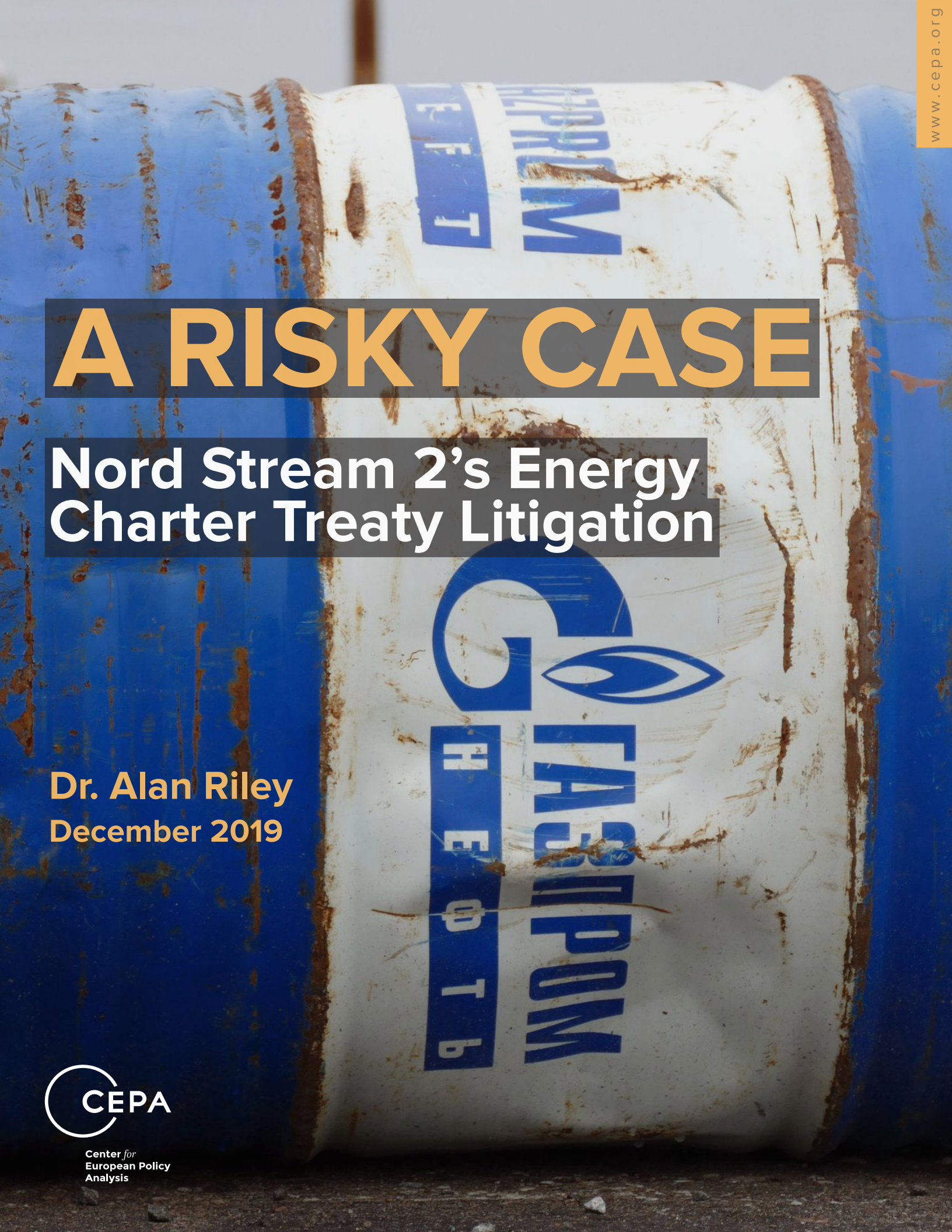

A RISKY CASE

Nord Stream 2's Energy Charter Treaty Litigation

Dr. Alan Riley

December 2019

CEPA
Center *for* European Policy Analysis

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The Issue

From the Editor: *Russia is often described as a status quo actor in the international system which seeks to play the role of a great power. The reality is quite different. Whether in arms control, or through its membership in a wide variety of multilateral institutions, Moscow seeks to transform the global order either by manipulating those institutions in order to advance Russian security and commercial interests or by hollowing them out entirely. The saga of Gazprom-backed Nord Stream 2's lawsuit against the European Union illustrates the Kremlin's approach.*

Nord Stream 2 is suing the EU under the Energy Charter Treaty. It may not end well for the *Gazprom*-backed pipeline company, which alleges that the EU's April 2019 amendment to the 2009 Gas Directive discriminates against import pipelines and is intended to undermine the value of its investment in the project. Although this litigation case has been widely publicized, upon closer examination, its argument is highly flawed and wrongly assumes that the company has acted as a responsible investor. What does this mean for the pipeline project, which is nearing completion?

INTRODUCTION

On September 26, 2019 the *Gazprom*-owned company Nord Stream 2 (NS2) served a notice of arbitration on the European Union under the Energy Charter Treaty (ECT). NS2 alleged that the European Union, by enacting an amendment to the Gas Directive 2009 in April 2019 (Directive 2019/692) which extended the 2009 Directive to import pipelines, had unlawfully discriminated against the pipeline company. This discrimination, NS2 argued, was targeted, deliberate, and had the effect of undermining the value of its investment. This discrimination, it argued, was therefore tantamount to expropriation under the investment protection provisions of the ECT. The publication of the notice of arbitration resulted in a flurry of media headlines suggesting that the EU would end up paying billions of euros to NS2. However, on closer examination, the flaws in NS2's case, together with the prospect of extensive document discovery, suggest that the ECT litigation will fail. Rather than this litigation being a brilliant winning strategy it looks in fact closer to being the desperate and unwise act of a pipeline company running out of options.

NORD STREAM 2'S PLAUSIBLE LEGAL CHALLENGE TO THE EU

At first sight, NS2 appears to have a case. Clearly part of the motivation for formally extending the Gas Directive 2009 to import pipelines was to bring NS2 within its scope. By the time the legislation was enacted, NS2 had already made a final investment decision and constructed approximately 40% of the pipeline on the seabed. The amending directive also applies the full weight of the EU energy liberalization regime to all pipelines completed after May 23, 2019. As a consequence, NS2's line of argument that it had fundamentally committed itself to take on the risk of investment before the legislation came into force appears reasonable.

It also appears to be a reasonable argument that the legislation should apply on the basis of whether the risk of the investment has been taken on by the May deadline. NS2, the pipeline company argued, was more a completed pipeline—with investment costs already sunk—than an uncompleted pipeline where no investment risk has been taken.

Essentially, NS2 argued that it had made the investment and then found itself dealing with a regulatory regime that it had not anticipated. Its investment had been prejudiced by the new

"**Essentially, NS2 argued that** *it had made the investment* and then found itself dealing with a ***regulatory regime that it had not anticipated***."

legislation and been subject to unreasonable and discriminatory measures by the EU in breach of the ECT. This treatment was tantamount to expropriation under the ECT for which the pipeline company could obtain substantial damages against the EU.

LACKING A PERMIT: IS NS2 A RESPONSIBLE INVESTOR?

However, on closer examination, NS2's line of argument looks far from strong. The first problem is that it moved to execute the project without all the route permits in place. In other words, the final investment decision

> "**However, on closer examination,** NS2's line of argument ***looks far from strong***."

and the move to construct the pipeline were taken without all the route permits, which are vital to complete the project. In particular, NS2 proceeded without the Danish route permit in place, which it only obtained in late October 2019. It cannot commence construction work until late November 2019 at the earliest, six months after the legislation came into force. Furthermore, route permits—even in the Exclusive Economic Zone—can be refused on environmental and safety grounds. The EU has a compelling argument that by proceeding to execute the project and taking on the risk of the project before all the permits were in place, NS2 was acting as an irresponsible investor. It took on unnecessary risk and cannot claim that its investment risk capital was prejudiced by the EU legislator enacting the EU directive.

This argument may well be reinforced in the course of ECT proceedings, where the EU can make substantial discovery demands of NS2. It can seek information from NS2 about why it decided to invest and proceed with construction before all the permits were in place. NS2's case would be substantially on the backfoot if the reason for the project's haste was to construct as much of the pipeline as possible before the new EU legislation was enacted. And if the reason for haste was an attempt to position the pipeline to make the present ECT claim, this would significantly undermine its case. NS2 would also be under pressure if the project was rushed in order to construct the pipeline as far as possible before the Russian-Ukrainian gas transit contract expires on January 1, 2020. Evidence of such a geostrategic motivation—permits or no permits—would undermine NS2's ECT claims.

DOES THE EU HAVE A LEGITIMATE INTERESTS DEFENSE?

A further problem for NS2 is that the EU is permitted, under ECT rules, to raise legitimate objective justifications for its legislation in its defense. Contrary to NS2's claims, the EU clearly has legitimate policy objectives in play. For instance, by imposing the same rules on import pipelines as it does domestic pipelines, it aims to create a single regulatory playing field.

Equally, EU liberalization rules on ownership unbundling regulation, third party access, and tariff regulation, combined with the express supply security assessment required under Article 11 of the Directive, protect legitimate EU interests. These include ensuring additional natural gas supplies, enhancing competition, functioning of the single market, and supply security. They already apply to pipelines within the EU, so it is difficult to make a compelling case that import pipelines are being targeted or expressly discriminated.

Furthermore, NS2 clearly threatens these legitimate EU interests. The pipeline does not provide any additional gas supplies to the EU; it merely shifts gas flows from the Ukrainian Brotherhood pipeline to NS2. By flooding the west-to-east EU pipeline interconnectors, gas flows from NS2 split the EU gas market in two. With gas flows from NS2 running through CEE states on pipelines controlled by *Gazprom* and its allies, the company's market power will be increased across the region. The CEE states currently have some transit security as gas flows from the Brotherhood pipeline flow further west into Western Europe. NS2 removes that transit security.

As a consequence, the EU has a compelling argument that the new legislation was a timely, proportionate, and legitimate response to a legitimate threat to EU interests. Brussels can therefore defend its legislation, arguing that it was seeking to achieve legitimate policy objectives in a proportionate manner. This raises another danger for NS2: that the litigation will expose the extent to which the pipeline is damaging European policy and security interests.

There is another connected and problematic question for NS2, which is arguing that it should not be subject to the full weight of EU energy liberalization rules, but rather the much softer derogation regime under the new legislation. However, the derogation regime envisages a completed pipeline undergoing a regulatory assessment of the pipeline's impact on the EU's internal market, competition, and supply security. As NS2 undermines all three bases of the assessment, it is unlikely to receive clearance under the derogation regime, which would fatally undermine its case. Perhaps even worse for *Gazprom* would be questioning whether the derogation regime can apply to NS2, which would also raise questions about whether it applies to NS1, which also affects EU supply security by removing transit security, undermines competition by enhancing *Gazprom*'s market power in the CEE region, and does not actually provide any additional gas supply to the EU.

AND DOES EU LAW APPLY TO IMPORT PIPELINES EVEN WITHOUT NEW LEGISLATION?

Another difficulty with NS2's ECT litigation is that it invites additional unfortunate (from NS2's perspective) responses from the EU, particularly that EU law already applied to import pipelines. The underlying argument of NS2 by contrast is that there has been 'radical change' in EU legislation: that import pipelines were not subject to EU energy law, and then unexpectedly were. The reality is somewhat different. The EU did adopt an amendment to the Gas Directive 2009, formally extending the Directive to imported pipelines. However, EU law clearly applied to import pipelines before the amendment came into force: the Yamal pipeline, which flows through Russia and Belarus before flowing into Poland, was

subject on Polish territory to the full application of the Gas Directive 2009. NS2 is an offshore pipeline and Yamal is an onshore import pipeline, but it is difficult to see what turns on this point. Domestic law (absent a *lex specialis*) applies equally to the soil of the nation, its inland waters, and territorial sea. The new legislation itself makes no distinction between offshore and onshore pipelines, saying in the new Article 2(17) that EU law applies "between a Member State and a third country up to the territory of the Member States… or the territorial sea of that Member State." Clearly, the Gas Directive applies to both onshore and offshore pipelines.

> "***Without distinguishing between*** offshore and onshore pipelines *in the new legislation,* **NS2 is in trouble.**"

Without distinguishing between offshore and onshore pipelines in the new legislation, NS2 is in trouble. EU energy liberalization law clearly already applies to onshore pipelines and it is difficult to see how EU law does not on ordinary principles of territorial jurisdiction apply to the territorial sea and inland waters of a state. So there is no basis to distinguish between offshore and onshore pipelines in applying EU law prior to the adoption of the new legislation. That view is reinforced by the fact that the European Commission was prepared to apply EU energy law to the South Stream pipeline before it was cancelled. New 2019 legislation was formally adopted—expressly amending the Gas Directive 2009 and applying it to import pipelines for a mix of practical and political reasons—but the new legislation does not assist NS2 if the arbitration panel takes the view that EU law already applied to import pipelines. Worse still, if the panel does take that view, it will also color the view about the appropriate regulatory regime for NS1. If EU energy law applied to NS2, surely it also should have applied to NS1?

A RISKY CASE: WILL THIS LITIGATION BACKFIRE?

The ECT litigation is extremely risky for NS2 on a number of counts. As a matter of principle, the litigation raises questions surrounding Russian use of the ECT. *Gazprom* has used the fact that the pipeline company is headquartered in Switzerland for the ECT case. Switzerland is an ECT member, unlike the Russian Federation, which removed itself from the legal scope of the ECT in 2009. Technically, *Gazprom* can deploy this approach because of the generous provisions for foreign-owned companies to use registration in a third state to obtain ECT protection. However, from an EU perspective, direct EU investors in Russia have no ECT protection for the last decade because of Russia's withdrawal from the ECT's legal scope. This lack of reciprocity is likely to generate considerable discussion in Brussels and EU capitals as to what steps could remedy this lack of equal protection. As the ECT is

currently undergoing a modernization and reform process, the NS2 case could be the last time that the Russian Federation is able to make use of the ECT. The EU may well seek to reform the ECT to limit Russia's ability to obtain future benefit of the Treaty.

More immediately, NS2 faces an extremely challenging arbitration process where it must explain why it accelerated its final investment decision and construction without having all the route permits. Protecting its claim for damages under robust probing by the panel is likely to prove difficult even for NS2's extremely capable external lawyers.

In addition, the arbitration litigation risks creating a trap for the pipeline company. Rather than assisting NS2 in forcing the EU to provide a legal escape route from EU energy law, the arbitration panel could take the view that the derogation regime does not provide a shelter from EU law for the pipeline company, and that EU law applied to offshore pipelines even before the new 2019 legislation. If the panel rules positively for the EU on either issue, then *Gazprom* could face the application of EU energy law in full to NS2 and also to NS1.

Many arbitration cases never proceed to a full ruling. They are often settled or withdrawn. The best solution for NS2 in this case is to pull the publicity on this case, slow down the procedures, and then quietly—perhaps over Easter 2020—withdraw the case and walk away. *Gazprom* needs to recognize that this litigation is a desperate and unwise act which may badly backfire on the company

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