat to the majority of fishermen. However, after the change of government in May 2018, the state authorities who had advocated the abolition of the historical catch principle for crabs began to operate in a much more organized manner and formally dropped the idea of defending competition and fighting against oligopolies. At the end of April 2018 the pre-final version of the annual Federal Anti-Monopoly Service report on the state of competition was released, and on August 16 the road map on competition development was signed by the new-old Prime Minister Dmitry Medvedev. These documents allowed, theoretically, revenues from future crab auctions in Russia's draft budget for 2019–2021.

The Battle is Joined

In late August and early September, the parties came into open conflict. Proponents of auctions made a bureaucratic error—they marked the draft crab bill amendments as "secret." Perhaps the new Agriculture Minister Dmitry Patrushev lost sight of the two most important "institutional" barriers for such secrecy—(1) the clear norm in federal law no. 166-FZ "On fishing and conservation of aquatic biological resources", which requires since 2004 the participation of citizens and business associations in matters relating to fisheries and (2) the obligation for a regulatory impact assessment of draft bills affecting businesses (in effect since 2010).

Opponents of the auctions have adopted a legalistic strategy for fighting to save the existing system: formally for the last 10 years the Russian administrative system has included a number of smart regulation mechanisms, whose business potential is rarely used (see "Regulatory Policy in Russia — Smart Suggestions, But Poor Implementation" in Russian Analytical Digest 227). For this purpose, they sought the support of major Russian think tanks, whose opinions carried weight with at least two state bodies, the Chamber of Accounts, headed by Alexei Kudrin, and the Ministry of Economic Development.

Ultimately, the anti-Moscow protest vote in the Primorsky Krai gubernatorial elections in September 2018 transformed the political context. The loss of Kremlin-appointed acting Governor Andrei Tarasenko had a dual influence. On the one hand, the crabbers had bet on him, and Tarasenko shortly before the first round of the election discussed their concerns about the auctions at a meeting with President Putin. On the other hand, while the Kremlin was not sure that a new governor would be elected in Primorye (eventually the new governor became Oleg Kozhemyako, also with a background in the fishing industry, but importantly no connection with the crabbers), it had to pause its introduction of the bill into the federal parliament, as well as the media campaign supporting this step.

Complicated Bureaucratic Infighting

The first setback Rosrybolovstvo and the Agriculture Ministry received came in October 2018 in the State Duma Budget and Finance Committee, which has authority over the draft budget for 2019–2021. The crux of the problem was that the Budget Code does not allow for planning income which does not have a basis in law, while the financial and economic calculation of such incomes must follow Ministry of Finance methodologies. Often these requirements are ignored, but this time the Accounts Chamber, having received a "heads up" from the fishing business associations, questioned the income from the crab auctions in its review of the draft budget. The budget was still accepted, but the justifications from Rosrybolovstvo, citing non-public correspondence with the Finance Ministry, looked weak.

Only after Oleg Kozhemyako's victory in the Primorsky Krai gubernatorial elections (December 16, 2018), could the supporters of the crab redistribution scheme use their second main resource—television. In the last days of December all national networks simultaneously broadcast reports about the "Crab Kings," the majority of whom, ostensibly maintained foreign residences while receiving insane incomes provided by poaching marine resources and exporting them abroad. Only insiders and experts understood that these reports mixed the history of the 1990s (describing practices no longer in use) with outright nonsense about smuggling (the modern means of monitoring the catch by the Border Service (part of the Federal Security Service, FSB) and Rosrybolovostvo and a series of rigid regulatory restrictions practically prevent such opportunistic behavior). Not only typical TV viewers, who could not afford expensive crabs, but also members of the State Duma and Federation Council from inland regions, were supposed to be horrified and convinced that it is time to impose order on this industry!

At the end of January, 2019, the Agriculture Ministry and Rosrybolovstvo finally submitted their "crab bill" to the government apparatus. It contained an additional requirement for future auction winners—building new crabbing vessels in Russian shipyards (a demand from the Ministry of Industry and Trade).

But at this point, an unexpected surprise worked in favor of the fishing industry: two weeks earlier, at the Gaidar Forum, Prime Minister Medvedev announced the launch of a "regulatory guillotine" aimed at removing redundant norms and bad regulations (the idea had been introduced in 2004 by the consulting firm Jacobs, Cordova & Associates). The curator of deregulation was appointed Deputy Prime Minister Konstantin Chuychenko, who as government chief of staff also headed the Commission on law-making activity, which considers all bills before they are submitted to the State Duma. In this situation, he obviously did not want to lose face, so the commission removed the secret classification, and Deputy Prime Minister Alexei Gordeev (who is responsible for agriculture and fisheries) sent the bill for regulatory impact assessment.

More Insider Intrigue

Going forward the political struggle around interpreting the rather complicated regulations of the government and the State Duma and certain gray areas in the Russian rule-making process formed the main canvas of confrontation.

While the public consultations were given less public time than required (15 working days), the regulatory impact assessment was implemented in full. The fishers marshalled good expert support and their experience in public discussions showed as they hit the regulator with a series of criticisms:

1) The bill did not provide a financial and economic analysis of its impacts. The two paragraphs submitted by the bill authors did not meet the requirements of the government regulations or the Finance Ministry requirements for financial and economic analysis;
2) Independent anti-corruption experts identified a number of inappropriate blanket rules in the bill (typical for Russian laws and a situation which usually is ignored);
3) On the site regulation.gov.ru, users posted nearly 1500 negative comments along with more than 650 dislikes. The few comments in support came from a small industry association and companies associated with the Russian Fishery Company, confirming the previous conviction that it was behind the initiative.

Agriculture Ministry officials ignored the critical opinions and in the mandatory summary of the discussion they simply repeated anodyne answers. Moreover, in about a third of the cases, there was no reaction to the business comments at all (a direct violation of the regulatory impact assessment procedure).

The fishery associations appealed all of the violations to the Prosecutor General's Office, and wrote letters to the Finance Ministry, Justice Ministry and the main legal department of the Presidential administration, but received only formal answers: officials refused to comment on the substance, a sign that the political decision had already been taken at the top.

The public consultations in the Ministry of Economic Development—the main department responsible for assessing the regulatory impact in the executive branch—were the only ones to turn out differently. The ministry issued a negative opinion, and this was the most significant victory for the fishing industry during the entire campaign.

The crabbers marshalled the following important arguments against the bill in the public hearing:

1) The drafters plan to receive 82 billion rubles in income in the next two years, but no one considered the associated losses: the unreceived tax income in the regions or the inability of the new players, who have financial resources, but lack competence, quickly to establish a production process.
2) The threat to domestic shipbuilding, which has been receiving bank credits since 2017 against the collateral of the existing quotas (in fact, property rights) which were now subject to redistribution. Will a new construction program be launched? According to the draft law, the model "first catch-then build" will allow the new players to use state resources, to receive profits, and then simply abandon the construction of new boats or lobby to receive state subsidies for their completion.
3) The risk of establishing foreign control over the fishing resources. It will be impossible to prevent this in the process of electronic bidding.
4) Social costs are not calculated, including a reduction in employment and a decrease in labor productivity; Devastation of existing seaside settlements, including due to the use of rotational employment methods (fly in/fly out), inevitable when new players enter the market; the phasing out of corporate social responsibility programs;
5) According to the data of the Higher School of Economics' Institute of Agrarian Research, if the crab

auctions were implemented for not more than 28% of the total amount of allocated quotas (the optimum according to their econometric model), it would be necessary to introduce an export duty for 3 years (this is a classic fiscal move to address windfall profits);

6) Last but not least—the quotas are considered property rights, which was confirmed by the Russian Federation Constitutional Court in 2001; the European Court for Human Rights supported similar positions in cases brought by Icelandic and Finnish fishermen between 2002 and 2008.

For the sake of fairness, it is necessary to mention the arguments in favor of the new regulation, in addition to support for competition and the one-time receipt of funds from auctions to the budget:

1) Outdated vessels have rather uncomfortable conditions for sailors (who make do because their salaries are twice the average pay received in the respective coastal regions);
2) The fishing industry had 10 years since 2008 to build ships, but they did not build any and it is not clear where the money went;
3) Coastal regions will not lose jobs, as new players need both sailors and ships to fulfill their quotas.

A Decision Already Made

The negative policy impact assessment issued on March 7, 2019, failed to hinder passage of the bill. Moreover, further developments demonstrated that the authorities had decided to no longer comply with their own regulations, silently acknowledging that the principles of transparency and evidence-based policy making favor the current owners of the quotas. First, despite the need for two rounds of conciliation meetings after the negative impact assessment opinion, the bill was immediately submitted to the Commission on Legislative Activity. Three days later, the government submitted it to the State Duma. Interestingly, at this point the media was invited to leave the government meeting, demonstrating that there were expected votes against the bill (!), and already on March 19 the bill was in the parliament.

The strategists of the fishery associations hoped for a lengthy discussion in the State Duma and some compromises, for example, the introduction of a transition period. First, natural resources are subject to joint management by the federal and regional governments, according to the Constitution, and the Duma rules stipulate that such bills should be sent to the executive and legislative bodies of the regions, as a rule, for 30 days, to allow sufficient time for them to prepare their positions. Moreover, since 2005 the Council of the Duma has considered 72 amendments to the law "On fishing and conservation of aquatic biological resources", and in 71 of the 72 decisions the Council consulted with the regions. Secondly, at the Russian Union of Industrialists and Entrepreneurs' Congress held at this time, Vice Prime Minister Dmitry Kozak said that any regulatory innovations that entail additional costs for business should be introduced only after a sufficient transition period typically lasting two to three years. Thirdly, there was hope for amendments from opposition party deputies seeking to score points on popular themes and from single-mandate deputies from the coastal regions (though all of them are representatives of United Russia, they should be re-elected in 2.5 years and protest votes on the frontier may well give victory to opposition candidates). Finally, the online broadcast of not only the plenary meetings, but also the meetings of the Committee on Natural Resources and parliamentary hearings on the "historical catch principle", seemed to guarantee the possibility of making the strongest arguments in public, thereby attracting the attention of the mass media.

But neither the regulations of the State Duma nor the articles of the Constitution could stop the development of events. The Council of the State Duma pretended that the bill was not regulated by article 72 of the Constitution (co-management of resources by the federal and regional governments), but by article 71 (exclusive management by the federal government), and gave only 10 days to receive comments, excluding the regions from the mailing of the requests for comments. Most of the opposition's amendments were rejected, and, conversely, amendments that improved conditions for the new players were accepted. The only gesture in favor of the regions was that the company winning the auction must be registered in one of the coastal regions so that tax income would flow to the region rather than Moscow (but nothing prevented the winners from creating subsidiaries there; and someone created them back in 2018, in anticipation of future auctions). The law was adopted quickly. The first reading was held on April 4, and the third one on April 10, 2019. On April 22, the Federation Council approved the bill and President Putin signed it on May 1. This game is over and the oligarchs are coming.

Conclusion

There are several conclusions that we can draw from this episode.

1) The fishermen, despite a number of miscalculations, including delays in recourse to external expert support and a chaotic media strategy, demonstrated that they could resist the powerful and devious oligarchic groups for quite a long time despite the existing legal system and their limited access to the media;

2) Despite its loss in this "Battle for the Crabs", the industry was able to induce both the State Duma and the Federation Council to create groups to monitor the implementation of the law. Now it is unlikely that someone will manage, for example by manipulating electronic platforms, to "exclude" undesirable bidders on certain lots or buy up the crab lots for one or two affiliated companies.
3) The State Duma, Agriculture Ministry and Rosrybolovstvo immediately after the adoption of the law publicly and firmly defended the "historical catch principle" for other types of marine resources (i.e. except crab);
4) For the sake of suppressing the various "oppositions," the authorities sacrificed a number of their own procedures, ignored the previous positions of the Constitutional Court, and also accepted serious media damage to the economically successful industry.

What conclusions will Russia's domestic business community (not just the fish sector) draw from these events? Will it support opposition candidates in the next elections? We will learn the answer on September 8, 2019, the next election day across Russia's regions. In two coastal regions, Murmansk and Sakhalin oblasts, will the Kremlin-appointed governors "answer for the quotas"? Will the business community be ready for future regulatory innovations against the backdrop of a "shrinking pie"—future investments in the industry data platforms and the possible transition from reactive to proactive government relations will provide an answer to this question. Will it invest money in social support activities in the regions where their profit margins are no longer as big as they used to be?

In other words, will a national bourgeoisie in Russia finally be born?

About the Author

Daniil Tsygankov is the Head of the Center for Regulatory Impact Assessment at National Research University—Higher School of Economics (Moscow) and was the team leader for the Research project "Analysis of the impact of regulation on the fishing industry in the Russian Federation" (August–December 2018).

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