



14 June 2019

**Nord Stream 2 AG ("NSP2AG")**

**ECT Article 26 meeting on 25 June 2019**

**Summary of NSP2AG's legal concerns regarding the Gas Directive Amendment**

**1. INTRODUCTION**

- 1.1 This note summarises NSP2AG's main concerns regarding the compatibility of Directive 2019/692/EC (the "**Amending Directive**") with Articles 10 and 13 of the Energy Charter Treaty ("**ECT**"). It is made available to the European Union (the "**EU**") in advance of the meeting pursuant to Article 26 of the ECT on 25 June 2019 to allow the EU more fully to understand and consider NSP2AG's position. NSP2AG hopes this will contribute to a fruitful discussion on 25 June 2019.
- 1.2 As discussed further below, and in its letter of 12 April 2019, NSP2AG reserves its rights under the ECT to seek appropriate remedies should this be necessary, including in circumstances in which an Article 49a derogation, or equivalent treatment, is not available.

**2. THE NORD STREAM 2 PIPELINE**

- 2.1 Since it was established in 2015, NSP2AG has been engaged in the planning and construction of the Nord Stream 2 pipeline. The Nord Stream 2 pipeline is a major gas infrastructure project in relation to which NSP2AG has made significant investment in the EU over a number of years. Of particular importance in this regard are (i) contracts for the supply of pipes, coating of pipes and laying of pipes concluded in April 2016, September 2016 and April 2017 respectively; (ii) the long term gas transportation agreement concluded between NSP2AG and Gazprom Export in March/April 2017; and (iii) financing agreements concluded between NSP2AG (as borrower) and Gazprom, Shell (NL/UK), OMV (Austria), Wintershall (Germany), Uniper (Germany) and Engie (France) (each as lenders) in April and June 2017.
- 2.2 The gas transportation agreement underpins the financing agreements as lenders to projects of this magnitude require a degree of certainty about future revenues before they are willing to make funding available to such an investment. Once the asset is built (partially or entirely) the capital investment has been made and the only way to recover the investment is by generating revenue by selling gas transportation capacity. In the absence of a high degree of certainty about these revenues on a long term basis lenders will consider the risk too high. In the case of NSP2AG the gas transportation agreement was an essential condition to the financing arrangement, specifically prepared in a form to meet the requirements of the lenders.
- 2.3 The need for a long term gas transportation agreement providing revenue predictability is a well-known feature of large gas infrastructure projects and is reflected in the structure of Directive 2009/73/EC (the "**Gas Directive**"). It is the reason why the Article 36 exemption possibility for future pipelines exists<sup>1</sup> and is an established part of the EU's Article 36 exemption practice, explained as follows in the Commission's *Nabucco - Bulgaria* Article 36 Decision:

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<sup>1</sup> Recital (35) of the Gas Directive explains that "*given the exceptional risk profile of constructing those exempt major infrastructure projects, it should be possible temporarily to grant partial derogations to undertakings with supply and production interests in respect of the unbundling rules for the projects concerned*".



*"(...) shareholders and lenders invest in a project of this scale only after they have been assured that the potential risks have been covered to a maximum degree which is usually guaranteed by the expected future revenues. The underlying reason is that the investment must be regarded largely as sunk costs. Returns can only be reliably predicted if the prices and terms in the initial contracts, which are fixed in accordance with the approved method, remain unchanged".<sup>2</sup>*

**3. IF AN ARTICLE 49A DEROGATION (OR EQUIVALENT TREATMENT) IS NOT AVAILABLE THE AMENDING DIRECTIVE DISCRIMINATES AGAINST NSP2AG**

- 3.1 As explained above, Article 36 provides for exemptions for major new gas infrastructure, in order to make construction economically and financially possible (by exempting them from EU rules concerning third party access, tariff regulation and ownership unbundling that significantly complicate long term contracts and ownership relations between pipeline operators and upstream suppliers).
- 3.2 Article 49a introduced by the Amending Directive complements Article 36 by creating a new and separate derogation possibility for pipelines that were "*completed before 23 May 2019*". A derogation from ownership unbundling, third party access and tariff regulation can be granted by Member States "*for objective reasons such as to enable the recovery of the investment made*". The conditions of Article 49a are less strict than those of Article 36 which is entirely rational and logical for the following reasons. An Article 36 exemption is only available to potential investors who have not yet taken investment risk.<sup>3</sup> Consequently, those potential investors who seek an exemption pursuant to Article 36 have a choice between (i) investing on the basis of an exemption if granted, (ii) investing on the basis of the normal rules of the Gas Directive, and (iii) not investing at all. The investors to whose pipelines Article 49a applies, by contrast, all took investment risk (and invested) before the Amending Directive became applicable.
- 3.3 In light of the above, it should be entirely clear that, if the Amending Directive were to have the effect of imposing on NSP2AG rules on ownership unbundling, third party access and tariff regulation (without a possibility for derogation), it imposes rules that fundamentally undermine the basis on which NSP2AG has invested.
- 3.4 This would not be the case if the derogation contained within Article 49a were available to Nord Stream 2. Such availability would be logical because NSP2AG has also taken fundamental investment decisions (and invested) before the rules came into force. Rationally, there should be no gap between the scope of Article 36, which concerns future projects for which investment risk *has not yet been undertaken*, and Article 49a, which concerns projects for which investment risk *has been undertaken*. It has been suggested, however, that there is such a gap and that the derogation would not be available to Nord Stream 2 because it was not operational on 23 May 2019. Simultaneously, it is entirely clear that an Article 36 exemption is not legally available to NSP2AG either and that it could not fulfil its role in any event since NSP2AG is not a potential investor in future infrastructure. NSP2AG is an actual investor in infrastructure that to a very large extent has already been built. Unlike a potential investor seeking an Article 36 exemption NSP2AG can no longer avoid a "sunk" investment if a satisfactory exemption is not provided.
- 3.5 NSP2AG notes that the EU was well aware of the situation of Nord Stream 2, namely that it was well advanced in the making of its investment but that the pipeline would not be operational on 23 May 2019. The "Fact Sheet" published by the Commission when it tabled its proposal explains that Nord Stream 2 is the only advanced project that would be

<sup>2</sup> *Nabucco – BG – C (2009) 3037*; SG Greffe D(2009) 2299 (20 April 2009), paragraph 52.

<sup>3</sup> Only those can meet the "risk" criterion of Article 36(1)(b). See Commission Staff Working Document of 8 November 2017 accompanying the proposal for the Amending Directive, "*Assessing the amendments to Directive 2009/73/EC setting out rules for gas pipelines connecting the European Union with third countries*" (SWD(2017) 368).



affected by the amendment.<sup>4</sup>

- 3.6 If it were indeed the case that the temporal limitation of "*completed before 23 May 2019*" excludes NSP2AG from the scope of the derogation, a gap exists because the temporal scope of Article 49a does not start where that of Article 36 ends. The rational border line between Article 36 and Article 49a is "investment risk not yet taken" versus "investment risk taken" (with NSP2AG clearly in the latter category). There should be no gap between the two. The fact that Article 49a has a different and irrational temporal scope, alongside opposition against Nord Stream 2 expressed by a number of representatives of the EU Institutions, indicates that the criterion of "*completed before 23 May 2019*" was deliberately chosen in an attempt to exclude Nord Stream 2 from the scope of the derogation.

#### 4. THE AMENDING DIRECTIVE CANNOT ACHIEVE ITS ALLEGED (UNCLEAR) OBJECTIVE

- 4.1 Although the amendment of the Gas Directive ostensibly applies to all import pipelines, in practice only has a legal effect on *offshore* import pipelines (as the Commission explained when tabling its proposal).<sup>5</sup> The reason is that onshore pipelines terminate at the non-EU borders of EU Member States (and EU rules of course do not apply on the territory of third countries). After the connection point at the border any pipeline that transports imported gas further inside the EU is part of the EU transmission network and was already subject to the rules on transmission before the Amending Directive.
- 4.2 The Amending Directive has the practical effect of extending the rules on transmission to offshore import pipelines but it is not at all clear what legitimate policy objective could be achieved by doing so.
- 4.3 As set out in a number of EU Regulations, the objective of the Gas Directive's rules concerning transmission is to create network conditions that allow competition to develop and an integrated wholesale market for gas to come about in the EU internal market.<sup>6</sup> However, it cannot credibly be argued that by adopting the Amending Directive the EU sought to extend its integrated wholesale market and its so-called "entry-exit" transmission system underlying it to Russia, Algeria, Libya and Morocco, countries of origin for such import pipelines.
- 4.4 Furthermore, the entry point(s) to the EU transmission system to which Nord Stream 2's exit point will connect in Germany will be subject to EU regulation. Any objectives that EU regulation of transmission networks seeks to achieve can be achieved by regulating those entry points.<sup>7</sup>

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<sup>4</sup> European Commission – Fact Sheet, Questions and Answers on the Commission proposal to amend the Gas Directive (2009/73/EC), answer to question 10.

<sup>5</sup> The Commission has explained that "*in practice, a change in the legal situation will currently only be experienced by pipelines crossing into the EU jurisdiction across a sea border*". European Commission – Fact Sheet, Questions and Answers on the Commission proposal to amend the Gas Directive (2009/73/EC), answer to question 4.

<sup>6</sup> See, for instance, Recital 19 of Regulation 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks.

<sup>7</sup> In this respect it should be noted that a number of Commission Regulations adopting Network Codes imposing detailed rules on transmission networks only apply to the network entry points connecting exit points of third country import pipelines if a Member State chooses to do so. The German authorities have decided to apply these rules to such entry points. The Italian and Spanish authorities have not. Consequently, even without the Amending Directive, any gas entering the EU from Nord Stream 2 would have had to do so via an entry point that was subject to stricter regulation than the entry points in Spain and Italy connected to the offshore import pipelines from North Africa. Recital (13) of the Amending Directive makes it clear that this position is not intended to change. Consequently, the import pipelines from North Africa are not only eligible for a derogation, but the EU transmission entry point to which they connect is also subject to less regulation.



- 4.5 NSP2AG notes that the Council Legal Service, in its opinion on the Recommendation for a negotiating mandate for an EU-Russia treaty on Nord Stream 2, also found that the Commission's explanation "*in no way allows the Council to regard as established*" that applying principles of EU energy law vis-à-vis third countries was necessary to achieve the objectives pursued by existing EU energy law.<sup>8</sup>
- 4.6 It is also difficult to see what reasonable policy objective could in practice be achieved by extending Gas Directive rules concerning transmission to offshore import pipelines up to the limit of the German territorial sea (i.e. without covering the entry point in Russia). In its Recommendation for a negotiating mandate the Commission itself argued that ineffectiveness of such a measure was a reason to conclude a treaty with Russia putting in place a specific regulatory regime for the entire pipeline.<sup>9</sup> Consequently, by adopting the Amended Directive the EU has adopted a measure that the Commission itself considered ineffective.
- 4.7 Finally, if the application of the Gas Directive to import pipelines was a genuine solution to a genuine problem (*quod non*), it should apply to all import pipelines. As explained above, however, the Amending Directive will have no practical impact on onshore import pipelines. Furthermore, the derogation of Article 49a appears to be available to all pipelines completed before 23 May 2019, i.e. all existing offshore import pipelines with the sole exception of Nord Stream 2. Furthermore, Article 49b(1) implies that offshore import pipelines covered by an existing international agreement between a Member State and a third country that diverges from the Gas Directive will indefinitely escape application of these rules unless the international agreement is amended or replaced. Consequently, it appears that the only pipeline on which the Amending Directive would necessarily have a practical effect is Nord Stream 2. Nord Stream 2, however, would represent no more than approximately 15% of the EU's total pipeline import capacity from third countries (excluding Norway). If the non-application of the Gas Directive to import pipelines was a genuine problem it is, therefore, not capable of being resolved by the Amending Directive.
- 4.8 In light of all the questions that arise about the objective and the effectiveness of the Amending Directive, it is striking that the proposal for the Amending Directive was not accompanied by an impact assessment, which is normally required and which could have explained the rationale for the Amending Directive and how the proposed measure would achieve that rationale. This further indicates that the Amending Directive is purely intended to target Nord Stream 2.
5. **ENERGY CHARTER TREATY ("ECT")**
- 5.1 As outlined in our letter of 12 April 2019, if and to the extent that an Article 49a derogation (or equivalent treatment) is not available to Nord Stream 2, it is apparent that the EU has breached a number of its obligations under the ECT. The EU has done so in its drafting and adoption of the Amending Directive and with regard to the effect and implications of the Amending Directive as described above. In particular, the EU has:
- 5.1.1 Impaired NSP2AG's Investment by unreasonable and discriminatory measures;
  - 5.1.2 Failed to encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties, such as NSP2AG, to make Investments;
  - 5.1.3 Failed to accord Fair and Equitable Treatment ("**FET**");

<sup>8</sup> Council of the EU, Opinion of the Legal Service of 27 September 2017, para. 76, published at: <http://www.politico.eu/wp-content/uploads/2017/09/SPOLITICO-17092812480.pdf>

<sup>9</sup> COM (2017) 320 of 9 June 2017, Recommendation for a Council Decision authorising the opening of negotiations on an agreement between the European Union and the Russian Federation on the operation of the Nord Stream 2 pipeline, page 4, published at: <http://www.politico.eu/wp-content/uploads/2017/07/NS-Draft-Mandate.pdf>



- 5.1.4 Failed to provide most constant protection and security to NSP2AG's Investment;
  - 5.1.5 Failed to accord NSP2AG treatment no less favourable than that accorded to the EU's investors or investors from a third state (the "**MFN Guarantee**"); and
  - 5.1.6 Expropriated NSP2AG's Investment.
- 5.2 The main legal basis for such breaches of the ECT is summarised below. Whilst there is considerable documentary evidence in the public record supporting each allegation of breach of the ECT, such claims may nonetheless be developed and/or other breaches of the ECT may become apparent as the documentary record is explored further (including NSP2AG's review of the documents which the EU will be required to produce during the document production phase of the arbitration proceedings).

**A. Breach of Article 10(1): Unreasonable and Discriminatory Measures**

- 5.3 Article 10(1) of the ECT provides that "*no Contracting Party [i.e. the EU] shall in any way impair by unreasonable or discriminatory measures [the] management, maintenance, use, enjoyment or disposal [of Investments of Investors of other Contracting Parties]*". This provision can be infringed by treatment which is one or the other (unreasonable or discriminatory). For all the reasons summarised above, in the event that it is not granted a derogation or equivalent treatment, the imposition of the Amending Directive on NSP2AG constitutes a breach of Article 10(1) of the ECT on the basis that it is both an unreasonable and a discriminatory measure, impairing the management, maintenance, use or disposal of NSP2AG's investment.
- 5.4 Article 10(1) protects Investments of Investors from treatment which differs to treatment given to others in similar or like circumstances, which treatment impairs the Investment.
- 5.5 In the event it is not eligible for a derogation, the treatment afforded to NSP2AG is wholly different to the treatment afforded to other Investments of Investors in similar or like circumstances, being the other offshore import pipelines. It is the temporal scope of application of the derogation which clearly excludes (and is designed to exclude) Nord Stream 2, while protecting all other similar pipelines and respective investments, with no justification. It is undisputable that these are all materially similar projects within the same economic sector.
- 5.6 The investments made in all such comparable projects are being protected from the deleterious effects of the radical change in the regulatory framework by virtue of Article 49a. NSP2AG has undertaken the risk of investment and Nord Stream 2 is now an *actual* pipeline in a similar position to the completed pipelines (and indeed even more worthy of protection because none of the investment made has been recovered to date).
- 5.7 NSP2AG is not required to establish *intent* to discriminate for there to be a breach of Article 10(1) by virtue of discriminatory measures. However, NSP2AG notes that the EU was well aware, both at the time of introduction of the draft Amending Directive, and of its adoption, of both the significant investment made in the Nord Stream 2 pipeline and the fact that the pipeline would not be operational on 23 May 2019. No explanation has been given as to why the derogation option is limited to pipelines physically completed at that cut-off date – if that is indeed the case.
- 5.8 The practical effect of a requirement that the pipeline be completed by 23 May 2019 to qualify for a derogation cannot be reconciled with the purpose of the derogation: i.e. to protect those who made investment decisions when the Gas Directive was not legally applicable to offshore import pipelines. Any decision to limit the scope of the derogation in this way was made in the context of strong opposition to the project by representatives of the EU closely involved in the adoption of the Amending Directive widely reported in public



media. NSP2AG anticipates further evidence of discriminatory intent and political motivation will become available during the document production process in the arbitration.

- 5.9 Moreover, for all the reasons explained above, the Amending Directive is not reasonable by reference to a policy in relation to the internal market and security of supply, including by reason of its lack of suitability for achieving its stated objective, and its lack of proportionality when considered against the burden it imposes.

#### **B. Other breaches of the ECT**

- 5.10 If and to the extent that an Article 49a derogation (or equivalent treatment) is not available to Nord Stream 2, the Amending Directive also breaches a number of other commitments of the EU as a Contracting Party to the ECT, including those set out further below.

#### **Treatment No Less Favourable (National Treatment / MFN)**

- 5.11 Article 10(6) of the ECT provides that "*Each Contracting Party shall accord to Investments in its Area of Investors of the other Contracting Parties, and their related activities, including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other Contracting Party or any third states and their related activities including the management, maintenance, use, enjoyment or disposal, whichever is the most favourable*".

- 5.12 As discussed above, in the absence of a derogation (or equivalent treatment) for Nord Stream 2, the treatment afforded to NSP2AG is clearly different from the treatment afforded to the other comparable offshore import pipeline projects. As discussed in Sections 3 and 4 above, any such different treatment cannot be justified by reference to the aims and policy of the EU. The failure to accord to NSP2AG treatment no less favourable than that which it accords to other like pipeline projects would therefore constitute a breach of Article 10(6).

#### **Failure to encourage and create stable, equitable, favourable and transparent conditions for Investors to make Investments**

- 5.13 Article 10(1) provides that "[e]ach Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area".
- 5.14 The EU has not created stable, equitable, favourable and transparent conditions: on the contrary, the EU has undermined such conditions by virtue of its discriminatory regulatory change. Such change has been inequitable (as discussed further below in the context of breach of the FET guarantee) and, moreover, its treatment of Nord Stream 2 has lacked transparency.<sup>10</sup>

#### **Failure to accord Fair and Equitable Treatment**

- 5.15 The EU has also guaranteed to provide FET to investments under Article 10(1) of the ECT. At its most basic level, the FET standard guarantees that the EU's treatment of NSP2AG's investment be both fair and equitable. The Amending Directive, and in particular, the deliberate design of the Article 49a derogation with a view to ensuring that Nord Stream 2 may not qualify, is transparently neither fair nor equitable.
- 5.16 Investment treaty jurisprudence has elucidated a number of categories of treatment which are part of, and guaranteed by, the obligation to provide FET:

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<sup>10</sup> As explained above, the EU has purported to justify the Amending Directive by reference to a policy objective which it does not meet, whilst at the same time ensuring that the only pipeline not to benefit from the derogation in the Amending Directive is Nord Stream 2. The EU's purported justification is at odds with its real objective to impact Nord Stream 2.



- 5.16.1 Protection of an investor's reasonable and legitimate expectations;
  - 5.16.2 Requirement that the host state act without arbitrariness or discrimination;
  - 5.16.3 Requirement that the host state act in good faith;
  - 5.16.4 Requirement that the host state act proportionately; and
  - 5.16.5 Requirement that the host state apply due process and prohibit denials of justice.
- 5.17 It is clear that the EU has breached Article 10(1) of the ECT by failing to accord to Nord Stream 2 FET by reference to the above categories of treatment, including by introducing regulatory change which is unreasonable, lacking in proportionality, discriminatory and not in the public interest.
6. **ARTICLE 49A CAN AND SHOULD BE APPLIED TO NORD STREAM 2**
- 6.1 Article 49a uses the term "*completed*" before 23 May 2019 and not "*operational*". This leaves scope for a number of different interpretations of Article 49a. In this respect it should be noted that it is a general requirement of EU law that secondary legislation must be interpreted in so far as possible so as to avoid calling into question its validity.<sup>11</sup> Hence, according to well-established EU case law:
- 6.1.1 The primacy of international agreements concluded by the EU over provisions of secondary EU law means that provisions of EU secondary law must, so far as is possible, be interpreted in a manner that is consistent with those agreements.<sup>12</sup>
  - 6.1.2 Preference should be given as far as possible to interpretation of a provision of secondary EU law which renders the provision consistent with, *inter alia*, general principles of EU law (including the principle of equal treatment).<sup>13</sup>
- 6.2 Taking into account this requirement of consistent interpretation and that the objective of Article 49a is to protect investments that were made before the Gas Directive became applicable to offshore import pipelines, the EU should interpret the criterion of "*completed before 23 May 2019*" as encompassing pipelines in which actual investment has been made. This would include Nord Stream 2 and avoid violation of the ECT (and other international and EU law principles).

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<sup>11</sup> See, e.g., Case C-149/10 *Zoi Chatzi v Ypourgos Oikonomikon*, para. 43.

<sup>12</sup> See, e.g., Joined Cases C 288/09 and C 289/09 *British Sky Broadcasting*, para. 83

<sup>13</sup> See, e.g., Joined Cases C 402/07 and C 432/07 *Sturgeon and Others*, paras. 40-69.