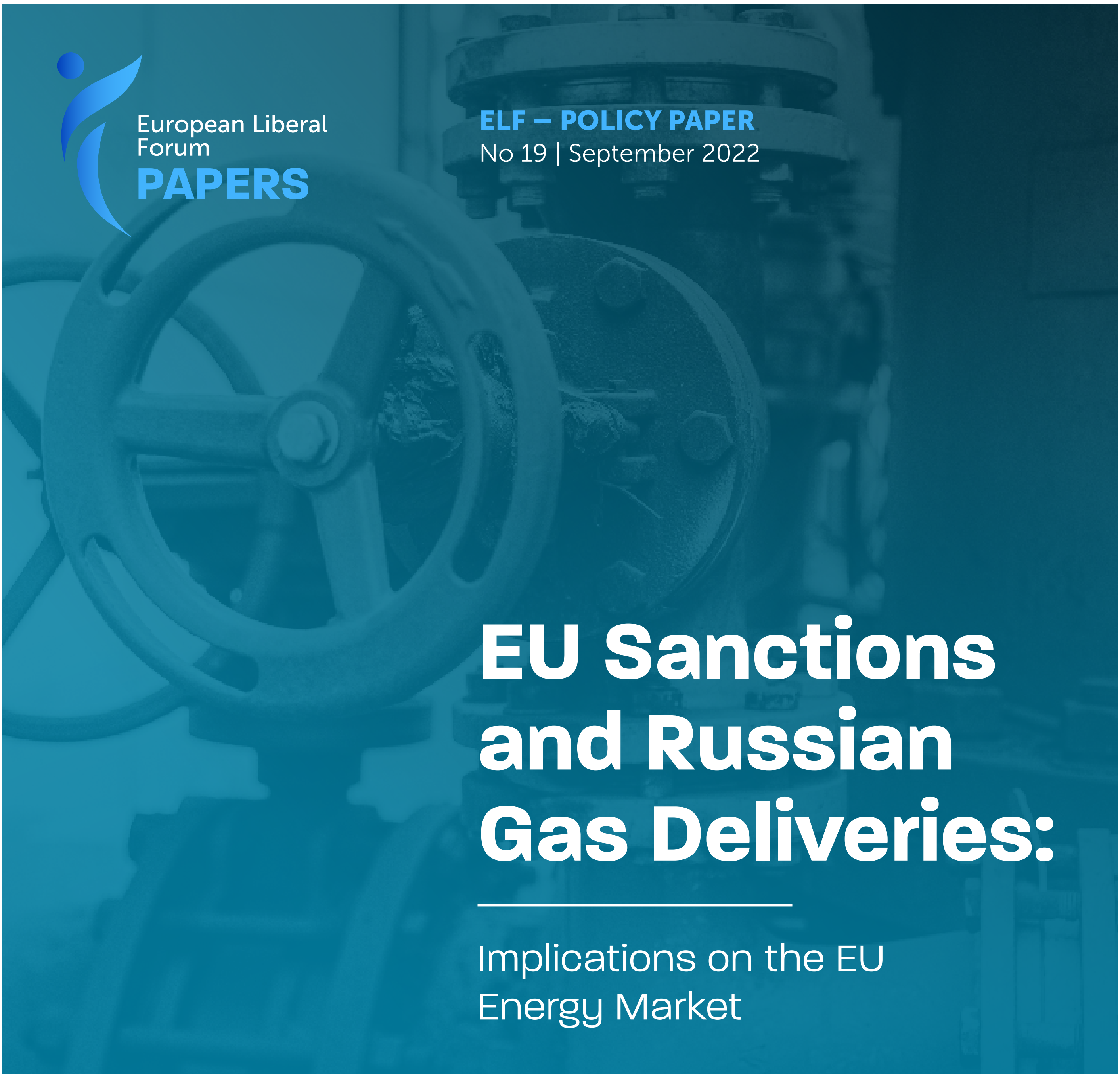

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EU Sanctions and Russian Gas Deliveries:

Implications on the EU Energy Market

Abstract:

The purpose of this paper is to provide an overview of the current difficulties with the delivery of Russian gas to the EU as a result of Russia's invasion of Ukraine. The ongoing economic restrictions introduced by both blocs have complicated the gas supply process, creating a supply crunch in several European states. The paper provides an overview of the challenges behind gas supply and explores the options EU Member States have for navigating the sanctions and replacing Russian gas altogether. Most importantly, the paper argues that the EU should adopt a more cohesive approach to dealing with Russian sanctions and give European gas importers more flexibility to ensure a gradual and steady transition from Russian energy. The paper starts with an overview of the legal basis for EU to deploy sanctions, followed by a description of the current EU sanctions framework in place against Russia. It continues with an analysis of the Russian sanctions and the effect they have on the gas supply contracts between European gas companies and Gazprom, a Russian state-owned company. The paper concludes with policy recommendations for navigating both the current gas crisis and the long-term energy supply transition as smoothly as possible.

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Introduction: the new normal in the gas economy

The Russian invasion of Ukraine has caused shock and outrage worldwide, prompting the EU to impose a series of sanctions upon the former. In addition to the sanctions in effect since the Russian annexation of Crimea in 2014, the EU has adopted six new sanctions packages. These extensive measures have drastically affected relations between the EU Member States and Russia. In response, on 1 April 2022, Russia imposed new payment conditions on the gas delivery contracts between European gas importers and its state-owned energy company, Gazprom (Putin, 2022).[1] Many EU Member States have disapproved of the decree, while others have been attempting to find a way around it (Abnett, 2022).

Gas supplies to countries refusing to comply with the new conditions have been cut, while the rest are struggling to secure a steady supply while also complying with the sanctions by both sides. This dynamic puts states that are heavily dependent on Russian gas –such as Germany, Poland and the landlocked countries in Eastern Europe – in a difficult situation, with low supplies and increasing gas prices (Dezem, Shiryaevskaya, and Stapczynski, 2022).

Considering these issues, this paper will provide an overview of the challenges to gas supply and explore the options EU Member States have for navigating the sanctions and replacing Russian gas altogether. Most importantly, it argues that the EU should adopt a more cohesive approach to Russian sanctions and give European gas importers more flexibility to ensure a gradual and steady transition from Russian energy sources. The paper starts with an overview of the legal basis for the EU to deploy sanctions, followed by a description of the current EU sanctions framework against Russia. It continues with an analysis of the Russian sanctions and their effect on the gas supply contracts between European gas importers and Gazprom. The paper concludes with recommendations for navigating the current gas crisis and the long-term energy transition as smoothly as possible.

The EU's power to adopt sanctions

The EU's power to deploy political and economic measures against countries is enshrined in article 29 of the Treaty on the European Union (TEU). Accordingly, the Council of the European Union can unanimously define the approach of the Union to particular geographical or thematic issues (Dezem, Shiryaevskaya, and Stapczynski, 2022).[2] This legal basis is used to adopt *decisions* concerning arms embargoes and restrictions on admission, and the Member States are ultimately responsible for implementing them.[3] Additionally, the EU has also the power

[1] The conditions are addressed in detail later in the paper.

[2] TEU, article 29, https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=LEGISSUM:sanctions.

[3] Council of the European Union (2018), 'Guidelines on implementation and evaluation of restrictive

under article 215 of the Treaty on the Functioning of the European Union (TFEU) to adopt *regulations* pertaining to the interruption of economic relations and freezing of funds and financial sources.[4] The Council of the European Union first receives a joint proposal on such regulations from the High Representative of the Union for Foreign Affairs and Security Policy and the European Commission, and then adopts them after securing a qualified majority. The regulations are then implemented across the EU.[5] Moreover, the Court of Justice of the European Union has the authority to rule on challenges to the legality of these acts.[6] According to article 263 of the TFEU, individuals and other entities can challenge the decisions of the Council that address them and are of direct and individual concern to them.[7] Additionally, individuals can also challenge regulatory measures that are of direct concern to them and do not entail implementing measures.[8]

It is also important to note that apart from its own capacity to deploy sanctions, the EU can also deploy sanctions on behalf of the United Nations Security Council (UNSC). The UNSC has the authority to adopt binding resolutions that involve restrictive measures under Chapter VII of the UN Charter, and the EU has to implement them. However, the UNSC was unable to adopt a resolution regarding the conflict between Russia and Ukraine because Russia, which as one of the 'permanent five' members holds veto power, blocked the resolution. For that reason, the EU and countries such as the United States decided to adopt sanctions by themselves.

EU sanctions against Russia

The first wave of sanctions deployed by the EU against Russia came in 2014, in response to Russia's illegal annexation of Crimea. This was done through the 'Regulation concerning restrictive measures in view of Russia's actions destabilising Eastern Ukraine'.[9] These sanctions primarily targeted the Russian defence sector, cutting it off from EU capital markets, placing an embargo on arms trading, and banning exports of dual-use goods for military and civilian purposes.[10] Moreover, the EU restricted Russian oil exploration and production activities in the offshore

measures (sanctions) in the framework of the EU common foreign and security policy', 4 May, https://data.consilium.europa.eu/doc/document/ST-5664-2018-INIT/en/pdf.

4 Consolidated version of the TFEU, article 215.

5 Ibid.

6 Ibid., article 267; European Parliament Policy Department for External Relations (2018), 'Targeted Sanctions against individuals on grounds of grave human rights violations – impact, trends and prospects at EU level', PE 603.869, https://www.europarl.europa.eu/RegData/etudes/STUD/2018/603869/EXPO_STU(2018)603869_EN.pdf.

7 TFEU, article 263; European Parliament Policy Department for External Relations (2018).

8 Ibid.

9 Council Regulation (EU) No 833/2014 concerning restrictive measures in view of Russia's actions destabilising the situation in Ukraine, and amending Regulation (EU) No 960/2014 amending Regulation (EU) No 833/2014.

10 Council Regulation (EU) No 1290/2014 of 4 December 2014 amending Regulation (EU) No 833/2014 concerning restrictive measures in view of Russia's actions destabilising the situation in Ukraine, and amending Regulation (EU) No 960/2014 amending Regulation (EU) No 833/2014 article 2.

area north of the Arctic Circle.[11] More precisely, it prevented Russian companies from gaining access to exploration technology, thus making it too costly to exploit the Arctic Circle. These measures left the companies unable to find new sources of oil because they were reliant on exported technology and services as most Russian exploration technology was outdated and based on Soviet models (Gustafson, 2021: 83). Aside from losing opportunities to find new oil, the Russian finance minister declared in 2014, the sanctions would cost Russia $140 billion (Rutland, 2014).

Despite the severity of the sanctions, Russia decided to invade Ukraine in February 2022, prompting the EU to impose even more extensive and fiercer sanctions. The first of these was introduced on 23 February 2022, in response to Russia's recognition of the areas of Donetsk and Luhansk as independent and its decision to send troops to the region. The sanctions package targeted the Russian state and a number of individuals, and added further restrictions on access to EU capital and financial markets.[12] The second package, released on 25 February 2022, prohibited the sale, supply, transfer, or export to Russia of specific goods and technologies in oil refining and added further restrictions on financing activities. The third package was announced on 28 February 2022 and was amended on 2 March 2022. It banned transactions with the Russian Central Bank and excluded key Russian banks from the SWIFT system, only exempting banks designated to facilitate transactions related to energy and gas supply (Moens and Barigazzi, 2022). It also cut off access to EU airspace and airports for all Russian carriers, among other heavy restrictions (Moens and Barigazzi, 2022). This was followed by the Compliance Package, introduced on 9 March 2022, and the fourth package introduced on 15 March. These added further prohibitions on dealing with Russian banks and enterprises, and imposed a ban on imports of iron and steel products from Russia. The fifth package added a ban on Russian coal and freight road operators as well as on exports and imports of many other Russian goods. In the sixth package of sanctions, introduced on 3 June 2022, the EU banned all Russian seaborne crude oil and petroleum products.[13] This ban covered 90 per cent of current EU oil imports from Russia and is expected to prompt Member States to further reduce reliance on Russian energy sources. Considering Russia is the second largest exporter of oil in the world, this move could deepen the EU's energy crisis.

[11] Ibid., article 1(4).

[12] European Commission, 'Sanctions adopted following Russia's military aggression against Ukraine' https://ec.europa.eu/info/business-economy-euro/banking-and-finance/international-relations/restrictive-measures-sanctions/sanctions-adopted-following-russias-military-aggression-against-ukraine_en.

[13] European Commission, 'Russia's war on Ukraine: EU adopts sixth package of sanctions against Russia' https://ec.europa.eu/commission/presscorner/detail/en/IP_22_2802.

Russia's response to the sanctions

Unsurprisingly, the EU measures met with retaliation from Russia. In March, Russian President Vladimir Putin issued a decree mandating that, from 1 April, gas payments would have to be made in roubles (Putin, 2022). He declared that the new condition would also apply retroactively. Additionally, the decree provided a second payment option whereby European importers could pay in euros, but only through an account held in Gazprombank. To elaborate, it required European importers to open a foreign currency and rouble account – called 'type K' – with Gazprombank, in which they may deposit money (in euros or dollars) to pay for gas. Gazprombank will arrange the currency conversion and pay the funds into the Russian exporter's account in roubles (Davies and Roth, 2022). Only then would the payment obligation be deemed completed.

According to the decree, a refusal to comply would amount to a failure to fulfil contractual obligations and thus lead Gazprom to halt gas deliveries. It is not clear whether companies can comply with the Russian decree without breaching EU sanctions (Murray, 2022). As noted in the introduction, several Member States, such as Poland, Bulgaria, Finland, France, the Netherlands, and Denmark, declared that they would not comply with the new conditions. Consequently, Russia cut all gas supplies to those states, and partial cut supplies to others (, 2022a). The question is whether Russia's actions are legal and whether the European gas importers can find a remedy for the failure to deliver.

Understanding gas supply contracts

> It is important to note that gas supply is managed through complex, long-term contracts running from 10 to 25 years.

Firstly, it is important to note that gas supply is managed through complex, long-term contracts running from 10 to 25 years. This is because gas deliveries are crucial to consumers, and if the parties had to renegotiate the terms every year it would risk supply disruptions. This also causes the parties to become more reliant on each other, as with Europe and Russian gas. For that reason, the parties usually agree that the terms of the contract cannot be changed unilaterally. If one of the parties decides to introduce new terms to the contract without the other party's approval and stops fulfilling its obligations as per the original terms of the contract, that party would be in breach and thus, liable for damages or performance (delivery of the gas). However, before getting into that discussion, we will first clarify the role of the state in gas supply as well as the influence it has on gas importers and exporters.

As noted above, the need for long-term arrangements complicates gas supply contracts, but that is not the only reason these contracts can be troublesome. In fact, the issue with gas supply contracts is that they involve gas, a natural resource owned by the state, and states can be very sensitive about natural resources. Nevertheless, states do make arrangements for the sale of such resources, but most of the time they are not the ones entering into the supply contract. Instead, they do so through private companies that are fully or partially state-owned, while still reserving the right to legislate on the use of the resources. For example, Finland has used Gasum, a fully state-owned entity to enter into a gas delivery contract with Gazprom, the Russian state-owned gas exporter. In this way, states avoid direct contractual liability to each other and thus, turn gas delivery issues from an inter-state dispute into a commercial matter. So, Finland is facing a complete Russian gas cut, but the dispute has remained between Gasum and Gazprom (Ballantyne, 2022). The next section analyses the obligations that the two parties have towards each other in connection with the new Russian decree.

The Russian decree and CISG

It was recently announced that Gasum has decided to sue Gazprom in the Stockholm Court of Arbitration for not delivering gas. The Stockholm Court of Arbitration is a commercial tribunal and not a national court, and the latter usually have more flexibility when it comes to dealing with the relationship between contracts and state sanctions (Kotelnikov, 2021).[14] This means that the tribunal at hand will focus more on the contractual terms and then ascertain whether the sanctions apply to the contract. As for now, the contract has not been made available to the public, so it is impossible to identify the exact obligations that the parties have agreed on, or determine whether EU law or Russian law applies to the contract. Thus, for the purpose of this discussion, we will assume that the applicable law is the United Nations Convention on Contracts for the International Sale of Goods (CISG). The reason why we are using this body of law is that it was created for the purpose of governing contracts for the international sale of goods such as gas and, most importantly, it has been signed by both Russia and Finland.

It is relevant to the new payment conditions and the modifications that they impose on the original contract between Gazprom and Gasum that article 29 CISG notes that a contract may only be modified or terminated with the *agreement* of the parties. This means that even under CISG, a party cannot introduce new terms to a contract without the other party's approval. Concretely, Gazprom cannot introduce new payment conditions and demand Gasum follow them if Gasum did not agree to those terms. On the other hand, if Gazprom does not adhere to the original terms of the contract, it would be in breach of the contract, allowing Gasum to either require performance (gas delivery) under provisions in articles 46 to 52 CISG or claim damages.

[14] Usually, tribunals enjoy a wider discretion than national courts in determining the applicable law or mandatory rules.

However, as noted above, the new payment terms were not introduced by Gazprom but rather imposed by the Russian government acting in its capacity as a legislator. To that end, Gazprom will claim that the laws of the Russian government make it impossible for it to adhere to the original contract terms. article 79(1) CISG states that a party can escape liability under the contract under two conditions: First, it needs to prove that the failure was due to an impediment beyond its control. Second, it needs to prove that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

Gazprom can easily satisfy the first condition, as the Russian government controls Gazprom and not vice versa, and so an act by the former is beyond the control of the latter. Moreover, even if the Russian government had not had control over Gazprom, its laws would still be superior and binding on every Russian natural or legal person, and that authority is also beyond Gazprom's control.

In respect of the second condition, however, the discussion gets more complex. The Russian government owns 51 per cent of Gazprom, so it is reasonable to assume that Russia is the main stakeholder that defines the company's agenda. That also means that Russian officials are in close contact with Gazprom executives, so the acts of the former do not come as a surprise to the latter. In fact, history shows that Russia has indeed used Gazprom as a foreign policy tool, or more precisely, as leverage against other countries who are dependent on its gas to further its ambitions (Light, 2008). A recent example includes the 2005 case in which Gazprom raised the highly subsidised price of gas sold to Ukraine, leading costs to quadruple without any transition period; a move that corresponded with the timing of the Ukrainian parliamentary election. Another recent example is from 2006, when Gazprom threatened to take its business to China and North America and cut gas supplies, in an attempt to induce Europe to be more responsive to Gazprom's business proposals to acquire European downstream assets. These cases show that Gazprom is not just a regular company acting in its own capacity, but rather is under the Russian government's control. Gasum could use these examples to point out that the close relationship between the Russian government and Gazprom suggests that the latter was aware of or could have been expected to be aware of the intentions of the former.

However, according to article 79(1) CISD, the decisive point here is not whether Gazprom was aware of Russia's intentions, but whether it knew or was expected to know that this decree would be introduced at the time when the parties were concluding the contract. If the time when the contract was concluded corresponds with the time when Russia initiated or was preparing to initiate the conflict in Ukraine, then Gasum might have a better chance of attributing liability to Gazprom. This is because the new decree could have been part of Russia's larger strategy to manage the conflict, and because Russia is close to Gazprom executives, there's a high chance that the executives were briefed or even consulted on the plan. On the other hand, if the contract was concluded long before Russia initiated the conflict, then Gasum will have little chance of holding Gazprom accountable.

Nevertheless, it is important to be realistic and understand that finding proof that Gazprom executives were aware of Russia's intentions will be very difficult. This proof is likely to be found in Russian official and perhaps classified documents, and considering the present political climate, obtaining these documents seems impossible. Even if Gasum were to somehow find these documents and attribute liability to Gazprom, it would be unrealistic to imagine a scenario in which Gazprom decides to defy the Russian government and supply the gas in accordance with the original contractual terms. Compensation for the damages caused by the supply cut seems more probable, but considering the present energy crisis, this is not the ideal solution, because gas is more valuable than monetary compensation.

It is discomforting to see the true intentions behind Russia's tactics in this conflict. It appears that Russia intends to impose the new payment conditions on European gas importers, putting them in a difficult position, as a means to fuel its war machine. The importers will either have to comply with the conditions or be left without gas or compensation, since Gazprom will try to shift the blame on the Russian government, which in turn cannot be sued or held accountable directly.

> It appears that Russia intends to impose the new payment conditions on European gas importers.

Fortunately, Finland has announced that it is prepared for a gas shortage and can find alternatives (Laikola, 2022), but what about other countries that are less able to do so? Given the fact that a successful legal challenge to the Russian decree is unlikely, is there a way for these countries to comply with the Russian decree without breaching the EU sanctions?

As noted above, it is unclear whether European gas importers can do so. Technically, in its guidelines, the European Commission has declared that opening an account with Gazprombank is not in breach of EU sanctions, while Commission President Ursula von der Leyen has claimed that if companies that have contracts with Gazprom accede to the new terms, they would be in breach of EU sanctions (Thomas, 2022). The following section further elaborates on this issue.

The interplay between Russia's retaliatory decree and EU sanctions: an issue of legality, interpretation, and loopholes

Regarding the legality of the payment procedure introduced by the decree, the Commission warned that the procedure would potentially involve the Russian Central Bank, giving it complete control over the euro notes for the time of the conversion.[15] Due to the fact that the time of this process is indefinite, the transfer could amount to a loan, and loans are prohibited under the sanctions regime (Eni.com, 2022). This statement, however, is ambiguous, because Council Regulation (EU) 833/2014 does not provide any exact conditions or time limits that further explain how a payment can be considered a loan. In fact, article 1(o) clarifies in the financial assistance definition that 'payment as well as terms and conditions of payment of the agreed price for a good or a service, made in line with normal business practice, do not constitute financing or financial assistance'.[16] Therefore, a plain reading of this article does not clarify the difference between a loan and a payment. As a result, this leaves it entirely up to companies to determine whether their engagement with Gazprombank is legal. Considering the fact that gas deliveries are crucial at the moment, the burden seems heavy.

In practice, some companies have attempted to find a way around the decree without breaching the sanctions. For example, Eni, an Italian energy company that imports from Gazprom, has decided to open an account with Gazprombank. On its official website, Eni clarifies that the account has been opened without prejudice to the present contractual rights and without recognising the new payment procedure as an amendment to the contract (Eni.com, 2022). The reason for opening such an account was to comply with upcoming payment deadlines and to ensure that uninterrupted gas supply.

Several conditions have been attached to this payment. First, Eni explains that the risk or cost of this payment procedure is allocated to Gazprom Export. Second, the invoicing and payment will continue to take place in euros. Third, the conversion will be carried out by a clearing point agent operating at the Moscow Stock Exchange within 48 hours and without any involvement of the Central Bank of Russia. Finally, in the event of any delays or technical inability to complete the conversion on time, there will be no impact on supplies (Eni.com, 2022).

Eni claims that this decision has been shared with Italian institutions and to date it has not faced any objections (Eni.com, 2022). This approach may serve as an example for other companies, especially when considering the issue of determining whether the payment to Gazprombank can be considered a loan. Concretely, as noted above, the Commission has clarified that Council Regulation (EU) 833/2014 prohibits payment to Gazprombank to the extent that the conversion process involves the Russian Central Bank or falls under the category of a loan. By agreeing with Gazprom Export that the conversion will be conducted by a clearing point agent without the involvement of the Central Bank of Russia, Eni could be setting an example of how to ensure gas delivery while still adhering to the sanctions regime.

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15 European Commission (2022) 'Frequently asked questions on imports and purchase of goods concerning sanctions adopted following Russia's military aggression against Ukraine', 14 June, https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/faqs-sanctions-russia-gas-imports_en.pdf.

16 Consolidated text: Council Regulation (EU) No 833/2014 of 31 July 2014 concerning restrictive measures in view of Russia's actions destabilising the situation in Ukraine article 1(o).

What's next? A desirable way forward and a pathway for potential compromise

It is safe to say that the present circumstances have made it difficult for Member States and European gas importers to go about business as usual. To address these disruptions in the long run, on 18 May 2022, the European Commission released its plan to replace Russian energy sources, particularly gas, by 2027. The communication is called the 'REPowerEU Plan'. 17 The Commission stated that as a result of the invasion of Ukraine as well as the above-mentioned decree, Russia could no longer be considered a reliable partner and so the EU should seek new energy supply partners. The plan aims to accelerate diversification and the addition of more renewable energy sources, front-load energy savings and electrification with the potential to deliver as soon as possible energy savings equivalent to the fossil fuels that Europe imports from Russia annually.18 It is an ambitious strategy that requires solidarity among Member States and an investment of up to €210 billion. In the long term, the plan seems promising. However, in the short term, it has a few shortcomings.

First, the plan does not sufficiently address the impact on some European countries of Russia's decision to cut gas deliveries. The main alternative that the plan presents for replacing Russian gas is imported Liquified Natural Gas (LNG) from North America and Asia. However, some claim the EU cannot realistically use all its import capacity to immediately replace Russian gas for the whole bloc (Mcwilliams et al., 2022). Moreover, the high demand from the EU is expected to tighten the market and drive up LNG prices (BloombergNEF, 2022).

Second, the plan is dependent on immediate cooperation among the Member States. As the Commission notes in REPowerEU Plan, there is a risk that without further action in the coming months, storage will not be sufficiently filled to meet the demand over the coming winter (BloombergNEF, 2022). Additionally, the plan requires national-level implementation, which makes it subject to lengthy bureaucratic procedures and dependent on the political willingness of each Member State. Since the degree of reliance on Russian gas differs among Member States, the incentive to replace it might also differ, causing a real challenge in terms of coordination.

There have also been suggestions that the EU should subsidise energy use reduction instead of subsidising replacement of the gas (McWilliams and Zachmann, 2022). One way that this could be achieved is by pooling all the untapped energy potential of the Member States and jointly procuring gas on international markets (McWilliams, Tagliapietra, and Zachmann, 2022). For example, exploiting and utilising Dutch gas fields or German and Ukrainian nuclear capacities could reduce the energy demand and give the EU a stronger bargaining position with Russia (McWilliams, Tagliapietra, and Zachmann,

[17] Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and The Committee Of The Regions REPowerEU Plan https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2022%3A230%3AFIN&qid=1653033742483.

[18] Ibid.

2022). This also requires the Member States to make energy replacement a top priority and reach difficult compromises. As reality has shown, the gas crisis and sanctions have led to a disparity instead of unity in action, because Member States have taken different approaches. One reason may be that some states cannot imagine a scenario in which they are completely independent of Russian gas. But nevertheless, the governments of the Member states should understand that by acting individually they will have a much weaker bargaining position and, at some point, Russia will use their dependency on its gas against them. For that reason, the Member States should strive to make both the replacement plan and demand reduction top priorities. It is important for the EU to use this powerful window of opportunity to not only reduce demand for Russian gas, but also enable a speedier transition to non-fossil fuels, which is at the core of the sustainability goals of the EU Green Deal and Fit-for-55 initiative.

In the meanwhile, more cohesion and flexibility are required regarding the sanctions regime and gas delivery issues. Although bending completely to the Russian demands is not advisable, a total refusal is not practical either. It is understandable that some countries have the capacity to say 'no' to Russian gas, but as noted above, an immediate replacement of Russian gas for the whole bloc is not possible yet. Besides, despite the extensive scope of the EU sanctions, the Russian economy has proven to be more resilient than expected (*The Economist*, 2022b). And although the measures are sending a strong message to Russia and may damage its economy in the long term, the sanctions are also damaging the EU and its gas consumers. Therefore, it is in the interest of the EU to grant EU gas importers more flexibility, and not shoot itself in the foot when making a new energy transition and meeting its requirements.

Member States should instead undertake a gradual replacement, allowing highly dependent countries to also adjust to the tight gas market without risking their energy supply or ability to meet demand. Moreover, the Commission needs to clarify the legality of gas payments, the time limit for defining the difference between a payment and a loan, and encourage cohesion in terms of dealing with Russian sanctions and avoiding confusion. Ultimately, these economic measures will cripple Russia and its war resources permanently. However, it is necessary to remind ourselves that this is a tit-for-tat situation, and the EU should prepare for retaliation. ■

Author bio

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