Atlantic Council

GLOBAL ENERGY CENTER and
DINU PATRICIU EURASIA CENTER

ISSUE BRIEF

BY ALAN RILEY

# Nordstream 2: Too Many Obstacles, Legal, Economic, and Political to be Delivered?

NOVEMBER 2015

## Introduction

This paper considers the prospects for the Nordstream 2 pipeline project. The pipeline would bring significant gas supplies from Russia to Germany via the Baltic Sea. The first set of pipelines, known as Nordstream 1, was completed in 2012.[1] However, it is open to question whether Gazprom and its partners will be able to successfully deliver a second set of pipelines by the envisaged completion date of 2019. There are a number of factors that make this new project much more difficult to deliver than Nordstream 1, and the two most significant factors are questions surrounding the financing of the project and its compliance with EU law. Firstly, Gazprom is in a much weaker financial position than it was when Nordstream 1 was completed. Furthermore, financial institutions are likely to be far less willing to support this project, due to the sanctions imposed on Russia by the European Union and the United States. The second significant factor is the development of European Union (EU) energy-liberalization law in the years since Nordstream 1 was launched. EU law now becomes a significant obstacle to completion of the project on the terms that Gazprom desires. EU regulatory requirements are likely to reduce Gazprom's control over the pipelines, and reduce its access to the network's full capacity.

1 For clarification: Nordstream 1 consisted of two pipelines, each with a capacity of 27.5 billion cubic meters per year (bcm/y). Nordstream 2, it is understood, will consist of two additional pipelines, each with a carrying capacity of 27.5 bcm/y. Some papers refer to Nordstream 1 as Nordstream 1 and 2, and the proposed new pipelines as Nordstream 3 and 4. In this paper Nordstream 1 means the first two strings of the Nordstream pipeline (1 and 2), and Nordstream 2 is the two proposed strings (3 and 4).

### Global Energy Center

At a time of unprecedented volatility and opportunity, the Atlantic Council Global Energy Center works to promote global access to affordable, reliable, and sustainable energy.
Alongside government, industry, and civil society partners, the Center devises creative responses to energy-related geopolitical conflicts, advances sustainable energy solutions, and identifies trends to help develop energy strategies and policies that ensure long-term prosperity and security.

The overarching problem that Gazprom and its commercial allies face is that the world has changed very much since the original Nordstream project was launched in 2008. The invasion, occupation, and annexation of Crimea—and the invasion and occupation of eastern Ukraine—by forces of or controlled by the Russian Federation have undermined the basis for cooperation between Brussels and Moscow. Furthermore, the EU's policy response to Russian aggression cuts across the Kremlin's objectives with respect to Nordstream 2. For instance, one of Nordstream 2's objectives is to remove the remaining gas transited across Ukraine, from those existing transit pipelines to its new Baltic pipeline. This would have the effect of stripping an already financially strained Ukraine of more than $2 billion in revenue, and reducing the country's value as a supply corridor for transporting natural gas to Europe.[2] Yet the EU, together

2 Tatiana Jancarikova, "Nordstream 2 Risks Strangling Ukraine-US Official," *Reuters*, November 5, 2015, http://uk.reuters.com/article/2015/11/05/eu-gas-russia-idUKL8N1303G720151105.

**Alan Riley** is a Nonresident Senior Fellow in the Global Energy Center, Atlantic Council.

with the United States, has been seeking to support Ukraine financially, along with economic reforms to rebuild the country. Nordstream 2 appears, therefore, to be a very bold move by the Russian Federation. It is an open question as to whether it can be delivered on time, and whether Gazprom can have the sort of control over the pipeline that it envisages.

The second part of this analysis provides an overview of the Nordstream projects. Part three considers the financing of the project, part four considers its compatibility with EU liberalization law, and part five offers a conclusion.

## From Nordstream 1 to Nordstream 2

The first Nordstream pipeline project was conceived in the early 2000s as a means to avoid conflicts over Ukrainian transit of gas to Europe, and to bring gas to Russia's most lucrative market, Germany. The project was conceived as having two pipelines—each with a carrying capacity of 27.5 billion cubic meters per year (bcm/y). Hence, the two pipelines combined would provide 55 bcm/y of capacity. They run under the Baltic Sea, from Vyborg on the Russian coast to Greifswald on the German coast, passing through the exclusive economic zones of Finland, Sweden, Estonia, Latvia, Lithuania, Denmark, and Germany (and the territorial seas of the latter two states). The pipeline length is 1,224 kilometers, making it the world's longest undersea gas pipeline. The technical proposals and environmental applications were submitted between 2005 and 2008. The majority of the permits to proceed were obtained in October 2009, while the first pipeline was completed and operations commenced in November 2011. The second pipeline was completed and operational from October 2012. The cost of the project was €7.4 billion, with 30 percent of equity injections from shareholders and 70 percent from financial institutions. The holding company is Nordstream AG, and the shareholders are: Gazprom, with 51 percent; E.ON, 15.5 percent; BASF/Wintershall, 15.5 percent; Gasunie, 9 percent; and GDF Suez (now Engie), 9 percent.[3]

In addition, a number of pipelines that connect to the Nordstream pipeline are substantially owned and controlled by Gazprom. These include the OPAL pipeline, which takes natural gas from the Nordstream pipeline into the German and Czech markets and has a capacity of 36 bcm/y, and NEL, which has a capacity of 20 bcm/y and takes gas into the markets of Germany and the Low Countries. Both pipelines, as discussed below, have been subject to the application of EU energy-liberalization

3 Nordstream AG, *The Nordstream Pipeline Project,* August 2014.

**GAZPROM WILL NEED TO FIND €5 BILLION FOR ITS SHARE OF THE APPROXIMATELY €10 BILLION COST OF THE PIPELINE.**

rules, which have limited Gazprom's ability to make full use of the pipelines.

At the St. Petersburg International Economic Forum in June 2015, Gazprom CEO Alexi Miller announced that Nordstream 2 would proceed with the support of some of the existing partners, along with Shell and OMV.[4] On September 4, at the Eastern Economic Forum in Vladivostok, Russia, a shareholders' agreement was signed by Shell, OMV, BASF/Wintershall, Engie, and E.ON. Gazprom took a 51-percent share, with all the other firms taking 10 percent—save Engie, which would take 9 percent.[5] The proposal would seem to involve taking the same route as Nordstream 1, and also constructing pipelines with the same carrying capacity, which would mean two lines of 27.5 bcm/y each. The combined total capacity of Nordstream 1 and 2 would therefore be 110 bcm/y, just short of the likely total for exports to the EU in 2015.

## 3.0. Financing the Pipelines

Gazprom will need to find €5 billion for its share of the approximately €10 billion cost of the pipeline. This amount will be difficult to generate from internal funds. Not only does Gazprom have the new Nordstream project to contend with, but also the $55 billion Power of Siberia project, and Turkish Stream—even if Turkish Stream is scaled back to only one or two pipelines, instead of the originally conceived four pipelines. More fundamentally, the collapse in revenues makes it difficult to see how the company can generate the capital required for Nordstream and other projects, either from internal funds or by attracting external financing. Gazprom's EU exports fell from a height of 163 bcm in 2013

4 Dmitry Zhdannikov and Denis Pinchuk, "Russia's Gazprom to Expand Nordstream Gas Pipeline with OMV, E.ON and Shell," *Reuters*, June 18, 2015, http://uk.reuters.com/article/2015/06/18/energy-gazprom-pipeline-idUKL5N0Z42OB20150618.
5 BASF, press release, "Gazprom, BASF, E.ON, Engie, OMV and Shell Sign a Shareholders Agreement on Nordstream 2," September 4, 2015, https://www.basf.com/en/company/news-and-media/news-releases/2015/09/p-15-334.html. See subsequently, Neil Barnett, "Germany's deal with Russia," Centre for Policy Studies, November 19, 2015.

to 139 bcm in 2014, and they are expected to be even lower in 2015.[6] To make matters worse, the collapse in oil prices in late 2014 has seen a fall in gas prices linked to oil under Russian supply contracts—from approximately $350 per thousand cubic meters (mcm) in 2013 to an average price of $240 per mcm in 2015. The Russian economy ministry estimates that prices could fall as low as $187 per mcm next year; it sees no recovery at least until 2018.[7] Its overall revenues are likely to be cut by one third over the next three years, and its EBIDTA (earnings before interest, taxes, depreciation, and amortization) is likely to fall by 50 percent.[8]

Worse still, under increasing competition from Rosneft and Novatek, Gazprom has lost approximately 90 bcm in sales from the domestic gas market since 2006, and sales have declined domestically in each of the last three years. The increasingly gloomy economic prospects for the Russian economy do not suggest that this market will recover, at least in the short term. Furthermore, the fall in the value of the ruble significantly reduces the overall value of domestic revenues to Gazprom.[9]

The Russian response to these figures—and to financial institutions that would be the source of any loans to build Nordstream 2—is that this situation is temporary, and the market will recover. The principal sources of gas in the EU, from the Norwegian, Dutch, and British North Seas are declining, and additional gas sources will be required. In addition, the major alternative source of supply, North Africa—particularly, Algeria, Libya, and Egypt—is now replete with political risk, making it difficult to bring forward capital investment to develop the region's resources.

The difficulty with this argument is that it does not take account of additional alternative sources of natural gas, particularly with respect to liquefied natural gas (LNG). According to the International Energy Agency (IEA), an additional 175 bcm of supplies will come on stream between now and 2020, principally from Australia and Papua New Guinea, and also from the United States. Given this increase in supply over the next few years, plus falling Chinese and Japanese demand,[10] there is a real danger of LNG becoming a considerable source of alternative energy for the European market.[11] Furthermore, as Henderson and Mitrova have recently pointed out, marginal-cost LNG is competitive against Russian pipeline gas in the short run, unless Gazprom is prepared to absolutely cut its own margins to the bone.[12]

Along with these challenges, the fact is that the European gas market itself has been shrinking, from 577 bcm in 2008 to less than 500 bcm in 2014. There are a number of factors at play here: first, a stagnant Eurozone market; second, the growth of renewables across the European market, whose onward targets for 2030 will result in even greater deployment in the 2020s; and third, the dumping of cheap coal into the European market (in part, a result of US shale gas displacing US coal and forcing it onto international markets). More fundamentally, the cost of renewables in the EU markets has made utility companies focus on the cheapest possible alternatives. Coal, rather than gas, is the cheapest possible alternative; as a result, even Germany is building 8 gigawatts of coal plants. This is partly a failure of the EU's Emissions Trading Scheme (ETS), which was supposed to price coal out of the market. This would require a price of approximately €30 a tonne (currently, the price is around €8 a tonne).

These factors, which shrink the size of the European gas market, will not be easy to change. Worse still, gas now carries an "energy security," or "Gazprom," charge. The effect of this Gazprom charge is that fears about supply security encourage states, energy companies, and utilities to use less gas—or, if they decide to use gas, not Russian gas. Hence in Lithuania, although the negotiated contract with Gazprom—which cut prices by 20 percent with the arrival of the Klaipeda floating LNG facility—is in place, the country also signed a long-term contract with Norway, where the prices are 10 percent higher than the Gazprom price.[13]

Gazprom, therefore, has a significant difficulty in persuading financial institutions to support the Nordstream project. It is also trying to persuade investors to invest in an expensive pipeline into a shrinking market, and

6 Justin Burke, "How Russian Energy Giant Gazprom lost $300 billion," *Guardian*, August 7, 2015, http://www.theguardian.com/world/2015/aug/07/gazprom-oil-company-share-price-collapse.
7 Elena Mazneva and Misha Savic, "Russia Sees Bleak Outlook for Gazprom in Europe," *Bloomberg*, May 28, 2015, http://www.bloomberg.com/news/articles/2015-05-28/russia-sees-bleak-outlook-for-gazprom-sales-in-eu-on-price-drop.
8 James Henderson and Tatiana Mitrova, *The Political and Commercial Dynamics of Russian Gas Export Strategy* (Oxford, United Kingdom: Oxford Institute for Energy Studies, September 14, 2015), p. 7, http://www.oxfordenergy.org/2015/09/the-political-and-commercial-dynamics-of-russias-gas-export-strategy.
9 Ibid, p. 4.
10 Based on official figures, the Chinese economy has fallen below 7 percent growth, and actual growth is likely to be significantly lower. One of the major drivers of high oil prices, and thereby high natural gas prices, was high levels of Chinese growth at 10-12 percent. A long period of relatively low Chinese growth will act as a demand anchor, keeping energy prices at a much lower level than that to which energy commodity countries such as Russia have been accustomed. In addition, the gradual return of much of the Japanese nuclear fleet also reduces demand for LNG. Japan is the world's largest single customer for LNG, further adding to global liquidity and to pressure on LNG pricing.
11 International Energy Agency, *IEA Medium-Term Gas Market Report 2015* (Paris: IEA, 2015) p. 112, http://www.iea.org/bookshop/707-Medium-Term_Gas_Market_Report_2015.
12 Henderson and Mitrova, pp. 51-52
13 Henderson and Mitrova, p. 51.

> IT WILL, HOWEVER, BE VERY CHALLENGING TO FIND THE FINANCING AT A PRICE GAZPROM WILL WANT TO PAY.

one where substantial alternative supplies are coming on stream. In addition, a large part of the consumer base has a significant aversion to Gazprom, which will make it difficult to obtain additional market share, or even to maintain the current share.

If those factors do not raise serious questions in the minds of the investors, there are also two other factors to ponder. The first is whether investors will consider the sanctions risk too great. Although Gazprom itself is not sanctioned by the current US and EU regime, there is a knock-on effect in the market. This makes investors wary that the project could be affected if sanctions are tightened. This problem has already impacted the Vladivostok LNG project, as Gazprom is finding it difficult to obtain long-term customers, because of fears that they might be affected by future sanctions.[14]

A further consideration involves the award of $50 billion to the principal Yukos shareholders in the Energy Charter Treaty case against Russia, which was heard in The Hague in 2014.[15] This case stemmed from the expropriation of the Yukos oil company by the Russian Federation in 2004. The award against Russia is in the process of being registered as a judgment under the New York Convention.[16] Once that is done, it can potentially be enforced against any Russian state-owned assets not subject to sovereign immunity anywhere in the world. Gazprom is controlled by the Russian government, and 51 percent of its shares are owned by the state. Gazprom, as a commercial gas company, would not be able to rely on any sovereign-immunity claim if the pipeline became subject to a claim in the courts of EU member states. Investors would need at least some substantial assurances that the pipeline, or at least the shareholding of Gazprom, could not be seized by the Yukos shareholders.

Together, these factors—Gazprom's reduced financial capacity, the shrinking European gas market, the prospect of greater competition in the market from LNG by the time the pipeline would be completed, sanctions, and the potential impact of the Yukos case—cast a significant shadow on the prospect of external financing. These factors demonstrate that Gazprom is no longer in the fiscal and political environment of this century's first decade, when its market capitalization reached $367 billion in 2008. Today, its market capitalization is approximately $50 billion, and Gazprom is under far greater pressure than when it launched Nordstream 1. This is not to say that it won't ultimately be able to find the financing for the pipeline. It will, however, be very challenging to find the financing at a price Gazprom will want to pay.

## Nordstream and EU Energy-Liberalization Rules

One of the most formidable barriers to the full-capacity utilization of Nordstream 2 will be the rules established by the European Union under the 2009 Gas Directive, and accompanying legislation known as the Third Energy Package (TEP).[17] Under that directive, gas supply must be separated from the network over which it is carried. A number of options are provided by the legislation, from full ownership unbundling to significant restrictions on the gas supplier's control of the network, through an ISO or ITO regime.[18] In addition, third-party access to the network must be provided to competing gas suppliers.[19] Under Article 11 of the directive, there is also a requirement that any non-EU entity seeking substantial participation in, or control over, a network will be subject to the same unbundling requirements as an EU-based entity. In particular, member states' regulatory authorities must certify that the foreign owner complies with the unbundling requirements of EU law, and will not put at risk the security of either the member states' or the EU's energy supplies.

Nordstream can potentially seek an exemption from these requirements under Article 36 of the gas directive.

---

14 Henderson and Mitrova, p. 9.

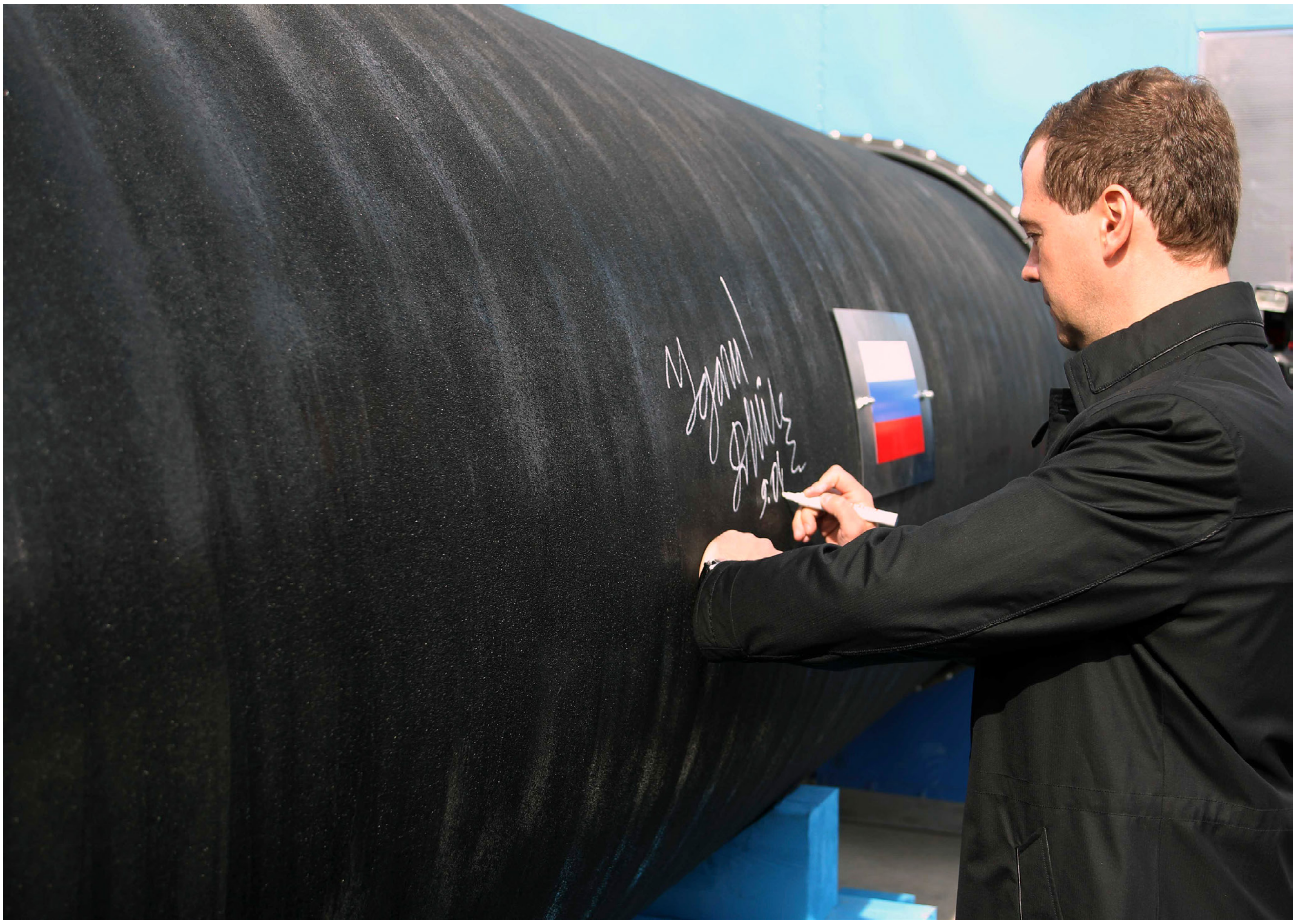
15 *Hulley Enterprises v. The Russian Federation*, Permanent Court of Arbitration, Case No. AA 226, July 18, 2014.

16 The registration process is ongoing on October 20, 2015 and the Russian Federation filed a suit challenging the registration in the Federal District Court for DC, *Hulley Enterprises, Yukos Universal and Others v The Russian Federation*, Case No. 1-14-cv-01996-ABJ.

17 The key relevant elements of the third package for gas are: Directive 2009/73/EC concerning common rules for the internal market concerning gas, OJ 2009 L211/94; Regulation 715/2009/EC on conditions for access to the natural gas transmission networks, OJ L211/36; and Regulation 713/2009/EC establishing an Agency for the Co-operation of Energy Regulators, OJ L211/1.

18 Under the Gas Directive, EU member states have a number of options to separate the network from the supply of natural gas. One option is full ownership unbundling (i.e., the network owner is entirely separate from the gas suppliers). This usually means that what had been a vertically integrated system sees the network being sold off to a third-party, which then runs the network. The independent system operator (ISO) or independent transmission operator (ITO) options provide two different models under the Gas Directive, in which the network owner remains a supplier but the network is subject to a substantial regulatory control, in order to ensure that the network remains open to access by actual and potential competitors.

19 Ibid.



Then-Russian President Dmitry Medvedev wishes “good luck” to a portion of the Nordstream pipeline in April 2010.
*Photo credit:* Alexander Demianchuk/Reuters.

However, several conditions have to be met, including that the investment will enhance competition in the supply of gas.[20]

The liberalization regime set out in the 2009 Gas Directive was still coming into being while Nordstream 1 was being permitted and constructed.[21] Now it is fully in place, and the European Commission and its member states have some experience in operating it. In proposing to launch Nordstream 2, Gazprom and its commercial allies are likely to face a much tougher regulatory environment than that faced by Nordstream 1.

*EU Law and the Connecting Pipelines*

As with Nordstream 1, the connecting pipelines to bring Nordstream 2’s gas into the European market will be subject to the full weight of the Gas Directive. The pipelines will have to be unbundled on one of the approved models, and third-party access will be required. If Gazprom is deemed to have control of those pipelines, they will likely need to be certified under Article 11 of the Gas Directive—to ensure that unbundling has occurred, and that Gazprom’s ownership does not threaten national and European supply security. The difficulty for Gazprom is that constructing two extra pipelines into Germany does undermine the supply security of Central and Eastern European (CEE) member states. As a result of Russian gas transit across their territories, those states have access to natural gas. Furthermore, the fact that the gas transiting across their territories is heading for the lucrative Western European market provides the transit states with a degree of supply security; Gazprom

20 The full list of exemption conditions under Article 36 are: (a) the investment must enhance competition in gas supply and enhance security of supply; (b) the level of risk attached to the investment must be such that the investment would not take place unless an exemption was granted; (c) the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems the infrastructure will be built; (d) charges must be levied on the users of the infrastructure; and (e) the exemption must not be detrimental to competition or the effective functioning of the internal market in natural gas or the efficient functioning of the regulated system to which the infrastructure is connected.

21 It is, however, open to question why the Second Energy Package was not applied to the Nordstream pipeline. For further discussion of the application of EU law with respect to offshore pipelines, see below.

cannot cut them off without threatening the supplies to Western Europe. However, as the new pipelines would provide gas directly to Germany, they would represent a supply security threat for the Central and Eastern European states. Russia could cut off existing routes at will, without affecting access to its main Western European market. This would not only deprive those states of transit revenues, but also remove their underlying supply security.

It can be argued, however, that this threat is overstated, because of the increasing capacity of EU states to reverse-flow gas from Germany to Central and Eastern Europe. This essentially involves taking Russian gas already sold into the European market via Nordstream, and reverse-flowing the gas using the now- greater range of bidirectional pipeline interconnectors to send gas eastward. The difficulty with this argument is that Gazprom may well seek to undermine reverse-flow operations by restricting supply via its primary supply routes into the European market. There is already some precedent. In 2014 and 2015, Gazprom made it clear to several member states that it was displeased with the agreements to reverse-flow gas to Ukraine. There were clear instances of gas supplies being cut to states that were seeking to provide gas to Ukraine by reverse-flow.[22] Furthermore, relying on reverse-flows via Nordstream 2 not only means relying on Russia not to cut the level of gas flows westward via the new pipeline, but also relying on German cooperation to ensure that the gas does indeed flow eastward. CEE states may be willing to trust German Chancellor Angela Merkel; however, the German leadership might change. The CEE could well face a new Ostpolitik, if a new German chancellor takes an approach closer to that of former Chancellor Gerhard Schröder[23].

It could also be argued, in the alternative, that gas is going to flow solely via Nordstream, and that the Ukrainian transit route will not be utilized at all. This argument, however, does not assist the Gazprom position, as it further exposes how dependent the CEE states will be on Gazprom deciding not to manipulate the flows from Nordstream, and on German goodwill.

It is also difficult to see how easily an exemption from unbundling and third-party access could be granted under Article 36. Nordstream 2 does not enhance competition. It merely alters the route of existing gas supplies, which currently transit via Ukraine and CEE states.[24] Equally, by bringing gas via Germany, Nordstream will strengthen Gazprom's already significant market dominance in the German market. Gazprom will also gain market power by having more choices as to where to place gas markets across Europe, using the two sets of Nordstream pipelines, Yamal, Turkish Stream, and the Ukrainian transit route. A dominant market player holding the capacity to choose where supply should be directed significantly increases its market power.

THE DIFFICULTY FOR GAZPROM IS THAT CONSTRUCTING TWO EXTRA PIPELINES INTO GERMANY DOES UNDERMINE THE SUPPLY SECURITY OF THE CENTRAL AND EAST EUROPEAN STATES.

Furthermore, the European Commission is currently undertaking an antitrust investigation into Gazprom, in which it is considering the impact of the exercise of Gazprom's market power. At the very least, the Directorate-General (DG) for Energy is going to have to liaise with the Commission's competition department running the case, DG Competition, in considering the competition issues under Article 36.[25] The Commission will want to ensure a coordinated response to the increase in market power with respect to Nordstream, as well as any Article 36 conditions that may be imposed, and any commitments accepted by DG Competition with respect to the antitrust case.

The likelihood is that the connecting pipelines will be subject to intense scrutiny from both the European Commission and concerned member states. First, a national regulatory authority—probably for Germany, as this is from where the connecting pipelines will run—will have to make a draft decision on certification of the network

22 Neil Buckley, "Hungary Halts Flow of Gas to Ukraine," *Financial Times*, September 26, 2014, http://www.ft.com/cms/s/0/7c5d2bf0-4552-11e4-ab86-00144feabdc0.html; "Ukraine Complains about Reduced Gas Flows from EU," *Euractiv*, July 24, 2014.

23 At the very least, the willingness to trust Germany to provide a dependable source of gas to the CEE states will already be damaged by the publication of the transcript of the meeting between the German Energy Minister and President Putin. See the box with the relevant text of the transcript.

24 With respect to Nordstream 1, Gazprom did identify a new source of supply for one of the strings of the project. There appears to be no credible indication of alternative sources of supply in the new project.

25 In terms of European Commission responsibilities, DG Energy is responsible for the operation of the Third Energy Package, and DG Competition is responsible for the application of the antitrust rules to the energy sector.

operators in compliance with the Gas Directive, considering Article 11 and the application of Article 36. Only then would it be considered by the European Commission. At the very least, it is likely that the Commission will require that Gazprom can only access part of the capacity of any new connecting pipeline.[26]

*The Application of EU Energy Law to the Offshore Pipeline*

However, it is not only connecting pipelines that have to be considered under EU law; Nordstream 2 itself has to be considered. The fact that the pipeline is offshore does not, in and of itself, immunize the project from the application of EU law.[27] For almost 100 kilometers, the pipeline goes through the territorial seas of both Denmark and Germany.[28] It also goes through the exclusive economic zones of Denmark, Germany, Poland, Sweden, Finland, Estonia, Latvia, and Lithuania.

It is difficult to see how the rules of the Gas Directive and accompanying EU legislation do not apply to gas pipelines running through the territorial seas of the member states. The European Court of Justice in *Commission v. United Kingdom*,[29] in discussing the application of the EU Habitats Directive, was clear that EU law applied with respect to territorial seas. The court also applied the Habitats Directive to the exclusive economic zone. One can argue that this extension was exceptional, as the Habitats Directive had objectives similar to those contained in the United Nations Law of the Sea Convention (UNCLOS), in terms of the protection of marine life. However, the court's approach in that case was to argue that member states should apply EU law to the fullest extent of their sovereign rights.[30] In fact, UNCLOS has nothing to say about the governance regime for pipeline structures through the economic zone. Furthermore, one can make a compelling argument that an attempt to use the exclusive economic zone to run a pipeline from a foreign supplier to an EU country, rather than build a pipeline more cheaply on land through several EU states, is tantamount to an attempt to circumvent the application of the EU's energy acquis.[31] If the European Court of Justice (ECJ) takes this view of the use of the exclusive economic zone for the Nordstream pipelines, then it is likely it will be inclined to extend the application of the acquis to those zones.

At the very least, it is difficult to see how Nordstream 2 can avoid the full application of EU law when it enters the territorial seas of Denmark and Germany. There appears to be no legal difference between the application of EU liberalization law to the Yamal Pipeline once it enters EU territory, and to Nordstream 2 once it enters the territorial seas of the member states. Currently, Polish regulatory authorities are seeking certification from the European Commission for their regulatory regime. The Commission has raised a number of questions regarding compliance with the full unbundling requirements of the Gas Directive and application of the supply security requirements of Article 11.[32]

The initial view, with respect to Nordstream 2, is that it is likely to face formidable legal obstacles, both in terms of the main offshore pipelines and the onshore connecting pipelines. EU energy-liberalization law is likely to apply to both, requiring compliance with both unbundling and third-party access rules. This will severely reduce the scope for the amount of gas that can be expected to pass through the pipeline.

*Germany's Attempted Subversion of EU Law in Respect of Nordstream*

However, one could take the view that as long as Nordstream 2 has powerful EU supporters, such as the German government, then EU law can be overcome. This view is supported by the transcript of the meeting on October 28 where the German Energy Minister Sigmar Gabriel met with President Putin outside Moscow (see the box with the relevant text of the transcript). Mr Gabriel, it should be noted, is also German Vice-Chancellor and Chairman of the SPD, the coalition partner in Chancellor Merkel's coalition. At that meeting, Minister Gabriel made it clear that Germany was prepared to avoid 'external meddling' presumably by the European Com-

26 It is possible that the German regulator may decide that the pipeline is only an interconnector, and may seek to impose lesser conditions upon the pipeline, as it did in the case of the NEL Pipeline. However, any such conditions would be subject to review by the European Commission.
27 It is unclear from the literature how the Second Energy Package and existing EU law were not applied to Nordstream 1 at the time of the initiation and permitting, at least in terms of when the pipeline entered the territorial seas of the member states.
28 Here the author assumes the route of the pipeline will be the same as for Nordstream 1.
29 C-06/04 [2005] I-9017 *et seq.*
30 Ibid., paras 117-118.
31 Existing transit costs are $33 per 1,000 cubic meters via Ukraine, and $43 per 1,000 cubic meters via Nordstream. Katya Golubkova, Denis Pinchuk, and Jan Lopatka, "Bypassing Ukraine Will Be Costly say Analysts," *Reuters*, July 16, 2015, http://www.reuters.com/article/2015/07/16/ukraine-crisis-gazprom-idUSL5N0ZV1KM20150716.
32 There is currently an ongoing dialogue between the European Commission and the Polish regulatory authorities about the scope of the EU regime for the Polish section of the Yamal Pipeline. For an understanding of the issues being debated between the European Commission and the Polish authorities, see European Commission, *Commission Opinion Pursuant to Article 3(1) of Regulation (EC) no. 715/2009 and Article 10(6) and 11(6) of Directive 2009/73/EC-Poland-Certification of Gaz-System as the operator of the Polish Section of Yamal-Europe Pipeline*, September 2014, and European Commission, *Commission Opinion Pursuant to Article 3(1) of Regulation (EC) no. 715/2009 and Article 10(6) and 11(6) of Directive 2009/73/EC-Poland-Certification of Gaz-System as the operator of the Polish Section of Yamal-Europe Pipeline*, June 2015.

### Extract of Transcript of Meeting between German Energy Minister Sigmar Gabriel and President Putin, October 28, 2015, Novo-Ogaryovo, Moscow Region.

Sigmar Gabriel: Mr Miller and Mr Matthias Warnig will continue to pursue Nordstream 2 project. This is in our interests; but it is not just in Germany's interests—it is a very interesting project even beyond Germany's borders.

What's most important as far as legal issues are concerned is that we strive to ensure that all this remains under the competence of the German authorities, if possible. So if we can do this, then opportunities for external meddling will be limited. And we are in a good negotiating position on this matter.

And in order to limit political meddling in these issues—you are, of course, aware, this is not just a formality—we need to settle the issue of Ukraine's role as a transit nation after 2019. There are technical reasons for this: you know that Ukraine's gas transportation system is not in very good state. And, of course, the financial and political role it will play for Ukraine, as will the backflow of gas.

As regards everything else, I believe we can handle it. What's most important is for German agencies to maintain authority over settling these issues. And then, we will limit the possibility of political interference in this project.

*Source:* Kremlin's official website, http://en.kremlin.ru/events/president/news/50582.

mission by ensuring that all the legal issues remained under the competence of the German authorities.

It is however very difficult to see how Minister Gabriel will be able to so subvert EU law. Both the application of the so-called Gazprom clause in Article 11 of the Gas Directive, and the Article 36 exemption provision, require the involvement of the Commission. In addition, third parties may well seek review of any German decision ultimately in the EU courts.

One approach that the Russian and German governments may be seeking to take to evade the application of EU law is to suggest that Nordstream 2 is not really under the control of Gazprom. It is noticeable that two weeks after the meeting with the German Energy Minister, Engie, which had agreed to take a 9 percent shareholding in Nordstream 2, suddenly increased its stake to 10 percent, with Gazprom falling to 50 percent.[33] However, the difficulty for the German and Russian governments is that the Gas Directive provides that the concept of control is governed by EU merger law[34]. That law takes a much broader concept of control that is not limited to mere shareholdings. It looks at actual control and influence over an entity. Even a shareholding of 25 percent may be sufficient given the surrounding commercial relations and past history to give Gazprom control for the purposes of the Directive.

Although Germany is the single most powerful country in the European Union, it does not own the EU, or EU law. It is extremely difficult to see how the German government can exclude 'external meddling' from the European Commission seeking to ensure uniform application of EU law across the whole territory of the Union. It will also be difficult to reduce Gazprom's shareholding in a way that will permit the company to escape the concept of control in EU law.

The Russian government may have sought in publicising the extent of German-Russian co-operation to push the German government to openly support Nordstream 2. It is likely that the actual effect of the transcript's publication is the opposite. It has first alerted the European Commission to the extent of the willingness of the German government to subvert EU law, as well as the Central and Eastern European states. Secondly, the negative reaction to the publication of the transcript is likely to make German and corporate co-operation in evading EU law much more difficult to deliver.

## Conclusion

The overarching problem with Nordstream 2 is that the political context is so utterly different than that in the first decade of the twenty-first century, when there was a more cooperative relationship between the Russian Federation and the European Union. It is difficult to see how, for instance, the EU can support Nordstream 2, which will strip Ukraine of at least $2 billion in revenue and undermine its role as a major shipper of gas to Europe, while the EU is also seeking to stave off Ukraine's collapse. The EU and the United States provided $17 billion in financing to Ukraine via the International

33 Neil Barnett, op. cit.
34 Gas Directive, op. cit, Recital 10.

Monetary Fund. Both the EU and the United States are seeking to provide additional aid, and promote economic and legal reform in the country. Protecting Ukraine from collapse and promoting reform have become major objectives of the EU's external policies. It is difficult to understand, therefore, why the EU should see any reason to support Nordstream 2, which has the effect—and, almost certainly, the intention—to undermine Ukraine. Equally, the European Union has committed itself, via the Energy Union program, to radically transform its energy markets. At the core of the Energy Union program is a commitment to reduce the supply dependency in the gas markets of member states that significantly depend on Gazprom. Nordstream also cuts across this objective. It seeks to undermine the supply security of states in Central and Eastern Europe, reducing their direct access to gas supplies and increasing their supply dependence on Gazprom. Again, it is difficult to see why the European Union should give any support to this project, given its negative impact on supply security. Even substantial German cooperation and willingness to subvert EU law is not sufficient to overcome the changed political landscape in EU-Russia relations.

One can also note that, whether or not falling foul of EU policy objectives is enough to make Nordstream undeliverable, the fiscal and legal obstacles will suffice to do so. It is open to question how easy Gazprom will find it to raise the financing for an expensive natural gas pipeline in a shrinking market—where new competition is expected to enter the market, where further shrinkage may well occur, and where there is a considerable aversion to the product within the customer base. This is reinforced by the prospect of investors being deterred by the potential impact of sanctions and of Yukos claims. Brave investors, for a price, may ultimately be willing to provide funds to Gazprom. But at the very least, the cost of capital will not be cheap.

The legal problems also impact upon the obstacles to raising capital. If both the offshore and connecting pipelines are subject to the full application of EU energy law, it is difficult to see how more than half the capacity of the pipeline will be able to be utilized in the market. Investors will be faced with the prospect of investing in a 55-bcm/y pipeline project, only half of which will be utilized.

The further difficulty Gazprom faces is that Nordstream 2 is likely to be subject to far greater scrutiny than Nordstream 1. Member states now have a greater understanding and experience of the rules than they did when Nordstream 1 was under construction, and can insist on full application. There is also the prospect that issues, such as application of the EU rules to the offshore pipeline network, may well be litigated all the way to the ECJ, further delaying the commencement of the project.

There is also a question as to whether some member states may ask the Commission for an investigation of Nordstream 1's compliance with the current law. If the Polish section of the Yamal Pipeline had to be adapted to be in compliance with EU law, then surely Nordstream 1 also must be brought into full compliance with EU law as well.

MEMBER STATES NOW HAVE A GREATER UNDERSTANDING AND EXPERIENCE OF THE EU RULES THAN THEY DID WHEN NORDSTREAM 1 WAS UNDER CONSTRUCTION, AND CAN INSIST ON FULL APPLICATION.

The EU could also respond to Nordstream 2 in other ways. For instance, it could increase the capacity of the British and Spanish interconnectors, making it possible to make greater use of the 110 bcm/y of Anglo-Spanish gasification capacity. Greater capacity across the English Channel and the Pyrenees, combined with additional interconnectors to carry LNG-sourced gas into Central and Eastern Europe, could substantially offset the impact of Nordstream 2.

No doubt, Moscow and its allies within the EU will lobby hard for Nordstream 2. However, on this occasion, they may have taken on a project that is undeliverable, or only deliverable on terms they do not want to finance and will not deliver the market access they are seeking.

# Atlantic Council Board of Directors

The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.



1030 15th Street, NW,
12th Floor,
Washington, DC 20005

(202) 778-4952

**AtlanticCouncil.org**