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Nord Stream 2 and the EU Regulatory Framework: Challenges Ahead

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Highlights

- An approach towards Nord Stream 2 (NS2) will set a precedent for other new pipelines importing gas from third countries into EU.
- The EU-part of NS2 should follow rules of the Third Energy Package and the non-EU part of NS2 could either be subject to EU law by territorial extension or be governed by an EU-Russia agreement relating to the whole pipeline. The latter would need to be in line with the EU Treaties, which explicitly place an obligation on the EU to 'ensure security of energy supply' and 'ensure the functioning of the energy market'.
- Gas Market Directive should apply to the part of NS2 that is located in the EU territory. It requires a full liberalisation regime, and it remains unclear if derogations from the regime are possible. The EU part and the non-EU part of NS2 are legally connected and regulating one part influences the other. In case of lack of an EU-Russia international agreement, the non-EU part of NS2 could be subject to EU law through a territorial extension, which is widespread in EU law.
- NS2 will have a substantial impact on the current arrangements for the gas security of supply. New stress tests are necessary to assess the measures needed to mitigate the impact of NS2 on the security of supply.
- NS2 will impede competition in the EU energy market and will deter necessary investments in the gas infrastructure. The existing divide between Western and Eastern markets will be deepened, and the cost for the EU of establishing a well-interconnected market will significantly increase. The final settlement of the EU antimonopoly investigation against Gazprom should find remedies for these market challenges.

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POLICY BRIEF



1. Introduction

1.1 Controversial Gas Pipeline

The NS2 gas pipeline is one of the most controversial international pipeline projects. Officially the pipeline is planned to be operational by the end of 2019. The project consists of two new strings with a total capacity of 55 billion cubic meters (27.5 bcm each). Together with two strings of Nord Stream 1, the new combined capacity would be 110 bcm. Such high volumes mean that the project, if completed, will have significant consequences for the EU. All four strings of Nord Stream could transport almost 70% of Russian gas export to the EU.

1.2 Political Issues

NS2 has significantly divided the EU. At least one-third of Member States expressed opposition against the project. Although this paper does not deal with political issues, it is worth noting three reasons why the project has been challenged.

- The project goes against agreed aims of the Energy Union. Instead of desired diversification of routes and suppliers, NS2 concentrates both.
- Russia has been subject to EU sanctions due to its military invasion in Ukraine and breaching fundamental principles of international law. In some of the EU's Member States Russia is perceived as a security threat.
- The project will have a serious impact on Ukraine, which is a member of the Energy Community. Ukraine will lose important revenue sources and could be exposed to additional security risks.

1.3 Financial Issues

The cost of the project is estimated at 9,5 billion euro, and Gazprom is not able to finance it on its own. The original financing model collapsed due to objections of the Polish competition regulator issued in July 2016. As a result, the Western European com-

panies (BASF, E.ON, Engie, OMV and Shell) left the NS2 consortium. Still being interested in the project, they have announced supporting NS2 through loans of almost 5 billion euro in total.

The new US sanctions law, adopted in August 2017, made financing the NS2 project even more problematic as it could target any company involved in the project. It grants the president the power to impose sanctions on those investing in and contributing to building Russian exporting pipelines. The mere possibility of sanctions has created additional financial risk.

The result of litigation between Ukrainian Naftogaz and Gazprom in the Stockholm arbitration court might lead to further financial implications. The first interim award of the arbitration panel was very positive for the Ukrainian company. Final awards – both in the case on pricing and supply and in the case on transit – are expected by the end of November 2017.

2. Application of EU Law to Nord Stream 2

NS2 is being constructed in a different legal situation than its earlier predecessor. Whereas Nord Stream 1 was built before the Third Energy Package (TEP) entered into force, NS2 operates in the regulatory environment based on it.

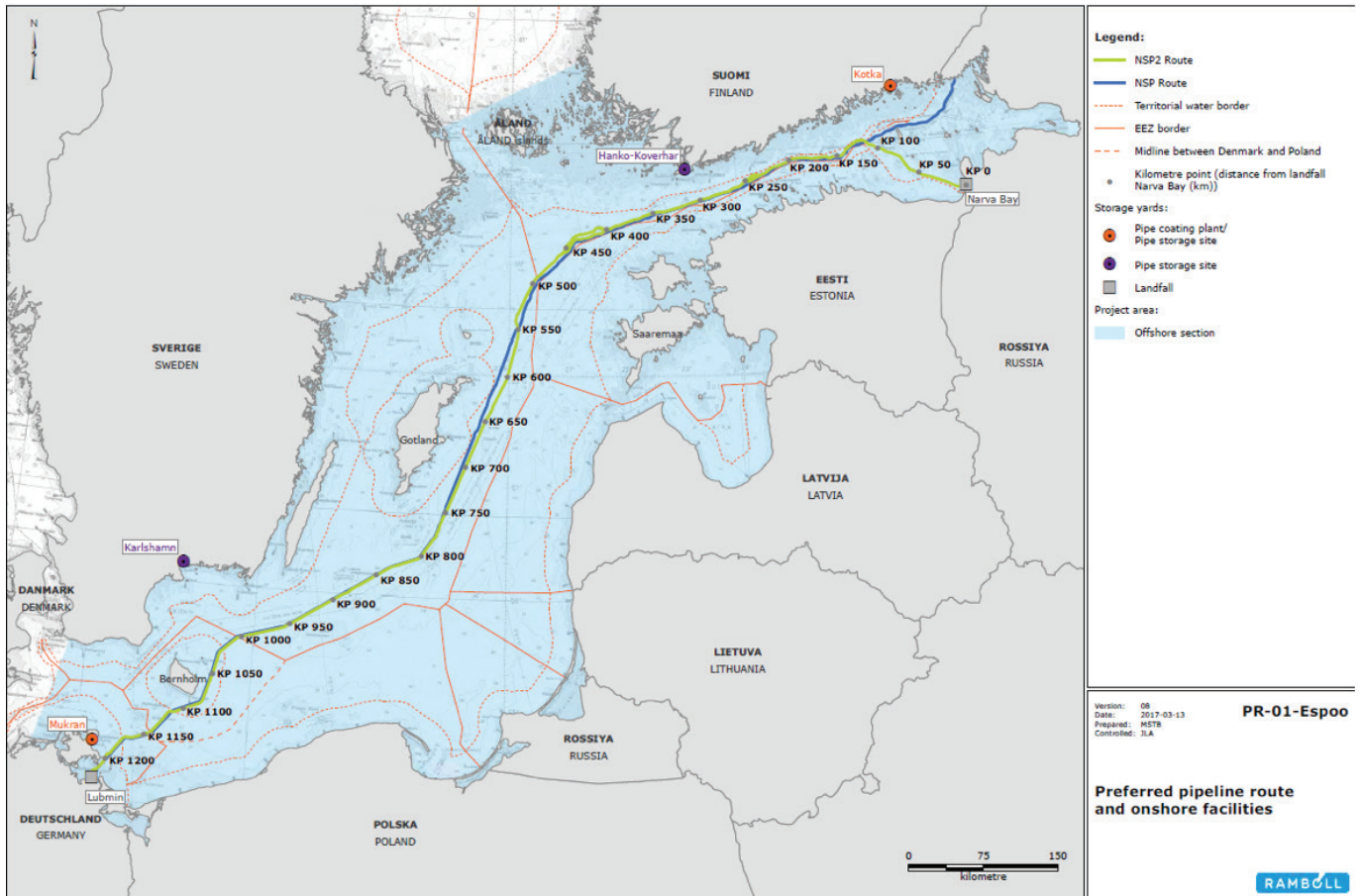
The legal situation of NS2 primarily depends on being in or outside EU territory. One has to be, therefore, very precise when using the phrase 'application of TEP to NS2'. First and foremost, its application is referring to the part that lies within EU territory and not to the whole pipeline. Only after should a legal arrangement for the remaining part be considered. For this reason, terms like 'onshore' or 'offshore' do not matter much in the legal analysis from the perspective of the Gas Market Directive. Not to mention that the latter does not even use such terms.

The EU part and the non-EU part of NS2 cannot be easily legally disconnected because of the way the pipeline will be constructed. From a technical point of view, the gas pipeline will constitute one whole –



Graph 1 The planned route of NS2, including borders of territorial waters and exclusive economic zones.

Source: ESPOO Atlas (NS2, April 2017)



there will be one single entry point in Russia and one exit point in the EU. As a result, it is not possible to establish rules for the one part without consequences for the other.

2.1 The EU Part of Nord Stream 2

NS2 will run through the territory of some Member States and therefore through the territory of the EU. For this reason, EU law in its entirety applies to parts of the pipeline that lie in the German and Danish territory (Denmark – 88 km of territorial waters; Germany – 50 km of land territory, internal waters and territorial waters). The Gas Market Directive is the key EU legislation applicable to the EU part of NS2.

The directive leaves no doubt as far as its territorial scope is concerned. It establishes common rules for the internal market in natural gas. According to the EU Treaties – hierarchically the most important source of EU law – the internal market is defined as ‘an area without internal frontiers’ (Art 26 par 2 TFEU). In other words, the directive refers to the EU territory and does not limit the basic principle that EU law is applicable in its territory (enshrined in Art 52 TEU and Art 355 TFEU).

The directive does not provide any grounds for a special treatment of NS2 in the EU territory. According to definitions specified in the directive, the EU part of NS2 can only be classified as a transmission gas



pipeline. The term ‘transmission’ is defined very broadly as ‘the transport of natural gas through a network’. There are only two instances that are excluded from this definition, namely upstream pipelines and distribution pipelines, both of which definitions are not adequate for NS2.³ Consequently, any pipeline that transports natural gas through a network and does not belong to the two excluded categories is a transmission pipeline.

The Gas Market Directive creates a special category of a transmission pipeline, namely an interconnector, which is subject to additional rules. However, its definition requires connecting national transmission systems between Member States, which is not the case of NS2.

The directive explicitly mentions pipelines transporting gas from third countries without making it a special category as it does with interconnectors. As a result, such pipelines fall under a very broad definition of a transmission pipeline. The recital 35 reads: “The possibility of temporary derogations should apply, for security of supply reasons, in particular, to new pipelines within the Community transporting gas from third countries into the Community”. Certainly, the EU part of NS2 belongs to ‘new pipelines within the Community’ and transports gas from Russia into the Community. Contrary to what the recital says, the directive does not provide for derogation later on in the text.⁴ The importance of this issue is, however, limited and pertains only to the question whether derogation can be granted or not. A lack of precision for specific legal arrangements cannot undermine the general fact that the directive regulates such a pipeline.

Putting aside the issue whether derogation to the NS2 could be applied (this, in turn, would lead to

a demanding assessment enshrined in Article 36), there are three main legal challenges for the NS2 project stemming from TEP:

- **Ownership Unbundling (OU):** It means that a network ownership requires being separated from production and transport of gas. This is not the case of Gazprom that is the only shareholder of NS2.
- **Third Party Access (TPA):** The problem lies in the Russian legislation, according to which Gazprom has the monopoly in exporting gas and in result has exclusive access to the pipeline.
- **Non-discriminatory Tariff Setting:** Tariffs for gaining access to a pipeline need to be published and apply objectively without discrimination to all eligible customers.

2.2 The Non-EU part of Nord Stream 2

Much less clear from the perspective of EU law is the situation of the remaining part of NS2. The question remains open if the application of EU law should be extended beyond its borders due to a territorial extension that is pervasive in EU law.

There is no doubt that in the EU territory (almost 140 km of the pipeline) EU law is applicable, including the Gas Market Directive. Similarly, in the Russian territory, its law will apply (almost 120 km of the pipeline). The remaining some 950 km of the pipeline is located in exclusive economic zones (EEZ) of Germany, Denmark, Sweden and Finland. Unlike in its territory, no country enjoys full sovereign rights in EEZ. As a result, neither national or EU law provides legal regime therein but international law. According to the latter, EU legislation will be applicable only as far as environmental and resource exploitation

3. The upstream pipeline is out of the question because NS2 is neither part of a production project nor it is connected to it. The distribution pipeline requires connection to customers whereas NS2 connects the Russian and the German systems instead.
4. ‘Major new gas infrastructure, i.e. interconnectors, LNG and storage facilities, may, upon request, be exempted, for a defined period of time’. The use of ‘i.e.’ would suggest that derogations are possible only to the listed type of infrastructure. However, there are some other language versions of EU Treaties (having the same legal importance) that suggest the list to be just exemplary and thus not exhaustive.



aspects are concerned (Article 56 of UN Convention on the Law of the Sea, UNCLOS). However, as mentioned earlier, the EU part and the non-EU part of NS2 are not legally disconnected and regulating one part influences the other. Consequently, legal arrangements necessary in the EU territory would need to be applied in the remaining part of the pipeline.

Table 1 The NS2 route

Territory of the EU (Germany, Denmark)	140 km
Territory of Russia	120 km
Exclusive Economic Zones (Germany, Denmark, Sweden and Finland)	950 km

The territorial extension is widespread in EU law and applying it to a transnational pipeline would not be something unique. The EU has succeeded in using access to its huge market as a tool to extend its norms abroad. In other words, imported goods or services need to follow conditions set by the EU to access its market. One can find many examples of such practice in several policy sectors, *inter alia* in climate change, environment, maritime transport, air transport, and financial services. Not to mention even the most obvious case of extraterritoriality in EU competition law. Importantly, the European Court of Justice deems territorial extension in line with customary international law.⁵ Moreover, the WTO's Appellate Body seems to agree upon fulfilment of certain conditions,⁶ which should not be problematic in the case of NS2.

It is unlikely that Russia would easily consent to a territorial extension of EU law. It opposes EU regulations of the energy sector and has initiated a WTO dispute against the EU Third Energy Package. A final report of the WTO panel in this case is expected at the end of 2017.

In such a situation the only way forward for the NS2 project to continue is to attempt to settle the appli-

cable law in an international agreement between the EU and Russia. The agreement will need to be in line with the EU Treaties, which explicitly place an obligation on the EU to 'ensure security of energy supply' and 'ensure the functioning of the energy market' (Article 194 TFEU).

3. The Objective of Security of Supply

Security of supply is a legal requirement and not merely a political matter. The objective of the security of supply has been written into EU primary law in the Treaty of Lisbon. Secondary legislation explicitly refers to it in many instances. As a result, guaranteeing security of supply belongs to the regulatory framework that NS2 needs to follow.

The construction of NS2 does not necessarily mean more Russian gas in the EU market but could lead to major changes of gas flows in Europe, in particular in its Central and Eastern parts. The currently existing routes through Belarus and Poland (Yamal gas pipeline) and through Ukraine (western corridor via Slovakia and southern corridor via Romania) could be seriously impacted. Depending on the extent of capacity allocation in Opal and Eugal (onshore extensions of NS1 and NS2) and the construction of Turkish Stream, they could be even completely switched off. There is clear evidence for the competition between the routes: when Gazprom started utilising more capacity in OPAL (following new exemptions granted in October 2016) amounts of gas sent through Yamal and Ukraine decreased.

The major changes of gas flows pose several challenges to the EU security of supply:

- The CEE countries will be at the end of a pipeline delivery system and their security will not be linked anymore to supplies to the Western markets. They will lose access to virtual reverse flows.

5. See European Court of Justice, Case C-366/10 *Air Transport Association of America* ECLI:EU:C:2011:864

6. See WTO, United States – *Import Prohibition of Certain Shrimp and Shrimp Products*, DS/58/AB/R



- The efficiency of physical reverse flows could become more critical.
- The pipeline congestion could appear because the demand in the East (which includes, in this case, Italy and parts of Germany) amounts to 150 bcm whereas the transport capacity from the West to the East is 110 bcm.⁷

Addressing the security of supply challenges would require a thorough assessment. New stress tests that include the scenario of 110 bcm running through the Baltic Sea would need to be initiated. Only the results of these tests could give an idea for the investments required to mitigate the impact of the changing flows to the security of supply. Moreover, the new results might lead to the necessity of rethinking the current division into groups under the Security of Supply Regulation.

4. The impact of Nord Stream 2 on the Internal Energy Market

NS2 will mean more market power of Gazprom in the North-West Europe (NWE). Its dominant position will increase in particular in Germany. These changes will be enhanced by the decrease of EU gas production (in the UK and the Netherlands). Gazprom might intend to prevent arising of more competition in NWE to defend its market share. As demonstrated by Georg Zachmann, one way to achieve it would be offering cheap gas from the Nord Stream route first to the NWE market before selling it eventually for a higher price on the markets of CEE. The high volumes of available gas would lead

to the decrease of price and disincentivise other suppliers to compete on the market.⁸

Outcompeting will also take place in the CEE region but on a different level. Instead of competing on price levels, Gazprom will take advantage of underdeveloped infrastructure and will disincentivise investments needed to attract new suppliers (LNG, Norwegian gas). Efforts to increase competition in the CEE market might be abandoned and a development of the market put in question.

As a result, the already existing divide between hub based Western markets and isolated Eastern markets will be even deepened. As demonstrated in the gas market modelling by Péter Kotek, Adrienn Selei and Borbála Takácsné Tóth, if NS2 becomes operational, the gas prices in Central, Eastern and Southern Europe will increase. Moreover, it will slow down the process of liberalisation. Without NS2, the capacity of pipelines bringing gas from the West would be mostly allocated to spot traded gas. With NS2 in place, the latter will be crowded out by long-term contracts of Gazprom.⁹

New investments could address the existing West-East price divergence. Despite much investment undertaken so far in CEE to fulfil the aim of establishing a well-interconnected market, still, around 890 million euro is needed to reach this objective. However, if NS2 is operational, the bill rises to 1880 million euro.¹⁰ Moreover, the additional cost of 1 billion euro does not take into account stranded costs that will inevitably appear because already financed projects might not be utilised as they were originally planned.

7. G Zachmann, 'Nord Stream 2 – a Risk for the Internal Market and Security of Supply?', presentation at the Bruegel conference 'Different perspectives on Nord Stream II' (Brussels, 2017)

8. *ibid.*

9. P Kotek, A Selei, B Takácsné Tóth, 'The Impact Of The Construction Of The NS2 Gas Pipeline On Gas Prices And Competition' (Regional Centre for Energy Policy Research, Budapest, 2017)

10. *ibid.*



In assessing the impact of NS2 on the internal energy market, one should keep in mind that Gazprom has been subject to an investigation due to the abuse of its dominant position in CEE (Art 102 TFEU). The formal proceedings were opened in 2012 and have moved recently to a final stage. After Gazprom formally submitted its proposals of commitments addressing objections, it remains to be seen what would be the final Commission's decision. The settlement should find remedies for the challenge of having a single competitive market.

An in-depth study, using a global gas market simulation model, has revealed that the Gazprom's proposed commitments lead to 'fundamental challenges for the current regulatory model in Europe to complete the project of a single market for gas.'¹¹ Chi Kong Chyong demonstrated that the possibility of changing delivery points ('swap deals') might have a positive impact on limiting Gazprom's potential market power, price convergence of Russian gas in the CEE region, and connecting the latter to the more competitive NWE market. The analysis argued, however, for several clarifications and amendments demonstrating that commitments offer too much uncertainty whether the positive changes would take place. Importantly, according to the research, the commitments pose challenges in regards to diversification and energy security. They lead to an increase of the market share of Russian gas in some instances and no improvement in diversification in others. Additionally, they could negatively impact the utilisation of strategic gas infrastructure and even lead to the disintegration of some markets from the rest of EU markets.

11. CK Chyong, 'An Assessment of Gazprom's Proposed Commitments Concerning Central and Eastern European Gas Markets Using a Global Gas Market Simulation Model' (Energy Policy Research Group, Cambridge, 2017)

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