

# Nord Stream 2: Trust in Europe

The prospect of building the Nord Stream 2 pipeline between Russia and Germany is dividing the EU into two camps. By following geopolitical considerations, both sides are neglecting the concept of a liberalized natural gas market and are overlooking Europe's favorable position in current international gas trade.

by Severin Fischer

When Russia's Gazprom and its five European partners (BASF, E.ON, Engie, OMV and Shell) signed a declaration to build two new pipelines through the Baltic Sea ('Nord Stream 2') in September 2015, this came as a real surprise for most observers. The project would increase existing capacity from 55 to 110 billion cubic meters (bcm) a year by 2019. Gazprom would act as the main shareholder with a stake of 50 percent in the Swiss-based pipeline company. Nord Stream 2 will follow a similar route along the seabed as the first pipeline project that started deliveries in 2011. The project is completely financed by its shareholders and does not receive financial support from public sources of the EU or a Member State. It is clear that from the Russian side, not only the aspect of defending and maybe even the possibility of enlarging market shares in Europe, but also the geopolitical motivation of circumventing Ukrainian territory and reducing payments for Ukrainian transit play an important role in the project. After the Black Sea pipeline project 'South Stream' to Bulgaria was cancelled in 2014 and considerations to involve Turkey in

the transit business have been put on hold, the Baltic Sea seems to be Gazprom's most reliable and secure route to retain a hold on its most important market: Europe.

Immediately after the new pipeline project was launched, a controversial debate started among EU Member State governments and within EU institutions. Even

## KEY POINTS

- Nord Stream 2 has turned out to be a symbolic conflict about how to deal with Russian gas imports and infrastructure projects
- The German government has lost diplomatic reputation and credibility by politically backing Nord Stream 2
- The EU needs to make clear, in how far a market approach or in how far a geopolitical approach is structuring its natural gas policies in general
- When sticking to its liberalized gas market model, the EU Commission will have to evaluate Nord Stream 2 under existing regulation, not based on an undefined foreign policy assessment

the European Council meeting of December 2015 was dealing with the topic – an impressive record for a single infrastructure project.

### Actors and arguments

So far, Germany is the most outspoken supporter of Nord Stream 2. The official position, also referred to by Chancellor Angela Merkel during the European Council meeting, recognizes the nature of the pipeline project as a commercial activity of economic actors involved in gas trading. Following this argument, the role of politics should be restricted to ensuring the fulfilment of legal obligations. This line of argumentation is consistent with a tradition in German approaches to new infrastructure projects over recent decades, despite the fact, that the continuation of Russian-German natural gas trade has always received strong political support in the country. Economics minister Sigmar Gabriel even added that building the pipeline would serve European energy security purposes by increasing direct links between producer and consumer. While most government officials in Germany's grand coalition support this view, more skeptical voices can be heard in the German parliament and even among leading party members of CDU and SPD as well as among foreign policy experts. While in Germany and Austria, the promoters of Nord Stream 2 are quite outspoken, in the Netherlands and France, there is recognizable, but more silent support in government circles. Here, as well, the main line of argumentation is based on the added value of infrastructure diversification and the neutrality of political actors on economic activity in the market.

While support for Nord Stream 2 is mainly concentrated within a relatively small but powerful group of actors, the range of opponents is broader and more diverse. They all challenge the project as not being compatible with the goals and aims of the EU's new rhetoric about building an Energy Union.

First, political and geopolitical considerations are most prominent here. Not just Poland and other Central-Eastern European governments, but also actors from the transatlantic community are fiercely arguing against Nord Stream 2. They point out that there is an ongoing war in Ukraine, and that sanctions remain in place against Russia – although they are not directed at natural gas trading. In their view, building a new pipeline and dealing with this difficult political situation at the same time would contradict each other. This culminated in a common letter of seven prime ministers to the Commission, asking for a cancellation of the project, since it would create additional dependency for Germany and

the EU, therefore influencing the political standpoint vis-à-vis Russia negatively. In addition, avoiding transit routes would weaken the political status of Ukraine as transit country and could deprive it of transit fees to the tune of USD 2 billion a year. Although less openly stated, the same argument applies to Slovakia, Hungary and Poland, who would also potentially lose transit fees.

A second line of opposition concentrates on regulatory questions. These focus mainly on intergovernmental agreements, third party access to the pipeline system and the effects on competition in the gas market. Regulatory arguments already stopped Gazprom from building South Stream in the past, when intergovernmental agreements were signed, that most likely did not comply with EU law. Therefore it doesn't come as a surprise that the Italian government as a disappointed supporter of the Black Sea pipeline is now trying to stop Nord Stream 2 for comparable reasons. Also, some EU Commission officials are cautiously trying to play this card against the project.

Third, a new aspect to the debate is mainly brought up by environmental groups and interestingly adapted by a broad range of other actors. It focusses on the future role of natural gas in the European energy mix. In this context, antipathy against Gazprom is mixed with energy scenarios suggesting that the EU would not need the proposed additional quantities of gas imports, if it follows decarbonization policies strictly. Improved energy efficiency and the increase in the share of renewables would most likely lead to less natural gas consumption in the EU, although the plausibility of these scenarios depends on a whole range of different factors and policy frameworks.

All three lines of arguments against Nord Stream 2 tend to refer to the project as not being compatible with

### FURTHER READING

#### **European Energy Security and the Role of Russian Gas: Assessing the Feasibility and the Rationale of Reducing Dependence**

*Katja Yafimava (IAI Working Paper 2015).*

The paper looks into the geopolitical arguments behind Russia's "gas weapon" and calls for a pragmatic approach.

#### **Energy Security and Natural Gas Markets in Europe: Lessons from the EU and the United States** *Tim Boersma (Routledge 2015).*

The author of this monograph looks at the functioning of the EU's gas markets. He argues convincingly that the creation of this market has helped the EU deal with energy security challenges in the past.

#### **Nord Stream 2: policy dilemmas and the future of EU gas market**

*Agata Loskot-Strachota (NUI Policy Brief 2016).*

The paper offers an insightful synopsis of the debate around Nord Stream 2.



More pipes: The project Nord Stream 2 would double the capacity of pipeline transit from Russia to the EU through the Baltic Sea to 110 bcm. *REUTERS / Tobias Schwarz*

the EU's political project of building an Energy Union. Depending on the personal standpoint, it either runs against energy security considerations (looking at diversifying away from Russian imports as an aim in itself) or against its internal market policies by offering a single actor (Gazprom) too much power on the market, or against the environmental objectives of Europe's low-carbon economy as part of the Energy Union. There is a surprisingly broad consensus in Brussels, strongly supported by actors from the foreign, security and environmental policy communities, that Nord Stream 2 should be stopped by political actions rather sooner than later.

#### Natural gas in Europe: More market and less geopolitics

What becomes clear by following the debate about Nord Stream 2 is a growing divergence between the categories under which different policy communities assess an infrastructure project. The competitive market reality of private energy companies faces the geopolitically oriented mindset of foreign and security policy actors, with little understanding for the internal policy dynamics of each other. However, both dimensions are important. Without grasping each other's world, it is hard to develop criteria under which one could analyze projects such as Nord Stream 2.

First of all, it is important to understand the changes that natural gas markets have seen in Europe lately. With the beginning of the liberalization process in the 1990s, the role of governments and state actors in gas trading has been transformed fundamentally. Today, private companies are the main market players with a high degree of freedom to take their economic decisions based on cost-benefit considerations. The EU Commission has gained power as the ultimate regulatory authority, guaranteeing access to infrastructure, but also guaranteeing free competition between different models of gas-trading, between

different supply routes and between different fuels in the market. Still, infrastructure bottlenecks, insufficient competition and political influence by national governments are every day phenomena in many parts of Europe. Although this market is certainly not functioning in a perfect way, the improvements during the last couple of years are impressive. What has changed, however, is the desperate dependency of single national or regional markets on one source and one supplier, as the growing number of terminals for the import of liquefied natural gas (LNG) and reserve-flow investments in pipelines show clearly. The increasing natural gas import from non-EU markets and the growing trade in flexible gas hubs with spot-markets have changed the context of the debate significantly. Under these framework conditions, Gazprom's former

business model is under stress. The possibility to use political influence or coercion on single state actors is fading. At the same time, the role of long-term contracts and 'take-or-pay' provisions is less prominent. Today, Gazprom and its economic partners are under pressure from market dynamics in every single region in the EU. Meanwhile, Gazprom is adapting to this new situation by changing its business model, accepting spot-trading and the Commission's regulatory oversight. One could conclude: The European liberal market model has silently prevailed against the geopolitically motivated Russian model of creating one-sided dependencies.

Comparing this situation with most of the arguments against Nord Stream 2, it becomes obvious, that we are rhetorically returning to 20th century energy geopolitics, moving away from the reality of a modern energy market. The new geopolitical frontier between the EU and Russia shows a spill-over effect in the world of natural gas markets and one should ask the question, whether the EU has to allow that to happen. The project's opponents call for the state to intervene and for strong command-and-control policies that do not fit into the picture of a liberalized gas market. Asking a national government 'to dump' a pipeline project just appears to be outdated. For good reasons, one can deny public financial support for a project – as is happening in the Nord Stream 2 case. In order to stop a privately financed endeavor in a market environment, there must be more than just uncomfortable feelings on the side of regulators.

Also the second line of arguments against Nord Stream 2 – 'Europe doesn't need more gas' – is flawed. Since the nature of a market economy is to be found in actors' taking risk and chasing opportunities, the claim that political actors should intervene and stop a project because there will be 'no need' for gas in the next 20 years, stems

from a time of centrally-planned and state-controlled energy markets. Natural gas will compete against other fuels in the heating, transport and electricity sector, while the restrictions of climate policy can be met by many different mitigation options. The idea of a market economy implies, that every actor should have the right to take risks and dump money, as long as this is not public money.

### Trust in the rule of law

One of the main aims of the liberalization process in gas markets was to Europeanize regulatory practices, to introduce competition and to put the consumer at the center of political action. Most of the arguments around Nord Stream 2 are – on purpose or not – trying either to re-nationalize the debate, to avoid a competition-friendly environment with Gazprom as one among several actors or to put geopolitics before consumer interests. If we follow these arguments, this would mean a 180 degree turn-around from a policy approach that has been successfully followed during the last 15 years in the EU's internal gas market. Instead, the EU should be more self-confident about its market policy, allowing competition to pick winners and trusting in the Commission's regulatory control.

To readjust the debate, three important aspects need to be considered for future dealing with the Nord Stream 2 case: First, the EU Commission has to be in the regulatory driver seat, expecting an unbiased assessment of realistic compatibility options of the project with unbundling, third party access and competition provisions under the internal market laws. Following these criteria, the Commission has to analyze the project and decide how to deal with the investors' approach. This should be done

without taking gas demand scenarios or geopolitical considerations into account.

Second, for good reasons, the German government has lost a lot of political credit on Nord Stream 2. Not because the project is wrong from an energy point of view, but because the rules of good diplomacy and the perspective on geopolitics were absent in dealing with the proposal. Consulting the Russian government before talking to Central-Eastern European member states or the Commission was a major fault and discredit the commercial nature of the project. In an integrated European gas market, the time of national energy infrastructure politics should be over. Therefore, it would be wise to end engagement with the project on the side of German politics.

Third, in a community that is based on the rule of law, the rule of law should apply to all actors in the same way. In the end, this means, that economic activities in the range of the legally defined framework should be assessed under the existing regulatory criteria, but not under normative categories of good or bad. It is a question of self-confidence of Europe's liberal market approach to handle a project such as Nord Stream 2. If there is a desire to change the way politics and markets interact in the EU, this would need a more fundamental debate for which Nord Stream 2 is certainly not the right point of departure.

**Dr. Severin Fischer** is a Senior Researcher in the Global Security Team at the Center for Security Studies (CSS), ETH Zürich. He is also author of 'An Energy World Order in Flux' (2016) in Strategic Trends 2016.  
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Editor: [Martin Zapfe](mailto:Martin.Zapfe@css.ethz.ch) / Assistant Editor: [Prem Mahadevan](mailto:Prem.Mahadevan@css.ethz.ch)

Comments welcome at [PolicyPerspectives@sipo.gess.ethz.ch](mailto:PolicyPerspectives@sipo.gess.ethz.ch)

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