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## **Nord Stream 2: between monopoly and diversification**

Nord Stream 2 (NS2) has become one of the most contested pipeline projects in European history. The controversy hinges upon the assessment of whether NS2 is a friend or a foe to European gas market security. It is rooted as much in diverging historical legacies as it is in the distinct market realities. In this context, smart policy choices grounded in understanding of the deepening and globalising natural gas market and new options for natural gas delivery can provide a common ground and facilitate a win-win situation for all Europeans.

**Keywords:** Nord Stream 2, Nord Stream, energy security, energy diversification, Russia, geopolitics, Ukraine, Ukrainian transit, LNG, natural gas, pipelines, natural gas market

## **Nord Stream 2 – między monopolem a dywersyfikacją**

Nord Stream 2 (NS2) jest jednym z najbardziej spornych projektów rurociągów w historii Europy. Kontrowersje dotyczą przede wszystkim tego, czy NS2 sprzyja, czy raczej szkodzi budowaniu bezpiecznego rynku gazu na kontynencie. Wynika to zarówno z różnych doświadczeń historycznych, jak i odmiennych realiów rynkowych poszczególnych państw. W takim kontekście rozsądne decyzje polityczne, oparte na zrozumieniu, że rynek gazu coraz bardziej się globalizuje i dostępne są nowe opcje dostaw, mogą stworzyć Europejczykom wspólną płaszczyznę korzystnej dla wszystkich współpracy.

**Słowa kluczowe:** Nord Stream 2, Nord Stream, bezpieczeństwo energetyczne, dywersyfikacja energii, Rosja, geopolityka, Ukraina, ukraiński tranzyt, LNG, gaz ziemny, rurociągi, rynek gazu

Nord Stream 2 (NS2) has become one of the most contested pipeline projects in European history. The controversy hinges upon the assessment of whether NS2 is a friend or a foe to European gas market security. It is rooted as much in diverging historical legacies as it is in the distinct market realities. But the divide also underscores that to achieve energy security Europe needs to diversify its gas market, independent of whether NS2 is completed or not. To achieve that goal, strategic investment in natural gas infrastructure is

needed, particularly in places where infrastructure and market connectivity is lacking such as Central and Eastern Europe, the Adriatic region and Spain. These developments can shield Europe as a whole from the negative effects of either NS2 and/or potential interruptions in the Ukrainian transit, especially if market liberalisation follows.

The deepening and globalising natural gas market provides a special opportunity to undertake this challenge as new options for natural gas delivery make it easier to access new sources under more flexible conditions. They can also provide common ground and facilitate a win-win situation for all Europeans.

This paper's goal is to highlight the issues above and look into the policies that could ensure European energy security. The paper is divided into two parts. The first one is descriptive and includes a history of Nord Stream undertakings and the current status of NS2. It considers the EU's natural gas market supplies, issues surrounding Ukrainian transit and its geopolitical and commercial significance. It also presents the arguments voiced by the two sides of the NS2 controversy. The second part of the paper looks into the measures that the EU can undertake to ensure European energy security and considers challenges that those measures can face. The paper concludes by highlighting the importance of diversification and liberalisation of the European gas market(s), both of which are crucial for ensuring the continent's energy security irrespective of the fate of the NS2 pipeline.

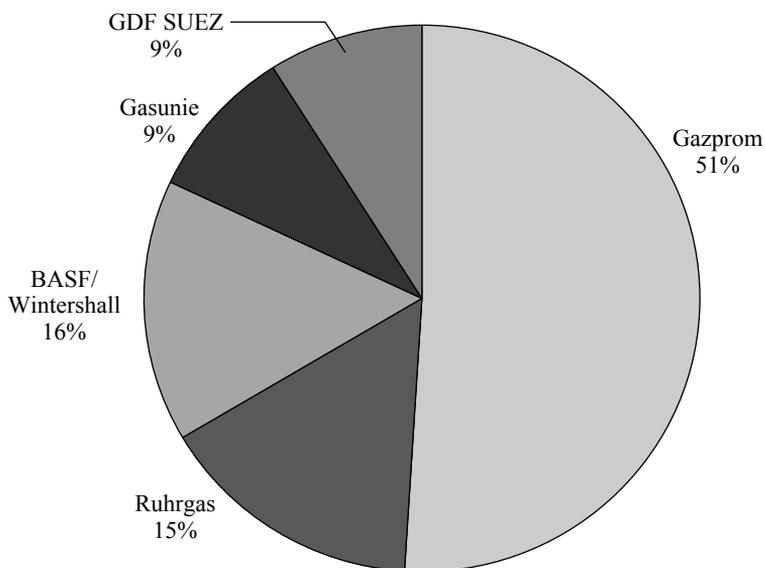
## **Nord Stream 2: the history, status quo and European energy security**

The Nord Stream project began in earnest in 2006 when a group of shareholders that included Russian Gazprom and Germany's E.ON Ruhrgas and BASF SE / Wintershall Holding founded the Nord Stream company to lay the North European Gas Pipeline. It would transport Russian gas under the Baltic Sea directly to the German border. Later on, Dutch N.V. Nederlandse Gasunie and French GDF SUEZ SA also joined the group (Figure 1).<sup>1</sup> With an annual capacity of 55 billion cubic metres (bcm), Nord Stream (NS) became fully operational by 2012. The pipeline operated at virtually full capacity during

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1 *Secure energy for Europe. The Nord Stream pipeline project*, "Nord Stream" [online, accessed: 22.10.2018], available at: <[https://www.nord-stream.com/media/documents/pdf/en/2014/04/secure-energy-for-europe-full-version\\_245\\_20140417.pdf](https://www.nord-stream.com/media/documents/pdf/en/2014/04/secure-energy-for-europe-full-version_245_20140417.pdf)>.

the unusually cold finale of the 2018 winter season contributing to record high Russian gas exports to Europe.<sup>2</sup>



**Figure 1. The Nord Stream Consortium**

Source: “Nord Stream” [online, accessed: 23.10.2018], available at: <<https://www.nord-stream.com/>>

On the back of the success of the first pipeline, a new project company, Nord Stream 2 AG, was established, though its timing has not been as precipitous, fraught by the difficult political situation following the Russian annexation of Crimea. This time, Gazprom was unable to share the investment with western European firms. The Polish Office of Competition and Consumer Protection (UOKiK) successfully blocked the joint venture, citing competition and market power concerns.<sup>3</sup> As a result, Gazprom retained entire ownership of the company. France’s ENGIE, Austrian based OMV, Royal Dutch

2 J. Sharples, *Ukrainian gas transit: still vital for Russian gas supplies to Europe as other routes reach full capacity*, The Oxford Institute for Energy Studies 2018, p. 5. Available at: <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2018/05/Ukrainian-gas-transit-Still-vital-for-Russian-gas-supplies-to-Europe-as-other-routes-reach-full-capacity-Comment.pdf>> [accessed: 26.10.2018].

3 *Zastrzeżenia wobec koncentracji – Nord Stream 2*, “Urząd Ochrony Konkurencji i Konsumenta” [online], 22.07.2016 [accessed: 24.11.2018], available at: <[https://www.uokik.gov.pl/aktualnosci.php?news\\_id=12476](https://www.uokik.gov.pl/aktualnosci.php?news_id=12476)>.

Shell, and Germany's Uniper and Wintershall have only been participating in the financing of the project.<sup>4</sup>

The difficult start has been followed by an even more difficult road to actually building the NS2 pipeline as concerns over Gazprom's dominant position in the European market and issues of European security have been raised by Central and East European countries.

As of May 2019, NS2 is expected to face at least a delay in its expected completion (from 2019 to 2020). The delay reflects the passing of a new EU law, which brings in NS2 under the Third Energy Package requirements of unbundling and Denmark's refusal to grant the pipeline underwater construction permits. All this as the Stockholm Tribunal Dispute with Ukraine persists and the U.S. repeatedly highlights the possibility of imposing sanctions that could further cripple the progress the pipeline's construction.<sup>5</sup> In contrast, NS2 stakeholders highlight arguments of diversification of European gas supply routes and support of European energy security. According to their position, NS2 would provide an alternative to an "uneasy and unreliable" transit of Russian gas via Ukraine.

### *EU energy security and Nord Stream 2*

In 2017 for the third consecutive year Europe increased its imports of natural gas.<sup>6</sup> Weather, economic recovery, dwindling domestic supply, and power generation drove the increases<sup>7</sup> in both Russian gas (the share of total Russian imports was up from 42% in 2016 to 43% in 2017) and liquefied natural gas (LNG) imports (10%).<sup>8</sup> But this pattern is not exclusive to the last three years. Per figure 2, European production has been on the decline for some time now

4 *Company overview of Nord Stream 2 AG*, "Bloomberg" [online, accessed: 23.10.2018], available at: <<https://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=383208587>>.

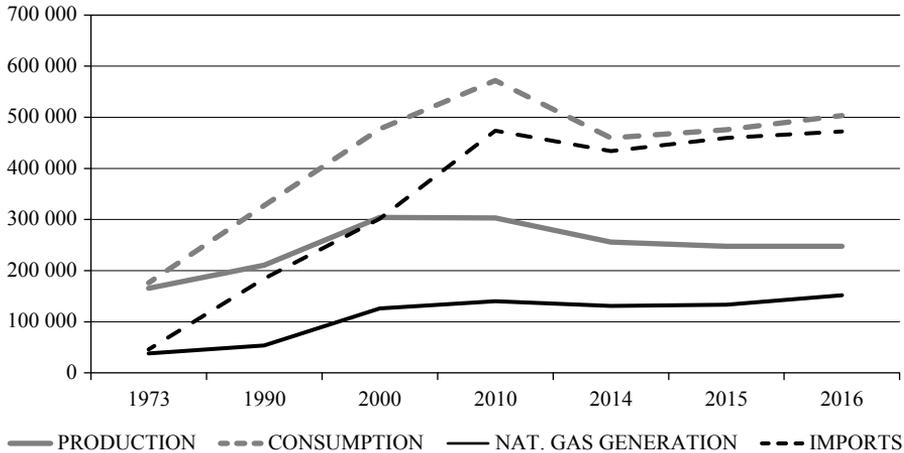
5 *Gazprom chief says slight changes to Nord Stream 2 timings possible: Ifax*, "Reuters" [online], 19.05.2019 [accessed: 19.05.2019], available at: <<https://www.reuters.com/article/us-gazprom-nordstream-2-miller/gazprom-chief-says-slight-changes-to-nord-stream-2-timings-possible-ifax-idUSKCN1SP0CS>>.

6 European Commission, *Quarterly report on European gas markets*, "DG Energy" 2017, vol. 10, issue 4. Available at: <[https://ec.europa.eu/energy/sites/ener/files/documents/quarterly\\_report\\_on\\_european\\_gas\\_markets\\_q4\\_2017\\_final\\_20180323.pdf](https://ec.europa.eu/energy/sites/ener/files/documents/quarterly_report_on_european_gas_markets_q4_2017_final_20180323.pdf)> [accessed: 26.10.2018].

7 A. Honoré, *Natural gas demand in Europe in 2017 and short-term expectations*, The Oxford Institute for Energy Studies 2018 (Oxford Energy Inside, 35). Available at: <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2018/04/Natural-gas-demand-in-Europe-in-2017-and-short-term-expectations-Insight-35.pdf>> [accessed: 28.10.2018].

8 Conglin Xu, *US LNG for Europe*, "Oil & Gas Journal" [online], 23.04.2018 [accessed: 28.10.2018], available at: <<https://www.ogj.com/articles/print/volume-116/issue-4c/regular-features/journally-speaking/us-lng-for-europe.html>>.

while consumption of natural gas has been generally on the rise (with the notable exception of the 2010–2014 period when European debt crisis negatively impacted economic growth and by that also energy demand).



**Figure 2. EU volumes of natural gas production, consumption, power generation, and imports as guided by years: 1973, 1990, 2000, 2010, 2014, 2015 & 2016 (in millions cubic metres per year)**

Source: World Energy Balances, IEA. Author's interpretation

In addition, energy balances of the OECD Countries in Europe (IEA)<sup>9</sup> show that the share of natural gas in the total energy supply in Europe has increased from 9.8% in 1973 to 16.1% in 1990, and to 24% in 2016. IEA projects that both growth in demand (at an annual average rate of 1.4%) and increase in gas generation (at an annual average rate of 3.2%) are going to increase in Europe through 2050.<sup>10</sup> The experienced and projected growth in demand combined with the increasing import share puts Europe in a potentially vulnerable position with respect to any natural gas delivery disruptions – whether technical like the Baumgarten accident or geopolitical like those experienced due to Ukraine-Russia transit issues, or related to abnormally high prices.

These numbers should inform European policy makers at both national and EU-levels. As such, diversification is critical, including not only diversification of routes but also diversification of supply sources. Fortunately, recent developments in the natural gas markets support this task. Advances

<sup>9</sup> *World Energy Balances*, “International Energy Agency” [online, accessed: 3.10.2018], available at: <<https://www.iea.org/statistics/balances/>>.

<sup>10</sup> *Ibidem*.

in LNG technology and new sources of supply such as the US have facilitated a more liquid and more global natural gas market that directly threatens the dominance of regional gas suppliers such as Russia.<sup>11</sup>

But to be able to take advantage of those changes, countries have to be prepared for LNG and other alternative deliveries, which includes LNG import infrastructure as well as an infrastructure that can efficiently distribute LNG and piped gas across the entire EU territory.

Here Western European markets are much better prepared to welcome new market realities than their Central and Eastern European (CEE) neighbours. Given their interconnectedness and well-developed LNG infrastructure, they are also better prepared to withstand any potential attempts to dominate their markets, including by providing supplies of cheap gas via the newly built NS2. The already existing import and pipeline infrastructure insulates western Europe relatively well from Gazprom dominating their markets even if it can temporarily clear its competition by establishing a “credible threat” of competitive supplies able to flow at (almost) any time.

This is still not necessarily the case in CEE, where many new natural gas infrastructure and interconnections are in their infancy: either just opened, under construction or in the planning stage. Thus, there is the theoretical potential that a flood of cheap gas could stifle the investment and, in effect, leave the region highly dependent on Russian gas and susceptible to geopolitical pressure and high prices set by the dominant player.

### *The Ukrainian debacle: arguments and what's at stake*

Historically, over two-thirds of Russian gas destined for Europe moved through pipelines running across Ukrainian territory. This is a matter of Soviet-era legacy. Most recently, however, pricing disputes, debt settlement issues, and politics have profoundly affected Ukrainian transit as Russia repeatedly cut off supplies intended for Ukraine. To be clear, gas to the EU never stopped flowing. But European consumers experienced related shortages. These were framed as either result of syphoning of EU-bound gas by the Ukraine (per Gazprom) or as demanded by the servicing needs of the pipeline (per Ukraine).<sup>12</sup> The disruptions were particularly painful in 2005/2006 and

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11 P. Hartley, *The future of long-term LNG contracts*, Baker Institute for Public Policy 2013. Available at: <<https://scholarship.rice.edu/bitstream/handle/1911/91305/CES-Pub-GeogasLNG-110113-1.pdf?sequence=1>> [accessed: 23.10.2018].

12 *Ukraine siphons Russian gas shipment*, “Washington Times” [online], 3.01.2009 [accessed: 25.11.2018], available at: <<https://www.washingtontimes.com/news/2009/jan/03/ukraine-siphons-russian-gas-shipment/>>.

2008/2009 as they occurred during peak demand season and clouded the security of supply for European countries.

The relationship between Russia and Ukraine has deteriorated steadily since 2014, following Russia's invasion of Ukraine and annexation of Crimea. All deliveries of Russian gas to Ukraine ceased in November 2015. A lack of resolution in the disputes between Gazprom and Ukraine's Naftogaz on payments and pricing resulted in Ukraine purchasing its gas on the western border via reverse flows.<sup>13</sup>

Ukraine continues, however, in its role as a transit territory and remains Gazprom's main gas artery to Europe.<sup>14</sup> This role is supported by the transit contract between Gazprom and Naftogaz, existing transit and delivery contracts between Gazprom's European customers, and the lack of a sufficiently large alternative transit capacity.<sup>15</sup> But the contract between Gazprom and Naftogaz is set to expire in 2019 and delivery contracts to many European consumers are to end soon thereafter. And Gazprom is eyeing the possibility of freeing itself from the Ukrainian transit. Adding a new set of new pipelines – Nord Stream 2 with a capacity of 55 bcm per year – could complete the NS1 investment and the task of establishing an alternative transit route for Russian gas destined for Europe.

Arguing for the new route, Gazprom cites the unreliability of the Ukrainian transit and the low cost of Russian gas. An insightful discourse analysis by Katya Lyulina<sup>16</sup> shows the Russian side framing its actions as purely economic and non-political, where Gazprom and Russia are portrayed as rational actors and where Russia is a victim of the dispute suffering both financial losses and accusations of geopolitical meddling. Ukraine is, on the other hand, painted as an “unreasonable” and “unconstructive” partner, which has been abusing the relationship with Russia and the inability of the latter to shift all of its gas to other routes.

Hence, according to Gazprom, NS2 could support Europe's energy security by increasing route diversification and the EU's growing natural gas

13 Reverse flows i.e. from countries like Poland or Czech Republic that have until now been on the receiving end of the gas flows from Ukraine but now are re-exporting some of the gas they receive back to Ukraine.

14 *Ukraine not importing gas from Russia for 900 days*, “Interfax-Ukraine” [online], 15.05.2018 [accessed: 22.10.2018], available at: <<https://en.interfax.com.ua/news/economic/505377.html>>.

15 J. Sharples, *Ukrainian gas transit...*

16 K. Lyulina, *Understanding the 2014 Russo-Ukrainian gas dispute. A comparative analysis of Russian and Ukrainian political discourses*, master thesis, Leiden University 2015, p. 14–19. Available at: <<https://openaccess.leidenuniv.nl/bitstream/handle/1887/34429/Thesis%20Katya%20Lyulina.pdf?sequence=1>> [accessed: 28.11.2018].

demand.<sup>17</sup> To underline its reputation as a reliable supplier, Gazprom points to a lack of supply disruptions to its western European customers dating back to the Cold War.

The picture of the gas disputes painted by the Ukrainian side is diametrically different as Ukraine focuses on Russia's geopolitical motivations with the ramifications much broader than ensuring uninterrupted gas supplies. According to Lyulina, there is a prevailing notion of Russia's actions having been focused on "returning Ukraine to its sphere of influence" and "tearing it from Europe".<sup>18</sup> The disruptions are designed to discredit Ukraine in the eyes of Europe with NS2 proposed as a safe alternative to the Ukrainian route. A potential loss of its status as an essential gas transit country leaves Ukraine with no bargaining power against Russia, not only in energy but also all other policy matters, making the former more susceptible to Russian influence. According to Ukraine, not only are the disruptions in gas supply political in nature, but also Russia's decisions to provide discounted prices is geared towards subordination of Ukraine. This is why Ukraine has been working hard to devise its policy to reflect the requirements within the EU and potentially become completely independent of Russian gas supplies.<sup>19</sup> In the wake of Russian aggression on Crimea and the most recent Russian seizure of Ukrainian ships in the Sea of Azov, there is also the notion that, in the future, NS2 could serve as a tool of potential Russian military aggression against Europe.<sup>20</sup>

Ukraine and Russia had a chance to highlight their positions in a legal battle in the Stockholm Arbitration Tribunal that considers the arguments related to disruptions in the Russian gas flow to Ukraine over pricing of contracted volumes. The tribunal sided with Naftogaz awarding the latter \$4.7 billion in damages. It concluded that Gazprom failed to supply the contracted transit volumes and needs to pay the balance of \$2.53 billion, after considering what Naftogaz already owed Gazprom. It also rejected Gazprom's claim of \$37 billion from Naftogaz under the take-or-pay agreement, for gas debts and gas supplied between May and June of 2014. Gazprom refused

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17 *Project Background*, "Nord Stream 2" [online, accessed: 25.11.2018], available at: <<https://www.nord-stream2.com/en/pdf/document/4/>>.

18 K. Lyulina, *Understanding...*, p. 19.

19 *Ibidem*.

20 *Why Russian aggression in Azov Sea area is important for Nord Stream 2 case*, "DiXi Group" [online], 28.11.2018 [accessed: 2.12.2018], available at: <<http://dixigroup.org/eng/publications/why-russian-aggression-in-azov-sea-area-is-important-for-nord-stream-2-case/>>.

to acknowledge the verdict quoting a positive bias in favour of Ukraine whose economy is suffering as it endures higher prices for gas that needs to be imported via flows from the west and lower gas transit fees.<sup>21</sup> The parties have been engaging back and forth on the decision before the Swedish appeal court, which, on the basis of Gazprom's appeal, suspended the Stockholm Tribunal decision in June 2018 which then withdrew that ruling in September 2018. Also, Ukraine engaged in attempts to seize Gazprom's assets and promised to formally demand over \$100 million in compensation for the difference between the gas Gazprom fails to deliver to Ukraine and the more expensive gas the country needs to import from the west. For now, these efforts have resulted in the Swiss court blocking all payments to Nord Stream AG and Nord Stream 2 AG as reported by Gazprom in early November 2018.<sup>22</sup> But the situation is far from resolved.

### ***Between “the commercial” and “the geopolitical”***

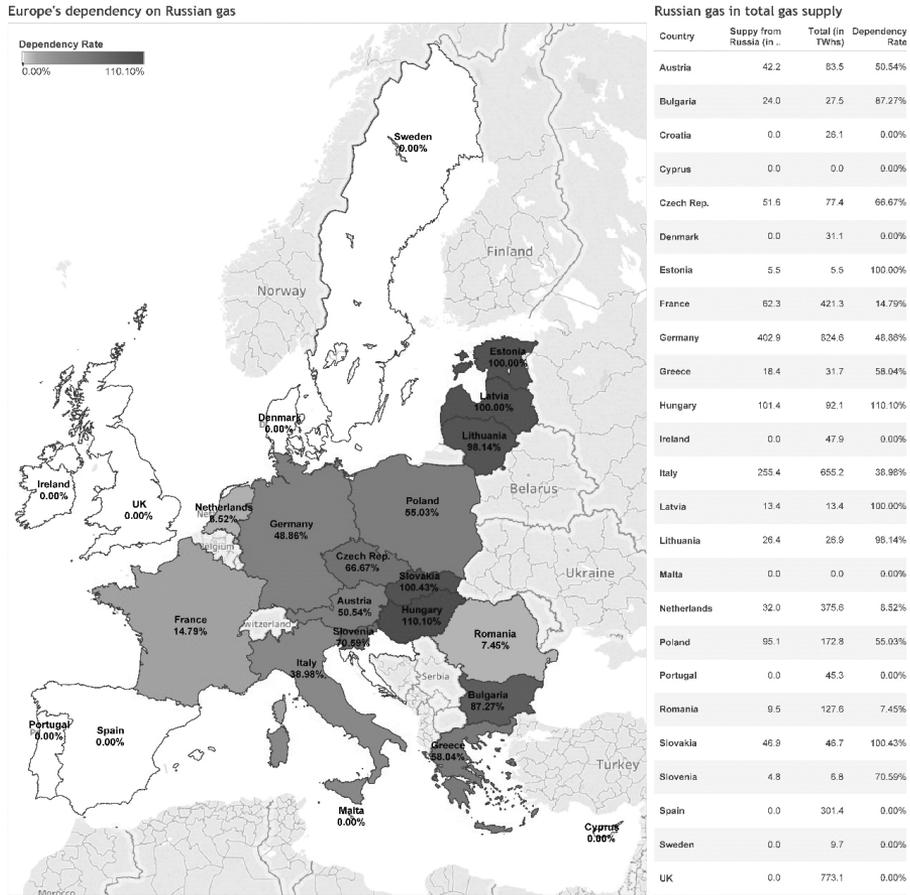
It may seem paradoxical that Europe's troubles with natural gas have developed only after the fall of the Soviet Union. Historically, market realities rather than political considerations shaped relationship between Gazprom and western European gas utilities. The west needed cheap gas and Russia needed the market. But Russian gas has never been the exclusive option. As the western European market progressed towards a more integrated model, Gazprom needed to be competitive, which made potential geopolitical games unwise, if not damaging to the company's market position. The strategy – based on market realities and long-term relationships between Gazprom and western European countries and their gas utilities – has also been a basis for arguments expressed by countries like Germany or Austria that have supported Nord Stream and Nord Stream 2.

Meanwhile, the realities to the east of the German border have been dramatically different. Before the Iron Curtain fell, deliveries to Central and Eastern Europe (CEE) were understandably uneventful given the countries' status as either Soviet republics or satellite states.<sup>23</sup> But as CEE countries

21 *Naftogaz's cheap victory: 30–50-year transit exchanged for \$2.6bn.*, “EurAsia Daily” [online], 1.03.2018 [accessed: 21.10.2018], available at: <<https://eadaily.com/en/news/2018/03/01/naftogazs-cheap-victory-30-50-year-transit-exchanged-for-26bn>>.

22 *Gazprom says Swiss court blocks Nord Stream payments*, “Reuters” [online], 12.11.2018 [accessed: 25.11.2018], available at: <<https://www.reuters.com/article/us-gazprom-nord-stream/gazprom-says-swiss-court-blocks-nord-stream-payments-idUSKCN1NH1YM>>.

23 E.J. Holland, *Poisoned by gas: domestic networks and energy security strategy in Ukraine*, “Journal of International Affairs” 2015, vol. 69, issue 1, p. 1–17.



**Figure 3. Europe's dependency on Russian gas in 2014**

Source: Eurogas *Statistical report 2015*<sup>24</sup>

have sought freedom in the post-Soviet era, Russia has pushed back. Energy supplies, including natural gas, have been an important element of Russia's strategy given its position of either a monopoly or the dominant supplier, particularly before the launch of the LNG terminals in Lithuania and Poland (Figure 3). As Figure 4 indicates, Russia exerted geopolitical pressure using this position relatively frequently.<sup>25</sup>

24 *Statistical report 2015*, Eurogas 2015. Available at: <<https://eurogas.org/website/flip-books/statistical-report-2015/mobile/index.html#p=1>> [accessed: 26.10.2018].

25 G. Collins, *Russia's use of the "energy weapon" in Europe*, "Baker Institute for Public Policy" [online], 18.07.2017 [accessed: 26.10.2018], available at: <[https://www.bakerinstitute.org/media/files/files/ac785a2b/BI-Brief-071817-CES\\_Russia1.pdf](https://www.bakerinstitute.org/media/files/files/ac785a2b/BI-Brief-071817-CES_Russia1.pdf)>.



In fact, Russia developed a distinctive strategy of carrot and stick to reward countries that follow its lead and punish those that break away from the fold.<sup>27</sup> Potential “awards” would include cheap oil and gas transfers, transit fees, allowing accumulation of debt, and price differentials between friendly and unfriendly nations. This was also a way to create dependence on Russia, a special type of “Trojan horse”. Insubordination meant unexpected price hikes, embargos, “technical difficulties” at times of high demand, requests for immediate payments of previously accumulated debt and subsequent breaks in deliveries. Such penalties could cause serious distress to economies addicted to cheap gas, cheap credit and/or the influx of budgetary funds from transit fees.

One cannot help but notice the resemblance between the above and the arguments surrounding the Ukrainian gas disputes where commercial decisions, such as providing discounts and allowing accumulation of debt intertwine with price hikes and demands for debt repayment. The latter often happens at times when crucial political decisions are made. Take, for example, the 2014–2015 gas disruptions that have been considered instrumental to Yanukovich’s last-minute rejection of a deal with the EU that would open Ukraine’s borders to traffic in goods with the EU and fewer travel restrictions. In fact, Yanukovich himself cited Russian pressure and concerns about sacrificing trade with Russia as one of the reasons for not signing the deal.<sup>28</sup>

That being said, Ukraine has not been without leverage during the gas crises. In fact, as a main transit territory for Russian gas travelling to Europe, it exerted some geopolitical power over Russia as well. A relationship of mutual dependence developed over the last two decades between Ukraine and Russia. Ukraine should however be more cognizant of the fact that reliance on cheaper gas and accumulation of debt can become a liability, including the geopolitical influence it hands to Russia.<sup>29</sup> This influence has been additionally reinforced by a high reliance on gas and the inefficiency of Ukrainian industry and the lack of implementation of an effective and substantial energy reform.

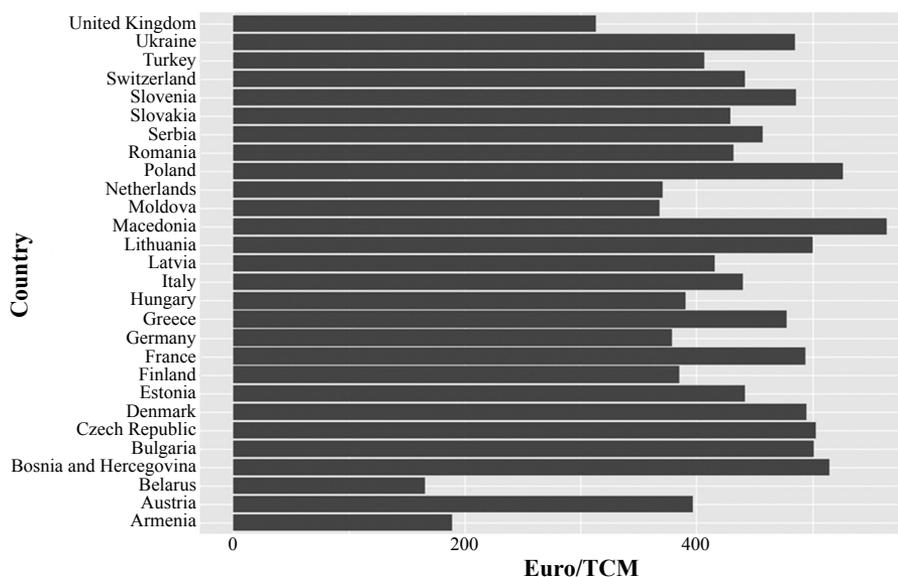
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27 R. Newnham, *Oil, carrots, and sticks. Russia’s energy resources as a foreign policy tool*, “Journal of Eurasian Studies” 2011, vol. 2, p. 134–143.

28 *Ukraine protests after Yanukovich EU deal*, “BBC” [online], 23.11.2018 [accessed: 28.11.2018], available at: <<https://www.bbc.com/news/world-europe-25162563>>.

29 For more details on those issues go to: Th. Van de Graaf, J.D. Colgan, *Russian gas games or well-oiled conflict? Energy security and the 2014 Ukraine crisis*, “Energy Research and Social Science” 2017, vol. 24, p. 59–64; A. Dubien, *The opacity of Russian-Ukrainian energy relations*, “Russie.Nei.Visions” 2017, No. 19.

Going beyond geopolitics, the dependence on Russian gas in the CEE region has also provided Russia with a strong bargaining position in market terms. Lacking competition it has been able to charge higher prices for the gas it delivered. As shown in Figure 5, countries in CEE have generally paid more for Russian gas than their western counterparts. Some exceptions to this rule are Hungary, Armenia, Moldova, and Belarus, which pay some of the lowest prices despite a high level of dependency on Russian gas. But these countries have exemplified a Russia-friendly foreign policy. Thus, low prices seem to confirm the carrot and stick strategy described above.



**Figure 5. Prices of Russian gas imports by country (Euro/TCM)**

Source: Izvestia, Gazprom as per: N. Hinchey, *The impact of securing alternative energy sources on Russian-European natural gas pricing*<sup>30</sup>

### ***The European rift over the Nord Stream 2 project***

The contrast in experiences between Europe's "West" and "East" has been critical of the way the parties frame arguments that surround the debate over the Nord Stream 2 project.

Informed by their utility companies' long-term and market-based relationship with Gazprom, the governments of Germany, Austria, and France

<sup>30</sup> N. Hinchey, *The impact of securing alternative energy sources on Russian-European natural gas pricing*, "The Energy Journal" 2017, vol. 39, No. 2.

(among others) have looked at NS2 as a commercial undertaking that can contribute to energy security by freeing their markets from unexpected gas disruptions and supply cheap gas to fuel their economies. This at the time when European domestic gas supplies dwindle and the cost of alternative LNG supplies is pointedly higher. In the case of Germany, not without significance have also been the potential economic or even geopolitical benefits that the country could derive from being a port of entry for the distribution of gas flowing via NS2.

But many of the CEE countries – most prominently Poland and the Baltics (especially Lithuania and Latvia) – have been sceptical of purely commercial motivations for the project in line with the way Ukraine has portrayed the gas disputes. According to their view, NS2 could substantially limit market diversification in Europe by reducing investment and access to alternative supplies of natural gas. This could hurt LNG infrastructure build-up and diversification of pipeline gas deliveries that have been currently progressing via projects such as the Baltic Pipe. As a result, there is the potential for higher dependence on Russian gas not only in CEE but throughout Europe. By eliminating competition, Russia would reassert not only its geopolitical but also its market power and make price hikes of natural gas likely down the road.<sup>31</sup>

While some of the EU's most prominent institutions, as well as the government of the United States, echoed similar concerns to those of the CEE nations, for now neither has exhibited sufficient political will or the ability to block the NS2 project.

## Discussion

As highlighted by the above narrative, two intertwined issues inform positions and frame the arguments of the parties on the two sides of the Nord Stream 2 debate: first, is the project's potential impact on energy diversification and energy security; second is the Ukrainian issue, in particular the difficult economic and geopolitical situation the country may experience if Russia follows up on its resolve to avoid Ukrainian territory for the transit of its natural gas. Thus, it is helpful to detail those concerns pointing to both market and geopolitical factors.

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31 A. Gawlikowska-Fyk, M. Terlikowski, B. Wiśniewski, S. Zaręba, *Nord Stream 2: inconvenient questions*, PISM 2018 (PISM Policy Paper, 5 (165)). Available at: <<https://www.pism.pl/Publications/PISM-Policy-Paper-no-165>> [accessed: 26.10.2018].

### ***What can be done about Russian domination?***

The disruptions in delivery of Russian gas supplies via Ukraine have sent a strong signal to the EU about the increasingly inconvenient leverage Russia holds over Europe and prompted efforts to support European energy security. In 2014, the European Commission released its Energy Security Strategy where it pointed, inter alia, to the need for increasing energy efficiency, its own energy production, as well as the need for diversification of Europe's suppliers and supply routes.<sup>32</sup>

The European Commission had also formally investigated Gazprom's dominant position in Central and Eastern Europe in response to accusations that the company prevented competition, extracted price rents, restricted the resale of its gas, and limited expansion of natural gas infrastructure. The proceedings concluded in May 2018 with a settlement that obliged Gazprom to 1. remove any contractual barriers to the resale of its gas once delivered to European consumers; 2. promote competition; 3. ensure competitive prices; and 4. refrain from influencing countries about decisions on their infrastructure.<sup>33</sup>

That being said, at least some of the EU institutions do not seem to be convinced of Gazprom's ability to adjust to the ruling, in particular if Nord Stream 2 is built. To begin, the European Commission is adamant about its competence to negotiate with Gazprom with respect to the new pipeline. And, in an effort to potentially block NS2, the Commission and the European Parliament<sup>34</sup> have proposed that the EU Gas Directive (2009/73/EC) be amended (2017/0294) to "ensure that all major pipelines entering the EU territory comply with EU rules, are operated under the same degree of transparency, are accessible to other operators and are operated efficiently".<sup>35</sup>

32 European Commission, *Communication from the Commission to the European Parliament and the Council. European Energy Strategy*, Brussels 28.05.2014, COM (2014) 330. Available at: <<https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52014DC0330&qid=1407855611566>> [accessed: 26.10.2018].

33 M. Kruse, A. Berkhahn, *The proposed Gas Directive amendment and the EC-Gazprom settlement*, Arthur D. Little 2018. Available at: <[http://www.adlittle.co.uk/sites/default/files/viewpoints/adl\\_gazprom\\_settlement-compressed.pdf](http://www.adlittle.co.uk/sites/default/files/viewpoints/adl_gazprom_settlement-compressed.pdf)> [accessed: 21.10.2018].

34 *Gas: MEPs strengthen EU rules on pipelines to and from third countries*, "European Parliament" [online], 21.03.2018 [accessed: 21.10.2018], available at: <<http://www.europarl.europa.eu/news/en/press-room/20180320IPR00143/gas-meps-strengthen-eu-rules-on-pipelines-to-and-from-third-countries>>.

35 *Energy Union: Commission takes steps to extend common EU gas rules*, "European Commission" [online], 8.11.2017 [accessed: 22.10.2018], available at: <[http://europa.eu/rapid/press-release\\_IP-17-4401\\_en.htm](http://europa.eu/rapid/press-release_IP-17-4401_en.htm)> – as to Directive of the European Parliament and of the Council amending Directive 2009/73/EC concerning common rules to import pipelines.

In February 2019, once NS2-sceptical Romania succeeded NS2-supportive Austria in EC presidency, the proposal has moved quickly and was approved through the Council of Representatives of EU (COREPER). On April 15, the amendment was passed into law directly affecting all new and existing pipelines. It remains to be seen if NS2 succeeds in seeking exemption from the Directive. The results is all but clear as only completed projects are seen as eligible for this type of exemption.<sup>36</sup>

The discussions and proceedings in the Council Working Group on Energy highlighted two main factors impeding enactment of the amendment: 1. the already described split between the “West” and the CEE region and 2. the concerns related to the application of the amendment and international maritime law, competence allocation between the EU and its members, and the amendment’s practicality as it would affect not only NS2 but all other cross-border pipelines.

In the meantime, countries in the CEE region undertook a series of investments to support gas market diversification. Most notably these include the LNG terminals in Poland and Lithuania, the newly agreed upon Baltic Pipe, and the already discussed reverse flows capability. But these are not enough to ward off the potential negative effect that NS2 can entail. The region needs much more investment to facilitate connections between the countries. Those investments need to be designed to use each country’s comparative advantage and not to overlap and create redundancies in the system. For example, building an LNG terminal in Latvia is probably superfluous given the size of the Baltic market and the terminal which already exists in Lithuania. But building a transfer and storage infrastructure in the Latvian caverns makes it possible to take better advantage of the Lithuanian terminal and thus advances the region’s energy security goals. Thus, of utmost importance are projects such as The Gas Interconnector Poland-Lithuania, Balticconnector between Finland or Estonia and creation of common gas markets such as stipulated by Latvia, Lithuania, Estonia and Finland.<sup>37</sup>

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36 E. Krukowska, V. Dezem, *Permit woes could delay new gas link to EU*, “Rigzone” [online], 17.05.2019 [accessed: 19.05.2019], available at: <[https://www.rigzone.com/news/wire/permit\\_woes\\_could\\_delay\\_new\\_gas\\_link\\_to\\_eu-17-may-2019-158862-article/](https://www.rigzone.com/news/wire/permit_woes_could_delay_new_gas_link_to_eu-17-may-2019-158862-article/)>.

37 *Finland, Estonia and Latvia to be single gas transport zone from 2020*, “ICIS” [online], 14.02.2019 [accessed: 14.03.2019], available at: <<https://www.icis.com/explore/resources/news/2019/02/14/10319058/finland-estonia-and-latvia-to-be-single-gas-transport-zone-from-2020/>>; L. Woellwarth, *Tariff agreement once the Balticconnector pipeline is running*, “World Pipelines” [online], 15.02.2019 [accessed: 4.04.2019], available at: <<https://www.worldpipelines.com/business-news/15022019/tariff-agreement-once-the-balticconnector-pipeline-is-running/>>.

Also, a new economic approach is needed when assessing the profitability of diversification investments. For example, LNG terminals may not be used to their full capacity or countries may need to pay what amounts to a “security premium” on contracted LNG. This may seem uneconomical or generate losses. But by keeping options open, those investments provide actual market benefits.

Take, for example, Lithuania. As pointed by Nathalie Hinchey, the country saved more than 130 million Euros (USD 144 million) on ALL gas purchases in 2016 just because of its ability to access LNG supplies via its new LNG terminal.<sup>38</sup> This is despite the fact that it was willing to pay more for the LNG that it would for Russian gas.<sup>39</sup> Gazprom lowered its prices to compete for this market based on the “credible threat” that LNG has become to its position.<sup>40</sup> Hinchey’s analysis indicates that if Lithuania decides to buy LNG to cover 20% of its supply, this would lead to 11% of total savings on all (i.e. including Russian) gas delivered to Lithuania, leading to savings of 17.7 million Euros a year.<sup>41</sup> Only by diversifying its supply and keeping the LNG option open, can Lithuania assure this effect.

In this context, western European countries that are supportive of NS2 should not only make sure that their markets continue to diversify and become better interconnected, they should also be supportive of new natural gas investment in the CEE region. A recent announcement by Germany that it will co-finance a new LNG import terminal in Brunsbüttel<sup>42</sup> is a step in the right direction even if its scale is too small to impact Germany and/or Europe’s energy security in a significant manner. In addition, direct investment in European gas infrastructure at the most critical junctions (Figure 6) could be the best way to facilitate the development of a diversified, secure, and free of Russian interference European gas market. And such investment could flow not only

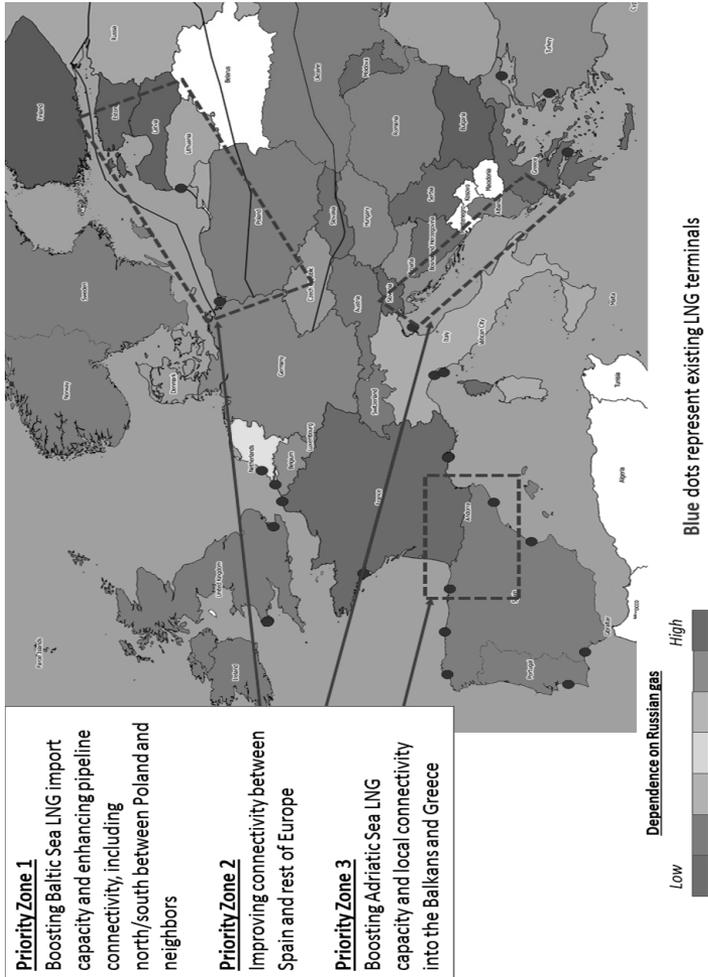
38 N. Hinchey, *The impact...*

39 *Lithuania to pay more for Norwegian LNG than Russian gas*, “Reuters” [online], 13.11.2014 [accessed: 18.10.2018], available at: <<https://www.reuters.com/article/lithuania-lng/lithuania-to-pay-more-for-norwegian-lng-than-russian-gas-idUSL6N0T268X20141113>>.

40 K.B. Medlock III, *A “credible threat” approach to long run deterrence of Russian-European hegemony*, “Forbes” [online], 10.03.2014 [accessed: 27.10.2018], available at: <<https://www.forbes.com/sites/thebakersonstitute/2014/03/10/a-credible-threat-approach-to-long-run-deterrence-of-russian-european-hegemony/#3826296f5072>>.

41 See detailed information on level of savings here: N. Hinchey, *The impact...*, p. 100. Total savings estimated in: N. Hinchey, A. Mikulska, *LNG versus Russian gas in Central and Eastern Europe. Playing poker on a continental scale*, “Forbes” [online], 24.08.2017 [accessed: 27.11.2018], available at: <<https://www.forbes.com/sites/thebakersonstitute/2017/08/24/lng-versus-russian-gas-in-central-and-eastern-europe-playing-poker-on-a-continental-scale/#6e78272a2c3a>>.

42 W. Jakóbiak, *Niemcy budują gazoport. Uczą się od Polaków*, “Wojciech Jakóbiak Blog” [online], 27.10.2018 [accessed: 28.10.2018], available at: <<https://wjakobik.com/2018/10/27/niemcy-buduja-gazoport-ucza-sie-od-polakow/>>.



**Figure 6. Priority zones for LNG and pipeline investments**

Sources: BP Statistical Review of World Energy, GADM, Gas Infrastructure Europe, Gazprom per G. Collins, A. Mikulska, *Gas geoeconomics in Europe. Using strategic investments to promote liberalization, counter-balance Russian revanchism, and enhance European energy strategy*<sup>43</sup>

43 Ibidem.

from within the EU. U.S. could also engage as proposed by my colleague and I in a recent article.<sup>44</sup> Several U.S. senators expressed a similar idea: they want U.S. to commit \$1 billion to European gas infrastructure that could deliver non-Russian gas to European shores and in doing so undercut Russian influence in the region.<sup>45</sup>

For now there has been considerable effort by the CEE critics of NS2 to lobby the United States, in particular to expand the sanctions that the US imposed on the Russian energy sector to include NS2.<sup>46</sup> Following Russia's invasion of Ukraine in 2014, the US severely limited several Russian energy companies including Gazprom, Gazprom Neft, Lukoil, Surgutneftgas, and Rosneft in terms of receiving financial services and banned the export, re-export, or foreign transfer of equipment that could be used by the energy sector in projects that could result in the exploration and production of crude. The ban also included the transfer of knowledge as well as any other "applicable transactions" that any US citizen had to rescind no later than September 26, 2014. But the sanctions target deepwater and shale exploration in the Kara Sea in the Arctic that Russian Rosneft has undertaken with ExxonMobil.

But the US sanctions have not included trade in natural gas. This is despite the fact that the US for couple of decades now has expressed its concerns with the new natural gas supply routes that Gazprom builds to deliver Russian gas to Europe, including the Trump administration's criticism of NS2.<sup>47</sup> Although the administration has repeatedly floated the idea of the imposition of sanctions on NS2, these have yet to materialise.<sup>48</sup>

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44 G. Collins, A. Mikulska, *Gas geoeconomics in Europe. Using strategic investments to promote liberalization, counterbalance Russian revanchism, and enhance European energy strategy*, Baker Institute for Public Policy 2018. Available at: <<http://hdl.handle.net/1911/102766>> [accessed: 27.10.2018].

45 J. Dillon, *Senators hatch \$1B plan to promote gas, curb Russia*, "E&E News" [online], 8.03.2019 [accessed: 3.04.2019], available at: <<https://www.eenews.net/energywire/stories/1060123499>>.

46 A. Barteczko, *Poland wants U.S. sanctions to cover Nord Stream 2*, "Reuters" [online], 29.01.2018 [accessed: 3.12.2018], available at: <<https://www.reuters.com/article/us-europe-nordstream-usa/poland-wants-u-s-sanctions-to-cover-nord-stream-2-idUSKBN1F1134>>.

47 T. DiChristopher, *Behind Nord Stream 2. The Russia-to-Germany gas pipeline that fueled Trump's anger at NATO meeting*, "CNBC" [online], 11.07.2018 [accessed: 29.11.2018], available at: <<https://www.cnbc.com/2018/07/11/behind-nord-stream-2-the-russia-to-germany-gas-pipeline-that-fueled-t.html>>.

48 *U.S. maintains option of sanctions related to Nord Stream 2: Perry*, "Reuters" [online], 8.11.2018 [accessed: 3.12.2018], available at: <<https://www.reuters.com/article/us-energy-poland/u-s-maintains-option-of-sanctions-related-to-nord-stream-2-perry-idUSKBN1ND2CW>>.

Also, repeated assurances of US support with respect to natural gas deliveries from US administrations are not backed by the actual ability to dispatch US LNG to Europe if needed. For example, the agreement between President Trump and Jean-Claude Juncker is rather declaration of goodwill than an actual commitment to more LNG trade. Private firms – not the US government – own the natural gas produced and liquefied within US territory and they act upon profit, not geopolitical, considerations. And the European Commission does not have a mandate to oblige EU member states to accept gas deliveries from any one supplier.<sup>49</sup>

That being said, the EU can do something to attract not only US but also other LNG suppliers to participate in its natural gas market. This includes building a vibrant market structure based on liberalised gas flows and strong European gas hubs. Even though gas hubs already exist in Europe, including NBP and TTF, they are not nearly as developed as the American Henry Hub that was developed following the liberalisation of the US natural gas market. If the EU wants to host a similar hub, it needs a stronger push liberalisation of gas markets, including in many EU member states where often large state-owned companies monopolize gas market.<sup>50</sup>

### *About Ukraine*

A similar strategy of market diversification and liberalisation could also help the Ukrainian issue. Europeans are visibly concerned about the future of Ukraine as shown by the many attempts to save the Ukrainian transit by the European Commission and the European Parliament.<sup>51</sup> And Ukraine has taken important steps to implement changes that would transform its natural gas market to one more in line with the Third Energy Package. Of course, no one expects that the road to a more liberal natural gas market in Ukraine

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49 A. Mikulska, *A closer look at the Trump and Juncker agreement*, “Kleinman Center for Energy Policy” [online], 31.07.2018 [accessed: 30.11.2018], available at: <<https://kleinmanenergy.upenn.edu/blog/2018/07/31/closer-look-trump-and-juncker-agreement>>.

50 Shi Xunpeng, *Development of Europe's gas hubs. Implications for East Asia*, “Natural Gas Industry B” 2016, vol. 3, p. 357–366.

51 Most prominently this includes the amendment to the Gas Directive described earlier in the paper as well as the recently voided OPAL exemption that for over a year limited Nord Stream flows to support transit via Ukraine. K. Yafimava, *The OPAL exemption decision: a comment on the CJEU's ruling to reject suspension*, The Oxford Institute for Energy Studies 2017 (Energy Insight, 18). Available at: <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2017/09/The-OPAL-Exemption-Decision-a-comment-on-CJEU's-ruling-to-reject-suspension.pdf>> [accessed: 27.10.2018].

will be easy.<sup>52</sup> However, the steps taken towards the actual implementation of the new law will give Europe and other observers an actual idea of how serious Ukraine is in its endeavour.<sup>53</sup>

It is important to remember that, for Ukraine, Nord Stream 2 does not only mean the loss of transit fees to support its budget but also of the geopolitical influence that allowed Ukraine to push back against Russia's carrot and stick strategy. With Nord Stream 2 in place, the relationship of mutual dependence between Russia and Ukraine will be dramatically transformed with the latter losing any of the geopolitical bargaining power it derived from its status as a transit territory for the majority of Russian gas destined for Europe.

It is thus in the interest of both Ukraine and the EU to work towards changes that could balance the relationship. For now, the European Commission and European Parliament are supportive of Ukraine and the CEE countries in their struggle against NS2. But neither non-conditional EC support for Ukrainian transit nor legal limitations to Gazprom's access to the European market are a given.

The complicated history of the exemption decision with respect to OPAL, the pipeline that connects NS1 in Germany with the Czech market, can illustrate some of the potential challenges ahead.<sup>54</sup> Initially, the European Commission approved 50% OPAL exemption from third party access and tariff regulations, effectively limiting access to the Russian gas flowing via NS1.<sup>55</sup> The decision was supposed to mitigate the potentially negative impact on competition in the Czech gas market that a virtual monopoly of Gazprom's access to the pipeline could create. But, in 2016, this access was expanded to 50% exempted capacity, 40% capacity subject to regulation and 10–20% of the remaining capacity available for auction, though only at a base price, i.e. one that “may not exceed the average price of comparable capacity on other

52 J. Kucera, *Ukraine has made great progress reforming the gas sector – but its fate still hangs in the balance*, “Energy Post” [online], 10.08.2018 [accessed: 10.10.2018], available at: <<https://energypost.eu/ukraine-has-made-great-progress-in-reforming-the-gas-sector-but-its-fate-still-hangs-in-the-balance/>>.

53 *Wspólnota Energetyczna ostrzega Ukrainę przed papierową reformą gazową*, “Biznes Alert” [online], 14.11.2017 [accessed: 28.11.2018], available at: <<http://biznesalert.pl/ukraina-gaz-wspolnota-energetyczna/>>.

54 Commission Decision of 28.10.2016 C(2016) 6950 on review of the exemption of the Ostseepipeline-Anbindungsleitung from the requirements on third party access and tariff regulation granted under Directive 2003/55/EC. C(2016) 6950.

55 European Commission, Exemption Decision for OPAL Pipeline According to Art.22 of the Directive 2003/55. Available at: <[https://ec.europa.eu/energy/sites/ener/files/documents/2009\\_opal\\_decision\\_de.pdf](https://ec.europa.eu/energy/sites/ener/files/documents/2009_opal_decision_de.pdf)> [accessed: 25.11.2018].

pipelines”.<sup>56</sup> And though the European Court of Justice initially suspended the 2016 exemption decision, it lifted the suspension in July of 2018 allowing Gazprom to utilise close to the maximum of the pipeline capacity ever since.<sup>57</sup>

Also, in August of 2018, while reaffirming the role of the Third Energy Package within the EU, the WTO upheld Russia’s complaint against the 50% condition on the OPAL pipeline, deemed Lithuania’s, Hungary’s, and Croatia’s certification rules on foreign companies to be against WTO rules and considered as discriminatory the granting of a status of a Project of Common Interest when such a status clearly favours some suppliers over others.<sup>58</sup> The WTO ruling can be indicative of challenges that Russia will mount if NS2 is not granted exemption from the Natural Gas Directive in the amended Third Energy Package.<sup>59</sup> In the context of the WTO rules, it will be particularly difficult for the EU to favour (explicitly or implicitly) the Ukrainian route of gas delivery over NS1 and NS2.

Considering that laws are difficult to enact and can be subject to international scrutiny, what else can Europe do to help Ukraine? One way is to support the reforms Ukraine has undertaken in its energy sector. This includes major legal reform that overhauls their natural gas market and adjusts it to EU rules, including unbundling, third party access, and general liberalisation. To be truly successful, those reforms need to be followed by strict adherence to the rule of law and decisive rejection of the corruption that has plagued the Ukrainian energy sector over the last decades.<sup>60</sup> Perhaps there is an oversight role the EU could perform to support these changes.

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56 *Gas markets: Commission reinforces market conditions in revised exemption decision on OPAL pipeline*, “European Commission” [online], 26.10.2016 [accessed: 25.11.2018], available at: <[http://europa.eu/rapid/press-release\\_IP-16-3562\\_en.htm](http://europa.eu/rapid/press-release_IP-16-3562_en.htm)>.

57 Definitive judgment is anticipated some time in 2019. For one position on the decision see: K. Yafimava, *The OPAL exemption decision...* For a different take on the OPAL exemption decision see: A. Riley, *The OPAL pipeline exemption. The implications of a questionable decision*, “The Institute for Statecraft” [online], 24.02.2017 [accessed: 30.11.2018], available at: <<https://www.statecraft.org.uk/research/opal-pipeline-exemption-implications-questionable-decision>>; A. Łaskot-Strachota, *The OPAL pipeline: controversies about the rules for its use and question of supply security*, Ośrodek Studiów Wschodnich 2017 (OSW Commentary, 229). Available at: <<https://www.osw.waw.pl/en/publikacje/osw-commentary/2017-01-17/opal-pipeline-controversies-about-rules-its-use-and-question>> [accessed: 30.11.2018].

58 T. Miles, *Russia loses bulk of WTO challenge to EU gas pipeline rules*, “Reuters” [online], 10.08.2018 [accessed: 27.11.2018], available at: <<https://www.reuters.com/article/us-russia-eu-gazprom-wto/russia-loses-bulk-of-wto-challenge-to-eu-gas-pipeline-rules-idUSKBN1KV1OX>>.

59 M. Kruse, A. Berkhahn, *The proposed Gas Directive...*

60 E.J. Holland, *Poisoned by gas...*

If successful, the reforms in the Ukrainian legal system, including in energy law, can become a major force to attract domestic and foreign investment. Both are critical for the Ukrainian energy sector, whether or not Russia continues to send its gas via Ukrainian territory. In the energy sector, investment could help by exploiting the country's comparative advantage, including its expansive natural gas storage capacity and well-developed pipeline system. It could also provide replacement for transit fees as sources of budgetary revenues.

Foreign investment is particularly difficult to attract as Ukraine's political situation is destabilised by Russia's continuous occupation of some of Ukraine's territory and its aggressive behaviour, including most recent events in the Kerch Strait where Russia seized three Ukrainian ships.

Accordingly, the EU could look into ways to support investment in Ukraine. This includes a diplomatic/political component that could lead to de-escalation of the conflict via both negotiations and a strong stand against Russia, as well as measurable steps such as potential loan guarantees, loan forgiveness programmes, or tax breaks for EU and/or Ukrainian entities willing to invest in Ukraine who are otherwise discouraged by the political instability and high level of risk.

### ***Gazprom: between a rock and a hard place?***

One cannot discuss NS2 without considering the position of its sole owner and representative of the Russian government – Gazprom. Much of the project's success does and will depend on the company's resolve to go forward as well as on the factors the company needs to consider while planning, building and, if completed, utilising NS2.

As mentioned earlier, Gazprom's motivation for NS2 stems from the company's and Russia's determination to circumvent Ukrainian transit, either in the name of increasing European energy security or to support Russia's geopolitical position in the region. Irrespective of which of those arguments one supports or believes in, there should be a clear realisation that in the era of a more global market, Gazprom has no choice but to compete in the European market. This includes competing in the Central and Eastern European market as the region expands its LNG and interconnector infrastructure.

Admittedly, Russian gas distributed in Europe by Gazprom is the cheapest to produce. Gazprom is reported to have been able to produce gas at \$1 / million Btu for decades.<sup>61</sup> As such, it can successfully compete for its market

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61 W. Powell, *US export threat forced Russia to raise its game: Mitrova*, "Natural Gas World" [online] 19.10.2018, available at: <<https://www.naturalgasworld.com/us-export-threat-forced-russia-to-raise-its-game-mitrova-65321>> [accessed: 27.10.2018].

share and also within a more globalised and more competitive environment. The key is, however, that it competes rather than imposes conditions and high prices based on a dominant position in any one region.

Europe needs gas, especially cheap gas. But Russia (and Gazprom) also needs the European market. There is virtually no other comparable market where the gas that currently goes to Europe could be otherwise sold. Russia tried to draw its new routes of gas supplies to China to make this country an alternative market, but this attempt failed. For example, the Power of Siberia pipeline to China will move Russian natural gas from sources that are too far to feed European demand. Thus, Russia cannot use that new pipeline as a bargaining chip in gas negotiations with the Europeans.<sup>62</sup>

In addition, the \$1 / million Btu estimate of the cost of Russian gas does not take into account Gazprom's budgetary obligations as a state company. Besides serving potential geopolitical goals, the company is also expected to contribute to Russia's budget. At a time when the Russian economy is not doing well, any influx of cash from the sale of energy resources is important and pricing gas at cost is not a solution that can be sustained long term.

Lastly, the new deeper and more global natural gas market also affects Gazprom at home. For a while now, Rosneft, Novatek, and Lukoil have tried to undermine Gazprom's position as the sole natural gas exporter.<sup>63</sup> As a result of this pressure, the Russian government has already allowed an exception for the export of LNG by non-Gazprom entities. And Novatek's indisputable success with respect to Yamal LNG gives a powerful argument to companies that would like to enter Russia's gas export market and support a push towards that goal. It is indicative that Rosneft has signed an agreement with BP in 2017 to develop cooperation that could result in the sale and purchase of natural gas in Europe.<sup>64</sup> And just in September 2018, Lukoil received approval to supply LPG to Ukraine.

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62 J. Henderson, T. Mitrova, *The political and commercial dynamics of Russia's gas export strategy*, The Oxford Institute for Energy Studies 2015 (OIES Paper, NG 102). Available at: <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/09/NG-102.pdf>> [accessed: 14.10.2018].

63 J. Henderson, *Russian LNG. Progress and delay in 2017*, The Oxford Institute for Energy Studies 2017 (Energy Insight, 8). Available at: <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2017/03/Russian-LNG---Progress-and-delay-in-2017-OIES-Energy-Insight.pdf>> [accessed: 19.10.2018].

64 *BP and Rosneft agree strategic cooperation gas business*, "Rosneft" [online], 2.06.2017, available at: <<https://www.rosneft.com/press/releases/item/186763/>> [accessed: 10.10.2018].

## Conclusion

There are two, very different ways in which NS2 could affect European energy market. On the one hand, given increasing European reliance on natural gas as an energy source and the increase in reliance on imports, Nord Stream 2 can create an additional route to feed European markets with cheap gas. As of now, the pipeline is marketed as one to replace the Ukrainian route and as such would not contribute to additional supplies coming into the market. However, one cannot dismiss the possibility that the Ukraine route continues to be operational. The European market is growing, and Russia is keen on continuing as its major supplier. Thus, in one scenario Gazprom could continue to use Ukraine as a transit territory even if not to the extent it has done it until now. The route could also be maintained for peak season purposes, becoming an element of energy security strategy under conditions of unusually high demand. After all, since NS1 already operates at full capacity and NS2 is projected to do the same, Ukrainian transit would be the only one to offer flexibility to Gazprom's gas deliveries and ability to ramp then up at times of unexpectedly high demand.

In another scenario, one could imagine that the Ukrainian pipeline system attracts entities other than Gazprom. For now, Gazprom has the monopoly over pipeline exports of natural gas but this does not need to hold in the future. As mentioned above, there is already a strong domestic lobby against this monopoly that, at some point, could lead to the opening of pipeline routes into Asia and Europe.<sup>65</sup> The amendment to Natural Gas Directive that would require unbundling of Russian gas sent via NS2 makes the possibility of Gazprom losing its monopoly on pipeline gas exports.<sup>66</sup> Thus, Gazprom needs to proceed with caution and may be inclined to use Ukrainian transit in the future to prevent domestic competitors from taking it over.<sup>67</sup>

But the energy security argument of additional supplies cannot be realised if these are not checked by a careful policy of diversification and support for investment to access alternative gas sources. Route diversification is helpful

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65 J. Henderson, *Russian LNG...*

66 S. Lorenz, *Gazprom could be about to see unprecedented change*, "Seeking Alpha" [online], 19.05.2019 [accessed: 19.05.2019], available at: <<https://seekingalpha.com/article/4267105-gazprom-see-unprecedented-change>>.

67 A. Mikulska, *Yamal LNG – a big win for Russian gas?*, "Kleinman Center for Energy Policy" [online], 10.01.2018, available at: <<https://kleinmanenergy.upenn.edu/blog/2018/01/10/yamal-Ing—big-win-russian-gas>> [accessed: 27.11.2018].

but without diversification of suppliers, NS2 could potentially support or even increase Europe's dependence on Russia, especially in the CEE region.<sup>68</sup>

Thus, smart policy choices adopted across Europe are crucial. Projects such as LNG terminals in Świnoujście in Poland, Klaipėda in Lithuania, and Krk in Croatia are vital. So are new pipeline connections such as the TANAP, TAP and Baltic Pipe. These and similar projects directed to increase the diversity of supply and interconnectedness are especially important in markets that have until now been dominated by Gazprom. This is well understood in countries such as Poland, Lithuania and Latvia that are adamant about the need to build alternative supply routes. These countries have been working towards establishing more a liquid and interconnected natural gas market in the region through sharing/moving supplies and supporting each other within regional organisations such as the Three Seas Initiative. But more effort on the part of other CEE countries is also needed. It is also crucial that western Europe clearly shows that it understands the concerns voiced by the CEE and potentially provides resources that address those concerns in a targeted and strategic manner.

If NS2 is built (which for now still seems rather likely),<sup>69</sup> the EU needs to devise a plan to make sure the scenario of Russian gas domination painted by those opposing NS2 does not come to fruition. To do so, the EU should ensure that the relationship between all European countries and Gazprom is akin to that the west of Europe experienced since the Cold War, one based on competition rather than dominance or monopoly. Luckily, this is not as difficult to achieve today as it used to be even a decade or two ago, given the emergence of a more global natural gas market supported by the rise in LNG trade and the already ongoing investment in infrastructure to bring in alternative supplies to Central and Eastern Europe, including import and transfer infrastructure as well as storage capabilities. The key is the speed with which the changes occur as many contracts between Gazprom and CEE countries expire in the early 2020s and existing or upcoming availability of competitive suppliers will determine the conditions under which those countries renegotiate their contracts (if they decide to buy from Russia at all).

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68 Such outcome is suggested for example by the following research: P. Kotek, A. Selei, B. Takácsné Tóth, *The impact of the construction of the Nord Stream 2 gas pipeline on gas prices and competition*, REKK. Available at: <[https://www.europeangashub.com/wp-content/uploads/attach\\_799.pdf](https://www.europeangashub.com/wp-content/uploads/attach_799.pdf)> [accessed: 27.11.2018].

69 D. Keating, *Russia's controversial Nord Stream 2 pipeline may now be unstoppable*, "Forbes" [online], 5.09.2018, available at: <<https://www.forbes.com/sites/davekeating/2018/09/05/as-of-today-russias-controversial-nord-stream-2-pipeline-is-already-underwater/#68ec7f41e1c8>> [accessed: 27.11.2018].

But it should also be noted that the need for additional gas infrastructure should not be considered only as a response to NS1 and/or NS2. The infrastructure would be just as crucial without those pipelines and with Ukrainian transit remaining the major delivery route of gas to Europe. The rationale for the new infrastructure is diversification of gas supplies independent of where the routes of Russian gas delivery are. Therefore, it is crucial to realise that there is a certain economic value in paying a security premium for gas (LNG or piped) delivered by alternative suppliers and in the unused capacity of any diversification projects. As long as those projects can serve as a credible threat, they perform an important function as they keep in check both Russian natural gas prices and geopolitical influence.<sup>70</sup>

There also is a need to address the rift that emerged as a result of the NS2 controversy. The rift can be damaging to future relations within the EU. Thus, it would be helpful if countries supportive of NS2 joined not only in infrastructural support but also directly expressed their understanding of the challenges that CEE countries face in relation to gas supplies. As mentioned above, there is a small movement towards alternative supply acquisition in Germany that opens the door to dialogue. Another opening could possibly be also created by the departure of Angela Merkel, particularly if new German Chancellor is seen as having a clean slate for building trust and common understanding between Germany and the CEE region when it comes to natural gas politics.

Lastly, Ukraine should remain part of the European equation that results in a stable and secure energy market. In fact, if Ukraine's energy market develops and liberalises successfully along the lines of the current energy reform, the country could become an important element of energy security and diversification for the EU.

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