

Russian Energy Sector Sanctions: One Year On

Law360, New York (September 1, 2015, 10:40 AM ET) --



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On Aug. 7, 2015, the U.S. Department of Commerce Bureau of Industry and Security published a final rule adding the Yuzhno-Kirinskoye Field, a Russian oil and gas field located in the Sea of Okhotsk that is owned by Russian energy giant Gazprom, to its Entity List. This designation by BIS marks the latest chapter in a gradual ratcheting up of U.S. energy sector sanctions affecting Russia since the initiation of U.S. and international sanctions against Russia began more than a year ago. This latest action generally prohibits the export, reexport or transfer of any U.S.-origin goods or technology to the field, as well as certain foreign items incorporating de minimis amounts of U.S. content or that are direct products of certain U.S. technology or software. Importantly, this is the first time that BIS has used the Entity List to restrict exports to a specific location, signaling a new approach by the Obama administration to impose further limitations on access to equipment and technology to support the development and realization of Russia's substantial oil resources.

The BIS action on Aug. 7, although characterized informally by U.S. officials as "sanctions maintenance," rather than as an escalation of sanctions against Russia, adds one more impediment to the framework of U.S. restrictions targeting the Russian energy sector, which has grown steadily since the U.S. government first initiated sanctions against Russia last year in connection with developments in eastern Ukraine and Crimea. Since August 2014, the U.S. Department of the Treasury Office of Foreign Assets Control, BIS and the European Union, have implemented various sanctions targeting and restricting the Russian energy sector's access to equipment, technology and services used in deepwater, Arctic offshore and shale oil exploration and production projects ("unconventional exploration and production projects"), as well as long-term financing to fund these projects. These sanctions are not designed to interfere with Russia's ability to sell current supplies of oil and gas; rather, they are aimed at impeding Russia's ability to develop long term, technically challenging exploration and production projects.

These energy sector sanctions fall into two general categories: (1) export controls that limit provision of goods, technology and services; and (2) OFAC restrictions on transactions and long-term financing. This article provides a brief overview of U.S. sanctions measures under each of these two categories and a review of related practical compliance concerns that these measures create for U.S. and foreign companies in the energy sector. Given the complexity of these measures and multijurisdictional considerations associated with parallel sanctions against Russia implemented by the European Union and other countries, global companies that engage in business involving Russia's energy sector must be alert and attentive to compliance risks associated with transactions that involve equipment, technology, locations, end parties and end uses affected by international sanctions measures and corresponding licensing restrictions.

Export Controls Targeting Russia's Energy Sector

OFAC and BIS have implemented separate, coordinated sanctions measures aimed at preventing Russia from receiving necessary equipment, technology and expertise that it requires to extract oil using unconventional methods (i.e., deepwater, shale or Arctic offshore exploration and production projects). These measures include export controls targeting certain energy-related equipment and technology and certain key Russian energy companies. In coordination with the U.S., the EU has also imposed its own sanctions restricting exports of certain energy-related equipment and technology to Russia, as well as necessary services for unconventional oil exploration and production processes.

BIS Russian Oil Industry Sanctions

On Aug. 6, 2014, BIS implemented its "Russian Oil Industry Sanctions," which are codified in Section 746.5 of the Export Administration Regulations. These sanctions impose a license requirement on all exports, reexports or transfers of certain controlled items suited for unconventional oil exploration or production projects (e.g., drill pipe, subsea processing equipment, high pressure pumps and remotely operated vehicles) when the exporter, reexporter, or transferor knows or is unable to determine "that the item will be used directly or indirectly in exploration for, or production of, oil or gas in" the unconventional exploration and production projects listed above in Russia. BIS reviews such license requests with a presumption of denial when the items are "for use directly or indirectly" in unconventional exploration and production projects in Russia that "have the potential to produce oil." Unlike the Entity List restrictions described below, these restrictions are not specific to certain designated entities, but apply generally to any exports, reexports or transfers of the specified controlled items to Russia.

Export Controls Targeting Major Russian Energy Companies: OFAC Directive 4 and BIS Entity List Restrictions

On Sept. 12, 2014, OFAC implemented Directive 4 of Executive Order 13662, imposing specific export controls on five major Russian energy companies designated on OFAC's Sectoral Sanctions Identifications List (SSI List). As a result, U.S. persons and persons within the United States are prohibited from providing, exporting or reexporting goods, services (excluding financial services) or technology in support of exploration or production for deepwater (greater than 500 feet), Arctic offshore or shale projects that have the potential to produce oil in Russia or in maritime area claimed by Russia and extending from its territory, and that involve these designated Russian energy companies. These restrictions apply not only to the specific designated entities listed under Directive 4 on the SSI List, but also to any company that is owned 50 percent or more by one or more designated entities

under Directive 4.

In a coordinated move on Sept. 12, 2014, BIS added these same five major Russian energy companies to its Entity List, imposing a licensing requirement for the export, reexport or transfer (in-country) of items subject to the EAR to the identified companies when the exporter, reexporter or transferor knows or is unable to determine that those items “will be used directly or indirectly in exploration for, or production of, oil or gas” in Russia through the unconventional energy projects listed above. As with its Russian oil industry sanctions, BIS reviews such license requests with a presumption of denial when the items are “for use directly or indirectly” in unconventional exploration and production projects in Russia that “have the potential to produce oil.”

BIS Entity List Restrictions Targeting Certain Locations

On Aug. 7, 2015, BIS published a final rule adding the Yuzhno-Kirinskoye Field, a Russian oil and gas field located in the Sea of Okhotsk, to its Entity List, marking the first time that BIS has designated a location on this list. Under agency guidance included with the final rule, the Yuzhno-Kirinskoye Field, which is owned by Gazprom, was “added to the Entity List because it is reported to contain substantial reserves of oil in addition to reserves of gas.” In particular, the U.S. government determined that “exports, reexports and transfers (in-country) of all items subject to the EAR” to the oil field present “an unacceptable risk of use in, or diversion to” deepwater (greater than 500 feet) oil and gas exploration or production activities in Russia.

Importantly, unlike other sanctions targeting Russia’s energy sector, the restrictions on the Yuzhno-Kirinskoye Field apply to any and all transactions involving any items subject to the EAR, not just when the exporter knows or is unable to determine that the items will be used for deepwater, Arctic offshore or shale exploration or production projects.

EU Restrictions on Energy Equipment, Technology and Services

In coordination with the United States, the EU has also imposed similar sanctions restricting exports of certain energy-related equipment and technology to Russia, as well as services necessary for deep water, Arctic or shale exploration or production projects in Russia. These restrictions, although similar to the U.S. restrictions, differ in terms of what items are controlled and what exceptions and licensing procedures may apply. Because the EU and U.S. measures are not identical, companies cannot assume that a proposed transaction that is permitted under one regime is also permitted under the other. Sanctions compliance and sanctions risks associated with Russia must be considered and addressed on a multijurisdictional basis.

OFAC and EU Financing Restrictions on Certain Russian Energy Companies

In addition to the export controls listed above, OFAC has also designated certain Russian energy companies under Directive 2 of its SSI List, imposing restrictions on long-term financing for these companies. Specifically, Directive 2 of Executive Order 13662 prohibits U.S. persons and persons in the United States from transacting in, providing financing for or otherwise dealing in “new debt” of greater than 90 days maturity issued by these energy companies. Importantly, OFAC has clarified that the term “new debt” is an expansive term that includes “bonds, loans, extensions of credit, loan guarantees, letters of credit, drafts, bankers acceptances, discount notes or bills or commercial paper,” as well as extended payment terms that exceed 90 days. As with other sanctions imposed by OFAC, these restrictions apply not only to the entities specifically designated under Directive 2, but also to any

company that is owned 50 percent or more by one or more entities designated under Directive 2.

In a coordinated move, the EU has also imposed sanctions prohibiting persons subject to EU jurisdiction from dealing in new transferable securities and money-market instruments with a maturity exceeding 30 days by three designated Russian energy companies. Furthermore, these sanctions restrict EU persons from “be[ing] part of any arrangement to make new loans or credit with a maturity exceeding 30 days” to these designated major Russian energy companies. These restrictions also apply to non-EU companies owned by more than 50 percent by these designated companies.

Key Compliance Concerns

To ensure compliance and prevent violations of law, this complex framework of international sanctions affecting Russia requires companies to carefully scrutinize all transactions involving Russia’s energy sector to ensure that they do not involve activities, persons or locations restricted by U.S. and/or EU sanctions. A number of compliance considerations are important for companies to examine when contemplating export, financial or other transactions that may intersect with the U.S. and/or EU sanctions regimes.

Sanctions Due Diligence

Consistent with an effective and robust sanctions compliance program, companies conducting business with Russia should screen all parties to proposed transactions associated with Russia to establish and ensure that they do not involve restricted locations, end users, end uses or restricted persons. In addition, companies must address risks posed by the fact that key sanctions measures extend automatically to companies which may not be named on sanctions lists but are still subject to sanctions restrictions by virtue of a sanctioned parties’ ownership or control. Consequently, it is important to conduct further diligence and screening regarding the ownership chains of counterparties in proposed transactions. For example, OFAC sanctions against Russian energy companies designated under Directives 2 and 4 extend to companies in which they directly or indirectly hold a 50 percent or greater equity interest, either individually or in the aggregate with other entities designated under the same directive. The EU similarly extends financial sanctions targeting designated Russian energy companies to entities that they own by more than 50 percent or that “act on their behalf” or “at their direction.” BIS Entity List restrictions also extend to companies that sanctioned entities “control.” As screening software does not always identify companies that are subject to sanctions because of ownership or control, the only way that a company can safeguard against such risk is to conduct due diligence extending to such third parties to ensure that sanctions are not triggered through direct or indirect ownership interests or control of sanctioned parties.

Relevant Jurisdictions and Sanctions Regimes

As a threshold issue, U.S. and non-U.S. companies alike should determine whether U.S., EU or other jurisdictions’ sanctions provisions apply. As discussed above, U.S. Entity List restrictions aimed at the Russian energy sector apply extraterritorially to items subject to the EAR, wherever located. Non-U.S. companies that wish to export or reexport U.S.-origin goods or technology subject to the EAR must comply with BIS’ restrictions on exporting to Russia’s energy sector. Furthermore, a non-U.S. company may face sanctions exposure if U.S. persons (e.g., officers, directors or shareholders) are involved in a transaction that is prohibited under U.S. sanctions. Accordingly, companies should initially consider these factors when conducting threshold due diligence on a proposed transaction involving Russia to determine whether one or multiple jurisdictions’ sanctions programs apply so that they can identify and

effectively address related concerns.

Applicability of OFAC Sanctions and/or BIS Export Restrictions

Although U.S. sanctions measures administered by BIS and OFAC, respectively, share certain similarities and are grounded in common policy considerations, there are important distinctions between the restrictive measures that they impose. In some cases a proposed transaction can intersect with sanctions restrictions and licensing requirements of one or both agencies.

For example, OFAC's Directive 4 sanctions apply to all U.S. persons, wherever located (i.e., U.S. citizens, permanent residents and entities organized under the laws of the U.S., including foreign branches). In contrast, BIS' Entity List restrictions apply extraterritorially to items that are subject to the EAR, including U.S. origin items (wherever located), certain foreign-origin items incorporating more than a de minimis amount of U.S. content or that are the direct product of certain technology or software and items located in or moving in-transit through the United States. Thus, a non-U.S. company, while not generally subject to OFAC's restrictions, must still apply for a license from BIS to export line pipe manufactured in the United States to a designated entity if it knows or is unable to determine that the designated entity would use it for one of the unconventional oil projects listed above. Likewise, a U.S. person must comply with OFAC restrictions, even if it is dealing in non-U.S. goods or technology. In many (if not most) instances, companies will need to comply with both sets of sanctions because U.S. persons and items subject to the EAR are involved in the transaction.

Additionally, whether the project is oil- or gas-related also determines which sanctions regimes apply. OFAC's Directive 4 only restricts transactions involving unconventional energy projects that have the "potential to produce oil." Projects that only have the potential to produce gas, but not oil, are not covered by these restrictions. In contrast, BIS' restrictions require companies to apply for a license if the unconventional energy project has the potential to produce oil or gas. As a result, a U.S. company seeking to export drilling equipment to a designated entity for a deepwater oil production project in Russia would have to apply for a license with both BIS and OFAC (which would, in most instances, likely be rejected). However, if the project involved in this transaction only has the potential to produce gas, the company would only have to seek a license from BIS.

OFAC and BIS restrictions also differ in the extent to which they affect transactions involving Russian entities that are owned or controlled by a sanctioned party. The restrictions of Directive 4 apply to entities designated under the directive, as well as companies owned 50 percent or more by such companies, but do not apply to companies that are only "controlled" by Directive 4 entities. In contrast, the export control restrictions administered by BIS do not apply a "50 percent rule" that automatically extends Entity List restrictions to separately incorporated companies based on sanctioned party ownership interests. Instead BIS focuses on whether the listed entity "controls" the target entity. According to BIS, "if the listed entity controls the company as a result of its level of ownership and/or its involvement in the company's business activities, the Entity List's licensing requirements and policies specific to the listed entity apply to the company." Companies should therefore conduct additional due diligence to determine whether OFAC or BIS restrictions apply to a counterparty because it is owned or controlled, directly or indirectly, by a sanctioned party.

End-Use Certificates and Contractual Protections

Companies that engage in transactions associated with the Russian energy sector can also take affirmative steps to obtain documented compliance assurances that the items or services they provide

will not implicate applicable U.S. or EU sanctions restrictions. In addition to conducting meaningful and effective diligence, companies can seek end-use certifications and include express contractual terms and conditions in their commercial agreements to ensure sanctions compliance. Because U.S. and European financial institutions are increasingly requiring such assurances and terms in conjunction with financing for projects associated with Russia, the inclusion of such provisions has become increasingly common and foreseeable in commercial agreements associated with the Russian energy sector.

Payment Term Limitations

As mentioned above, OFAC's Directive 2 sanctions restrict U.S. companies from extending payment terms of greater than 90 days maturity to designated Russian energy companies. Companies wishing to transact business with such companies should ensure that they are not extending payment terms that are longer than 90 days from either (i) the "point at which title or ownership of goods" transfers to the Directive 2 company, in the case of the sale of goods; or (ii) "the date of each final invoice (for payments relating to services, subscription arrangements, and progress payments." OFAC further advises that "[i]n the event that a U.S. person believes that it may not receive payment in full by the end of the ... 90-day period, the U.S. person should contact OFAC to determine whether a license or other authorization is required."

Conclusion

In the context of U.S. and EU sanctions affecting Russia, Western companies engaging in business involving Russia's energy sector must be vigilant in their compliance practices with respect to provision of financing; supply of equipment and technology; locations of projects; identities of counterparties, end users and end uses of goods and technology; and chains of ownership associated with companies that they do business with in commercial activities associated with the Russian energy sector. They must also be mindful of the multijurisdictional dimensions of Russia-related projects they consider. At the same time, Russian companies must also consider the potential business risks that U.S. and EU sanctions may present when doing business with U.S., European or other potential business partners.

On all sides, companies considering energy sector projects that have a nexus with Russia or Russian parties have a common interest in evaluating and effectively safeguarding compliance with international sanctions to ensure the success of their commercial ventures. To ensure success and avoid sanctions liabilities, it is important for Russian, U.S. and European companies to take into account sanctions risks when planning and structuring proposed business transactions. In the current landscape of international sanctions affecting Russia, some kinds of transactions may be frustrated, but many kinds of business remain feasible and practical as long as companies properly consider and address sanctions risks on a preemptive basis. As developments over the past year demonstrate, international sanctions affecting the Russian energy sector may continue to evolve and are a practical reality that companies must build into business planning and in structuring commercial transactions with Russia's energy sector.

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