



The proposed Gas Directive amendment and the EC-Gazprom settlement

Could the proposed Gas Directive amendment compromise the progress made in the Gazprom dispute settlement?

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Introduction

During the spring of 2018, after seven years of deliberations, the European Commission concluded its investigation of Gazprom regarding alleged abuse of its market position in Central and Eastern European gas markets. The outcome is a finely crafted settlement setting out rules and guidelines for acceptable future market behavior. As the settlement is based on mutual agreement, while at the same time accepted by the European Commission as adequate to bring a locally dominant competitor to heel, it has a good chance of succeeding. This settlement completely changes the context within which the proposed Gas Directive amendment was formulated. From this point of view, it seems surprising that the proposed amendment, which adds very little to the enhancement of competition in these markets, is still being discussed without reference to these changed circumstances. Not only could it potentially put at risk what has been achieved in the settlement but, it might also endanger future investments in incremental gas infrastructure in a number of areas of the European Union.

This report is a supplement to a previous report, "Analysis of the proposed gas directive amendment," that was published in March 2018. The work has been commissioned by Nord Stream 2.

1. Background

In September 2012, the European Commission opened formal proceedings against Gazprom for possible abuse of a dominant position in several gas supply markets in Central and Eastern Europe. In 2015, the allegations were more precisely formulated in a Statement of Objections, claiming that Gazprom was pursuing a strategy to divide gas markets, in breach of EU anti-trust rules, that prevented competition in the markets of Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia. The claim was based on three issues: (1) territorial restrictions on the resale of gas (2) unfair pricing policies, and (3) use of a dominant position to obtain unrelated commitments concerning transport infrastructure.

Figure 1: The eight affected member states and their pipeline connections with Russia



Source: Arthur D. Little

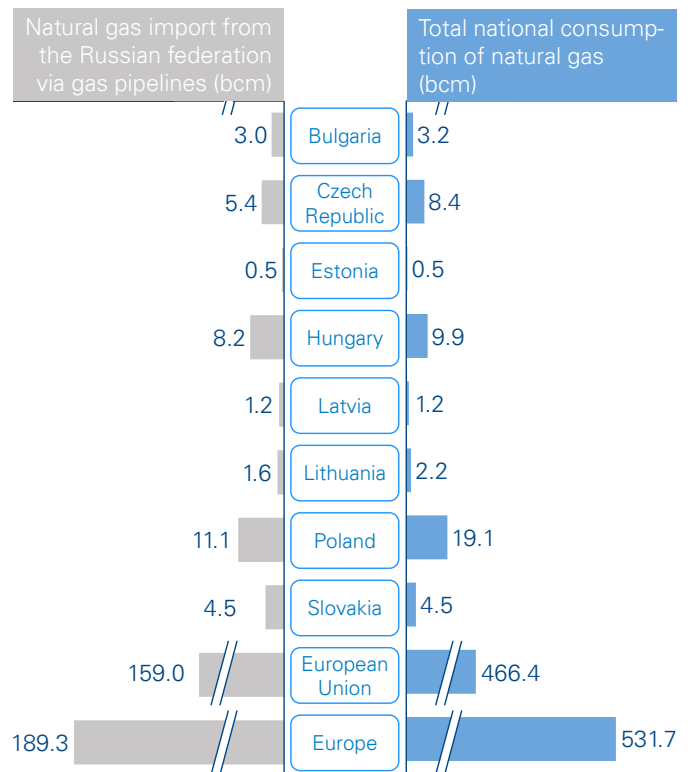
“These obligations address the Commission’s competition concerns and achieve its objectives of enabling the free flow of gas in Central and Eastern Europe at competitive prices.”

European Commission – Press Release 24 May 2018 – Antitrust: Commission imposes binding obligations on Gazprom to enable free flow of gas at competitive prices in Central and Eastern European gas markets

As can be seen from Figure 2, both consumption and imports from Russia in the affected member states are relatively small in comparison to the EU as a whole, and their import dependency on Russian gas is much higher.

It is noticeable that both Poland and the Czech Republic imported significant volumes from sources other than Russia in 2017.

Figure 2: Consumption and imports from Russia in the eight affected member states in 2017



Source: BP Statistical Review 2018.¹

¹ The following country-specific assumptions were made: (a) Bulgaria: import via pipelines from the Russian Federation assumed to be approximately 93 percent of the country’s natural gas consumption (source: Gazprom, 2016). (b) Lithuania: import via pipelines from the Russian Federation assumed to be equal to approximately 73 percent of the country’s natural gas consumption (source: European Network of Transmission System Operators for Gas, 2017-2018). (c) Europe: Turkey included (source, BP, 2017-2018)

Gazprom responded in 2016 with a proposal for commitments to alter its market behavior. It offered to remove all contractual barriers to the free flow of gas in Central and Eastern Europe. It also agreed to remove contractual barriers in export contracts to Bulgaria and Greece that prevented transmission system operators (TSOs) from making interconnection agreements with neighboring states. In addition, it offered existing buyers the right to change the delivery point of gas. And, last but not least, Gazprom offered to introduce competitive pricing benchmarks, including western hub prices, into its price review clauses, and to increase the frequency with which such reviews might occur². The recent settlement between the European Commission and Gazprom builds on these commitments, which are, each on its

own and in combination, important concessions and a significant step forward in terms of improving competition in Central and Eastern Europe, since they, as we shall see below,

- (1) enable the free flow of gas across borders to any buyer willing to pay competitive prices for commodity and transport,
- (2) provide buyers with influence over preferred delivery point, and
- (3) ensure that gas prices in Central and Eastern European markets reflect prices at competitive Western European hubs.

² Stern & Yafimava, OIES, "The EU Competition Investigation into Gazprom's Sales to Central and Eastern Europe – a comment on commitments," April 2017

2. Details of the May 2018 settlement³

In May 2018, the European Commission adopted a decision to settle the dispute with Gazprom in order to end its alleged anti-competitive behavior. The settlement imposes on Gazprom a set of rules, building on the commitments proposed by Gazprom in 2016. Combined, these obligations address the Commission's concerns and achieve its objectives. The obligations are legally binding; if Gazprom is found to have broken any of them, it can be fined up to 10 percent of overall turnover. Feedback on the proposed rules was collected from a wide range of stakeholders and used to refine the rules to ensure maximum efficacy. The provisions of the settlement include four different areas of mandatory action for Gazprom in Central and Eastern Europe:

1. Remove contractual barriers to the free flow of gas across European countries

This provision requires Gazprom to remove from existing export contracts any restrictions on the resale of gas, either domestically or internationally. Destination clauses and export bans have long been present in contracts with buyers in the eight countries concerned. Their purpose has been to prevent downstream buyers from profiting from price differentials by reselling gas bought from Gazprom at a higher price elsewhere. Such differentials can occur due to unexpected demand spikes, sudden oversupply, congestion, or other unforeseen events. These opportunities would otherwise only have been available to Gazprom which, in addition, would have had a strategic lever not to sell gas, despite the presence of a willing buyer, for example to maintain price levels. Gazprom will now refrain from introducing such clauses in future contracts. This means any holder of gas bought from Gazprom will be free to resell it to any buyer willing to pay a competitive price. It also means gas can flow freely between market players downstream of Gazprom, within or across country borders.

2. Obligation to facilitate gas flows to and from isolated markets, and thus promote competition

The free flow of gas between markets also requires that interconnectors with spare capacity which can allow this to happen are in place. This is already the case for some markets in Central and Eastern Europe, but not for all. Bulgaria, Estonia,

Latvia and Lithuania are not yet sufficiently connected to neighboring markets. In order to alleviate this lack of access, Gazprom will allow relevant buyers to take delivery of gas in these countries, or buyers in these countries to resell volumes elsewhere. This means buyers will be able to take delivery in countries other than their own home markets and swap gas with other buyers even if there is no direct physical access. This option will be available for all customers with contracts of more than 18 months duration, both to and from isolated markets. Gazprom can only refuse such swaps if there is no capacity available to carry them out - something that will be monitored by an external trustee.

Thus, gas buyers in Central and Eastern Europe will be able to benefit from cross-border trading of gas originally bought from Gazprom, even if the gas is not moved physically between markets. For example, a buyer in Bulgaria that has excess gas bought under contract from Gazprom can resell it to a customer in Slovakia, and request that Gazprom delivers the relevant volume at the exit point in Slovakia, reducing the flow to Bulgaria accordingly. The fees that Gazprom can charge for this service are fixed and transparent, and set to make the arrangement financially attractive. This will enable customers in isolated markets to seek new business opportunities as if interconnectors were already in place. This provision is a very important part of the settlement. Even if its wording is limited to the seven countries concerned, it opens up for other European buyers to make similar requests. As noted in a 2017 OIES study⁴: "In particular it suggests that any future refusal by Gazprom to grant a request (made by any of its European buyers [...]), to change a delivery point could be considered anti-competitive. This could be relevant, for example, in respect of gas transit across the Ukraine, making it more difficult for Gazprom to refuse a request to move delivery points to the Russia-Ukrainian border."

3. Employ structured process to ensure prices are competitive

Gazprom will be obligated to ensure that prices of gas bought under long-term contracts are and will remain competitive with Western European hub prices. For existing contracts in

³ European Commission Press Release 24/5/18: Antitrust: Commission imposes binding obligations on Gazprom to enable free flow of gas at competitive prices in Central and Eastern European gas markets

⁴ OIES 2017: The EU Competition Investigation into Gazprom's Sales to Central and Eastern Europe: a comment on commitments – Stern & Yafimava

Lithuania, Latvia, Estonia, Poland and Bulgaria, customers are entitled to request price reviews if prices are not in line with Western European benchmarks. The Czech Republic, Slovakia and Hungary were not included since they already have access to Western pricing via interconnections.⁵ This right can be exercised immediately after the Commission’s decision and again every two years. Any new prices must be set in line with price levels in competitive Western European gas markets, including the liquid gas-trading hubs. If no agreement is reached within 120 days after the request of a price review, the case can be referred to arbitration. This obligation guarantees that Gazprom will not be able to impose prices higher than relevant equivalents in Western Europe, even if prices in existing contracts are set via oil-indexed formulae. Western European benchmarks and hub prices thus set a cap on what can be charged for gas in Central and Eastern Europe. The obligation applies to all contracts, existing and new, with durations of three years or more. The impact of this change will most likely be to move all gas pricing in Central and Eastern Europe towards using Western European hubs as reference prices.

4. No leveraging of dominance in gas supply

The Commission has been concerned that Gazprom has used its dominant position in the gas supply market to obtain undue advantages with regard to access or control of infrastructure. These concerns applied particularly in two cases: the South Stream project in Bulgaria and the Yamal (EuRoPol) Pipeline in Poland. As regards South Stream, Gazprom will not seek damages as a result of the cancellation of the project, regardless of whether any benefits have been obtained. As regards the Yamal pipeline, the European Commission has found that the operator, EuRoPolgaz (co-owned by Gazprom) has not been able to block or delay any investments requested by the TSO, Gaz-System. Although no guilt has been proven, Gazprom will commit to refraining from influencing decisions regarding infrastructure to its advantage in the future.

Figure 3: Overview of the Gazprom Settlement⁶



Source: European Commission

In conclusion, with these mandatory rules in place, the pre-conditions for anti-competitive behavior by Gazprom in Central and Eastern Europe seem to have been removed. Moreover, these terms also pave the way for limiting any anti-competitive behavior in other parts of Europe, and enough transparency has already been achieved throughout Europe to allow market participants to quickly detect any rule-breaking elsewhere. Perhaps most importantly, given the rationale behind the proposed amendment to the Gas Directive, the settlement provides a mechanism through which buyers can influence the infrastructure used to deliver their gas, by requesting a different delivery point. Thus, it will be possible to prevent some infrastructure (for example, that which runs through Ukraine) from becoming less utilized than otherwise desired.

5 http://europa.eu/rapid/press-release_MEMO-17-554_en.htm

6 The obligation for adjusting prices does not apply in the Czech Republic, Slovakia and Hungary because these markets are already sufficiently linked to the Western European gas system

3. What does the settlement mean from the perspective of the proposed Gas Directive amendment?

The proposed Gas Directive amendment, as we have discussed in a previous report⁷, suggests that to complete the internal market for gas, it is necessary to extend the application of the Gas Directive to import pipelines from third countries, regulating them in the same way as any EU-internal pipeline. While this amendment may sound uncontroversial, it has some thought-provoking implications:

- (1) It suggests extending the EU's internal market rules to international waters, governed by the United Nations Convention on the Law of the Sea (UNCLOS) – potentially bringing EU regulation in conflict with those laws;
- (2) It imposes on entities owned by and/or subject to the regulation regimes of third countries (outside EU territory) an obligation to demerge their activities. It thus infringes on the property rights of foreign owners, without consideration for the regulatory regime of the third country and the detrimental impact such a requirement could have in the home territory of that foreign entity;
- (3) It fails to demonstrate that its adoption will have any positive influence on competition and integration of the European gas market.

From a political angle the amendment to the Gas Directive is an instrument that might be used to influence decisions about

whether particular gas pipelines from third countries, including Nord Stream 2 among others, should or should not be built, but at the price of collateral impact on all affected import pipelines.

Adoption of the proposed Gas Directive amendment, whether in its current or some future amended form, is still under evaluation by the EU Council. The key question here is whether the European Commission Gazprom settlement has any bearing on that evaluation. The implications of the settlement have shifted the context within which the amendment was first proposed, and it has created a new market environment, one in which Gazprom, both legally and through its own commitments, cannot abuse any dominant market position it might have. From that point of view, it seems a relevant and important change which needs to be recognized in further deliberations on the potential consequences of the Gas Directive amendment. This suggests that a detailed impact assessment would be appropriate.

At the very least, it would seem prudent to allow the effects of the settlement to sink in and become both broadly understood and apparent. This would allow the markets time to adapt fully to this new market reality before introducing further changes through more new regulation.

⁷ http://www.adlittle.com/sites/default/files/viewpoints/adl_review_gas_directive_amendment.pdf

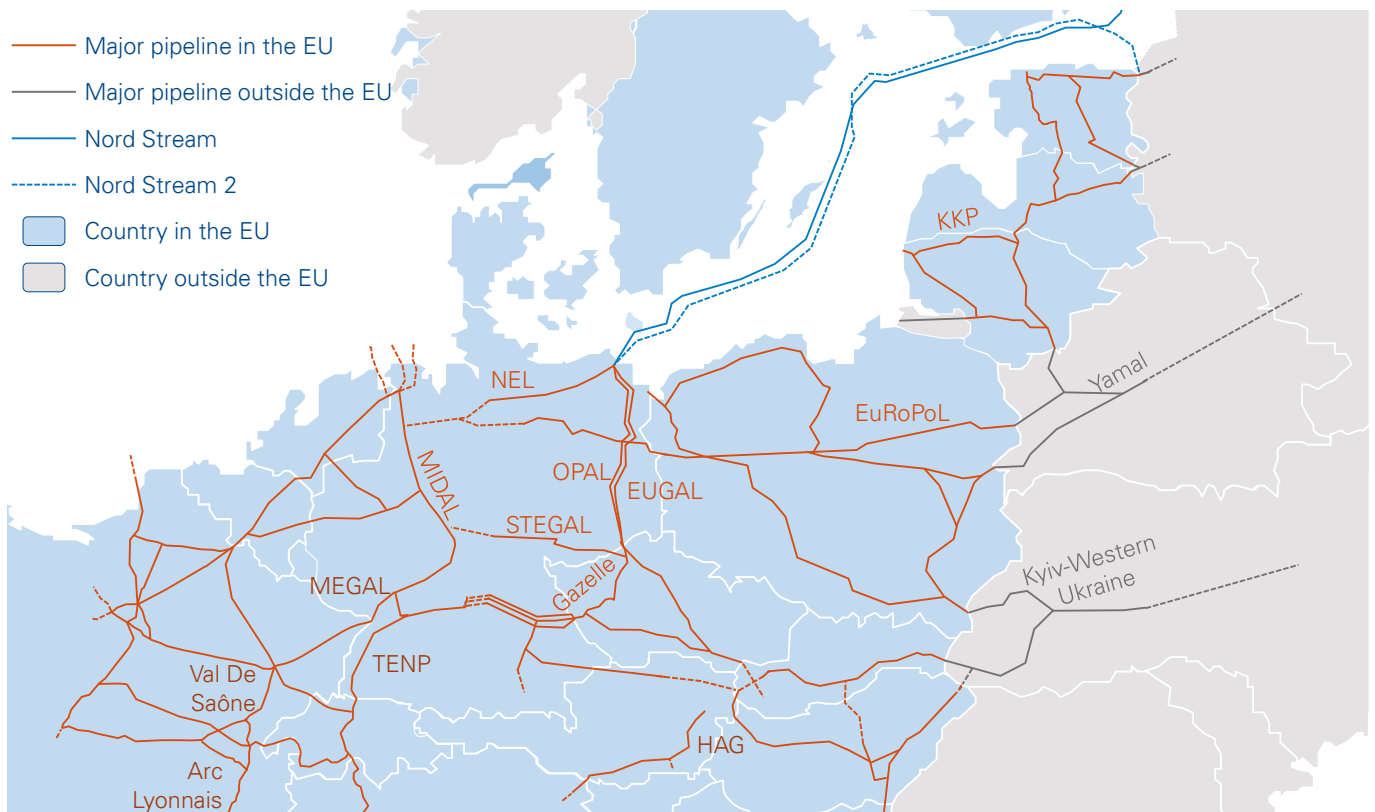
4. Other potentially damaging consequences

As argued in a recent study of the Oxford Institute of for Energy Studies⁸, the negotiating position of the European Commission vis-a-vis the Government of the Russian Federation over pipeline projects such as Nord Stream 2 is weak, even if the amendment is adopted.

Not only does it create a conflict with already agreed and approved contracts for utilization of the EUGAL pipeline (which connects to Nord Stream 2), it also violates the principles of legal certainty and legitimate expectations, since the amendment was proposed after the Nord Stream 2 project was initiated, without any safeguards for ongoing

investments. Should the European Commission proceed with inter-governmental negotiations with the Russian Federation to enforce the amendment, it thus risks legal consequences. It is far from certain what will happen if an agreement cannot be reached. Ultimately there might be a supply risk for gas to the European Union. The negotiating position of the European Commission is further undermined by the recent ruling (August 2018) of the WTO's Dispute Settlement Body⁹ on the complaints of Russia against the European Commission's Third Energy Package, finding that:

Figure 4: The Nord Stream pipelines and connections with the European gas system¹⁰



Source: ENTSOG

8 Yafimava, OIES, "Building New Gas Transportation Infrastructure in the EU – what are the rules of the game?," July 2018.
 9 European Union and its Member States–Certain Measures relating to the Energy Sector-Report of the Panel–Conclusions and Recommendations-WT/DS476/R
 10 Pipelines inside the EU (in orange) are covered by EU regulation.

- (a) Restricting flows through the OPAL pipeline to maintain flows via Ukraine (leaving Nord Stream underutilized) was unlawful;
- (b) Imposing certification rules on foreign-owned entities in Lithuania, Hungary and Croatia was against WTO rules;
- (c) Granting certain preferred infrastructure projects status as Projects of Common Interest, in order to promote imports from some sources over others, was discriminatory.

This demonstrates that even if the European Commission is acting with the best of intentions, and its best understanding of its own interests, it is not always clear that its proposals and decisions are in line with free trade and free market principles, or indeed with existing, applicable law.

Liberalization, regulation, integration and harmonization over the years have created a complex trading environment in which the consequences of an action in one area on another are

difficult to foresee. In particular, where political motives rather than commercial ones are driving the agenda, the risks of creating new problems while apparently solving others are both significant and obvious.

In addition to these concerns, parties contemplating the building of future gas-export infrastructure to Europe will be aware of the risks of the rules potentially changing, mid-journey, and may prefer other options instead, such as LNG or other, non-EU markets. This may lead to higher gas prices in Europe.

Overall it seems, that the settlement with Gazprom is further improving the functioning of European gas markets. The settlement seems to call into question the rationale of the proposed amendment to the Gas Directive and the viability of the arguments used to support it. It remains the case that we do not consider it a viable instrument for regulation.

Conclusion

The recent settlement of the dispute between the European Commission and Gazprom is a landmark decision that will benefit markets in Eastern, Central and other parts of Europe that import Russian gas for decades to come. Although it has taken time to deliver, this settlement has effectively dealt with one of the most difficult problems in the European gas market, namely how to persuade an external gas supplier to abide by internal EU market rules, to the benefit of both parties. The effects of the settlement will be felt through greater transparency, increased trust and market confidence, and lower barriers to market integration and trade. This will undoubtedly benefit all market participants. In addition, it has changed the market environment within which the proposed amendment to the Gas Directive was formulated, and should be taken into consideration when reviewing its potential effects.

Such agreements, whether voluntary or the results of dispute settlements, are a much better, sharper and more effective instrument than the very broad-brush, draft legislative action currently being considered. It aims to deal with only one piece of infrastructure, but risks affecting others as well.

With the settlement in place, the proposed Gas Directive amendment is even less necessary than before. It risks creating effects that could be detrimental to both market functioning and consumers, and could even cause unnecessary hurdles for the construction of new pipelines, where ever they may come from.

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