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German regulator opposes preferences for Nord Stream 2

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On May 15, Germany's Federal Network Agency (*BNetzA*) rejected the Nord Stream 2 company's request to grant the Nord Stream 2 pipeline derogations from the EU's gas directive. The agency did not share the economic and functional interpretation of the 'completion' criterion which the applicant had advocated. Under the 2019 amendment to the gas directive, the regime of the EU's Third Energy Package was partially extended to cover gas pipelines from third countries which end on the territory or in the territorial waters of an EU member state. The modified provisions of this directive were punctually implemented in Germany in December 2019 by amending the federal law on electricity and gas supply (*EnWG*).

The directive, and thereafter German law, provides for the possibility of waiving the application of EU regulations, subject to certain conditions. On 10 January Nord Stream 2 took advantage of this option to apply for this derogation, pursuant to Article 28b of the *EnWG* (reference number BK7-20-004). On 17 March 2020, the Polish state gas company Polskie Górnictwo Naftowe i Gazownictwo and its German subsidiary PGNiG Supply & Trading were summoned to the proceedings.

The application for derogation from the directive's regime was submitted even though the construction of the gas pipeline was not completed before the stated deadline of 23 May 2019. On the basis of the submitted legal opinion, the company opposed the adoption of a 'narrow understanding' referring to construction and technical conditions. It demanded that the scale of irreversible expenditure undertaken by the investor *before* the modification of the gas directive came into force be taken into account in confidence in the legal status. This argument was questioned by the German regulator who focused on the actual situation.

BNetzA is required to publish the text of the decision, which it has not yet done. In addition, the agency announced the publication of the contributions of the ten member states that took part in the consultations pursuant to Article 49a (2) of the gas directive once they have provided permission to do so. According to the agency, none of the opinions submitted shared Nord Stream 2's arguments regarding the interpretation of the 'completion' criterion.

Consequences for Gazprom

The German regulator's decision confirmed the importance of the actions delaying the construction of the gas pipeline, starting with the prolongation of the process of obtaining construction permits (which lasted longest in the case of Denmark, which took until 30

October 2019 to give its consent). In addition, the pipe-laying process was suspended due to the US sanctions at the end of 2019. The Swiss company Allseas withdrew from construction as a result of the American restrictions. Allseas' contribution could be replaced by a specialist Russian ship, the *Akademik Cherskiy*, which the Russians brought to the Baltic. The second half of 2020 or the beginning of 2021 are currently being given as possible dates for completing the work and commissioning the pipeline.

Although the decision by BNetzA will not affect the process of completing Nord Stream 2's construction, there may be negative consequences for Gazprom when the gas pipeline is launched. First, applying the third-party access rule to the German section of the pipeline will prevent the Russian company from making full use of the Nord Stream 2's capacity. Maintaining this restriction would result in financial losses for the Russian company, reducing its investment returns. Secondly, due to the EU regulations in force in Germany's territorial waters, Gazprom could not become both owner and operator of the whole new pipeline. In accordance with the ownership unbundling principle, the same entity cannot be both a gas supplier and an owner & operator of the infrastructure via which the gas is supplied. In addition, when the operator of the pipeline's German section is established, that decision will require certification by the European Commission.

Maintaining the restrictions resulting from EU law would prevent Russia from achieving one of its major foreign energy policy goals, which is to become independent of transit routes passing through third countries. The Nord Stream 1, Nord Stream 2 and TurkStream projects are intended to allow all Russian gas transmission to be diverted from the Ukrainian route to new pipelines.

At the same time, the decision by BNetzA and the other difficulties related to the Nord Stream 2 project will not hamper Gazprom's operation on the European market in the medium term. The existing infrastructure and normative base, in particular the new five-year transit contract concluded with the Ukrainian company Naftohaz in December 2019, still give the Russian company the opportunity to fulfil its contractual obligations to European customers.

However, attempts to influence German public opinion can be expected, e.g. by disseminating information on additional costs for German gas consumers resulting from the rigours of EU law. It is also likely that the project's promoters will further stoke anti-American sentiment in Germany, especially if continuing the construction work with the *Akademik Cherskiy* leads to the US sanctions being extended.

Further steps by Russia

Although Russia's reactions have so far been very restrained, we should expect both representatives of the Russian government and Gazprom to continue their efforts to get the Nord Stream 2 gas pipeline excluded from the restrictions resulting from the EU's energy law.

First, the Nord Stream 2 AG company, which is controlled by Gazprom, has already suggested that BNetzA's decision could be appealed. NS2 may appeal to the Higher Regional Court in Düsseldorf within one month of the decision (under Article 78 of the Electricity and Gas Supply Act). If this happens, the German court could submit a request to the EU Court of Justice to interpret the ‘completion’ criterion in the gas directive by way of a preliminary ruling, which would postpone the outcome of the case.

Secondly, we should expect a continuation of the actions taken in 2019, the aim of which is to annul the amendment to the gas directive. In July 2019, Nord Stream 2 appealed against the directive to the EU Court of Justice, bringing a case against the EU Council and the European Parliament. In turn, in September 2019, the company appealed the amended gas directive to the Arbitration Court. The company claimed that the adoption of the amendment represented a violation of the principles of the Energy Charter Treaty, in particular the regulations regarding the protection of investments. Both proceedings are currently in their initial phase; no details of the Nord Stream 2 company’s arguments are yet known. Thus, at this stage it is difficult to determine what the final result of these proceedings may be.

Thirdly, we should also expect that Russia – irrespective of its attempts to question the legality of the EU restrictions – will attempt to find other ways to circumvent EU law. In March 2019, in an article published in the *Financial Times*, it was reported that Gazprom intends to use the limitation of the geographical scope of the directive for this purpose. According to the amended directive, the application of EU law is limited to the territorial waters of an EU country where the cross-border gas pipeline ends. The variant being considered by Russia is based on setting up separate entities to manage individual sections of the NS2 pipeline: one for the section running through German territorial waters (around 4% of length of total infrastructure) and another for the remainder, running through Danish, Swedish, Finnish and Russian waters. One entity would be the owner and operator of the German section, which would be subject to the provisions of EU law, whereas the other (which would most likely be completely controlled by Gazprom) would be responsible for managing the remaining part of the pipeline, which in accordance with the amended gas directive would not be covered by EU regulations. The German *Handelsblatt* also wrote in November 2019 about the possibility of such a solution being considered. This option would allow Gazprom, through the Nord Stream 2 AG company, to retain its control over the vast majority of the infrastructure being built, which would certainly translate into financial benefits from its operation.

Another option would be to follow the path provided for in the amended gas directive, which allows EU member states to conclude intergovernmental agreements with third countries on the operation of transmission lines. However, commencing negotiations requires authorisation from the European Commission. The EC may not authorise such negotiations if it considers that the agreement would be contrary to EU law; would be detrimental to the functioning of the internal natural gas market, or to competition or the security of supply in one of the member states or in the EU; would undermine the objectives of pending negotiations of intergovernmental agreements by the EU with a third country; or would be discriminatory. In addition, when granting authorisation, the EC assesses whether the intended agreement concerns pipelines that contribute to the diversification of natural gas supplies and suppliers by means of new natural gas sources. In addition, the final text of the negotiated agreement must be approved by the European Commission.

Fourthly and finally, it can be expected that if Russia’s actions aimed at undermining the legitimacy of EU restrictions and its unsuccessful attempts to circumvent EU law end in failure, then Moscow will take some other measures to adapt to the situation. Firstly, these could revolve around a partial change in the rules for trading Russian gas with European customers, e.g. by selling the gas at the starting point of the Nord Stream 2 gas pipeline, i.e. while still on Russian territory. Less likely would be measures to limit Gazprom's monopoly on exporting gas via the pipeline system. Such a decision could destabilise the balance of power in Russia's energy sector by opening up a discussion on broader changes in how the domestic gas market operates, something which the Russian government is currently not interested in.