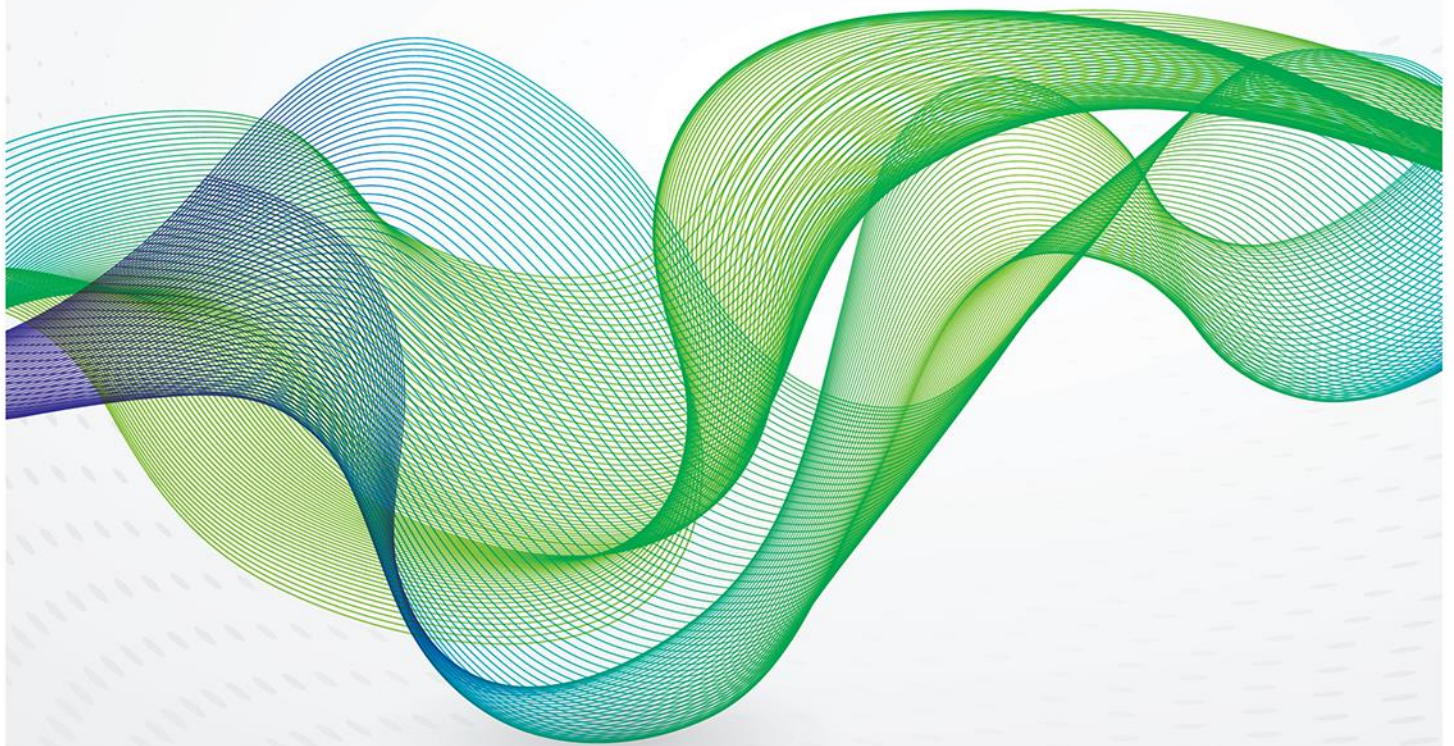
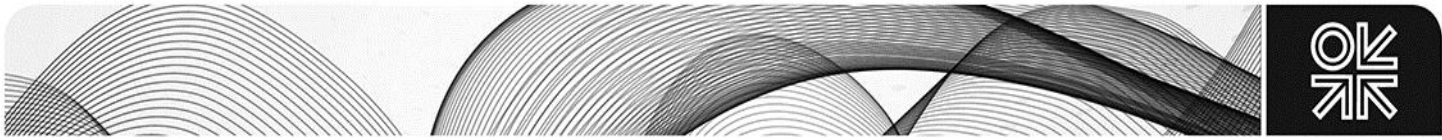


April 2017

The EU Competition Investigation into Gazprom's Sales to Central and Eastern Europe: a comment on commitments





Introduction

On 4 September 2012 the Competition Directorate (DG COMP) of the European Commission (EC), having carried out unannounced inspections ('dawn raids') at the premises of several companies in ten EU Member States one year earlier, opened formal proceedings against Gazprom for possible abuse of a dominant position under Art. 102 of the Treaty on the Functioning of the European Union (TFEU) in upstream gas supply markets in several central and eastern European member states. It stated that Gazprom may have (a) divided gas markets by hindering the free flow of gas across member states; (b) prevented the diversification of supply of gas; (c) imposed unfair prices on its customers by linking the price of gas to oil prices.¹

The Russian government, considering the investigation to be both politically and commercially motivated, adopted an executive order forbidding Gazprom to provide information on its activities upon request from non-Russian authorities, other than under the government's prior consent.² The all-encompassing nature and the swiftness with which the order (which should be seen as a form of insurance safeguarding the interests of the Russian state) was adopted suggested that the government did not rule out any – including the worst-case – scenario relating to the treatment of Gazprom's case by the EC.

Statement of objections

In April 2015, more than two and a half years after the investigation had started (and a further year after the initial 'dawn raids'), DG COMP issued a statement of objections,³ setting out its preliminary view that Gazprom was hindering competition in the gas supply markets in Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Slovakia by imposing *territorial restrictions* (including export bans, destination clauses, and other measures), pursuing an *unfair pricing policy* in Bulgaria, Estonia, Latvia, Lithuania, and Poland (with such unfairness resulting partly from price formulae indexing gas prices to a basket of oil products), and making gas supplies to Bulgaria and Poland conditional on *obtaining unrelated commitments concerning gas transport infrastructure* (South Stream and Yamal–Europe pipelines). DG COMP referred to these practices as abuses of dominance (Art. 102), although the strength of its position varied on each of the objections, being strongest in respect of territorial restrictions and, arguably, weakest in respect of unfair pricing policy. Gazprom dismissed DG COMP's objections as 'unsubstantiated'.⁴

Gazprom's commitments

In December 2016 Gazprom submitted its proposal for commitments⁵ (without admission of any wrongdoing) in line with Art. 9 of Regulation 1/2003 (which regulates the implementation of EU competition rules) in respect of DG COMP's objections, to cover a period of eight years.

Territorial restrictions (destination clauses)

In respect of *territorial restrictions* Gazprom offered not to apply any clause restricting resale or territorial restriction clause, and not to introduce any new clause restricting resale or new territorial restriction clause in any existing or new contract on gas supply. This would be done by means of notifying its existing customers in writing within ten weeks of the effective date of the commitments. In so doing,

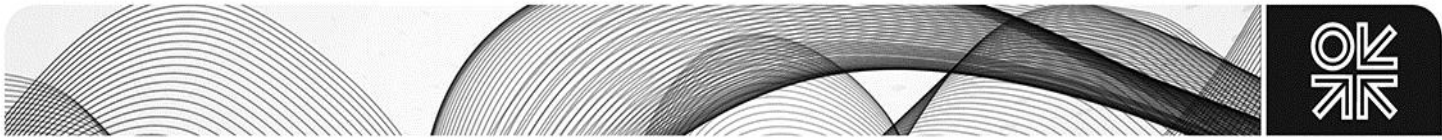
¹ European Commission, 'Antitrust: Commission opens proceedings against Gazprom', press release, 4 September 2012.

² Executive Order N 1285, 11 September 2012.

³ European Commission, 'Antitrust: Commission sends Statement of Objections to Gazprom for alleged abuse of dominance on Central and Eastern European gas supply markets', press release, 22 April 2015; European Commission, 'Antitrust: European Commission sends Statement of Objections to Gazprom – Factsheet', 22 April 2015.

⁴ Gazprom, 'Statement of OAO "Gazprom" with respect to the adoption of "statement of objections" by the European Commission under the antitrust investigation', press release, 22 April 2015.

⁵ Proposals for Commitments, COMP/39.816 – Gazprom, Commitments under Article 9 of Council Regulation N1/2003.



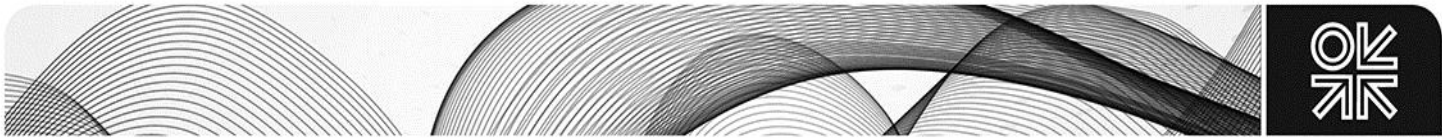
Gazprom has committed to remove all contractual barriers to the free flow of gas in central and eastern European gas markets (Section II.1, paras 5 and 6).

It is understood that Gazprom had ceased to apply territorial restrictions in all of its central and eastern European contracts prior to DG COMP issuing the statement of objections, with the last restrictions having been removed from the Baltic contracts by October 2013. Nonetheless, the existence of any such clauses is a very serious problem for Gazprom as they should have been removed in 2004 when the Baltic countries joined the EU. It is understood that DG COMP found at least one such clause (in the Lithuanian contract), which gives the competition authority sufficient grounds for imposing fines on Gazprom for violation of the EU competition law. Given the painful removal of all destination clauses from west European gas contracts in the 2000s, Gazprom can hardly claim lack of knowledge of this aspect of competition law. The only possible mitigating factor could be that the competition authority of Lithuania – an EU member state since 2004, whose complaint started the investigation – apparently made no attempt to request a removal of these restrictions, despite their illegality under EU law. But it was the existence of at least one destination clause, and the resulting ability to impose a fine on the basis of this violation of competition law (against which there is no defence), which gave DG COMP substantial leverage in its negotiations with Gazprom.

Responding to DG COMP's concerns, Gazprom also offered to make changes to its Bulgarian (supply and transit) and Greek (supply) contracts 'to the extent necessary to remove obstacles' that affected the ability of the Bulgarian TSO (Bulgartransgaz) to conclude interconnection agreements with the TSOs of adjacent EU member states. This would enable third-party access (TPA) not only at the existing interconnection point (IP) at Sidirokastro (where, historically, all capacity was booked by Gazprom), but also at the new (and yet to be built) IP at Komotini, for the Interconnector Greece–Bulgaria (IGB) – both IPs being at the Bulgaria–Greece border. This, in turn, would enable Bulgaria to access non-Russian gas alternatives, both pipeline and LNG, in line with the EU's energy security strategy.

Furthermore, Gazprom offered its existing buyers in Poland, Slovakia, and Hungary (with supply contracts with a duration of more than two years) a right to request a change from their original delivery points (Kondratki (Poland–Belarus border), Velke Kapusany (Slovakia–Ukraine border), Beregovo (Hungary–Ukraine border)) to the new delivery points (Negru Voda (Bulgaria–Romania border) and/or Kotlovka (Lithuania–Belarus border)) (section II.1.2, para 9). According to DG COMP, this would create opportunities for increased gas flows to the Baltics and Bulgaria, as the right to receive their contracted gas at the entry points for the Baltics and Bulgaria would enable Poland, Slovakia, and Hungary to 'seek new business opportunities' in these countries. However, Poland, Slovakia, and Hungary might perceive these new opportunities as being insufficiently advantageous to justify a change in the delivery points – one significant factor being the relatively small size of the Baltic and Bulgarian gas markets (~8 bcm in total in 2016).

Establishing the right to request a delivery point(s) change as a part of commitments in an anti-trust case is a very important development, potentially having significant implications outside the current investigation. In particular, it suggests that any future refusal by Gazprom to grant a request (made by any of its European buyers – not just those that are part of the current investigation) to change a delivery point could be considered anti-competitive. This could be relevant, for example, in respect of Russian gas transit across Ukraine, making it more difficult for Gazprom to refuse a potential request from EU buyers to move delivery points to the Russia–Ukraine border. In turn, this would necessitate the continuation of transit across Ukraine, thus contributing towards the EU's political objective of preserving transit across Ukraine post-2019. On the other hand, it also serves as an implicit acknowledgement that the original delivery points would stay unchanged until Gazprom's European supply contracts expire, unless EU buyers themselves request a change. As such, it provides an assurance that even if the existing Ukrainian transit contract is not replaced upon its expiry at the end of 2019, Gazprom's responsibility to deliver gas to the original delivery points will still remain.



Pricing issues

In response to DG COMP's concern that Gazprom may have pursued an unfair pricing policy in *Bulgaria, Estonia, Latvia, Lithuania, and Poland*, Gazprom has committed to introduce *competitive benchmarks*, including western European hub prices, into its price review clauses in contracts with customers in these member states. These commitments will give the customers an explicit contractual right to request changes to their gas prices when they diverge from competitive price benchmarks, thus ensuring competitive prices in these countries in the future. Gazprom has also committed to *increase the frequency and speed of price revisions* and will also introduce clauses reflecting the above elements into those contracts (for instance those with the Baltic states' customers) where price revision clauses do not currently exist.

DG COMP's switch of the original language in the statement of objections from 'fair' pricing to 'competitive' pricing, is an acknowledgement that the term 'fair' cannot be adequately defined (this was demonstrated in the 2016 Lithuanian arbitration judgement). 'Competitive' pricing also has definitional problems in relation to these five countries, as only Poland could be said to have even an operating hub, and none have anything that could be described as a liquid hub. The key provisions are in section II.2, para 19, particularly para 19 (i) the trigger for a price review clause, which reflects the Commission's judgement that:

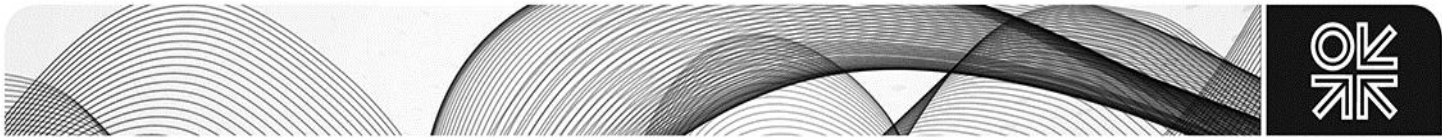
'... the prevailing price level resulting from the Contract does not reflect the development of the European gas markets as reflected, inter alia, in the development of the average weighted import border prices in Germany, France and Italy and/or the development of the prices at the relevant generally accepted liquid hubs in Continental Europe.'

Despite the fact that the 'weighted import border prices in Germany, France and Italy' and 'the prices at the relevant generally accepted liquid hubs in Continental Europe' cannot either *historically or currently* be said to be applicable to energy and gas market conditions in the Baltic countries and Bulgaria (and only in the past one to two years, and only approximately in Poland), Gazprom has accepted that these prices must be regarded as competitive. This is a big change in the terms Gazprom is required to offer the Baltic countries and Bulgaria (the Polish case is less of a change given the approximation of hub prices to those of north-west Europe), and should also mean that current arbitration proceedings will either be halted or will end in something very similar to DG COMP's requirements (albeit with some uncertainty about the date from when border or hub prices should be applied).

Gazprom may have taken the pragmatic stance that it was preferable to come to an agreement with DG COMP rather than risk further legal action and/or fines. Another part of Gazprom's pragmatism may be that although at present these weighted average prices do not represent a competitive price in either Bulgaria or the Baltics, this situation will change over the next two to three years with the construction of interconnectors between Poland and the Baltic states, Poland and central Europe, and within and between Bulgaria and the rest of Europe. By (and perhaps before) 2020, it is likely that only some of the very smallest south-east European markets (which are not EU member states) may remain cut off from north-west European hub prices.

These commitments are very important not just for Gazprom but also for the pricing of gas in Europe generally, because they probably signal a definitive end to oil-linked/alternative fuel pricing. Any party in a price negotiation or arbitration can now argue that DG COMP has ruled that even if a country is not connected to a hub, 'competitive pricing' means west European border or hub prices, and this is universally applicable.⁶

⁶ A different interpretation could be that DG COMP has applied this requirement only because of Gazprom's dominance in these markets. Following this logic, suppliers which are not dominant suppliers to a market could continue to argue that alternative fuels should remain a relevant pricing benchmark (although we believe with a decreasing likelihood of success).



Infrastructure issues

Although DG COMP has expressed concern about Gazprom making gas supplies to Bulgaria conditional on the latter's participation in the South Stream pipeline project, it is not clear whether this concern is justified, as the publicly available Bulgaria–Russia IGA (which served as a legal/regulatory framework for South Stream) does not appear to provide sufficient evidence. While the IGA stated that Gazprom ‘will provide *additional supplies*’ via the new pipeline system under market conditions, it did not say that either existing or additional supplies would be withheld should such a system not be built. Nonetheless, Gazprom offered a number of commitments in respect of South Stream, including an offer not to claim damages for its cancellation. Notably, the 100 per cent state-owned Bulgarian Energy Holding (BEH) would be liable for at least \$70 mn, if Bulgaria failed to honour its commitments under the IGA. Given that the IGA provides a *generic* framework for a new gas pipeline system for supplies to, and transit across, Bulgaria (rather than specifically for South Stream) it could serve as a framework for another gas pipeline system in the future (such as the second string of Turkish Stream), and could be a reason why Gazprom offered to forfeit damages.

Although DG COMP raised similar concerns in respect of the Yamal–Europe pipeline (owned by EuroPolGaz) in Poland, Gazprom made no commitments in its respect, with DG COMP admitting that the situation cannot be changed by means of anti-trust procedure due to the impact of the Poland–Russia IGA. Our preliminary analysis of the publicly available IGA and subsequent protocols suggests that there is insufficient evidence that Gazprom made its gas supplies to Poland conditional on control over investment decisions or on obtaining unrelated commitments concerning gas infrastructure. Neither the IGA nor the protocols appear to contain any provisions suggesting a connection between provision of supplies and any infrastructure issues. Moreover, they state that the investment programme must be agreed with EuroPolGaz’s *main shareholders* (PGNiG and Gazprom) and *parity management* must be ensured, thus suggesting Gazprom’s inability to control investment decisions in respect of Yamal–Europe.

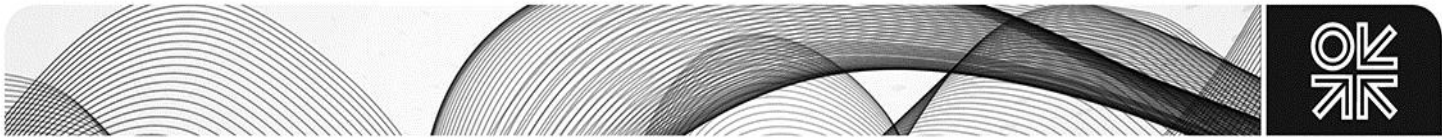
European reactions

On 13 March 2017 DG COMP announced its satisfaction with Gazprom’s commitments.⁷ According to Competition Commissioner, Margrethe Vestager, the commitments ‘will enable the free flow of gas in central and eastern Europe at *competitive* prices’, address competition concerns, ‘provide a forward looking solution in line with EU rules’, and ‘help to better integrate gas markets in the region’. Subsequently, DG COMP launched a market test, inviting third parties to comment by 4 May 2017. We believe that DG COMP is likely to accept the commitments and make them legally binding, thus closing the investigation with a settlement.

However the potential for confrontation remains and could be realized should third parties overwhelmingly express – and *substantiate* – their dissatisfaction with the commitments. DG COMP’s willingness to settle the case without a fine has caused a significant degree of unhappiness on the part of central and eastern European member states. This is especially true for Poland, which apparently views such fines not only as a commercial ‘revenge’ against Gazprom for what it claims have been unfair commercial practices – but seemingly also as political revenge against Russia. The Polish authorities threatened to sue the EC should the investigation be closed without a fine, referred to the commitments as ‘highly insufficient’, and promised to use ‘all legal means’ to block them.⁸ The European Parliament ITRE (Industry, Research and Energy) committee, headed by a Polish politician, Jerzy Buzek, sent a letter to DG COMP stating disappointment about the commitments ‘missing the provisions for compensation to the affected parties and a fine for the breach of the EU rules’, and called

⁷ European Commission, ‘Antitrust: Commission invites comments on Gazprom commitments concerning Central and Eastern European gas markets’, press release, Brussels, 13 March 2017.

⁸ ‘Poland to use “all legal means” to block Gazprom’s EU anti-trust deal’, *Reuters*, 15 March 2017; ‘Poland’s PGNiG: Gazprom antitrust settlement “highly insufficient”’, *Financial Times*, 13 March 2017.



for the introduction of 'all appropriate measures to ensure that Gazprom effectively compensates the affected parties for the losses they have incurred in the respective Member States'.⁹

Conclusions

Gazprom's proposal for commitments has addressed all substantiated DG COMP concerns in respect of territorial restrictions, prices, and infrastructure. Their acceptance would provide insurance against any future abuse by Gazprom of its dominant position in central and eastern European member states. Most importantly, Gazprom has henceforth agreed to charge average weighted import border prices in Germany, France and Italy and/or prices at relevant generally accepted liquid hubs in Continental Europe, instead of alternative fuel (oil-linked) prices, despite the fact that at present west European border/hub prices do not (yet) accurately represent gas market conditions in either Bulgaria or the Baltics (and only in the past one to two years, and only approximately in Poland). This means that if the proposals are accepted, buyers in these countries will be able to buy Russian gas at prices which otherwise would not have been offered to them until interconnections had been established with north-west European hubs (potentially up to three years hence). In our view, it would therefore be reasonable to expect an overall positive response to the commitments during the market test, followed by DG COMP's acceptance of the commitments and closure of the case with a settlement. However, it cannot be ruled out that some member states, specifically Poland, might attempt to derail such a settlement. Should that happen and the case be referred to the EU Court of Justice (CJEU), the whole episode could drag on for several more years.

⁹ European Parliament, 'Comments on Gazprom's commitments concerning Central and Eastern European gas markets and compensation for affected parties – letter to DG COMP', 16 March 2017.