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The Empire Strikes Back

Europe and the United States are ratcheting up sanctions on Russia, but Putin is not standing still.

BY KEITH JOHNSON

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As the United States and European Union prepare another round of sanctions on Russia, Moscow appears to have unsheathed its energy weapon to strike back, targeting European countries that are supplying Ukraine with natural gas in the wake of a Russian embargo.

The United States outlined a slate of sweeping measures against Russia's finance, defense, and energy sectors on Friday. In addition to tightening capital markets curbs on big Russian banks and energy firms, the latest measures will also, as promised, bar U.S. companies from sharing energy expertise with Russian companies trying to coax oil out of difficult locations. U.S. companies will have two weeks to wind down operations with Russian companies, U.S. officials said.

The measures are "designed to effectively shut down this type of oil exploration and production activity," a senior Obama administration official said.

Earlier, Bloomberg reported that the U.S. steps targeting Russia's energy sector would go further than the technology trade bans announced in July by barring U.S. oil companies from helping

Russia tap its vast but hard-to-reach energy resources. That could imperil multibillion-dollar projects that Russian firms hope to carry out alongside the likes of Exxon Mobil, BP, and others.

One other casualty from the new sanctions could be one of Vladimir Putin's pet projects: the South Stream pipeline, meant to pipe Russian gas to Europe while bypassing Ukraine. The new measures will crimp Gazprom's ability to raise money to complete the expensive pipeline project, which has already been delayed by the European Union due to the Ukraine imbroglio.

Faced with the threat of even more pain from Western sanctions, Russia appears to be striking back. The *Financial Times* reported that Moscow is preparing to limit the import of Western clothes and automobiles. More worrisome is that some European countries are hinting that Russia may be starting to wield its energy exports as a weapon. Many European countries had been reluctant to unleash heavy sanctions on Russia for fear of reprisals; Europe gets about one-third of its natural gas from Russia, with few easy prospects of alternative sources in the short term.

Poland has said that the volumes of natural gas that it receives from Gazprom, the big Russian energy firm, have steadily fallen this week. That, in turn, has forced Poland to temporarily halt its own shipments of natural gas to Ukraine, which hasn't been able to buy any Russian gas since June and which faces the prospect of a dark, cold winter without reliable sources of fuel.

The Polish Oil & Gas Company said Thursday that Gazprom deliveries were 45 percent below what it had ordered. Earlier in the week, it complained that deliveries had fallen by about one-quarter, and the supply disruptions appear to have intensified. The Polish firm asked Gazprom for an explanation for the sudden decrease in gas shipments, which mostly come via pipelines from Belarus. Slovakia, another country that buys energy from Russia and has been providing Ukraine with natural gas to make up for missing Russian supplies, also reported a drop in Gazprom shipments this week.

It's not entirely clear whether the sudden drop in Russian gas exports to those countries is politically motivated or if there is a technical reason, such as maintenance on the Russian gas system or the pipelines themselves. Gazprom said that shipments to both countries remain unchanged. In any event, Polish officials said they have been assured by Russia that gas volumes will return to normal on Friday.

But Russian President Vladimir Putin made clear earlier this year that Moscow would aggressively go after countries that buy Russian gas and then turn around and ship it to Ukraine. That kind of energy trade, known as "reverse flow" because most of the gas pipelines pump fuel from east to west, has long incensed Gazprom and the Kremlin, which charge different countries different prices for gas and which rely on energy exports to maintain leverage over former client states in Central and Eastern Europe.

In June, Putin fired a warning shot at countries peddling Russian natural gas to Ukraine. "If somebody thinks that they can resolve the problems of Ukrainian energy supply through reverse supplies, they are deeply mistaken," he told reporters. "If we see that somebody is violating our contracts for gas supplies, we will reduce the volume, and the physical volume on the European market will simply be insufficient."

To be sure, Gazprom has to walk a narrow line between acting as a commercial energy firm and carrying out the Kremlin's foreign-policy wishes, balancing domestic calls for reprisals against European countries with its own shaky financial situation. Gazprom's first-quarter earnings plunged because Ukraine hasn't paid the $5 billion it owes for gas, for example. But the sudden change in exports to customers such as Poland and Slovakia, which are actively promoting reverse flows to Ukraine, is hard to explain away.

"This is clearly politically motivated," said Andreas Goldthau, an energy expert at Harvard University's Belfer Center for Science and International Affairs. He said that Gazprom seems to be under political pressure from the Russian Duma and perhaps even the Kremlin to take actions against countries helping Ukraine.

The apparent Russian reprisals come right as Washington and Brussels are clamping down themselves. The new U.S. sanctions bar U.S. firms from selling goods, services, or technology to Rosneft, Gazprom, Gazprom Neft, Lukoil, and Sturguftneftegas.

If fully implemented, the new restrictions would take aim at, among other things, Russia's future ability to offset declining oil production from mature Siberian fields with exotic new discoveries. Cooperation with Western oil firms such as BP and Exxon Mobil are key to Russia's ability to tap oil fields in the frozen north or far offshore. Big oil firms had said they would keep working in the Russian market, despite the annexation of Crimea and a slate of lesser sanctions on Russia.

BP said Friday that it is studying the new measures and will comply with all that are applicable. ExxonMobil did not immediately respond to a request for comment.

Obama stated Thursday that the latest measures "will increase Russia's political isolation as well as the economic costs to Russia, especially in areas of importance to President Putin and those close to him."

In the meantime, before the energy sanctions can even be brought to bear, energy markets themselves are taking a healthy whack at Russia's petro-driven economy. Gazprom is expecting a 10 percent decline in European revenues this year because European customers are buying less gas, along with paying less for it. That is a reflection of slumping European demand for all kinds of energy, as well as Europe's ability to renegotiate gas contracts thanks to a glut of supplies, especially due to increased U.S. natural gas production.

Oil, the other big driver of Russian state revenues, is also under pressure thanks to weak global demand and overproduction. Crude oil prices have fallen this week to two-year lows, and the International Energy Agency cut its forecast for oil demand for 2014 and 2015. That's all potentially bad news for a Russian budget predicated on triple-digit oil prices for the foreseeable future.