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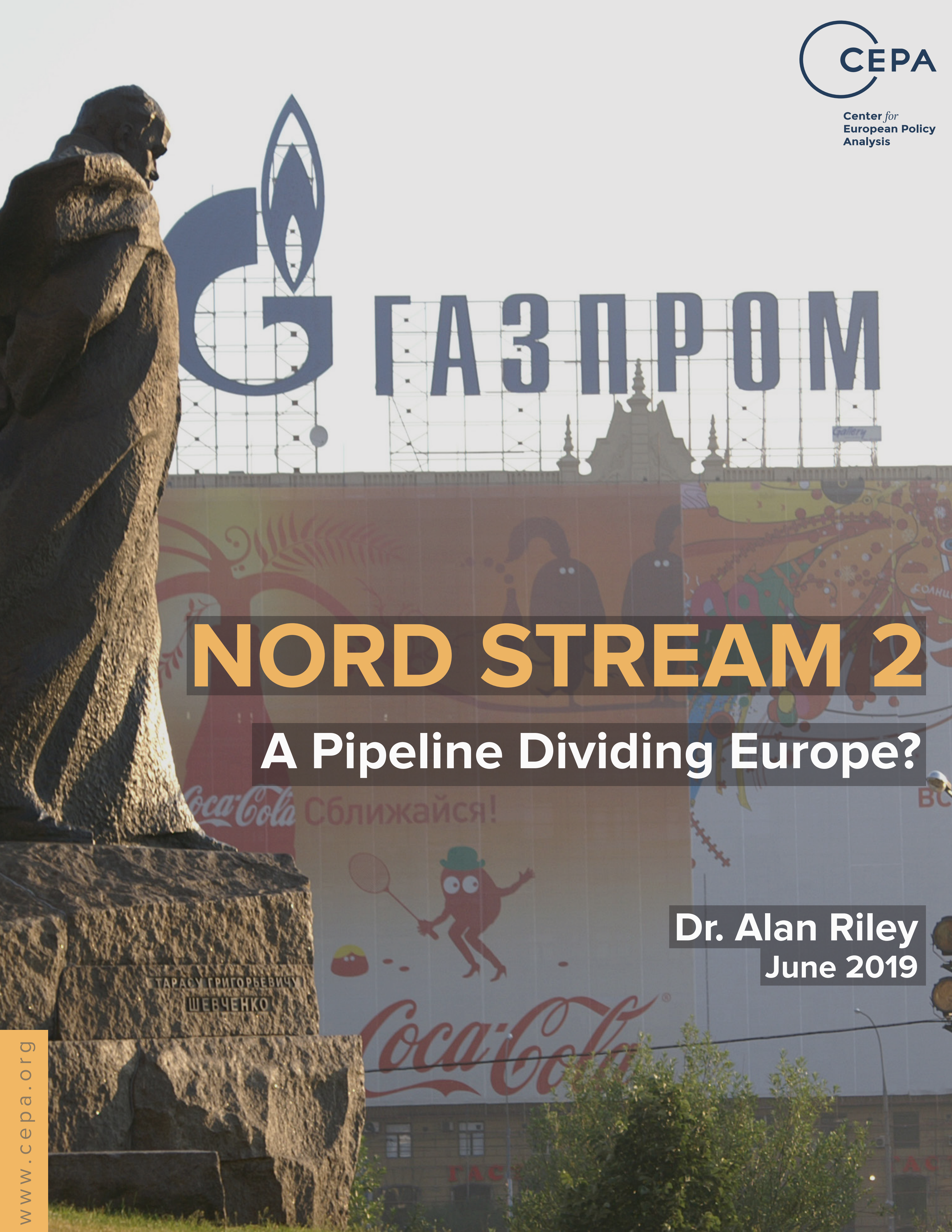

NORD STREAM 2

A Pipeline Dividing Europe?

Dr. Alan Riley

June 2019

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The Issue

***From the Editor:** The Nord Stream 2 pipeline, owned and operated by a firm whose majority stockholder is Russian state energy company Gazprom, has been one of the most contentious energy projects in recent years. Its supporters argue that the pipeline, which is to extend directly from Russia to Germany along the floor of the Baltic Sea, will bring needed gas supplies to Western Europe. Its opponents argue that the purpose of NS2 is primarily political – to undermine the European Union and give the Kremlin political leverage over those countries in Central and Eastern Europe which now derive revenues from gas transit fees. With the project now under way, CEPA guest contributor Alan Riley examines the legal thicket ahead.*

Russia has had some success deploying Nord Stream 2 as a means to achieve its aims, splitting Europe internally and Europe from the United States, undermining trust in EU law, dividing Europe's single gas market, and isolating Ukraine. But Russia's prospects for future success may be limited with the amendment to the 2009 Gas Directive, which formally extends EU law to import pipelines. This paper examines the strategies that Russia has employed so far, the implications of the Gas Directive, how Russia could react, and how Europe could build resilience moving forward.

NORD STREAM 2: A PIPELINE DIVIDING EUROPE?

Russia's objectives behind the Nord Stream 2 (NS2) pipeline are to divide Europe internally and Europe from the United States. So far the project has had some success at achieving the first objective: splitting Western Europe and particularly Germany from the rest of the European Union; Central and Eastern Europe (CEE) from Western Europe and the United States from the European Union (EU). Russia has also deployed NS2 to undermine trust in the EU's legal order, divide the EU's single market in gas, and weaken Ukraine-EU ties.

However, an amendment to the 2009 EU Gas Directive may have thwarted some of Russia's intentions by formally extending EU law to import pipelines such as NS2. This has created a 'law lock' on the regulatory regime for import pipelines such that all states, including Germany, will be forced to comply with EU law. Uniform application of European Union law is a basic requirement to build trust and solidarity against Russian attempts to divide and lever market power for political and commercial purposes.

This paper first considers the principal strategies that Russia—via Gazprom and NS2—has developed to divide and undermine the EU and weaken and isolate Ukraine. This includes: isolating Germany by offering seemingly preferential terms to German business; creating unlawful exceptions from EU law which undermine its credibility; persuading Western Europe that NS2 will fill the supply gap from Groningen field; and creating a distribution route for NS2 which will halve the EU single gas market. It then examines the 2009 Gas Directive amendment, which will make developing NS2 in its current form extremely difficult and require NS2 and other Gazprom-supported import pipelines to comply with EU liberalization rules. This will likely reduce Gazprom's market and political power and make terminating the flow of gas through Ukraine's transit route less likely. Finally, it considers the Russian reaction, which is unlikely to accept the amendment undermining of its division strategy. The EU must therefore take steps to reinforce the integrity of its single gas market.

THE RUSSIAN STRATEGY OF DIVISION

NS2 has been divisive since President Putin launched the project in June 2015. Most CEE and all Baltic states have always opposed it. Over time, the European Commission and some Western EU member states have also come to oppose it. Meanwhile, Germany and key allies have resolutely supported the pipeline. The prospect of another pipeline undermining CEE's supply security and isolating Ukraine has also created concern in the United States, putting the United States at loggerheads with Germany and other allies. In fact, division is one of Moscow' purposes in building NS2. Four elements of this strategy are discussed below.

Isolate and Enrich Germany: Russia has used NS2 to isolate and divide Germany from the rest of the EU using several historic and commercial influencers and levers. This includes the SPD and Chancellor Willy Brandt's historic Ostpolitik policy, which focused on normalizing ties with the USSR and East Germany and promoting trade and commerce.[1] The promotion of NS2 today within the SPD draws upon this Ostpolitik tradition. However, Brandt was dealing with a conservative pacific power in the USSR so an Ostpolitik policy made sense. Today, the Kremlin seeks to overturn the existing post-Cold War order. The prospects for successful Ostpolitik are more limited. The danger is that Moscow could take what Berlin offers and move to even more extensive demands.

> “Russia has used NS2 **to isolate and divide Germany from the rest of the EU** *using several historic and commercial* **influencers and levers.** ”

There also appear to be compelling commercial factors in Russia for German business. This is more about potential than reality. Russia is only the 14th largest export market for Germany, which exports more to the Czech Republic.[2] German business could eventually profit from Russia's consumer market of 145 million people and vast natural resources. The more tangible commercial potential is with energy companies such as Wintershall and Uniper (both corporate partners of NS2) who could gain access to profitable markets and energy resources for Germany and the EU.[3]

NS2 also offers to make Germany the gateway for Russian gas to Europe. With Nord Stream 1 (NS1) and NS2, 110 bcm or approximately 70% of Russian gas exports enter the EU at Greifswald. Germany is guaranteed supply security with a direct fixed energy link. This could also positively impact German consumer prices and make Germany a gas trading and distribution hub for Europe.

Sections of the German business and political establishment welcome these benefits. However, they come at the high price of alienating CEE and much of the EU. Although gas prices in Germany could decrease, prices will likely rise in CEE.[4] Gazprom will want to balance lower prices in Germany with higher prices elsewhere. Given that NS2 will increase Gazprom's market dominance, this is achievable.

Price increases are only the beginning of CEE's objections to NS2. Another is supply security. Currently there is a degree of transit security because much of the EU gas supply enters via the Ukrainian Brotherhood transit network. Russia cannot cut off individual CEE states without undermining the gas supply to other EU states downstream. NS2 removes this transit security. This is what undermined Germany's argument that it could guarantee natural gas flows from west to east via Nord Stream and its connectors. Gazprom had already threatened such flows in 2014 and 2015 and some CEE states were actually cut off in retaliation for reverse-flowing natural gas to Ukraine.[5]

There is also the prospect of Gazprom's increased market power across the CEE region and the loss of alternative supply sources. This relates to the effective partitioning of the single market and matters for the European Commission and some Western member states (discussed below).

These factors work to isolate Germany from other EU members and institutions by promoting German and Russian interests – much to the chagrin of the rest of the EU.

Undermine the EU Rule of Law with Pipelines: The uniform application of EU law within the EU is a vital element of the European project. Member states can only do deals with each other if the rules apply to everyone. Equally, uniform law allows the EU to deploy its considerable commercial leverage against third parties. Russia unfortunately has used natural gas to undermine the adhesion of member states and principally Germany to EU law.

The EU's third energy package, particularly the pro-liberalization 2009 Gas Directive, were never applied to NS1.[6] Gazprom, its Western corporate allies, and parts of the German government argued that it did not apply to offshore pipelines. The weakness of this argument is that it runs for approximately 90km through the territorial waters of Denmark and Germany, where EU law ordinarily applies. In March 2014, replying to a parliamentary question that implied EU law was applicable to NS1, the Energy Commissioner indicated that an exemption request was not received and could not be granted unless EU law in the 2009 Gas Directive applied to the pipeline.[7]

Although the Gas Directive and the rest of the third energy package was not applied to NS1, the European Commission was prepared to apply EU law to another substantially offshore pipeline: South Stream. Responding to another parliamentary question, the Commission indicated, "The Commission services' preliminary view is that the proposed amendments [of Bulgarian law] incorrectly and unilaterally exclude off shore pipelines—which are under EU jurisdiction for any part of EU territory—from key elements of the Third Package rules."[8]

> "**Russia unfortunately has used** *natural gas to undermine the* ***adhesion of member states and particularly Germany*** to EU law."

In December 2013, the Commission concluded that the Intergovernmental Agreement (IGA) between Bulgaria and Russia for South Stream breached EU energy law on unbundling and third-party access, and applied to both the onshore and offshore parts of the pipelines within EU territory.[9] Ultimately, the threat of Commission infringement procedures was a significant factor in President Putin cancelling South Stream in December 2014.[10]

The Gas Directive and third energy package has also been applied to at least one onshore import pipeline: Yamal. This is significant because there is usually no distinction between national law applied on soil versus inland waters and territorial seas.[11] Yamal carries natural gas from Russia through Belarus into Poland, running 600km through Polish territory. For that section, EU energy law applies, including the 2009 Gas Directive.[12]

This perception that one EU energy law exists for Germany and another for other member states was reinforced by the regulatory regime for the NEL pipeline, a NS1 connector. It has a capacity of 22 bcm and was constructed after the 2009 Gas Directive. As a new pipeline, it should have been subject to full liberalization, including ownership unbundling rules, unless an exemption was requested. Instead, the German national regulatory authority argued that it was only an extension of a pipeline to which EU law did not apply. As the Commission pointed out in 2013, this has no basis in the Gas Directive.[13] Notwithstanding the Commission's skepticism, no steps were taken to bring infringement procedures against Germany.

The sense in Poland, Bulgaria, and Italy (a strong supporter of South Stream) that EU law for pipelines does not apply to Germany damages the integrity of the EU and EU law. This view of double standards was reinforced with NS2. The battle over applying EU law to NS2 the last four years—where Commission and Council leaks appeared to demonstrate support for Germany—did not reconcile NS2's non-applicability with its application to Yamal or South Stream.[14,15] It also included a long debate about granting the European Commission a mandate to seek an intergovernmental agreement with Russia on NS2.[16] Finally, the Commission proposed formally extending the Gas Directive to import pipelines. With 22 member states in favor, Germany scrambled for allies to block the proposal and delayed legislation for over a year. With backing from the French government and faced with defeat in the EU Council, Germany finally agreed to the extension proposal.[17]

Although EU law applies to import pipelines including NS2, the process has damaged belief in the legal regime. In this respect, Russian pipeline projects—before and including NS2—have succeeded in dividing the EU and undermining its glue and motor: its legal and regulatory order.

This issue was not closed with the agreement on the amendment to the Gas Directive in February 2019.[18] The question remains the extent to which the German national regulatory authority and the European Commission will apply EU law to NS2. There could well be mileage left in the 'pipeline rule-of-law division game' for Moscow.

Apply the Groningen Lever: Another strategy to promote NS2 and divide Western Europe from CEE is promoting the pipeline as a source of natural gas to Western Europe. Gazprom, its corporate allies, and some parts of the German government argue that NS2 will fill the gap from declining gas production in the British and Dutch North Sea.

The production-consumption gap is indeed widening with declining production in the North Sea, which Norway is incapable of bridging. The gap will reach an estimated 292 bcm by 2022, up from 200 bcm in 2016.[19]

Declining West European gas production is of concern, given recent dramatic falls in Groningen's output, Europe's largest landward gas field. Because of a series of increasingly severe earth tremors over the last decade—which gas extraction has caused—the public has demanded action. Reluctantly, the Dutch government has agreed to closure by 2030.[20] Its production of 54 bcm from 2013 dropped to 19 bcm in 2018-2019, then to 5 bcm maximum per year in 2023 before closure in 2030.[21]

The unanticipated and rapid loss of Dutch and EU production creates near-term supply security worries beyond declining British and Dutch North Sea production. These fears are deployed by Gazprom and its allies as a 'Groningen Lever' to build support and convince West Europeans that NS2 will replace its gas production. For those unfamiliar with Russia's intentions or NS1's track record, this does not seem unreasonable. Surely a new pipeline will mean more gas for Europe?

> **"*Surely a new pipeline will* mean more gas for Europe?"**

However, the reality is that NS2 is intended to be a diversionary pipeline.[22] No additional gas will flow into the EU as a result of NS2. Both NS1 and NS2 have the same objective of reducing and ultimately eliminating the flows of gas through Ukraine. The principal political purpose is thus to deprive Ukraine of transit revenue, isolate it from the EU, and increase gas dependence on Russia. NS2 cannot be a new pipeline supplying the EU with additional gas.

Evidence of these objectives can be found in the operation of NS1 and its connecting OPAL pipeline. It was flooded with Russian gas flows via the Ukrainian transit network. When the European Commission granted an exemption in 2016 to OPAL, which permitted larger gas flows, greater flows immediately came though NS1 and onto OPAL while those in the Ukrainian transit network fell.[23]

Further evidence of Russia's intention to bypass Ukraine is found in its plans for Turk Stream 2.[24] Running across the Black Sea from Russia to either Greece or Bulgaria, it has a capacity of 15.75 bcm. Its only conceivable purpose for the project would be to replace the natural gas that currently flows via Ukraine down the Balkan pipeline network to Bulgaria and Greece. Turk Stream 2, in other words, is another diversionary pipeline aimed at further undermining the scale of transit flows via Ukraine.

Furthermore, NS2's main connecting pipeline would not supply Western Europe and the Netherlands to cover production lost from Groningen. Instead, the connector EUGAL, with a carrying capacity equal to NS2's 55 bcm, heads eastward toward CEE and the Polish and Czech interconnectors.

The intention here is clear: flood the east-west interconnectors with NS2 gas to make entering the CEE market more difficult. NS2 and its connecting pipeline effectively divide Europe into two markets: a liberalized gas market in Western Europe with diverse sources of supply and competitive pricing and a Gazprom-dominated market in CEE. To be effective, this strategy must ensure little or no flow through the Ukrainian transit network. In so doing, Gazprom reduces liquidity and increases prices as well as supply dependence in both CEE and Ukraine.

Weaken and Isolate Ukraine: With NS2, Russia intends to divide the EU and divide the EU from Ukraine. The EU and the United States have aimed to integrate Ukraine into the EU's single market and the Western rule of law-based value system over the last five years with the Deep and Comprehensive Free Trade Agreement (DCFTA), support of economic reforms, and liberalization of the gas market.

NS2 seeks to counteract these efforts and weaken and isolate Ukraine from the West and the EU. In 2018, Ukraine received $3 billion in transit fees, equivalent to nearly 10% of the state budget and approximately the same it spends on defense.[25] By terminating the transit regime, NS2 encumbers Ukraine's defense against Russia in the ongoing war.

Equally, terminating the transit network isolates Ukraine. It will no longer be of vital interest to Western Europe which will no longer rush to Kyiv whenever Russia threatens gas transit flows. Russia will be unconcerned that economic and military action against Ukraine will harm its capacity to deliver gas to the EU.

Further, if NS1 and NS2 together with Yamal deliver all Russian gas to Europe, Gazprom will have much more control over the direction of gas flows. The current situation where Ukraine can obtain one-third of its gas supply from friendly states on reverse flow (*i.e.*, gas sourced from Russia where title has passed to EU companies) could disappear.[26] Most reverse flow gas today comes through the Ukrainian transit network, which is not Gazprom-controlled. But once NS2 is on stream, and the Ukrainian network is reduced to at best minimal flows, Gazprom will have much greater control of gas flows.[27] It could reduce flows to EU states that meets their own consumption but not enough to re-export to Ukraine. This could leave Ukraine forced to seek accommodation with Moscow.

Overall, NS2 will weaken Ukraine economically, isolate it from the EU, and increase dependence on Russia – and Moscow could seek Ukraine's reintegration into its near abroad.

FRUSTRATING DIVISION: THE IMPACT OF THE AMENDMENT TO THE GAS DIRECTIVE 2009

On February 13, 2019, at a trilogue (European Commission, European Parliament, EU Council) legislative meeting, a compromise draft on 2009 Gas Directive amendment was approved.[28] This had been originally launched by the European Commission in September 2017 amid much controversy.[29] Its aim was to formally extend the scope of the Gas Directive to import pipelines. This proposal was made in the context of the imminent licensing and construction of NS2.

As explained above, there was an extensive legal debate had already taken place about the application of EU energy law to import pipelines, although EU law had already been applied in at least one case. By imposing EU energy liberalization rules on NS2, it would create significant problems for the project. As a consequence of enthusiastic support in the European Parliament, Germany, NS2's chief proponent in the EU Council, had difficulty blocking it. This became impossible when Paris supported the proposal.

> "**By imposing EU energy** *liberalization rules on NS2,* **it would create significant problems** for the project."

Despite the somewhat convoluted language of the final compromise amendment, it will likely significantly impact NS2 and other proposed import pipelines. It provides the basis for a unified application of EU energy law to all import pipelines, undermines Russia's capacity to divide the EU, and promotes the integrity of the EU legal order.

The amended directive applies to import pipelines in member states' territorial waters, inland sea, and soil. The initial jurisdiction for any import pipeline rests with the first landing point. For NS2 that would be in Greifswald, hence the German authorities must apply EU law to the pipeline. Some commentators have suggested that the amendment has therefore failed as the German National Regulatory Authority (NRA) could provide permissions and exemptions for NS2. Indeed, through the German NRA, EU law was not applied to NS1 and NEL, although it incontrovertibly should have been.

However, the political context has fundamentally changed with Russian aggression in Ukraine and interference in democratic elections, making it much more difficult for the NRA to misapply the law to a Russian pipeline. That is amplified with NS2, one of the most significant political issues currently dividing Europe.

Furthermore, the provisions and structure of the amendment make ignoring EU law very difficult. First, the NRA is applying EU law. Hence, any decision could be challenged in EU courts in Luxembourg or by the European Commission filing an EU law infringement claim against Germany. This is not a theoretical prospect. Already the second more generous exemption granted that OPAL, the other NS1 connector, is subject to legal challenge from Poland (a final ruling will likely come from EU courts this year) and the European Commission's decision in the antitrust case against Gazprom has been challenged again by PGNiG with interventions supporting its case from Poland and Lithuania.[30,31]

Should the German NRA attempt to wriggle out of applying EU law, there would be significant legal interventions from the member states and probably the European Commission.

That leads to the second major issue: how effectively does the amendment ensure the uniform application of EU law and how would it affect import pipelines such as NS2? All new import pipelines from the date of adoption (May 23, 2019) will fall under the amended directive.[32] As NS2 does not have all route licensing permits and is incomplete, it falls under the new provisions (as does Turk Stream 2).[33] This means that NS2, within EU waters, is subject to ownership unbundling, third party access, tariff regulation, and a gas release program. It is also subject to certification as to whether the non-EU owner Gazprom represents a threat to EU supply security (Article 11 of the Gas Directive, the Lex Gazprom clause).

It is difficult to see an easy way out for NS2 and Gazprom. One option could be applying for an exemption under Article 36 to avoid liberalization obligations. However, even the original version of Article 36 says "the investment must enhance competition in gas supply and enhance security of supply" and "the exemption must not be detrimental to competition or the effective functioning of the internal market in natural gas."[34,35] NS2 will reduce route diversity, undermine the supply security of CEE states, increase Gazprom's market dominance, make undertaking reverse flows of gas more difficult, and divide the single market. Consequently, the pipeline is unlikely to obtain the exemption. In addition, the amendments to Article 36 strengthen that provision. There is specific reference to exempt investments not being detrimental to competition "in the relevant markets likely to be affected by the investment" and not being detrimental "to security of supply of natural gas within the Union."[36]

Furthermore, exemption decisions do not fall entirely under the national regulatory authority. The German NRA must under Article 36 make a recommendation to the European Commission, which makes the ultimate decision that is challengeable before EU Courts by member states and anyone with a legitimate interest.

Whether or not an exemption is granted, being non-EU owned NS2 is subject to Article 11 of the Gas Directive, where the NRA must assess whether "granting certification will not put at risk the security of energy supply of the Member State and the Community (now Union)."[37] The NRA ultimately makes the decision but must also seek the European Commission's opinion. The Commission publishes its own final opinion at the same time as the NRA.

> "***It is difficult to see*** an easy way out **for NS2 and Gazprom.**"

The difficulty with any Article 11 assessment is the long history of Russian energy cut-offs detailed by Larsson, the 2006 and 2009 cut-offs, and Gazprom's more recent threats and attempts to stop reverse flows to Ukraine.[38.39] In addition, with NS2, the problem is the loss of transit security for CEE and supply diversity caused by gas being switched from Ukrainian transit. As a consequence, it is difficult to see how NS2 could legitimately obtain certification under Article 11.

Furthermore, Article 11 remains an application of EU law. The German NRA would face the prospect of a contrary opinion from the Commission, possible infringement procedures following a decision to grant certification, and domestic legal challenges from CEE energy companies which could be referred to the European Court of Justice. Hence, the German NRA and Gazprom could face history, precedents, and intentions of the company and the Russian state regarding gas cut-offs and threats being examined in detail in Luxembourg.

The amendment also includes a new 'empowerment procedure' in Article 49b. A member state can negotiate an intergovernmental agreement for import pipelines with a third state. However, the procedure is cribbed, crabbed, and confined with restrictions. Most notably, the European Commission must consent to the opening of negotiations and sign-off on any final agreement. Consent at either end of the process can be refused. The assessment of the Commission is also based on a similar assessment to Article 36: the Commission must consider whether the functioning of the internal gas market, competition, or EU supply security are at risk.[40]

To further demonstrate the difficulty for member states and particularly Germany with NS2, the provision also provides that "when performing the assessment under paragraph 3, the Commission shall take into account whether the intended agreement concerns a transmission line or an upstream pipeline that contributes to the diversification of natural gas supplies and supplies through new gas sources."[41]

Given that NS2 concentrates routes by having NS1 and NS2 running mostly the same route through a narrow Baltic channel and forcing the Ukrainian transit network either wholly or substantially offline, this test is unlikely to be met. Further, NS2 will shift supply from the Ukrainian network to the new pipeline, hence offering no new gas.

Alternatively, Gazprom could comply with EU liberalization rules. Gazprom would have to find a buyer for NS2 – ideally, given Article 11, an EU buyer. It would accept a cost-reflective tariff regime, third party access, and provide 10% of the gas for resale on the open market.

But complying with EU laws would significantly undermine Gazprom's leverage. It is also unclear which EU buyer would take the burden of owning NS2. The pricing of a cost-reflective tariff regime could trigger legal challenges against gas pricing in other long-term supply contracts. Third party access would be the first major breach in the Gazprom export monopoly. Reselling gas on the open market would dent Gazprom's market power. More fundamentally, full compliance with EU rules would reduce Gazprom to an ordinary energy company subject to market rules, undermining its capacity to lever economic and political power.

An alternative strategy could seek to minimize the amendment's impact. This could involve arguing that only the 12 miles of territorial sea where EU law applies would apply to NS2. This '12 mile' proposal underplays how much the pipeline runs through EU territorial seas. The pipeline goes through the territorial waters of Denmark and Germany and the German inland sea for approximately 90km, not just 12 miles. A separate company could be created to own this 'stub' of 90km where EU law would apply.[42] The rest would not be subject to EU law.

This strategy has several problems. First, the minimization or stub strategy does not go very far by focusing on the pipeline within territorial and inland waters. The ownership unbundling rules still apply to the section within EU waters, as would the gas release program, tariff regulation, and security of supply assessment under Article 11.

Gazprom could attempt to further minimize EU obligations. Ownership unbundling could be easier for a short section in territorial waters as it would be cheaper to sell. Avoiding Article 11 could also be easier with an EU owner for that section. However, Recital 10 imports the very broad EU merger definition of 'control' into the Directive so any prospective owner must be independent from Gazprom, otherwise both ownership unbundling and Article 11 would be applied.[43] Gazprom could also argue that third party access does not apply because of the legislative grant of a pipeline export monopoly to Gazprom by the Russian state. This, it can be argued, is reinforced by the stub pipeline 'receiving' gas from NS2 in international waters from one source.

There are two fundamental problems with this 'stub' approach. First, it is wholly artificial. NS2 is one pipeline physically, economically, and in business structure. Creating a formal division is unlikely to convince EU or member state authorities, or EU courts. Furthermore, EU law with its broad concept of business entities and control following its merger will likely supersede any evasive legal formalism. This is particularly the case with the Gas Directive, which was drafted with attempts at evasion by well-resourced and politically influential EU-based energy companies in mind.

Second, despite the debate about the Gas Directive and amendment jurisdiction, there has always been an unrecognized danger (from Gazprom's perspective) of broader EU law jurisdiction over the pipeline. The amendment now terminates that debate. EU law clearly applies to import pipelines within the member states' territorial seas and inland waters. The problem for Gazprom is that even without applying extra-territorial jurisdiction, the whole pipeline can be subject to EU laws' ordinary territorial jurisdiction.

Territorial jurisdiction applies to all entities present within the jurisdiction of the EU member states. Given the amendment, the pipeline is clearly physically present within EU jurisdiction. Territorial jurisdiction can then be extended to conduct and measures outside the jurisdiction which affects the pipeline within.[44] Furthermore, conduct and measures such as non-application of third-party access and granting Gazprom monopoly supply rights can only be undertaken because of the physical presence of the pipeline within EU territory. These are directly and intimately connected with the pipeline operating within EU territory and have no value without the presence of the pipeline in EU territory.

Legitimate territorial extension already has a long line of support in EU legislative practice and some EU case law.[45,46] Going down the stub route of inviting a range of legal challenges from the Commission and the member states will allow the European Court of Justice to rule decisively on this issue, which would affect not only NS2, but NS1 and all other planned pipeline projects.[47,48]

NS2's operation will therefore likely be delayed and if it does come into operation, will be significantly circumscribed by EU law.[49] Gazprom will have lost significant commercial and political leverage and the Kremlin will be less able to deploy pipeline politics to divide the EU in the future.

CONCLUSION: PREPARING FOR THE RUSSIAN REACTION

The more successfully the amended Gas Directive delays or reduces the impact of NS2, the more likely Russia and Gazprom will seek alternative measures to compensate their lost leverage. One option includes possibilities from the termination of the 2009 Ukrainian gas contract in January 2020. The Kremlin could use its expiry to force EU member states to accept NS2 without substantial compliance with EU law.[50]

This would require Gazprom being prepared to stop Ukrainian transit entirely by January 2020, triggering another cut-off crisis in Europe. For Russia, this would have the advantage of undermining Ukraine's supply security. Gas flows via Ukrainian transit are the principal source of reverse flow to make up its shortfall in gas demand.[51] These are not small, currently amounting to 10 bcm per annum.[52] No Ukrainian gas flows would apply significant leverage to the EU to force NS2 and would create a crisis in Ukraine.

This strategy may not work very well. Unlike in 2009, the EU has more interconnectors and alternative sources of supply and accessible storage facilities.[53] The EU, the member states, and energy companies across the EU can also ensure storages are full, domestic production increases, and additional LNG contracts are put in place.

There is already a 1.5 bcm capacity pipeline between Poland and Ukraine with plans for a second with 3.9 bcm. The latter could be ready in an emergency within a few months.[54] Other near and short-term measures include leasing regas ships in Polish harbors to increase regional and Ukrainian LNG capacity.[55] The more alternatives to Russian gas supplies, the more likely price increases will be dampened down should gas flows through Ukraine cease and the less likely gas flows via the Ukrainian transit route will cease entirely. The greater danger for Gazprom and the Kremlin is deploying the energy cut-offs without effect.

> “**The Gas Directive amendment is the keystone** *of a European strategy that can be supported* by the United States to *push back against Russian attempts at* **dividing the EU and the EU from the United States.**”

In the medium-term, in addition to ensuring uniform compliance with EU liberalization rules, the EU must enhance the resilience of the European energy market. This involves completing the interconnector infrastructure program so most of the EU's single market has access to multiple sources of electricity and gas; and overhauling the renewables market to encourage cheaper wind and solar power.[56] Common standards for EU subsidy regimes, promotion of auctions over feed-in tariffs, and surveillance of capacity payment mechanisms could help promote a cheap and accessible renewables market.

Greater access to more and cheaper renewables also opens the door to using more natural gas from LNG sources, where cheap renewables can help drive down overall power costs, especially in CEE. There is scope for combining in power generation, competitively priced LNG, and much cheaper wind and solar power generation to provide a collective power price offering that can deliver attractive pricing levels *vis-à-vis* Russian pipeline gas prices.

Furthermore, Russian gas prices have been significantly higher for so long in the region versus Western Europe that LNG is competitive with current Russian prices. Poland's long-term contracts with U.S. LNG exporters were 20-30% cheaper than the price that Poland paid Gazprom for much of the last decade. Gazprom could push pipeline gas prices below current U.S. LNG prices but CEE consumers are used to current prices and will not suffer any premium for using LNG.[57]

From a regulatory perspective, the EU energy market could be strengthened with greater antitrust surveillance. The European Commission should consider launching another antitrust inquiry into the EU energy market as the last one was in 2005. One concern is that pipeline regulators still adopt measures which assist domestic operators, undermine the EU market, and make some states more vulnerable to leverage. Another regulatory development would be creating an effective review system of foreign energy sector investment. The EU has taken some initial steps in strategic sectors.[58] Given the potential for China and Russia to obtain EU energy assets for leverage and division, a credible investment review system is required.

The Gas Directive amendment is the keystone of a European strategy that can be supported by the United States to push back against Russian attempts at dividing the EU and the EU from the United States. This requires the EU to fully apply the amended Gas Directive and not back down from further economic pressure, for example if the Ukrainian network is closed. Combined with a robust pursuit of greater interconnection, alternative sources of supply, and improved regulatory mechanisms, the book can be closed on the use of energy and energy markets as a means deployed by Russia to divide the EU.

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9 Dralle, *Ownership Unbundling and Related Measures in the EU Energy Sector*, Frankfurt: Springer, 2018, 174-175.

10 Behrens, "The Declared End of South Stream and Why No One Seems to Care," *CEPS*, Brussels, December 5, 2014.

11 This is in fact a point taken up, notwithstanding the fractious debate, by the amendment to the Gas Directive. Its new definition of what counts as an interconnector in its revised Article 2(17) specifically refers to both an import pipeline on the land and then one through the territorial sea being subject to the same legal regime.

12 See the European Commission's comments on the application of EU law to the pipeline in its opinion. Commission Opinion, pursuant to Article 3(1) of Regulation (EC) No.715/2009 and Article 10 of Directive 2009/73/EC-Poland Certification of Gaz-System as the operator of the Polish section of the Yamal Pipeline, *European Commission*, Brussels, 2014 and the second opinion, Commission Opinion,

pursuant to Article 3(1) of Regulation (EC) No.715/2009 and Article 10 of Directive 2009/73/EC-Poland Certification of Gaz-System as the operator of the Polish section of the Yamal Pipeline, *European Commission*, Brussels, 2015.

13 See Commission Opinion, pursuant to Article 3(1) of Regulation (EC) No.715/2009 and Article 10 of Directive 2009/73/EC-Germany-Certification of the Operators of the Nordeuropaische Erdgas-Leitung (NEL), https://ec.europa.eu/energy/sites/ener/files/documents/2013_083_084_085_de_en.pdf.

14 Opinion of the Legal Service, Recommendation for a Council Decision authorising the opening of negotiations on an agreement between the European Union and the Russian Federation on the operation of the Nord Stream 2 pipeline, *Council of the European Union*, 12590/17, Brussels, September 27, 2017.

15 It is correct that there is one substantial argument in favor of taking the view that the Gas Directive 2009 does not apply to import pipelines. That argument is that Article 36 of the Gas Directive which permits exemption from liberalization rules does not appear to apply to import pipelines. In particular, it is correct that import pipelines are not listed in the types of infrastructure that can be subject to an exemption in Article 36. The argument therefore goes that if an import pipeline cannot receive the benefit of an exemption, it cannot therefore be subject to the burden of the liberalization rules. While this argument has some weight, it is not decisive. It would be equally valid to argue that the Union's legislature had chosen not to grant the benefit of exemption to import pipelines. That argument is reinforced by the observation that Union law, subject to express exception or qualification in the text applies to the entire territory of the Union and that includes the territorial and inland seas of the Member States through which Nord Stream 2 passes. A further and compelling argument is that Article 36 does apply to import pipelines. It is clear from some language versions of the text of Article 36 that the list of types of infrastructure are given as examples and can be extended. In respect of import pipelines, that argument is reinforced by the reference to import pipelines being subject to Union law in Recital 35 of the Gas Directive. That latter view appears to be the view that the European Commission took in indicating that they would consider an exemption for Nord Stream 1; how it determined that it could bring infringement proceedings against the South Stream pipeline and be applied the Gas Directive in full to Yamal. For a further discussion see Riley, "A Pipeline Too Far? EU Law Obstacles to Nord Stream 2," *IELR* 14, 2018 et seq. For a contrary argument see Talus, "European Commission Crusade Against a Pipeline: Act Three," *Oil, Gas and Energy Law* 4, 2018 et seq.

16 "Commission Seeks a Mandate from Member States to Negotiate with Russia an Agreement on Nord Stream 2," Commission Press Release, IP/17/1571, *European Commission*, Brussels, June 9, 2017.

17 Germany was forced to accept the amendment to the Gas Directive in substance. It was ultimately faced with the prospect of defeat in EU Council, going down 24 to 4, meaning that it had no blocking minority on a EU qualified majority vote, which is why it had ultimately to give way.

18 The final substantive draft was agreed in trilogue on February 19, its formal enactment process through the European Parliament and the EU Council was completed on April 17, and it was published

in the Official Journal of the European Union on May 3, 2019. The directive is Directive 2019/692 of the European Parliament and of the Council Amending Directive 2009/73/EC concerning common rules for the internal market in natural gas OJ L117/1, May 3, 2019 (hereafter Amendment to the Gas Directive (2019)).

19 "European Gas Market Outlook 2018," *Atradius*, July 10, 2018.

20 For a discussion of the issues surrounding the Groningen field see: Van Den Beukel, "Groningen Gas Production and Earthquakes: Safety at all Cost?," *Energy Post*, December 21, 2016.

21 "Groningen Gas Production to Drop 75% by 2023," *Reuters*, December 3, 2018.

22 The Nord Stream 1 and 2 pipeline projects were always viewed by the Russian state and Gazprom as a means to remove their dependence on Ukrainian transit, and in turn make Ukraine dependent on Russia. One of the most recent statements of the clear intent of Russia in respect of Ukrainian transit can be found in the emphatic words of Chairman of Gazprom, Alexi Miller during the company's 2015 AGM: "Gazprom will not transit gas across Ukraine even if the sun will replace the moon," quoted in Pirani and Yafimava, "Russian Gas Transit Across Ukraine-Post 2019," *OIES*, Oxford.

23 Loskot-Strachota, "The OPAL Pipeline: Controversies about the rules for its use and the question of supply security," *OSW*, Warsaw, January 17, 2017.

24 For an overview of the issues surrounding the Turk Stream projects see Tagliapietra, "Beyond Nord Stream 2: A look at Russia's Turk Stream Project," *Bruegel*, Brussels, July 4, 2018.

25 The planned state budget for 2019 is $36 billion. See Bill on Ukraine's State Budget passed to the President, UA 112, December 5, 2018.

26 For a discussion of the issues surrounding reverse flow See Reverse-Flow Woes, *The Economist,* November 5, 2013.

27 Currently once gas flows leave Russian territory and enters the Ukrainian pipeline network Gazprom loses control over the flow. Once it passes to its customers in CEE states title passes to those states and they resell that gas to Ukrainian energy companies or companies in other states. However, once Nord Stream 2 comes on stream, reverse flow possibilities become much more limited. Gazprom controls Nord Stream 2, and has an interest in EUGAL with its Western corporate allies. It has therefore much more control of the gas supply direct to destination customers, which makes it easier to reduce supply to minimum contractual levels to limit the capacity of gas being sold on or reverse flowed to Ukraine or any other potential resale customer.

28 Proposal for a Directive of the European Parliament and of the Council Amending Directive 2009/73/EC concerning Common Rules for the Internal Market in Gas, Analysis of the Final Compromise Text With a View to Agreement, 6351/19, *Council of the European Union*, Inter-Institutional File, Brussels, February

14, 2019 (hereafter Agreed Amendment Text). Note that this text is the agreed legal text between the Member States in Council, the European Parliament, and the European Commission. A cleaned up version of this text will be presented for approval by both the EU Council and the European Parliament. The text should be approved both parts of the EU legislature by June.

29 For a discussion of the original draft of the amendment and the legal background to the adoption of this text by the Commission see: Hancher and Marhold, "A Common Framework Regulating Import Pipelines for Gas? Exploring the Commission's Proposal to Amend the 2009 Gas Directive," *JENR* 1, 2018 et seq.

30 Case T-883/16 Poland v. Commission (notably with Lithuania supporting Poland, and Germany supporting the Commission).

31 Case T-616/18 Polskie Gornicto Naftowe v. Commission (the Polish State, Lithuania and the Bulgarian firm Overgas have intervened on the side of PGNIG).

32 Amendment to the Gas Directive, Article 3, 2019, provides that the Directive shall come into force twenty days after publication in the Official Journal of the European Union. As the Directive was published in the Official Journal on May 3 the Directive came into force across the European Union on May 23.

33 This is however contested by Nord Stream 2. In his letter on April 12, 2019 to the President of the European Commission, the CEO of Nord Stream 1 and 2, Mr. Matthias Warnig, seeks to argue that the amendment does not apply to Nord Stream 2 as already substantial investment has been made in respect of the pipeline. However, as Nord Stream 2 still does not have all the necessary permits to build the pipeline (in particular it has no current permission to proceed through the Danish territorial sea or its exclusive economic zone) and it voluntarily chose to proceed with the investment without the necessary permits, it is difficult to see why the European Commission and the EU Courts would treat the pipeline as anything other than an incomplete project to which the amendment fully applied.

34 Gas Directive 73/09/EC, Article 36(1)(a).

35 *Ibid*, Article 36(1)(e).

36 Amendment to the Gas Directive (2019), amendment to Article 36(1)(e).

37 Gas Directive, *op cit*, Article 11(3)(b).

38 Larsson, Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier, *FOI* (Swedish Defence Research Agency), Stockholm, 2006.

39 See for instance Loskot-Strachota's discussion of the cuts in gas flows to CEE states in September 2014 not long after reverse flow gas began to arrive in Ukraine. Loskot-Strachota, "Central European Problems with Russian Gas Supplies," *OSW*, Warsaw, September 17, 2014.

40 Amendment to the Gas Directive, *op cit*, new Article 49b (3)(a) and 3(b), 2019.

41 Amendment to the Gas Directive, *op cit*, new Article 49b (4), 2019.

42 For a discussion of this 'stub' idea see "Nord Stream 2 eyes way to curb EU oversight of $9.5 billion pipeline," *The Financial Times*, March 14, 2019.

43 Recital 10 is quite explicit, "the definition of 'control' is taken from Council Regulation EC No.139/2004 of January 20, 2004 on the control of concentrations between undertakings (the EC Merger Regulation)."

44 Lowe and Staker, *Jurisdiction in International Law*, (Ed Evans) OUP, Oxford, 2010, 320.

45 Scott, "Extra-Territoriality and Territorial Extension in EU Law," *AJCL* 87, 2013, 96-113.

46 See Case C-366/10 Air Transport Association of America and others v. Secretary of State for Energy and Climate Change [2011] ECR I-13755.

47 Under the amendment to the Gas Directive already operating pipelines are subject to a special regulatory regime. However, even those pipelines would be likely to face more onerous obligations if the European Court of Justice sought to apply EU energy law in full to import pipelines.

48 An alternative approach the author saw raised by proponents of Nord Stream 2 was for EUGAL the connecting pipeline to Nord Stream 2 to be extended into the territorial sea of Germany as a means of avoiding the application of the amendment. This idea equally suffers from the flaw that it seeks to deploy legal formalism in economic legislation which deliberately avoids such formalism in order to ensure an effective and uniform regulatory system applies across gas and electricity markets.

49 Delay is now also built into the ongoing permitting process. Denmark now has three different routes for Nord Stream 2 proposed to its environmental agency one through its territorial sea and two its exclusive economic zones. These assessments are likely to take some time delaying the capacity of the pipeline to be completed into 2020 and increasingly likely beyond 2020. Most recently Gazprom has decided to challenge the decision of the Danish Energy Agency to consider an alternative third route. Such a legal challenge may well increase the period for delay in completing the project. Russia's Nord Stream 2 Appeals Against a Third Route Through Denmark, S&P Platts Global, April 30, 2019.

50 Author notes a discussion at the European Policy Centre, Brussels, on Ukraine and Russian gas, March 5, 2018. In that discussion Ukrainian officials took the view that the likelihood was that the 2009 gas contract would not be renewed in January 2019, and that they were preparing on the basis of that eventuality. See also Yafimava, "Gas Directive Amendment: Implications for Nord Stream 2," *OIES*, March 2019.

51 Reverse flow gas refers principally to gas flowing through the Ukrainian transit network and on to European customers such as Slovakia and Hungary. These countries do not need all of their contracted

gas under their long term supply contract with Russia. They therefore resell that gas via reverse flow, either physically (the gas is physically ‘reverse flowed’ or virtually, usually by swap arrangements).

52 Eyl-Mazzega, “Russia-Ukraine Gas Relations: The Mother of All Crises or a New Start to 2030,” *IFRI*, Paris, 2019.

53 See “Communication on the Short Term Resilience of the European Gas System,” *European Commission*, Brussels, Com 654 Final, 2014. This proved to be reassuring in that only a small group of Member States in Central and Eastern Europe were significantly affected via the energy stress test exercised undertaken by the Commission. Since 2014 more sources of supply, alternatives and interconnectors have come on stream so the overall resilience position will have strengthened in the last five years.

54 Successful Market Screening for Poland-Ukraine Pipeline Capacity, *Biznes Alert*, July 17, 2018.

55 Currently because of huge LNG demand from China the demand for regas ships has slowed. Hence there is likely to be greater availability of such ships available on the market to acquire or lease. See “For the Global LNG Industry, is the FSRU Honeymoon Over?,” *Reuters*, July 18, 2018.

56 The IEA renewables report 2017 described in some detail the scale of renewable price power collapse which opens up the possibility for many more countries to access renewables to deal both with climate change and improve their own supply security. See IEA Renewables, Paris, 2017.

57 Mikulska, “See Try Harder Gazprom. Why Poland Could Choose LNG,” *Forbes*, December 21, 2018.

58 “Regulation (EU) 2019/452 of the European Parliament and of the Council of 19th March 2019 establishing a framework for the screening of foreign direct investments into the Union,” OJ 2019 L79/1.

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