EU and South Stream pipeline: possible solutions.

Abstract

Energy relationships between Russia and Europe have been changed dramatically since 2009, when the Third Energy Package was adopted in the European Union. Apart from legal reforms in the EU energy sector, growing political tension over Ukraine has resulted in further deterioration of the EU-Russia energy dialogue. It had also a significant impact on the South Stream, one of the largest Russian pipeline project in Europe. The problems related to this project proved to be highly controversial. Gazprom’s recent cancellation of the construction of the South Stream pipeline (officially due to Bulgaria’s failure to provide its consent to the construction) just underlined legal and political complexity of the situation where political reasons tend to overweight economic rationale. In this blog post the main difficulties and disagreements over the South Stream project will be highlighted by describing the positions of the parties involved. Possible solutions regarding problems of the construction and future use of the pipeline will be described in order to emphasize that the best solution might be an international agreement to be concluded by the parties, where interests of both parties would be reconciled. The author will also address the latest changes of the Russian position regarding its plans to construct the pipeline via Turkey as an alternative to the South Stream in case of further obstructions from the side of the EU and will conclude that, nevertheless, there is still a chance for a kind of resurrection of the South Stream project. Russia leaves doors opened and the ball is now on the EU side.
Introduction

Due to a well-recognized dependency of the EU from import of energy resources, energy security and diversification of routes and energy suppliers have always been among the top priorities for the European Union. Certain steps in that direction have been already made being either successful such as the North Stream pipeline or failure (e.g. Nabucco project). It is worth noting that existing expectations and ‘hopes’ connected with shale gas seem to be vanishing because of growing environmental concerns and the costs of the production. In this case the South Stream - one of the largest Russian pipeline project in Europe - remains a one more possible way of diversification of the energy supply routes to the EU. However, the unfinished construction of the pipeline has already caused a huge number of controversies. The most arguable question among others is whether the construction of the South Stream will be completed, fully stopped, or temporary suspended. Another issue is how the EU institutions will approach this project from a regulatory point of view and how they will make an assessment of the risks related to the South Stream.

Such questions arise not by accident. Firstly, energy market rules have been changed globally. The process of liberalization of the European energy market resulted in the adoption of the Third Energy Package that has serious implications not only for EU member states but also for the third countries, especially for the EU biggest gas supplier - Russia. Another reason is a Ukrainian crisis. The problem with Ukraine debts for imported Russian gas might result in a termination of direct gas supplies from Russia to Ukraine (Pirani, Henderson, Honore, Rogers, Yafimava, 2014). In a need of gas during a winter period, Ukraine may threaten to block of transit via its territory that could result in interruptions or a shortage of gas supplies for European consumers, as it took place several years ago. For example, last gas dispute occurred in winter 2009, when shipments of Russian gas to both Ukraine and European destination were halted for two weeks (Pirani, Stern, Yafimava, 2009). It is not unlikely that gas crises between Russia and Ukraine might repeat again very soon. According to the ‘winter compromise’ reached at the end of October between the EU, Russia and Ukraine, the latter still will have to pay $1.65 billion to Gazprom by the end of the current year having no resources for that and yet again expecting financial support from the EU. Finally, the example with the North Stream pipeline illustrates that at least partial mutual understanding might be reached if it is necessary. At the same moment, the North Stream has also raised a serious questions, one of them is applicability of the TEP rules to that pipeline. The European Commission’s decision to reverse an initial decision of NRA and grant to Gazprom only 50% access to the capacity of the pipeline became a kind of ‘cold shower’ for Gazprom and at the same time a good lesson of the European decision-making procedures.

Despite the fact that the perspectives of the South Stream pipeline look rather gloomy after the cancellation of the project there is still a chance to find a solution which would be attractive for all sides.
South Stream project: overview and main characteristics

The main idea of the South Stream project is diversification of gas supplies to Europe.

If the South Stream pipeline is built, it will bring Russian gas to South-Eastern Europe across Black sea directly to Bulgaria running then through Serbia, Hungary, Slovenia, and Austria to the West, and through Greece and Italy to the South. Currently, this region receives gas from Russia via the Ukraine-Moldova corridor, where interruptions and loss of flows have often occurred. The planned capacity of the South Stream is 63 bcm (Pirani et al., 2014). The first string out of 4 is planned to be launched in late 2015. As far as all four strings are complete, Gazprom would be able to stop transit via Ukraine fully by 2020. This deadline seems crucial for Gazprom and for Russia taking into account that the transit agreement with Ukraine will expire in 2019.

In any case, the South Stream would provide additional security for the gas supplies for Europe. Gazprom as a founder and one of the main investors of this project would benefit from it by avoiding costs and risks of transit via Ukraine which, to a large extent, is non-reliable and unstable.

South Stream pipeline: existing issues

1) Legal collision with Third Energy Package (TEP)

The main regulatory problem in the case of the South Stream is the way in which rules of the TEP will be applied to the project. Significant reforms of European energy market took place in the last 2 decades in order to create competitive and internal market. Presently, EU energy market
regulation is based on three main pillars: third party access (TPA), unbundling of networks and more effective market supervision. One of the most important rules of the TEP is that access to the gas infrastructure (gas pipeline) should be granted on a competitive basis. The latter means the owner of the particular pipeline should provide access to the infrastructure for other companies on non-discriminatory basis. One more significant rule of the TEP is unbundling of networks from production of energy and sales to the consumers.

These regulatory problems might not only block the possibility for Gazprom to book and utilize full capacity in the onshore extension of the South Stream (OIES, 2014), but also to stop the construction of the pipeline completely as it occurred at the beginning of December. In case of parties reach a consensus and agree to continue the construction of the South Stream the attractive option for the EU could be granting to the project an exemption from the requirement of TPA upon the application from Gazprom. In this case such exemption might be given to the South Stream as “large infrastructure project” if the Commission considers that the project increases competition in the EU energy market and enhances energy security for Europe.

2) The South Stream and the Nord Stream: similar cases?

It seems that Gazprom will unlikely apply for any exemptions for the following reasons: firstly, it already had unsatisfactory but, certainly, useful experience with the Nord Stream project and, secondly, Gazprom already concluded bilateral agreements with EU member states which territory the pipeline will cross. In the case of the Nord Stream Gazprom obviously relied too much on lobbyist support of its German partners while asking for the exemptions from the TEP rules. Such exemption was given by German national regulator (BnetzA) and Gazprom received an authorization to use 100% capacities of OPAL, which is onshore extension of the North Stream. However, on the EU level the decision was changed and the EU Commission reduced the volume of gas transportation capacities for Gazprom by 50%. That automatically decreased profitability of the project and terms of return of investments. At the same moment, the South Stream might have significant differences from the Nord Stream project in respect of potential users of the former pipeline capacities. The South Stream will carry Russian gas straight from Russia to the Bulgarian coast. Therefore, it is not obvious who else, except Gazprom, might claim to use capacity in this pipeline.

3) Status of the intergovernmental agreements

Understanding the complexity of the situation with the South Stream, Gazprom intends to use bilateral agreements as a main legal argument for the construction of the project. Intergovernmental agreements were signed before the adoption of the TEP with those EU member states, who participate in the building of South Stream or those whose territory the new pipeline will cross. However, the European Commission has already announced that such agreements are not in line with the Third Energy Package. Hence, there are a number of serious problems regarding
the South Stream pipeline, and variety of scenarios for the project as well as possible solutions for both EU and Russian Federation.

**Variety of scenarios for the South Stream**

At present time, future scenarios for the South Stream project could vary, whereas there is no scenario acceptable for both parties simultaneously. The reason is that in the South Stream case political and economic reasoning are dramatically intertwined. Moreover, political considerations to some extent may prevail over pure economic benefits of cooperation that might be observed during the whole period of negotiations regarding the South Stream.

1) **Economically motivated scenario**

From the business point of view the South Stream project looks relatively simple. Europe would have 3 different routes for Russian gas supplies: transit via Ukraine, the Nord Stream, and the South Stream. Bearing in mind that last two run through the seabed, it means that they will not completely depend on transit countries. As regards to Gazprom, the South Stream will strengthen the reputation of the Russian ‘giant’ as a reliable supplier (according to the current contracts with European customers Gazprom bears full responsibility of the delivery of gas and takes all transit risks). However, what is much more important for Gazprom is anticipating a minimization of the transit costs and risks associated with Ukraine.

2) **Politically motivated scenario**

Such scenario seems to be more negative for both parties including third countries such as Ukraine. In case the EU approves the construction of the South Stream and decides not to apply the TEP rules, Ukraine will lose its significant transit revenues which might be a “killing factor” for its economy. It is unlikely that the EU will decide to abandon this way of supporting new ‘Ukraine’ project. The refusal of the European Union to authorize the construction of a new transit route on the basis of its incompatibility with the TEP rules may create an ambiguous situation for Europe itself. Moreover, in that case the EU would be forced to participate regularly in Russian-Ukraine negotiations in order to find a compromise and reach an agreement. According to the OIES researchers (Pirani, Henderson, Honore, Rogers, Yafimava, 2014), such a political scenario should not prevail over the "more economically rational solution", because it may result in substantial economic costs and uncertainty for both Europe and Russia.

**Possible solutions for the South Stream project**

Bearing in mind main scenarios mentioned above, it is worth describing a possible solutions concerning the South Stream based on the positions of the parties.

**Solution #1: new regulatory procedure for the South Stream.**

Recently the Oxford Institute for energy studies (OIES) published a research paper, which includes a deep analysis of the South Stream situation. The authors stressed that in light of the
Ukraine crisis parties should think about development of regulatory procedure concerning the South Stream as soon as possible. One of the experts of the OIES argues that there are no rules or regulations concerning the construction of the new infrastructure projects in the TEP in its current form. Therefore, it is necessary to develop a regulatory procedure enabling construction and utilization of new cross-border pipeline capacity in Europe (Yafimava, 2014). The position of the Gazprom is partly based on the analogic argument as follows: the Third Energy Package should not apply to the South Stream. Therefore, the EU should allow Gazprom to use its pipelines granting the right to utilize as much capacity of the pipeline as it is necessary for European customers. The logic of such position is easy to understand bearing in mind the existing high risks of interruption of gas supplies via Ukraine which could have serious negative impact on those European countries who fully depend on Russian gas import. Finally, the paper concludes that the EU needs to find a balance between intention to enhance its energy safety and efforts of diversification away from Russian gas and becoming independent from Russian import. However, it seems that it is impossible for Europe to do that so far. Firstly, because the volume of the gas exported from Russia to Europe is still huge, secondly, there is no other reliable supplier that would be ready to deliver such amount of gas as Russia supplies at the moment.

**Solution #2: strong application of the TEP**

Another possible solution for the EU is strong application of the Third Energy Package and competition rules to the South Stream project including requirements such as third party access to the pipeline and unbundling rules for Gazprom. The authors of another research paper insist that the very existence of the South Stream will present imminent danger for the energy security of the EU being a reason of not minimization but significant increase of the risks for the Europe (Dreyer, Grätz, 2014). In reality, full application of the TEP regulations to the South Stream would exclude any chances to finalize the project. However, Swiss experts argue that the EU should adopt a strict regulatory approach towards the South Stream and implement its competition policy in the energy sector according to the TEP rules without any compromise. It is noted in the report that the Russian strategy is to “fix dependency” from Russian import by “neutralizing Ukraine”.

**Solution #3: exemption from the TEP, intergovernmental agreements**

One more possible solution for the South Stream project might be granting to Gazprom an exemption from the Third Energy Package rules. In this case, the South Stream might be given the status of the large infrastructure project. However, bearing in mind previous situation with the Nord Stream and the consequences of granted exemption, Gazprom is unlikely to make a similar decision. One more reason for that is the Russian complain to the WTO challenging compatibility of the TEP with WTO agreements. (EurActiv, 2014).

In order to defend its position Gazprom tries to use already concluded intergovernmental agreements with the EU member states appealing to the principle pacta sunt servanda. However, these arguments still look unpersuasive for the European Commission. The main legal reason (put
politics aside) is the main principles of the EU legal order. The logic of the EU-law is any bilateral agreements between EU member states and third countries have to comply with EU law even if European legislation was adopted later than the date of conclusion of intergovernmental agreements in question. Otherwise, the European Commission may require to bring such agreements in compliance with EU-law or even terminate such agreements under the threat of huge fines which might be imposed.

**Solution #4: “win-win” solution.**

Finally, both the EU and Russia could find the way that will be acceptable for both parties. It is worth thinking about concluding international bilateral agreement that would satisfy both parties. Such solution could bring benefits to the EU because Europe will get one more route for gas supply avoiding transit via Ukraine and will not lose its reliable supplier Gazprom. The South Stream project will also resolve the problems with interruptions of gas supply for Gazprom that will be able to fulfil its obligations according to the contracts with Europe.

**Current situation: the endgame?**

In a current situation when Vladimir Putin officially announced the cancellation of the South Stream construction it is necessary to evaluate soberly the perspectives of the project for all parties that are involved. Experts argue that it is far from the end of the game even after the announcement of the South Stream cancellation. Most European countries that depend on Russian gas supplies significantly, such as Austria and Italy, are still hoping that discussions over the project will somehow be resumed. Other countries including Greece, Bulgaria and Hungary may also face difficulties and start depending on “Turkey goodwill”, in case the South Stream project fails finally (Escobar, 2014). The Commission has already started to feel itself extremely comfortable being blamed as a main opponent of the construction of the pipeline that is vitally essential for the EU. It is highly interesting to note that recently German chancellor Angela Merkel has supported resumed talks with Russia over the South Stream project on the basis of the already concluded intergovernmental agreements.

As regards Russia, it still plans to build a pipeline now redirected to Turkey which is Gazprom’s second biggest gas buyer after Germany. “The proposed pipeline between Russia and Turkey, augmenting the existing Blue Stream link, could carry 63 billion cubic meters a year, or more than 10 percent of European consumption” (Mazneva, Khrennikova, 2014). The explanation for such decision is simple – to avoid the “non-constructive” approach of the European Commission. Therefore, cancellation of the South Stream construction must be interpreted as a clear message that (a) Ukraine shall be fully excluded from the transit of Russian gas and (b) Russia starts to look “South” (Turkey) and “East” (China) in order to diversify its buyers (c) any renewal of the South Stream could be done only on initiative from the side of the EU. Obviously, Russia does not want to discover itself again in a position of ‘poor applicant’ asking for mercy from the EU. Therefore, the
rules of the game seem to be changed. As a result, Russia designed so-called ‘Plan B’ in order to avoid any risk in the situation of ‘EU colonialism’ when conditions are dictated by only one party and other third countries should follow them.

Although European experts argue, that Europe automatically will decline by 20% the export of Russian gas by 2020, it is hardly likely a miracle will happen in the nearest future. Europe tends to hope on renewable energy and US shale gas. However, Russian gas will be unlikely replaced at all, because the volume of the imported Russian gas to Europe is still colossal. Moreover, Russia gets to build a new LNG central hub in the Mediterranean (Escobar, 2014) and actively promote its partnership with East region (e.g. China).

Turkey is also looking forward to East planning to become the global energy hub for Europe. There are plenty of prerequisites for such intentions: Turkey gets natural gas from Iraq and Azerbaijan, plans to start import of fuels from Turkmenistan, purchases LNG gas from Algeria, not mentioning Turkey's ambitions to build a pipeline to Iraq and new pipeline network to Iraq and Azerbaijan. Hence, Turkey's strategy at this moment is to show itself to be the essential energy crossroads from East to West – transiting everything and from everywhere. Therefore, 'Blue Stream' project via Turkey might become a significant contribution in order to reach Turkey's goals get to be the "central transiter" of energy resources and realize Russians plans to avoid the transit via Ukraine and European uncompromising rules in the energy sector.

Conclusion

In conclusion, the South Stream as one of the largest pipeline project in Europe might become a “central test for the EU energy policy in the nearest future in question of whether the Europe will strictly adhere to its internal market policy” or EU’s reforms are “at risk of being undermined” (Beckman, 2014). It is also still questionable whether the South Stream project is a "strategic geopolitical weapon" for Russia or way of diversification of energy supplies for Europe. In economic terms, both parties will benefit from one more giant route for gas supplies. In legal terms, the problem could be resolved by reaching an international agreement, where the interests both parties would be taken into account. Probably the main reason for tensions and misunderstanding is a current situation when political reasons tend to prevail over economically rational solutions. However, if the lessons from the South Stream ‘saga’ will be taken seriously by the EU and Russia the author cannot exclude the possibility of certain ‘reincarnation’ of the South Stream.
Bibliography


