

March 2019

# Gas Directive amendment: implications for Nord Stream 2

## 1. EU agreement on the Gas Directive amendment<sup>1</sup>

In February 2019, acting on the proposal made by the European Commission (EC) in November 2017<sup>2</sup> and after more than a year of negotiations, the EU has reached a political agreement to amend the Gas Directive<sup>3</sup> to make it applicable to pipelines from third countries.<sup>4</sup> The proposal was an *ad hoc* instrument, aimed primarily at Nord Stream 2 (NS2) – a pipeline, which would bring Russian gas to Germany and is currently under construction across the Baltic Sea<sup>5</sup> – and was advanced with extreme urgency<sup>6</sup> to enter into force prior to NS2's scheduled start of operation at the end of 2019.<sup>7</sup> The amended Directive is expected to be signed into law in May 2019 and enter into force in July 2019, with a nine-month period set for its transposition into member states' national legislation. As the amended Directive threatens to upset the regulatory framework for NS2, its rejection by the EU Council would have been the best possible outcome for the project. This outcome seemed more likely because securing a qualified majority in favour of the proposal seemed a tall order throughout 2018 during the Bulgarian and the Austrian presidencies of the Council. However, the political calculus changed dramatically under the Romanian presidency, when it transpired in February 2019 that France was going to support the amendment, thus depriving its opponents – which, in addition to Germany, were understood to include Austria, the Netherlands, and Belgium – of a blocking minority.<sup>8</sup> France and Germany hastily agreed a last minute compromise text of the amendment, the essence of which was that the applicability of the amended Directive would be restricted to the territory and the territorial sea of the member state where the first interconnection point with its network is located – which in the case

<sup>1</sup> I am very grateful to Professor Jonathan Stern, founder of, and distinguished Research Fellow, OIES Natural Gas Research Programme, and Dr James Henderson, Director of the Programme, for their comments on this paper. I also thank everyone else who has lent their expertise in various ways. My thanks to John Elkins for editing and Kate Teasdale for administrative support. Responsibility for all the views expressed and all the conclusions reached is solely mine.

<sup>2</sup> *Amendment Proposal. EC (2017)*. See *Bibliography* for details.

<sup>3</sup> *Gas Directive*.

<sup>4</sup> *Amendment. EC (2019a)*.

<sup>5</sup> Gazprom, 'Nord Stream 2: a new export gas pipeline running from Russia to Europe across the Baltic Sea'. The NS2 pipeline consists of two strings of 27.5 bcm capacity each and 1,230 km length each. According to Gazprom, by early March 2019 overall 818 km has been built, see 'Nord Stream 2 one-third complete, 818 km built', *Interfax, Russia & CIS Oil and Gas Weekly*, 28 February – 6 March 2019. Both strings are under construction whereas the first string is significantly more advanced than the second. The NS2 company, which is owned by Gazprom, has been established for planning, construction and subsequent operation of the NS2 pipeline.

<sup>6</sup> The proposal was not envisaged either in the February 2015 EC energy union strategy or in the state of energy union reports, see Hancher and Marhold (2019). Notably, Director of DG Energy for Internal Energy Market, Klaus-Dieter Borchardt, stated that one of the proposal's main aims was to ensure that the amended Directive would apply to NS2, see *Negotiating mandate for Nord Stream 2: state of play*.

<sup>7</sup> Nord Stream 2, 'Factsheet: the Nord Stream 2 project'.

<sup>8</sup> 'In blow to Germany, France to back EU rules on Nord Stream 2', *Reuters*, 7 February 2019.

of NS2 is Germany.<sup>9</sup> Far from being a victory for NS2, the ‘Franco-German compromise’ was a damage limitation exercise. While it has removed some of the most contentious provisions of previous drafts<sup>10</sup> it has nonetheless left room for significant uncertainty in respect of NS2’s future regulatory treatment.

## 2. Ways of ensuring compliance of (the German section of) NS2 with the amended Directive

### A. Transfer of NS2 operatorship and/or ownership to an existing or a new TSO

At present the Gas Directive – and its key requirements of unbundling transmission from supply and production business (Art. 9), third party access (TPA) (Art. 32) and regulated and transparent tariffs (Art. 41) – only applies to transmission inside the EU. The amended Directive’s application will start at the border between Germany’s territorial sea (that is the 12 nautical mile limit around the coastline<sup>11</sup>) and its exclusive economic zone (EEZ) (that is the 200 nautical mile limit around the coastline<sup>12</sup>). Therefore, it is clear that once the amended Directive enters into force (July 2019) and is transposed into member states’ national legislation (April 2020), it will apply to the German section of NS2 (that is the section between its first connection point with the German domestic network at Lubmin and the border between the German territorial sea and the German EEZ) – but *not* to the Russian section (that is the section between its first connection point with the Russian domestic network at Ust’-Luga and the border between the Russian territorial sea and the Russian EEZ).

Ashore in Germany, at the Lubmin landfall, the NS2 pipeline is connected to a gas receiving station, which is a logistical link between the pipeline and the German transmission network.<sup>13</sup> There are several shut-down valves on the site, the last of which is located in the section that connects the pipeline to the natural gas transfer station – run by the German transmission system operator (TSO), GASCADE – which control the gas flow to both connecting EUGAL pipelines. Notably, all marketable capacity in EUGAL – that is, all capacity except 10% reserved for short-term and a further 10% reserved for mid-term bookings – was allocated via auctions and booked under legally-binding contracts for 20 years in March 2017.<sup>14</sup>

Once the amended Directive is transposed into German law, it will become a right and a duty of the German regulatory authority to ensure that the Directive’s requirements on unbundling, TPA and tariffs are all met in respect of the German section of NS2. It is argued here that it would be possible for NS2 to meet these requirements.

As far as tariff requirements are concerned, the Directive makes the German regulatory authority responsible for ‘fixing or approving [...] at least the methodologies used to calculate or establish the terms and conditions for: (a) connection and access to *national* networks, including transmission [...] tariffs’ and ‘(c) access to *cross-border* infrastructures, including the procedures for the allocation of capacity and congestion management’ (Art. 41.6), and requires ‘the methodologies or the terms and conditions’ referred to above to be published. Thus the Directive appears to be uncertain whether there would be a requirement for NS2 to publish its tariff methodology. The Directive can be interpreted as requiring the publication of tariff methodologies in respect of *national* networks only, rather than in respect of *cross-border* infrastructure – such as NS2 – with only publication of the methodology for access to capacity being required in respect of the latter. Nonetheless, for the sake of transparency it would be highly desirable if NS2 were to publish at least the tariff methodology (whereas publication of tariffs themselves is clearly not required by the Directive).

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<sup>9</sup> France and Germany submit a joint proposal ahead of Gas Directive talks, *Politico*, 8 February 2019.

<sup>10</sup> For example the provision allowing a member state to decide on the operation of the pipeline in its Exclusive Economic Zone (EEZ) (which would have violated the United Nations Convention on the Law of the Sea (UNCLOS)) and the provision allowing member states, other than the one where the first interconnection point is located, to regulate the pipeline.

<sup>11</sup> UNCLOS, Art. 3.

<sup>12</sup> UNCLOS, Art. 55 and Art. 57.

<sup>13</sup> Nord Stream 2, ‘German landfall facilities in Lubmin’.

<sup>14</sup> Yafimava (2018), pp. 46-49.

Thus once the amended Directive is transposed into German law, NS2 would be obliged to publish at least the methodology used to establish the terms and conditions for access to its capacity and *could* be requested by the German regulatory authority to publish its tariff methodology. At the time of writing, NS2 has not published either its tariff methodology or tariffs. However, it has stated in 2018 that its tariff will be 20% lower than the tariff stipulated by the 2009 Ukrainian tariff contract.<sup>15</sup> This suggests the NS2 tariff is competitive and that meeting the Directive's requirements – even *if* those were to include publication of the tariff methodology – should not pose a significant difficulty for NS2.

As far as TPA is concerned, although there is no TPA to the Russian section of the pipeline (under Russian law, only the owner of the Russian Unified Gas Supply System (UGSS) – that is Gazprom – has a right to export pipeline gas<sup>16</sup>), NS2 could *offer* capacity in the German section of the pipeline to any third party. However, as long as there is no third party which has gas to put into the Russian section of NS2 at Ust'-Luga and has the right to export it, no party would be able to *accept* such an offer.<sup>17</sup> But Gazprom could sell some of its gas outside its European long-term supply contracts (LTSCs) – or sell gas belonging to any other company, Russian or otherwise, which has gas production in Russia on its behalf – at an auction, with the NS2 starting point near Ust'-Luga as a delivery point. Gazprom would then be exercising its monopoly right over pipeline gas exports, and a third party could request short- and mid-term capacity *both* in the Russian and the German sections of NS2 for transporting this gas into Europe. The amount of such capacity could match the aforementioned capacity reservation quotas (that is 10% short-term plus 10% medium-term) applied to EUGAL pipelines. The Russian St Petersburg International Mercantile Exchange (SPIMEX) could potentially act as the mechanism by which this could be achieved for short-term gas sales.

Compliance with the unbundling requirement would be most difficult and require some changes in pipeline ownership and/or operatorship. Notably, the amended Directive would not require a member state to apply an ownership unbundling (OU)<sup>18</sup> model – whereby a TSO would be both an owner and an operator of the transmission system – in respect of the member state's section of a pipeline from a third country. The Directive states that the member state – Germany in the case of NS2 – may decide not to apply ownership unbundling (OU) 'as regards the part of the transmission system connecting a member state with a third country, *between the border of that Member State and the first connection point with that Member State's network*, where the transmission system belonged to a vertically integrated undertaking' on the date of adoption of the proposal to amend the Directive (Art. 9) (emphasis added). Thus the Directive allows for other models of unbundling:

- a) an independent system operator (ISO) – whereby an ISO would operate the system while its ownership would remain with a vertically integrated company, or
- b) an independent transmission operator (ITO) – whereby a TSO would be preserved as part of the vertically integrated company provided that the TSO independence is ensured, or
- c) *any other* form of unbundling which guarantees more effective independence of the TSO than ITO (emphasis added).

There are several scenarios under which NS2 could meet the Directive's unbundling requirements other than OU. Under one scenario operatorship of *the entire NS2 pipeline* could be transferred to one of Gazprom's wholly-owned transportation subsidiaries – regional Gazprom Transgaz companies – which have access to the Russian gas transmission system (part of the UGSS) on the basis of long-term lease agreements with Gazprom.<sup>19</sup> These companies result from Gazprom's restructuring reform embarked

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<sup>15</sup> Nord Stream 2, 'Gas market outlook: a new pipeline for Europe's energy future', p. 21. Our calculation suggests that given that in 2018 the Ukrainian tariff was ~\$2.7/mcm/100 km, the NS2 tariff would be ~2.17/mcm/100 km.

<sup>16</sup> See Yafimava (2014) for details on the Russian regulation of gas transportation.

<sup>17</sup> Talus (2019) suggests that a virtual entry point could be established at the border between Germany's territorial sea and its EEZ. Although this might be possible and the German regulatory authority could agree to establish such an entry point, the EC may raise objections on the grounds that there is no other gas which can access it.

<sup>18</sup> OU means that a TSO could not be a subsidiary of a vertically integrated company.

<sup>19</sup> Yafimava (2014).



on in 2005 which laid down the foundation for a non-discriminatory access regime in Russia, effectively amounting to legal unbundling of transmission. Historically, these subsidiaries have transported gas throughout Russia, with each subsidiary having some 8,000 – 9,000 km of pipelines in their zones of responsibility, corresponding to the geographic boundaries of Russian regions. More recently, they have also been involved in transmission outside Russia. For example, Gazprom Transgaz Krasnodar (responsible for gas transmission in part of the Russian southern federal district) owns 51% of South Stream Serbia with the Serbian company, Srbijagas owning the remaining 49%.<sup>20</sup> Similarly, Gazprom Transgaz St Petersburg could operate NS2 (both the Russian and the German sections) thus fulfilling accounting and legal unbundling requirements. Alternatively, a new TSO could be formed owned by Gazprom Transgaz St Petersburg and a European/German TSO (e.g. GASCADE) which could jointly operate the entire NS2 pipeline. Another possibility could be to transfer ownership of NS2 from Gazprom to a newly established Gazprom subsidiary, which would operate the NS2 pipeline. It would then be for the German regulatory authority to confirm whether any of these arrangements comply with the Directive's requirements on unbundling in respect of the German section of NS2.<sup>21</sup>

Under another scenario the operatorship rights could be transferred *in respect of the German section of the pipeline only* to either one of the existing German TSOs (e.g. GASCADE) or to a newly established TSO – while maintaining the Gazprom-owned NS2 company as an operator in respect of the Russian section of the pipeline.<sup>22</sup> For example, operatorship of the German section of NS2 could be transferred to the German TSO GASCADE (which holds a 50.5% stake in the EUGAL pipeline) either alone or together with three other TSOs - Fluxys Deutschland, Gasunie Deutschland, ONTRAS (which each have a 16.5% stake in EUGAL).<sup>23</sup>

As the amended Directive is expected to be transposed into German law in April 2020 (within the nine-month period after the Directive's expected entry into force in July 2019), certification would have to be completed *after* NS2's scheduled start of operation at the end of December 2019. Thus if NS2 is built on schedule it would be able to start commercial operation without its operator having to be certified under the amended Directive because the latter would not yet be transposed into German law and therefore not yet applicable to the German section of NS2. Should any *new* TSO be established to operate NS2 (either its German section or the entire pipeline), it would have to be certified once the amended Directive is transposed into German law. Should the NS2 operatorship be transferred to any *existing* (and thus certified) TSO, the latter's certification might need be re-assessed by the German regulatory authority as it would assume a new function (Art. 10.3).<sup>24</sup>

A very important question for NS2 is whether it would be allowed to operate while certification of its operator was ongoing. It is argued here that NS2 could be allowed to do so should certification re-assessment be required in respect of the *existing* TSO. This view is supported by the fact that the existing Polish TSO, Gaz-System, which had been designated as an operator of the Polish section of the Yamal-Europe pipeline in 2010<sup>25</sup> and has operated it since,<sup>26</sup> was only certified (under the ISO

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<sup>20</sup> South Stream Serbia owns Gastrans, a future operator of the new pipeline across Serbia connecting the Serbian transmission systems with those of Bulgaria and Hungary. See the Energy Community Secretariat, Opinion 1/2019 on the exemption of the Gastrans natural gas pipeline project from certain requirements under Directive 2009/73/EC by the Energy Agency of the Republic of Serbia, p. 2.

<sup>21</sup> It is worth recalling that NS2 was initially established as a joint venture between Gazprom and five European companies (Uniper, Wintershall, Shell, OMV and Engie) but this structure was abolished due to objections from the Polish competition authority and the subsequent start of infringement procedure. Gazprom became the sole owner, 'Poland's anti-monopoly office opens proceedings against Nord Stream 2', *Reuters*, 9 May 2018.

<sup>22</sup> According to media reports this option appears to be under consideration, see 'Nord Stream 2 eyes way to curb EU oversight of \$9.5 bn pipeline', *Financial Times*, 14 March 2019.

<sup>23</sup> Alternatively the operatorship rights over NS2 could be transferred to a newly established TSO formed by European companies that are financial investors in NS2 i.e. OMV, Uniper, Wintershall, Shell and Engie, but this option, while possible, is highly unlikely given that some of these companies are not TSOs and would not wish to take on that role.

<sup>24</sup> GASCADE is already certified by the German regulatory authority as an independent transmission operator (ITO) although it is worth noting that the EC has raised a number of objections in respect of GASCADE certification.

<sup>25</sup> ERO (2010).

<sup>26</sup> On the basis of a new contract with EuroPolGaz, signed on 25 October 2010, see Stern and Yafimava (2017), pp. 17-18.

model) by the Polish regulatory authority in 2015.<sup>27</sup> (The EC also provided its opinion on certification in 2015.<sup>28</sup>) Furthermore a new – as opposed to an existing – TSO could also be allowed to operate provisionally while its certification is pending. However, ultimately the decision on whether or not to allow NS2 operation while certification of its operator – whether an existing or a new TSO – is ongoing lies with the German regulatory authority. The EC could raise an objection should it take the view that NS2 should not be allowed to operate while certification is ongoing but such an objection alone would not be sufficient to halt NS2 operations unless the German regulatory authority takes the same view. Should the German regulatory authority decide to suspend operations while certification is ongoing, no gas could flow through NS2 for ten months (the total length of the process under which six months is allowed for consideration by a member state regulatory authority<sup>29</sup> and up to four months – by the EC<sup>30</sup>).

According to the Gas Directive, TSO certification is carried out under Art. 10 and aims to ensure compliance with unbundling requirements. TSO certification could also be carried out under Art. 11 where certification is requested by ‘a transmission system owner or a transmission system operator which is controlled by a person or persons from a third country or third countries’. In addition to ensuring compliance with unbundling requirements, certification under Art. 11 is also meant to ensure that certification ‘will not put at risk the security of energy supply of the member state or the Community’. The EC has a right to issue an opinion on certification but the national regulatory authority’s certification decision can diverge from the EC’s opinion, apart from where the national regulatory authority issued certification under a form of unbundling which guarantees more effective independence of the TSO than ITO, in which case the EC has the power to decide on certification (Gas Regulation, Art. 3<sup>31</sup>).

The option of transferring NS2 operatorship rights to an existing or a new (Russian or European or joint) TSO with subsequent certification by the German regulatory authority as applicable, appears to provide the most straightforward route for ensuring NS2 compliance with the amended Directive while causing the minimum regulatory change and the least regulatory uncertainty in respect of its future treatment. Nonetheless this option is not without potential complications. Should the EC or those member states – particularly, Poland – which viewed the Directive amendment as the means of stopping NS2 altogether and which has remained fervently opposed to the pipeline, believe that the treatment granted to it by the German regulatory authority is too lenient, they might initiate a complaint against it in the Court of Justice of the EU (CJEU). However, should this happen, the CJEU would likely uphold a decision by the German regulatory authority if the latter were to provide NS2 a regulatory treatment not too dissimilar to that applied to NS2 when the project was initiated (when the amended Directive did not apply).

## B. Exemption<sup>32</sup>

Should Gazprom not agree to a transfer of operatorship rights to an existing or a new TSO (as outlined in section 2.a) which could be subsequently certified as applicable by the German regulatory authority as being compliant with the amended Directive, it could apply for an exemption from the Directive’s requirements on unbundling, TPA and tariffs. An application for the exemption would have to be made to the German regulatory authority, which would have to ‘decide upon the rules and mechanisms for management and allocation of capacity’ applied to the exempted capacity and has the power to grant or reject an exemption. An exemption could only be applied for after the amended Directive has been

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<sup>27</sup> ERO (2015).

<sup>28</sup> EC (2015).

<sup>29</sup> Two months extendable to four for initial decision and then up to an additional two months for final decision after receiving an opinion from the EC, *Gas Directive*, Art. 10 and 11, *Gas Regulation 715*, Art. 3.

<sup>30</sup> Two months extendable to four if an opinion from the Agency for Cooperation of European Regulators (ACER) is sought, *Gas Directive*, Art. 10 and 11, *Gas Regulation 715*, Art. 3.

<sup>31</sup> *Gas Regulation 715*.

<sup>32</sup> NS2 would not be able to apply for a derogation, as opposed to an exemption because only those pipelines from third countries that will have been completed by the time of the amended Gas Directive’s entry into force (expected July 2019) are eligible (Art. 49 a). The planned schedule is for NS2 to be completed by the end of 2019, thus after the eligibility deadline.

transposed into German law.<sup>33</sup> The exemption must be subsequently notified to the EC, which has the power to approve, reject or request amendments. The EC power in respect of an exemption is final and binding.

The Gas Directive states that ‘major new gas infrastructure’ – including interconnectors – ‘may, upon request’ be exempted ‘for defined period of time’ from its provisions on inter alia unbundling, TPA and tariffs. An interconnector is defined in the amended Directive as follows:

‘a transmission line which crosses or spans a border between member states for the purpose of connecting the national transmission system of these countries or a *transmission line between a member state and a third country up to the territory of the member states or the territorial sea of the member state*’ (emphasis added).

This definition suggests that it would be within the power of the German regulatory authority to grant an exemption in respect of the *section* of NS2 between its first connection point with the German domestic network and the border between the German territorial sea and the German EEZ.

The German regulatory authority does not have the power to decide that an exemption is required and impose such requirement on Gazprom. It is only if Gazprom itself decides to apply for an exemption, that the German regulatory authority would be able to consider its application and decide whether to grant it. It is argued here that Gazprom is highly unlikely itself to decide to apply for an exemption, but if the German regulator indicates to Gazprom that it is not going to certify NS2 – even with suggested changes to its ownership / operatorship (as discussed in 2.a) – then Gazprom will have no choice but to apply for an exemption.

In order to be exempted NS2 must meet the exemption criteria which include *inter alia* that the investment must enhance competition in gas supply and security of supply (Art. 36.1(a)). The Directive states that the exemption ‘must not be detrimental to competition or the effective functioning of the internal market in natural gas, or the effective functioning of the regulated system to which the infrastructure is connected’. Notably, the amended Directive has changed the scope of this criteria by requiring that the exemption ‘not be detrimental to competition in *relevant* markets which are likely to be affected by the investment, to the effective functioning of the Union’s internal market in natural gas, the efficient functioning of the *concerned* regulated systems, or to security of supply of natural gas within the Union’ (Art. 36.1(e)).

Given Poland’s hostile attitude towards NS2 and its view of the amended Directive as being a tool for stopping NS2 from being built, let alone utilised, it would not be surprising if Poland were to claim that its gas market is indeed ‘relevant’ and that its regulated system is ‘concerned’, and that any exemption granted to NS2 could be detrimental to competition in the Polish market and detrimental to the efficient functioning of its regulated system.<sup>34</sup> As the Directive does not explain which markets could be considered ‘relevant’ and which regulated systems could be considered ‘concerned’, it would be for the German regulatory authority and ultimately for the EC to interpret this and to decide whether any such objection could be substantiated. It is possible that the EC could choose to assess the impact of the exemption in a broader context of regional cooperation as part of assessing EU member states’ progress in meeting Energy Union objectives in respect of *inter alia* energy security and internal market dimensions on the basis of their Energy and Climate Plans (ECPs) (as stipulated by Governance Regulation).<sup>35</sup> It could also assess the impact within a narrower context of a given risk group associated with the specific supply corridor (as stipulated by the Security of Supply Regulation).<sup>36</sup>

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<sup>33</sup> Given that the amended Directive is expected to enter into force in July 2019 and given a nine-month transposition period, the Directive would have to be transposed into German law by April 2020.

<sup>34</sup> However, this may be a difficult argument for Poland to make since it intends to cease importing Russian gas post-2022 when its current supply contract with Gazprom expires.

<sup>35</sup> Yafimava (2018), pp. 125-130.

<sup>36</sup> Yafimava (2018), pp. 131-136.

Importantly, one of the exemption criteria states that in order for an exemption to be granted the level of risk attached to the investment must be such that the investment would not take place unless an exemption was granted (Art. 36.1(b)). Given that the decision that construction of NS2 was economically and technically feasible was made in 2012, that the decision to proceed with the project was made in 2015, and that the financial agreement was signed in 2017,<sup>37</sup> it could be argued that the aforementioned criterion is not met, thus making NS2 ineligible for an exemption under the amended Directive. However, there are counter-arguments: for example, in the past, exemptions have been granted to projects after their final investment decisions (FIDs) were taken;<sup>38</sup> and also that the decision to proceed with NS2 was taken when the Gas Directive did not apply to pipelines from third countries and this decision may not have been taken had the Directive been applicable at the time.

The EC's power in respect of an exemption – and available discretion – is very significant and the process of granting or refusing an exemption lacks transparency. In the past the EC has been able to exercise a significant degree of discretion while making its exemption assessments, mostly due to the fact that the Directive did not provide any quantitative criteria for granting an exemption, including in respect of its impact on competition.<sup>39</sup> A change in the exemption criteria in the amended Directive, requires assessment of the exemption's impact on competition in (undefined) 'relevant markets' and on effective functioning of (undefined) 'concerned regulated systems'. It obliges the national regulatory authority to consult national regulatory authorities of those member states, 'the markets of which are likely to be affected by the new infrastructure', before adopting an exemption decision, making the degree of discretion in the exemption decision-making process even stronger.

Should Gazprom apply for an exemption in respect of NS2, it is conceivable that the EC could request the German regulatory authority to introduce a cap on the amount of capacity available to Gazprom at the German section of NS2 as part of the exemption decision, thus restricting Gazprom's ability to utilise capacity in NS2. For example, in 2009 the EC prevented Gazprom from being able to utilise more than 50% of capacity in the OPAL pipeline – one of Nord Stream's (NS) onshore extensions – as a condition of approving an exemption.<sup>40</sup> However, over time the EC requirement had become increasingly untenable as it could not be justified either on regulatory or competition grounds due to the lack of third party interest in OPAL capacity. In 2016 – seven years after the exemption was granted – the EC amended its decision and allowed Gazprom to bid for the remaining 50% of OPAL capacity alongside third parties at an auction, while guaranteeing that the third parties would have access to 20% of OPAL capacity.<sup>41</sup> (Notably, this decision was challenged by Poland, which launched a legal action against the EC in the CJEU on its decision to lift the cap. At the time of writing, the court proceedings continue and the CJEU is expected to make a judgement in the first half of 2019.<sup>42</sup>) As in the OPAL case, any decision to impose a cap on Gazprom's ability to utilize capacity in NS2 in the German section of the pipeline would not be possible to justify on regulatory or competition grounds as long as no third party could have gas available to put into NS2 at its starting point near Ust'-Luga in Russia.<sup>43</sup> The EC could impose a cap on Gazprom's ability to utilise NS2 capacity in the German section of the pipeline to match capacity reservation quotas applied to EUGAL capacity – 10% was set aside for short-term and another 10% for mid-term bookings<sup>44</sup> – while allowing Gazprom to utilise it in the event that no other parties apply for the capacity. Should the EC attempt to impose a cap higher than the EUGAL reservations quotas, this would create a direct conflict with the EUGAL contracts under which all capacity – apart

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<sup>37</sup> Gazprom, 'Nord Stream 2: a new export gas pipeline running from Russia to Europe across the Baltic Sea'.

<sup>38</sup> For example, an interconnector Greece – Bulgaria (IGB), see EC (2018).

<sup>39</sup> The 2009 EC exemption for OPAL is the case in point, see Yafimava (2017a).

<sup>40</sup> *OPAL Exemption*, see Yafimava (2017a).

<sup>41</sup> *Revised OPAL Exemption*, see Yafimava (2017a).

<sup>42</sup> Yafimava (2017b).

<sup>43</sup> As explained in section 2(a), if Gazprom were to sell at auction some of its gas outside its European long term supply contracts (LTSCs) – or gas belonging to any other company, which has gas production in Russia on its behalf – with the NS2 starting point near Ust'-Luga as a delivery point (thus exercising its monopoly right over pipeline gas exports), a third party could request short- and mid-term capacity both in the Russian and the German sections of NS2 for transporting this gas into Europe.

<sup>44</sup> Yafimava (2018).



from capacity set aside in line with the aforementioned reservations quotas – has been booked. Importantly, neither the EC nor the German regulatory authority raised any objections to EUGAL's capacity allocation procedure.

Should the EC take a position that no flows could be allowed through NS2 while it is considering an exemption, NS2 operation would be suspended until a final exemption decision is made. The Directive provides the EC with at least four months in which to make a decision: two months for initial consideration extendable by a further two months where additional information is sought (counted from the day following the receipt of the complete information). Extension is possible subject to national regulatory authority consent. Thus NS2 operation could be suspended/delayed for at least four months and potentially longer.

### C. German-Russian intergovernmental agreement (IGA) or EC-Russian agreement

Conclusion of an intergovernmental agreement (IGA) between the German and the Russian governments or of an international agreement between the EC and the Russian government is the least likely way of ensuring compliance of NS2 with the amended Directive. Although such an agreement could have established a consistent regulatory regime, governing operation of the *entire* NS2 pipeline, in line with EU legal *principles*, the amended Directive has dramatically reduced its potential added value. This is because, irrespective of provisions that could be agreed in respect of the Russian section of NS2, the agreement would in any event have to contain provisions ensuring that the Directive's requirements in respect of the German section of NS2 are met, thus reducing any incentive for the Russian government to enter negotiations.

It is worth recalling that in June 2017 the EC attempted to get a mandate from the Council to negotiate an international agreement on NS2 with Russia. The EC stated that the purpose of such agreement 'should be to ensure that the Nord Stream 2 pipeline is operated in accordance with a mutually agreed regulatory framework which incorporates core *principles* of international law and European Union law on energy, taking into account at the same time the impact of the pipeline's operation on the current gas supply from the Russian Federation to the European Union, including through Ukraine'.<sup>45</sup> However, the EC failed to get the mandate. Its failure can be attributed to the fact that it was not possible for the Council to know with any certainty – and it could be argued both ways – whether the EC's request was (a) a genuine 'good faith' attempt to ensure that NS2, when built, would not lead to sharp reduction of transit across Ukraine, or (b) a ploy to ensure that NS2 would not be built or would be significantly delayed, reflecting political opposition from several EU member states. A possibility that it may have been the latter, might have prevented member states supporting NS2 from granting the mandate. Moreover, the Council's legal service concluded there was no legal rationale for such a mandate due to absence of the conflict of laws which the agreement would aim to resolve, and granting the mandate would be a matter of a political choice rather of a legal necessity.<sup>46</sup>

As argued elsewhere, the EC may have advanced the Gas Directive amendment precisely in order to create a conflict of laws in order to strengthen its legal rationale for getting the mandate. Indeed, the Council's legal service has previously stated that there could be a potential conflict of laws should the Directive be amended to make it applicable to pipelines from third countries.<sup>47</sup> As the amended Directive has potentially created the conflict of laws, the EC could make another attempt to secure a mandate for negotiating the agreement, despite the fact that its added value has been significantly reduced in the process. Notably, Director-General at DG Energy, Dominique Rostori, speaking in March 2019 after the amendment had been agreed by the EU, stated that the EC's request for a mandate 'remains on the table' and the EC is 'ready' to act on the mandate should it be approved by the Council.<sup>48</sup> However, the German government has not shown any support for the EC's request for a mandate. Speaking on the

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<sup>45</sup> *Negotiating Directives*, as quoted in the Opinion of the Legal Service of the Council, para 68, p. 17.

<sup>46</sup> *Opinion of the Legal Service of the Council*, para 25. The *Opinion* was leaked to the media and is available in the public domain.

<sup>47</sup> *Ibid*, paras 22-23, p. 6.

<sup>48</sup> Transport, Energy and Telecommunications Council, press conference, 4 March 2019.



same day as Ristori, the German energy ministry secretary of state, Thomas Bareiss, stated that Germany does ‘not see any need for a further mandate’ and will be implementing the amended Directive ‘directly’.<sup>49</sup>

Notably, the German government is also not interested in negotiating an IGA with the Russian government itself, thus suggesting that the amended Directive’s new article ‘Empowerment procedure’ (Art. 49 aa), which envisages a possibility of concluding an IGA between a member state and a third country ‘on the operation of a transmission line with a third country’, is also highly unlikely to be used. However, if it were to be used, the EC – although not a party to such an IGA – would play a significant role as (a) its authorisation is necessary for a member state to ‘open formal negotiations with a third country for the part which may affect Union common rules’, (b) such authorisation could be refused if the EC considers that the opening of negotiations would be *inter alia* ‘detrimental to the functioning of the internal market, competition or security of supply in a member state or the Union’ (Art. 49 aa (1.b)), (c) its authorisation is necessary for a member state to sign and conclude the IGA.

With the amended Gas Directive becoming applicable to the German section of NS2, it is not clear how it could be possible either for the EC or the German government to conclude an agreement with Russia which would only be compliant with the EU energy law *principles* rather than with energy law *provisions*, as the latter is now required by the amended Directive. Thus, ironically, by deciding to amend the Directive, the EU has robbed itself of an opportunity of coming to an agreement on the operation of NS2 – either between the German government or the EC on one hand, and the Russian government on the other – which would i) be compliant with EU law *principles* – as opposed to its *provisions* – and ii) where both Russian and EU/German concerns – including in respect of NS2 impact on transit across Ukraine – could be taken into account.

### 3. The Danish permit for NS2: impact of the Directive amendment

At the time of writing, NS2 is awaiting a permit from Denmark (without which no pipe-laying work in the Danish sector of the Baltic Sea is possible). In April 2017 NS2 applied for a permit in respect of the southern route (139 km long, passing south of the Danish island of Bornholm through Danish territorial sea<sup>50</sup>) – for which a decision is still pending. Danish legislation had previously only allowed Denmark to reject a permit in respect of a pipeline in its territorial sea (as opposed to EEZ) on environmental grounds. However, in November 2017 Denmark passed a law which would allow it to reject such pipelines on foreign and security policy grounds.<sup>51</sup> In August 2018, following this change, NS2 also applied for a permit in respect of the northern route (175 km long, passing north of Bornholm through the Danish EEZ, but not its territorial sea<sup>52</sup>). Both permits remain under consideration by the Danish authorities, but there is a time limit – understood to be around 12 months from the date of application<sup>53</sup> – when a decision in respect of the northern route must be made, whereas there is no time limit on the decision on the southern route. This suggests that in summer 2019 Denmark will have to decide in respect of which route the permit will be granted. It is understood there are no grounds for rejecting the northern route on environmental grounds.<sup>54</sup> Thus if Denmark rejects the northern route permit it could face legal action which it would likely lose, but the entire project would be delayed as no construction is possible without a permit.<sup>55</sup>

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<sup>49</sup> ‘Germany to regulate Nord Stream 2 natural gas link directly: official’, *Platts*, 4 March 2019.

<sup>50</sup> Nord Stream 2, ‘Nord Stream 2 project: stakeholder engagement plan – Denmark’, December 2017, p. 7.

<sup>51</sup> ‘Denmark passes law that could ban Russian pipeline from going through its waters’, Reuters, 30 November 2017.

<sup>52</sup> Rambøll, Nord Stream 2 public hearing, 14 November 2018.

<sup>53</sup> ‘Denmark still working on Russia’s Nord Stream 2 gas pipeline permits’, *Platts*, 7 March 2019.

<sup>54</sup> Furthermore, it is difficult to see how a permit could be rejected for NS2 and not to the Baltic Pipe (also passing through the Danish territorial sea), which is actively promoted by the Danish and Polish governments.

<sup>55</sup> It was reported in March 2019 by the Danish media that Denmark is considering asking Gazprom to apply for a new third route for NS2. This route would run further south of the original route so that it would no longer be located in Danish territorial sea but only in its EEZ. This route was not available at the time when NS2 applied for either of its permits in respect of the original southern and alternative northern routes due to an unresolved territorial dispute between Poland and Denmark in respect of the section of the Baltic Sea through which this route would be passing. It was not until November 2018 that a delimitation agreement was signed by the two countries, under which this section would become part of the Danish EEZ. The

It is understood that the new law, allowing the Danish government to reject a permit in respect of the southern route – if it were to decide so – was adopted to allow Denmark more time to decide on the permit and wait for a common EU position on NS2.<sup>56</sup> With the EU agreement to amend the Directive – supported near-unanimously in the Council<sup>57</sup> – a common position has finally been agreed. This makes it easier for Denmark to grant a permit and even makes it easier to grant a permit in respect of the original – southern – route, which is understood to be environmentally preferable. Overwhelming EU support for the amendment suggests that, despite the opposition of some individual member states, particularly Poland, the EU *overall* is not against NS2 being built, provided there exists a regulatory instrument ensuring that NS2 will not have an adverse impact on the functioning of the EU internal market and competition. According to this logic any Danish refusal to grant a permit could even be interpreted as acting against the common EU position.

If the permit were to be granted in the first half of 2019 – irrespective of whether it is done in respect of the southern or the northern route – NS2 would be able to complete construction on schedule, that is before the end of 2019 (certainly the first string and possibly the second one too<sup>58</sup>). However, if the permit were to be granted closer to the end of Q3 2019, thus forcing pipe-laying in the Danish section towards autumn, NS2 completion on schedule could still be possible but would not be guaranteed, because pipe-laying could be affected by adverse weather conditions (not unusual for the Baltic Sea for this time of year).<sup>59</sup>

If no permit is granted by Denmark in the first half of 2019 (or at the end of Q3 2019 at the very latest), it might not be possible to complete NS2 construction (even its first string) by the end of 2019 as envisaged by the project's original schedule. Should this be the case, NS2 capacity will not be *physically* available for export of Russian gas to Europe by the time the existing transit contract with the Ukrainian company, Naftogaz, under which more than 40% of Russian exports to Europe was transported in 2018, expires at the end of 2019.<sup>60</sup> This means that if no agreement on transit of Russian gas across Ukraine is reached before the end of 2019, Ukrainian capacity will not be *contractually* available for exporting Russian gas to Europe. No access to Ukrainian corridor capacity and no access to NS2, would mean Gazprom would be forced to declare *force majeure* in respect of its deliveries under those European supply contracts that could not be served by other means other than via Ukraine. This would lead to a substantial reduction of Russian gas exports to Europe until the terms on which NS2 will be allowed to flow have been resolved given that, as long as the Danish permit has been granted, the pipeline will have been completed.

Gazprom's existing export pipeline capacity excluding the Ukrainian corridor (that is Nord Stream, Blue Stream, Yamal-Europe, Northern Lights, and a pipeline to Finland) is ~135 bcma whereas its exports to Europe in 2018 were more than 200 bcm. Therefore, if in 2020 Europe's import requirements for Russian gas were to remain at the 2018 level, Gazprom would face a ~65 bcma shortage of export

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agreement was ratified by the Polish parliament in February 2018 and at the time of writing is awaiting signature by the Polish president, see Sejm, '**Fourth day of the 77th sitting of the Sejm – report**', 22 February 2018; no ratification by the Danish parliament is required. It is argued here that even if Denmark were to suggest that Gazprom should consider this new route, Gazprom would likely insist that the Danish authorities first make a decision on the northern route in summer 2019 as required by law. "Det begynder at gøre ondt": Danmark er på ny kollisionskurs med Putin om gasrørledning', *Politiken*, 8 March 2019 (in Danish).

<sup>56</sup> 'Denmark seeks to change law on pipelines amid Nord Stream 2 divisions', *Reuters*, 9 April 2017.

<sup>57</sup> It is understood that only Bulgaria voted against the amendment.

<sup>58</sup> It is important that the first string of NS2 is completed before the end of 2019 as this would allow it to tie in with the first string of EUGAL which is also scheduled to be built before the end of 2019. Although there could be some doubt about whether the second string of NS2 would be completed by the end of 2019 as the schedule is understood to be very tight, it is of less importance because the second string of EUGAL is not planned to be completed before the end of 2020, see EUGAL, 'Creating the new transport pipeline step by step'.

<sup>59</sup> Given that the length of the Danish section of NS2 would be either 139 km (if the southern route is approved) or 175 km (if the northern route is approved) per string, assuming pipe-laying speed of 3-5 km/day and assuming both strings would be laid in parallel, pipe-laying in the Danish sector could be completed within two months. But additional time would be needed for testing the pipeline once built before its commercial operation could start.

<sup>60</sup> Gazprom has started arbitration proceedings to terminate the transit contract, which means the contract could be terminated even before its expiry date.

capacity. Even if Europe's requirements were to decrease to ~190 bcm in 2020 (as suggested by OIES modelling<sup>61</sup>), this author's research suggests that if neither one string of NS2 nor one string of Turkish Stream (TS) are available at full capacity by the end of 2019, Gazprom would need to transit at least ~65 bcm across Ukraine.<sup>62</sup> Even if one string of TS were to become available at full capacity in that time frame (which is likely), transit requirement, although decreased, would still remain very significant at ~50 bcm.

If not even one string of NS2 is operational at full capacity and only one string of TS is operational at full capacity at the end of 2020, transit requirement would still be ~60 bcm. The same situation at the end of 2021 would result in Gazprom's requirement for Ukraine transit in the range of 60-90 bcm. However, if one string of NS2 is made available at full capacity by the end of 2021, the Ukraine transit requirement would decrease to the level of 30-60 bcm. By 2025, Gazprom's need for Ukrainian transit capacity would likely decrease significantly (due to expected decrease of Europe's import requirement for Russian gas) but by the end of the 2020s, our modelling shows required volumes could increase again,<sup>63</sup> such that even if two strings of Nord Stream 2 and two strings of Turkish Stream are built and available at full operational capacity, Gazprom could still need to transit around 25 bcm across Ukraine.<sup>64</sup> Importantly, these estimates are conservative – that is the need for transit could be higher – because they are based on the assumption that Gazprom's ability to deliver gas to contractually specified delivery points at various European borders is not constrained by the availability of matching (existing and new) capacity in Europe as well as Gazprom's ability to access it. In reality, it is possible that such constraints may exist but their extent is impossible to ascertain on the basis of publicly available data. In addition, annual transit requirements may be misleading; analysis of daily flow data show that during periods of high winter demand, reliance on Ukrainian transit pipelines is greatly increased.<sup>65</sup>

#### 4. Post 2019 Ukraine transit agreement: impact of the Directive amendment

The latest (January 2019) round of political negotiations between Russia, Ukraine and the EC on a post-2019 contract for transiting gas across Ukraine failed to produce any agreement, just as the previous round held in July 2018 failed to reach agreement. According to the media, the EC has suggested that the agreement should oblige Gazprom to transit between 60 and 90 bcm of gas across Ukraine post-2019 for 10 years.<sup>66</sup> However, the EU *acquis* – including the Third Energy Package (TEP) and the Network Codes (NCs) – contains no requirement to book capacity for 10 years and allows bookings to be made on an annual basis.<sup>67</sup> From the Ukrainian side, Naftogaz suggested a transit tariff comparable with that of NS2 but only if all Ukrainian transit capacity is fully utilised, whereas the tariff would increase sharply should volumes decrease.<sup>68</sup> On the Russian side, Gazprom was referring to future transit volumes of 15 bcm whereas the Russian government was less specific, implying that transit volumes could be higher. This showed that although the parties' positions were not unbridgeable, nonetheless they were too far apart to reach an agreement. The situation is complicated by the fact that Ukraine has failed to complete the Naftogaz unbundling process whereby a new TSO, independent of Naftogaz, would be established and certified by an independent Ukrainian regulatory authority, to

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<sup>61</sup> Rogers as cited in Pirani (2018b).

<sup>62</sup> Yafimava (2019 forthcoming).

<sup>63</sup> Rogers as cited in Pirani (2018b).

<sup>64</sup> Yafimava (2019 forthcoming).

<sup>65</sup> Sharples (2018).

<sup>66</sup> 'Znamy propozycję układu o Ukrainie i Nord Stream 2. „To opcja maksimum”, *BiznesAlert*, 24 January 2019 (in Polish). Also see EC (2019b).

<sup>67</sup> Capacity Allocation Mechanisms (CAM) Network Code, Art. 8. Notably both CAM NC and Tariffs NC, which establish regulatory procedures for capacity allocation and payment for capacity respectively, were made part of the Energy Community *acquis* on 28 November 2018 whereas both NCs must be transposed into Ukrainian national legislation by 28 August 2019 and implemented by 28 February 2020. See Energy Community Secretariat, Decision 2018/06/PHLG-EnC and Decision 2018/07/PHLG0EnC.

<sup>68</sup> Vitrenko (2018).



become a party to any new post 2019 transit contract. It is complicated further by several ongoing arbitration proceedings in respect of the existing transit contract.<sup>69</sup>

The impact of the amended Directive on securing the post-2019 Ukraine transit contract is difficult to predict. It is clear that the EC views the amendment as a factor capable of influencing the trilateral negotiations.<sup>70</sup> The EC may believe that the amendment could strengthen its position as a mediator in the trilateral talks where the issue of NS2 compliance with the amended Directive could become part of the negotiation on the post-2019 transit contract. Although, the amended Directive does not give the EC sufficient power to block flows through NS2 permanently, as noted above the EC could be able to delay the start of its operation and impact the degree of its capacity utilisation. Thus, as part of trilateral negotiations, the EC could offer *not* to raise an objection to NS2 certification or agree to an exemption – as long as Gazprom signs a Ukraine transit contract with a ship-or-pay obligation of a defined length.<sup>71</sup>

In this author's view, relying on an arrangement which allows NS2 to go ahead in return for Gazprom agreeing to a long term Ukraine transit obligation, could be a risky strategy for the EC which, if it does not succeed, could endanger security of gas supply of several EU member states. While Russia would be interested in signing a post-2019 Ukraine transit contract – as repeatedly stressed by its president, Vladimir Putin,<sup>72</sup> and its energy minister, Aleksandr Novak<sup>73</sup> – it would be unlikely to agree to a contract it believes to be one-sided, disadvantageous and being forced upon it. It is clear that Russia interprets the Directive amendment as a means to force Gazprom to continue to transit more gas across Ukraine than it believes is either necessary or commercially advantageous. Notably, shortly after the EC reached agreement on the amendment, the Russian deputy foreign minister, Aleksandr Pankin, stated that, should the EC 'create obstacles' for NS2 'in order to force Russia to flow gas across Ukraine on their terms, under their tariffs, with uncertainty in legal issues, perhaps, this attitude will not work'.<sup>74</sup>

## 5. Legal constraints

The EC and/or the German regulatory authority's ability to use the amended Directive to impose changes in respect of the operation of NS2, that would result in restrictive regulatory treatment and have negative commercial impact, would be limited by legal constraints reflected in general principles of EU law, such as legal certainty and protection of legitimate expectations, non-discrimination, non-retroactivity.<sup>75</sup>

First, the EC initially proposed amending the Gas Directive in November 2017 – more than two years *after* a decision to proceed with NS2 had been made.<sup>76</sup> By the time the amendment is expected to enter into force (in July 2019), at least half of NS2 will have been built.<sup>77</sup> Application of the Gas Directive to a

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<sup>69</sup> Pirani (2018a).

<sup>70</sup> For example, in July 2018 a decision was made (under the Austrian presidency of the Council) to postpone discussion of the amendment until after the trilateral talks will have taken place on the 17<sup>th</sup> July 2018 presumably not to jeopardise the talks, see 'European Commission will not annoy Gazprom prior to the start of negotiations with Ukraine', *Vedomosti*, 5 July 2018. However, in January 2019 the opposite decision was made (under the Romanian presidency) to accelerate the discussion of the amendment in the run up to the talks taking place on the 21<sup>st</sup> January 2019, presumably to see whether an increased likelihood of the amendment could bring parties' positions closer. Both July 2018 and January 2019 rounds ended in failure, with no further talks expected until May 2019.

<sup>71</sup> As noted above, media reports suggest that the EC wants Gazprom to conclude a ten-year contract, but under EU law Gazprom has a right to book capacity on an annual basis, and is not obliged to conclude a longer term contract.

<sup>72</sup> News conference following Russian-Bulgarian talks, 30 May 2018; Joint news conference with president of Serbia Aleksandar Vučić, 17 January 2019.

<sup>73</sup> 'Запасы России: когда закончатся нефть и газ?' *Gazeta.Ru*, 26 February 2019 (in Russian).

<sup>74</sup> 'Замглавы МИД Александр Панкин: о полной де-долларизации речь не может идти', *RIA Novosti*, 7 February 2019 (in Russian).

<sup>75</sup> Talus (2019).

<sup>76</sup> According to Gazprom's website, the decision to proceed with NS2 was made in 2015 whereas various technical and economic feasibility studies in respect of the project were conducted even earlier.

<sup>77</sup> According to Gazprom, by early March 2019 overall 818 km (out of 1, 230\*2 km) had been built (both strings are under construction whereas the first string is significantly more advanced than the second) thus constituting almost 30% of the pipeline, see 'Nord Stream 2 one-third complete, 818 km built', *Interfax, Russia & CIS Oil and Gas Weekly*, 28 February – 6 March 2019.

project which had been initiated at the time when it did not apply to pipelines from third countries would be at odds with the principle of legal certainty as well as non-retroactivity.

Secondly, once built, NS2 is planned to be connected to, and provide gas for, the EUGAL pipelines in Germany, all of whose marketable capacity (80%) was allocated in March 2017 under legally binding contracts for 20 years (with 10% reserved for mid- and 10% for short-term bookings) in line with the 'more capacity' procedure.<sup>78</sup> This suggests that any cap on NS2 beyond 20% would make it impossible for the EUGAL contracts to be performed. Importantly, neither the German regulatory authority nor the EC raised any objections to this procedure. (The procedure closely mirrors the draft CAM NC which was under development at the time, and is not significantly different from the final CAM NC text.)

Thirdly, it is very clear that the amendment was an *ad hoc* instrument developed by the EC and supported by the European Parliament committee on industry, research and energy (ITRE), to have an impact specifically on NS2, which was its main target and *raison d'être*.<sup>79</sup> Although *de jure* the amended Directive would be applicable to all pipelines coming to the EU from third countries which have not been completed before the amended Directive's entry into force, *de facto* NS2 would appear to be the only pipeline from a third country that will be affected.

Finally the amendment might also be discriminatory under WTO law because it could be interpreted as being designed to decrease the availability of new import pipeline capacity to transport natural gas of Russian origin. The August 2018 WTO panel judgement on the EC – Russia dispute on the infrastructure exemption (the 2009 EC OPAL exemption) and the TEN-E (Projects of Common Interest) measures – both of which has found both discriminatory – follows the same logic.<sup>80</sup>

All of this suggests that NS2 would be in a strong legal position to contest any measures potentially taken either by the EC or the German regulatory authority, aimed at ensuring its compliance with the amended Gas Directive in respect of the German section of NS2, should those measures result in significantly more restrictive regulatory treatment and reduced profitability of NS2. Any such retroactive measures would provide serious grounds for legal action by Gazprom against the Germany regulatory authority and/or the EC. However, if that happened, it would depend on whether the pipeline would be allowed to operate and whether flows would be allowed to continue while the legal challenge was ongoing. If not, this could seriously delay and/or restrict flows. Thus irrespective of the strength of its legal position, any litigation in respect of application of the amended Gas Directive to NS2 would not be a desirable outcome for NS2 as it could delay its operation either partially or fully. (The amended Directive will have no impact on NS2 construction which will be completed by the end of 2019 unless the Danish permit is not granted.) Any delay in operations would mean continuing significant dependence on the existing export routes, including the Ukrainian corridor and, unless a post-2019 contract can be agreed, a significant reduction of Russian exports to Europe.

## 6. Conclusions

The Gas Directive amendment, which is on course to be signed into law in May 2019, will enter into force in July 2019, and is due to be transposed into member states' law within the subsequent nine-month period, is unable to halt construction of NS2 – as some EU member states had hoped. However, it is capable of delaying the start of NS2 operations (if it is not built before the amended Directive has been transposed into German law) or suspending its operation (if it started before the amended Directive has been transposed into German law). The amendment has also created significant regulatory uncertainty about the degree of utilization of NS2, and consequently the degree of utilization of the EUGAL pipeline to which NS2 is planned to be connected. Nonetheless, it is unlikely that a *significant* cap – that is higher than the reservation quotas already applied in respect of EUGAL capacity

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<sup>78</sup> Yafimava (2018).

<sup>79</sup> Comments by DG ENER deputy Director-General, Klaus-Dieter Borchardt, see *Negotiating mandate for Nord Stream 2: state of play*, and by European Parliament ITRE committee chairman, Jerzy Buzek, see 'Dyrektywa to koniec eldorado Gazpromu. Były szef PE: Nord Stream 2 nigdy nie powinien powstać, to nie koniec gry' – interview with Jerzy Buzek, chairman of the European Parliament's ITRE committee, *PolskieRadio24.pl*, 20 February 2019, leave no room for different interpretation.

<sup>80</sup> WTO (2018).

(10 % for mid- and 10% for short-term capacity) – would be imposed either by the German regulatory authority or by the EC on Gazprom’s utilization of capacity in NS2 due to significant pre-existing legal constraints.

Any cap that would be in conflict with EUGAL capacity contracts would constitute an extremely awkward development both for the EC and the German regulatory authority, neither of which publicly raised any objections to the ‘more capacity’ procedure, under which EUGAL capacity was allocated in March 2017.<sup>81</sup> Neither the EC nor the German regulatory authority would be in a position to request a significant change in regulatory treatment of EUGAL compared to the treatment awarded to it under the ‘more capacity’ procedure, given that the latter was not vastly different from and broadly consistent with the procedures being developed as part of the CAM NC.<sup>82</sup>

Transfer of NS2 ownership and/or operatorship to either an existing or a new (Russian, European, or joint) TSO, either in respect of the entire pipeline or its German section only (section 2.a) appears to be the option associated with the least possible regulatory change and regulatory uncertainty for NS2 compared to an exemption or an international or intergovernmental agreement. Under this option it would be for the German regulatory authority to confirm whether the establishment of such a TSO would result in NS2 compliance with the amended Directive’s requirements on unbundling, TPA and tariffs in respect of the German section of NS2. We suggest that the German regulatory authority is unlikely to impose conditions on NS2 that would result in the holders of capacity in EUGAL pipelines being unable to utilise their contracted capacity.

The exemption option (2.b) whereby NS2 could be granted an exemption upon request from Gazprom from some of the Directive’s requirements in respect of its German section, would cause a significant amount of regulatory uncertainty and delays for NS2. This is due to a very significant discretion on the part of the EC in respect of conditions that could be imposed on NS2 as part of an exemption, in addition to those that could be imposed by the German regulatory authority. Although any EC decision to impose a significant arbitrary cap on NS2 capacity utilization would be unlikely to be defensible on legal grounds, nonetheless any legal challenge from Gazprom could result in a significant delay to NS2 operations.

Neither intergovernmental agreement between Germany and Russia nor international agreement between the EU and Russia, on the operation of NS2 are likely to be workable (2.c).

The timing of Denmark’s permit is very important for NS2’s completion because no pipe-laying in the Danish section of the Baltic Sea is possible without it. Should the permit in respect of either southern or northern route be granted in the first half of 2019, NS2 would be built by the end of 2019 (certainly the first string and possibly also the second). Should the permit be granted closer to the end of Q3 2019, NS2 could still be completed on schedule but would not be guaranteed, because pipe-laying would have to take place in autumn thus becoming dependent on (not unusually) adverse weather conditions in the Baltic Sea at that time of year.

In conclusion, assuming the Danish permit is received in the first half of 2019 (or by the end of Q3 2019 at the very latest), there are several scenarios under which NS2 could proceed under the amended Directive:

- Once the Directive is transposed into German law, the German regulatory authority could confirm compliance of NS2 with the Directive, subject to publication of at least the methodology establishing the conditions for access to its capacity; and possibly also the tariff methodology; and a transfer of ownership and/or operatorship of the German section or the entire pipeline to an existing or a new Russian, European, or joint TSO, with its subsequent certification. While the German regulatory authority could allow NS2 to operate while certification continues, the EC could raise an objection to that as well as to certification itself, but this would be unlikely to

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<sup>81</sup> Yafimava (2018).

<sup>82</sup> Notably the ‘more capacity’ procedure was closely modelled on the available working drafts of the (then under development) CAM NC and closely (albeit not completely) follows it. *Ibid*, p. 152.



result in a suspension of operations unless the EC refers Germany to the CJEU and the latter orders a suspension;

- Alternatively, the Germany regulatory authority could indicate to Gazprom that it will not confirm compliance of NS2 with the Directive and issue certification even with suggested ownership/operatorship changes, in which case Gazprom would have no choice apart from applying for an exemption. The German regulatory authority could grant an exemption, which would then be referred to the EC, which could approve, amend or reject it. If the EC were to take a position that no flows could be allowed through NS2 while it is considering an exemption, NS2 operation would be suspended until a final exemption decision is made;
- Given its past record in suing the EC at the CJEU in respect of OPAL exemption and commitments decision in Gazprom anti-trust case, and its hostility towards NS2, it would not be surprising if the Polish government were to sue the EC over its position on the NS2 certification and exemption processes;
- Regulation of NS2 (particularly capacity utilisation) will probably become part of Russia-Ukraine-EC trilateral negotiations on post-2019 Ukraine transit (which are due to resume in May 2019, after the Ukrainian presidential elections). The EU might offer *not* to raise objections either to certification or exemption of NS2 as long as Gazprom signs a Ukraine transit contract with a ship-or-pay obligation for a defined capacity and a defined length of time;
- Failure to conclude a post-2019 Ukraine transit contract, combined with any failure to complete NS2 before the end of 2019, or suspension of its operation in 2020 for the duration of certification or exemption processes, or the duration of any legal action, would cut Russian deliveries to Europe by up to 65 bcm compared with the 2018 level of exports, or 50 bcm assuming the first string of Turkish Stream is operational.

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