

Suspension of the South Stream Project: International Legal Issues Revisited

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Introduction

One of the main trends in EU–Russia energy cooperation is the growing inter-dependence in terms of natural gas export and import. According to the public joint stock company, Gazprom (PJSC Gazprom), the company’s gas exports to Europe rose by 8.1% in 2017 to a record 193.9Bcm, which exceeds the maximum reached in 2016 by 14.6Bcm. In the view of the company’s Chief Executive, this record, “on the one hand demonstrates the rapidly growing demand of European countries for Russian gas, and on the other—its reliability to supply the required volumes”.¹ At the same time, Russia’s share of EU natural gas imports is around 31%, which makes it the largest natural gas supplier to EU Member States; whereas, the EU’s share of Russia’s natural gas exports amounts to 66%. It should be noted, however, that, according to World Energy Outlook 2017, released by the International Energy Agency, PJSC Gazprom’s share of European gas imports reached its all-time high in 2017 and will be decreasing to a figure of 150Bcm per annum until around 2040 because of competition with the “Southern Gas Corridor”, which will begin operations in 2020 and will transport 10Bcm annually from the Shah Deniz Gas Field in the Caspian Sea, Azerbaijan. Nevertheless, Russia is likely to remain Europe’s largest gas supplier. These trends, together with existing political tensions caused by the situation in Ukraine (and related EU sanctions in the energy sector) mean that legal issues regarding joint construction and operation projects for the supply of gas to Europe are of considerable importance at the present time.

In the light of issues such as the possible application of the EU Third Energy Package² to the Nord Stream 2 Project, the lack of legal certainty regarding the regulation of the European section of the Turk Stream Project and upcoming negotiations on Russian–Chinese energy cooperation concerning the Power of Siberia Project, particular emphasis should be placed on the legal consequences of suspending the South Stream Project. These include, for example, the rights of participants to compensation for potential losses resulting from the termination of contracts for the supply of goods and services concluded within the scope of the project. The issue of damages arose in the request for arbitration filed by Saipem SpA (Italy) against the South Stream Transport BV, which is a subsidiary of PJSC Gazprom. Both parties claim damages, interest and penalties resulting from the termination of the contract. The dispute is of interest in terms of both public international and private international law. The contract is not publicly available, which gives rise to much discussion about how states not implementing the project will affect the overall outcome. The Russian authorities have stated that the Russian Federation is not responsible for the delay in project realisation, which, in their view, has been “hindered” by European countries.³ It is therefore possible that the position taken by the Russian authorities could be adopted by Russian companies, including PJSC Gazprom, so that they, themselves, can claim damages or exemption from contractual liability in any arbitration proceedings.

It is possible that the parties to the various disputes, in order to relieve themselves from liability for the early termination of contracts, may seek to invoke doctrines (or a combination thereof) such as *clausula rebus sic stantibus*, *hardship clause* (when a fundamental change in circumstances places an excessive burden on a party to a contract) or *force-majeure clause*. These principles could possibly be relevant in the context of a decision by the Bulgarian authorities to halt the construction of the pipeline until it has been determined that the South Stream Project complies with EU law.

International arbitration case law frequently makes use of these doctrines when considering exemption from contractual liability. Such an approach dates back to the jurisprudence of the Foreign Trade Arbitration Commission of the USSR Chamber of Commerce. In *Jordan Investment Ltd v Soiuznefteksport* (19 June 1958), the chamber recognised an order of the Soviet Ministry of Foreign Trade prohibiting performance of a contract (and non-issuance of a mandatory permit) as an incident of force-majeure.⁴ A similar approach was adopted by the International Chamber of Commerce, which, in its drafting guidance, suggests that the notion “force-majeure” covers “act[s] of authority whether lawful or unlawful, compliance with any law or governmental

¹ A. Toporkov, “‘Gazprom’ to reach all-time high in the natural gas export”, available at <https://www.vedomosti.ru/business/articles/2018/01/09/747176-gazprom-eksporta-gaza> [Accessed 9 July 2018].

² A legislative package comprising EU Regulations and Directives aimed at EU energy market liberalisation and the provision of access to gas transmission infrastructures for European gas suppliers.

³ Meeting with the CEOs of the international information agencies 17 June 2016, available at <http://kremlin.ru/events/president/news/52183> [Accessed 9 July 2018].

⁴ M. Milyukova and I. Bunik, “EU and US Sanctions: Legal Impact on the Russian Energy Sector” [2017] I.E.L.R. 261.

order, rule, regulation or direction, curfew restriction, expropriation, compulsory acquisition, seizure of works, requisition, nationalisation”.⁵ If there was a similar clause in any of the contracts between South Stream Transport BV, PJSC Gazprom and their partners, this could potentially have an impact in any arbitration proceedings.

Having regard to the above, in the author’s opinion, the suspension of the South Stream Project did not, in fact, contribute to legal certainty in the relationships between states and private persons with regard to its realisation. Instead, it gave rise to a number of legal issues to be resolved by the parties involved in its implementation.

The South Stream Project: general overview of international legal issues

The South Stream Project in the context of international law and the law of contracts

The South Stream Project marked the commencement of PJSC Gazprom’s natural gas supply diversification strategy in the European market. Notwithstanding the fact that the project had long been discussed within the Russian business community, and by state authorities, the actual construction of the new gas infrastructure did not begin until the start of negotiations on the Nabucco Project in the EU. It would therefore appear that the South Stream Project was the Russian authorities’ response to the EU project (an alternative plan to diversify energy sources, meaning less dependency on Russia as a natural gas supplier).⁶

The main goal of the South Stream Project was to satisfy additional demand from European countries for natural gas. The new gas transportation system would meet the most advanced requirements in terms of environmental protection and technology,⁷ which would mark “[a] new level of European international energy cooperation”.⁸ The realisation of the South Stream Project was divided into two stages: (1) construction of a pipeline across the Black Sea; and (2) construction of a new pipeline network in southern and central Europe. The project would also facilitate the expansion of the gas transportation system across the territory of the Russian Federation. The costs of the project were estimated at €10

billion for the underwater pipeline and €55 billion for overland pipelines in Europe. These figures made the project the most expensive one in the world.⁹

The legal status of the project was first determined in private law by the Memorandum of Understanding on the South Stream Project executed by PJSC Gazprom and Eni SpA (signed 23 June 2007) within the framework of the Agreement on Strategic Partnership (signed 14 November 2006). This gave PJSC Gazprom the opportunity, from 2007, to make direct deliveries of Russian gas to the Italian market until 2035. The memorandum outlined the areas of cooperation between the companies with regard to designing, financing, constructing and managing South Stream.¹⁰ On 18 January 2008, the South Stream AG Special Purpose Entity was registered in Switzerland. The entity was established by PJSC Gazprom and Eni SpA on a parity basis in accordance with the Addendum to the Memorandum of Understanding (22 November 2007), which defined the aim of the joint company as one of market research, together with a feasibility study of the relevant project.¹¹

Russia subsequently signed several international treaties that provided for the establishment of joint companies by PJSC Gazprom and respective national companies that were given special rights to participate in the South Stream Project (e.g. realisation as gas pipeline operators, including the levying of transmission service tariffs). The treaties provided for the following share structures: (1) both PJSC Gazprom and the national company owning 50% of the company’s shares; or (2) PJSC Gazprom owning 51% of the company’s shares and the national company owning 49%. Such inter-governmental agreements (IGAs) were signed by the Russian Federation with Austria, Bulgaria, Hungary, Greece, Serbia, Slovenia and Croatia.

The agreements also determined the basis of taxation of the various companies, which included a range of tax reliefs and exemptions. For example, art.14 of the Bulgarian–Russian IGA 2008¹² provides for the exemption of a relevant company from the obligation to provide collateral for the temporary import of equipment and spare parts necessary for any construction activities given that they are “re-exported”. Article 14 is also aimed at the possible acceleration of refunding procedures for VAT in respect of materials, services and work required in connection with the construction and operation of the

⁵ ICC Force Majeure Clause 2003 para.3[d]/ICC Force Majeure Clause 2003/ICC Hardship Clause 2003, ICC Publishing SA 2003, available at <https://cdn.iccwbo.org/content/uploads/sites/3/2017/02/ICC-Force-Majeure-Hardship-Clause.pdf> [Accessed 10 July 2018].

⁶ A. Dellecker and T. Gomart (eds), *Russian Energy Security and Foreign Policy* (Routledge, 2011), available at <https://books.google.ru/books?id=q-q.sAgAAQBAJ&printsec=frontcover&hl=ru#v=onepage&q=south%20stream&f=false> [Accessed 10 July 2018].

⁷ S. Oxenstierna and T. Veli-Pekka (eds), *Russian Energy and Security up to 2030* (Routledge, 2013), available at https://books.google.ru/books?id=Fy_JBQAAQBAJ&pg=PT58&lpg=PT58&dq=russian+energy+and+security+up+to+2030&source=bl&ots=ALhB2MT3Fhs&ig=d-cFI58wqW0Gj-AM0dHHstxA0&hl=ru&sa=X&ved=0ahUKEvj8gf3ut8TZAhVJWjywKHcvCB60Q6AEIXTAI#v=onepage&q=south%20stream&f=false [Accessed 10 July 2018].

⁸ N. Branimir, “International legal issues of implementation of the EU–Russia joint projects in the energy sector (at the example of the South Stream project)” [2016] Jur.D. thesis, Moscow, 126.

⁹ N. Branimir, “International legal issues of implementation of the EU–Russia joint projects in the energy sector (at the example of the South Stream project)” [2016] Jur.D. thesis, Moscow, 126.

¹⁰ “Gazprom’ and ENI signed the Agreement on strategic partnership”, available at <http://www.gazprom.ru/press/news/2006/november/article55943/> [Accessed 10 July 2018].

¹¹ “Gazprom’ and ENI signed the Agreement on strategic partnership”, available at <http://www.gazprom.ru/press/news/2006/november/article55943/> [Accessed 10 July 2018].

¹² Agreement Between the Government of the Russian Federation and the Government of the Republic of Bulgaria Relating to the Cooperation in the Construction and the Operation of the Natural Gas Pipeline through Bulgaria (Sofia, 18 January 2008).

natural gas pipeline. Another example is art.11¹³ which exempts the counter-part company from VAT paid for equipment and spare parts, in addition to materials, services and work required, for the construction and operation of the natural gas pipeline until the pay-back period is over.

Some agreements also contain a *grandfather clause*, protecting participants from the changes in the national tax legislation that might negatively impact on the project (e.g. Bulgarian-Russian IGA 2008 art.15 para.2¹⁴ and the Agreement Between the Government of the Russian Federation and the Government of the Republic of Greece to the Cooperation in the Construction and the Operation of the Natural Gas Pipeline through Greece art.11¹⁵). However, certain IGAs (e.g. the Austrian-Russian IGA), despite the absence of such a clause, provide for a written notification procedure “through the diplomatic channel about the changes in the legislation with a view to minimizing these effects to the extent possible according to this legislation” (Austrian-Russian Intergovernmental Agreement 2010 art.8).¹⁶

Interestingly, the Bulgarian-Russian IGA 2008, is the only agreement that particularises the steps required to finalise the international legal status of the project. Under art.5, the parties must take measures to enter into bilateral agreements and, subsequently, into a multilateral agreement (memorandum) on the construction and operation of the pipeline system. The legal status of the South Stream Project was therefore determined by IGAs governing the relationships between states regarding the construction and operation of certain parts of the pipeline and by a series of international contracts between private companies regarding the realisation of the project.

EU's Third Energy Package: conformity with international law and significance for realisation of the South Stream Project

The adoption, and entering into force, of the EU's Third Energy Package (TEP) had a considerable impact on the realisation of the South Stream Project, causing both political and economic issues for Russia and European countries. The EU's Third Energy Package is defined as

a legislative package for an internal gas and electricity market in the EU. Its purpose is to facilitate the “opening up” of gas and electricity markets in the EU.

The TEP consists of the following Regulations and Directives:

- Directive 2009/72 concerning common rules for the internal market in electricity and repealing Directive 2003/54¹⁷;
- Directive 2009/73 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/¹⁸;
- Regulation 714/2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation 1228/2003¹⁹;
- Regulation 715/2009 on conditions for access to the natural gas transmission networks and repealing Regulation 1775/2005²⁰; and
- Regulation 713/2009 establishing an Agency for the Cooperation of Energy Regulators.²¹

The Third Energy Package entered into force 3 September 2009 and was applied from 3 March 2011, allowing for an implementation period of 18 months.

The enactment of the TEP ensures the independence of electricity and gas transmission services from generation, production and supply.²² These measures were implemented to curtail the market power of vertically integrated undertakings and to create exchange-traded gas markets controlled by national and European regulatory authorities governing national gas production companies.²³ Under the TEP, a vertically integrated undertaking (VIU) is

“a natural gas undertaking or a group of natural gas undertakings where the same person or the same persons are entitled, directly or indirectly, to exercise control, and where the undertaking or group of undertakings perform at least one of the functions of transmission, distribution, LNG or storage, and at least one of the functions of production or supply of natural gas” (Directive 2009/73 art.2(20)).²⁴

¹³ Agreement Between the Government of the Russian Federation and the Government of the Republic of Hungary Relating to the Cooperation in the Construction and the Operation of the Natural Gas Pipeline through Hungary (Moscow, 28 February 2008).

¹⁴ Bulgarian-Russian IGA 2008.

¹⁵ Agreement Between the Government of the Russian Federation and the Government of the Republic of Greece Relating to the Cooperation in the Construction and the Operation of the Natural Gas Pipeline through Greece (Moscow, 29 April 2008).

¹⁶ Hungarian-Russian IGA 2008.

¹⁷ Directive 2009/72 concerning common rules for the internal market in electricity and repealing Directive 2003/54 [2009] OJ L211/55, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0055:0093:EN:PDF> [Accessed 10 July 2018].

¹⁸ Directive 2009/73 concerning common rules for the internal market in natural gas and repealing Directive 2003/55 [2009] OJ L211/94, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:0136:en:PDF> [Accessed 10 July 2018].

¹⁹ Regulation 714/2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation 1228/2003 [2009] OJ L211/15, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0015:0035:EN:PDF> [Accessed 10 July 2018].

²⁰ Regulation 715/2009 on conditions for access to the natural gas transmission networks and repealing Regulation 1775/2005 [2009] OJ L211/36, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0036:0054:en:PDF> [Accessed 10 July 2018].

²¹ Regulation 713/2009 establishing an Agency for the Cooperation of Energy Regulators [2009] OJ L211/1 at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0001:0014:EN:PDF> [Accessed 10 July 2018].

²² G.G. Kandelaki, “Review of the methods of the state control of the foreign investment in the subsoil use of the European countries” [2015] *Law and Economy* N7, 45–51.

²³ Directive 2009/72 concerning common rules for the internal market in electricity and repealing Directive 2003/54 [2009] OJ L211/55.

²⁴ Directive 2009/72 concerning common rules for the internal market in electricity and repealing Directive 2003/54 [2009] OJ L211/55.

The TEP therefore applies the concept of ownership “unbundling” to the “undertaking” concerned, in addition to the legal separation of management and accounting implemented by the EU’s “second energy package”.²⁵ “[U]nbundling” means that the same person or persons are prevented from: (1) exercising control over an undertaking performing any of the functions of production or supply, and directly or indirectly exercising control or exercising any right over a transmission system operator or over a transmission system; (2) directly or indirectly to exercising control over a transmission system operator or over a transmission system, and directly or indirectly exercising control or exercising any right over an undertaking performing any of the functions of production or supply; (3) appointing members of the supervisory board, the administrative board or bodies legally representing the undertaking of a transmission system operator or a transmission system, and directly or indirectly to exercising control or exercising any right over an undertaking performing any of the functions of production or supply; and (4) not being a member of the supervisory board, the administrative board or bodies legally representing the undertaking of both an undertaking performing any of the functions of production or supply and a transmission system operator or a transmission system.²⁶

In addition to the effect of art.9 discussed above, it is also important to refer to art.11 of Directive 2009/7 (described by some commentators as the “Gazprom clause”²⁷), which regulates the certification procedure for transmission system owners and transmission system operators controlled by a person or persons from a third country or third countries. Certification is granted by the regulatory authority of the Member State concerned after the European Commission has confirmed that the operator meets the requirements of art.9 and that “granting certification will not put at risk the security of energy supply to the Community”.²⁸

Article 11, which effectively creates a more complicated certification procedure for transmission system operators from non-EU countries than for EU Member States, was the most significant impediment to the realisation of South Stream Project by PJSC Gazprom. Given that PJSC Gazprom is a natural gas supplier, in order to comply with the EU legislation on the unbundling of vertically integrated undertakings, it was faced with two options: (1) transfer its shares to a European company; or (2) transfer its right to operate the pipeline to an independent European entity.²⁹

As a result, the Russian Federation filed a request for consultation with the World Trade Organisation (WTO) on 30 April 2014. In its request, Russia challenged these rules and the application by several EU Member States: Belgium, Estonia, Hungary, Germany, Lithuania, Croatia and Estonia. Third parties to the dispute include Brazil, China, India, Japan, Ukraine, the US, Colombia, Republic of Korea and the Kingdom of Saudi Arabia. On 20 July 2015, the Dispute Settlement Body (DSB) established a panel to consider the challenge made by the Russian Federation. On 22 February 2016, the Russian Federation requested that the Director General assemble the panel in accordance with para.7 art.8 of the Understanding on Rules and Procedures Governing the Settlement Of Disputes (Annex 2 of the WTO Agreement). On 7 March 2016, the Director-General assembled the panel.³⁰ On 4 April 2017, the Chair of the panel informed the DSB that, because of the complexity of the dispute and the large volume of evidence, the panel anticipated releasing its final report to the parties no later than the end of 2017. On 10 August 2018, the panel report was circulated to Members.

The Russian Federation maintains that the rules of Directive 2009/73, which, in its argument, contemplates the possibility of gas transmission operators from third countries being denied certification and access to the European energy market on the basis of energy security considerations are inconsistent with the EU’s obligations under arts II, VI, XVI and XVII of GATS (and their “Specific Commitments” under GATS), arts I, III, X, and XI of GATT 1994, art.3 of the Agreement on Subsidies and Countervailing Measures, art.2 of the Agreement on Trade-Related Investment Measures and art.XVI:4 of the Agreement Establishing the World Trade Organisation.³¹ In addition, it is argued that the measures introduced by the TEP contravene fundamental WTO principles such as trade without discrimination, “national treatment” and “most-favoured-nation treatment”.³²

The findings of the panel, however, undermined, to some extent, the Russian Federation’s position on the issue. The “unbundling” rules of Directive 2009/73 were found “not to grant an advantage to natural gas of any particular origin”.³³ The Panel did not accept Russia’s argument that the provisions of the Directive in question constituted “de facto” discrimination against PJSC Gazprom, which was “prohibited from supplying its pipeline transport services to the European Union through a commercial presence in Lithuania” unlike VIUs from other non-EU countries that were “able to continue

²⁵ Directive 2003/54 concerning common rules for the internal market in electricity and repealing Directive 96/92 [2003] OJ L176/37 and Directive 2003/55 concerning common rules for the internal market in natural gas and repealing Directive 98/30 [2003] OJ L176/57.

²⁶ Directive 2009/73 concerning common rules for the internal market in natural gas and repealing Directive 2003/55 [2009] OJ L211/94 art.9.

²⁷ See e.g. K. Talus, “EU Energy Law and Policy: A Critical Account” (Oxford: OUP, 2013), p.85; P. v. Elsuwege, “The EU Governance of external energy relations: the challenges of a ‘rule-based market approach’” [2014] *The European Union’s Shaping of the International Legal Order* (CUP), p.230.

²⁸ Directive 2009/73 concerning common rules for the internal market in natural gas and repealing Directive 2003/55 [2009] OJ L211/94.

²⁹ E.A. Belova, “Russia and the WTO disputes: antidumping, countervailing and safeguard” [2016] *Russian Foreign Economy Journal* No.7, 120–131.

³⁰ *European Union and Its Member States—Certain Measures Relating to the Energy Sector—Constitution of The Panel Established at the Request of the Russian Federation*, available at [https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S006.aspx?Query=\(@Symbol=%20wt/ds476/*\)&Language=ENGLISH&Context=FomerScriptedSearch&languageUIChanged=true#](https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S006.aspx?Query=(@Symbol=%20wt/ds476/*)&Language=ENGLISH&Context=FomerScriptedSearch&languageUIChanged=true#) [Accessed 10 July 2018].

³¹ *European Union and Its Member States—Certain Measures Relating to the Energy Sector—Constitution of The Panel Established at the Request of the Russian Federation*.

³² L.P. Anufrieva, V. A. Zhdanov and P.A. Kalinichenko (eds), “WTO Law: doctrine and case law: monography” [2016] M.: NORMA, INFRA-M 528.

³³ *European Union and Its Member States—Certain Measures Relating to the Energy Sector—Report of the Panel*, p.276.

supplying their pipeline transport services to the European Union through a commercial presence in other Member States”.³⁴ Reference was made to *US—Clove Cigarettes* case in which it was established that “less favourable treatment” cannot simply be established by providing evidence that some imported products are treated less favourably than a group of the domestic products.³⁵ The panel also upheld the “compatibility” of the third-country certification measure in the Directive, stating that the various examples provided by Russia (regarding other pipeline projects) did not establish “de facto” discrimination.³⁶

Nevertheless, in spite of the difficulties facing PJSC Gazprom regarding compliance with the general rules of the TEP (ownership unbundling, establishment of independent system operator or independent transmission operator), some commentators have suggested that PJSC Gazprom could have filed a request under art.36 of Directive 2009/73.³⁷ Under art.36, new gas infrastructure (e.g. interconnectors, LNG and storage facilities) are potentially exempted, for a definite period of time, from the “unbundling” requirements if they satisfy a number of requirements. The regulatory authority of the EU Member State concerned can, on a case-by-case basis, determine exemptions, which are then subject to approval by the European Commission (which is entitled to amend or withdraw the exemption decision). The regulatory authority must comply with the Commission decision to amend or withdraw an exemption decision within a period of one month and must inform the Commission accordingly.³⁸

It is, however, arguable that PJSC Gazprom could have used a procedure similar to the one used in the context of the Nord Stream Project: relevant sections of the pipeline being awarded the status of a “national project” (such status was obtained in Bulgaria (2011), Hungary (2012) and Serbia (2013)) so that these sections can be exempted by national regulatory authorities under art.36 of Directive 2009/73 (the exemption to be approved at a later stage by the European Commission).³⁹ This approach, however, was not as attractive a proposition for the Russian Federation in connection with the South Stream Project.

First of all, the South Stream Project concerned countries that had limited political influence in the EU. As a result, in addition to the various legal arguments

deployed, the EU took a variety of “political” measures in connection with the project, e.g. the statement of the European Commission concerning the possible suspension in accession negotiations with Serbia (in the event that it continued to participate in the project).⁴⁰ The European Commission Memo containing the key findings of the Progress Report on Serbia (8 October 2014) states:

“Serbia needs to step up its efforts towards alignment with the EU *acquis* in particular in the fields of energy—including on the South Stream gas pipeline, environment, climate change, state aid, health and social protection system and asylum policies.”⁴¹

Secondly, the nature of conditions proposed by the European Commission meant that using the art.36 mechanism would be impracticable for PJSC Gazprom. By way of example, the OPAL Pipeline, which is the overland part of the Nord Stream Project, has only 50% of its capacity exempted from third-party access rules.⁴²

Thirdly, a request for an exemption under art.36 had potentially adverse implications for the legal position of the Russian Federation regarding the lawfulness of the TEP. Such a request might have been regarded as acquiescence to the TEP package having regard to the estoppel principle in international law.

The legal issues discussed above were made even more complex because of the difficulties reaching an agreement on the status of the project under Directive 2009/73. In particular, it was unclear whether or not it was possible to categorise the South Stream Project as an “upstream pipeline network”, which, in terms of art.2(2) of the Directive, means “any pipeline or network of pipelines operated and/or constructed as part of an oil or gas production project, or used to convey natural gas from one or more such projects to a processing plant or terminal or final coastal landing terminal” or as a “transmission pipeline network”, which, in terms of art.2(3) of the Directive, means “a network, which mainly contains high-pressure pipelines, other than an upstream pipeline network and other than the part of high-pressure pipelines primarily used in the context of local distribution of natural gas, with a view to its delivery to customers, but not including supply”. If the project qualified as an “upstream pipeline network”, it would not be necessary to undergo the certification procedure and obtain the approval of the European Commission.⁴³ Furthermore,

³⁴ European Union and Its Member States—Certain Measures Relating to the Energy Sector—Report of the Panel, p.169.

³⁵ European Union and Its Member States—Certain Measures Relating to the Energy Sector—Report of the Panel, p.169.

³⁶ European Union and Its Member States—Certain Measures Relating to the Energy Sector—Report of the Panel, p.310.

³⁷ D. Kirillov, “South stream one step ahead” *Gazprom Corporate magazine* No.11 2013, available at <http://www.gazprom.ru/press/news/reports/2013/one-step-ahead/> [Accessed 10 July 2018].

³⁸ Directive 2009/72 concerning common rules for the internal market in electricity and repealing Directive 2003/54 [2009] OJ L211/55.

³⁹ D. Kirillov, “South stream one step ahead” *Gazprom Corporate Magazine*, No.11 2013, available at <http://www.gazprom.ru/press/news/reports/2013/one-step-ahead/> [Accessed 10 July 2018].

⁴⁰ Commission Staff Working Document Serbia 2014 Progress Report Accompanying the Document Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions—Enlargement Strategy and Main Challenges 2014–2015 SWD/2014/0302 final, available at <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex:52014SC0302> [Accessed 10 July 2018].

⁴¹ European Commission Memo—Key findings of the Progress Report on Serbia—Brussels, 8 October 2014, available at http://ec.europa.eu/enlargement/countries/strategy-and-progress-report/index_en.htm [Accessed 10 July 2018].

⁴² J. Stern, P. Simon and K. Yafimava, “Does the Cancellation of South Stream Signal a Fundamental Reorientation of Russian Gas Export Policy?” [2015] 3(2) *Journal of Self-Governance and Management Economics* 33.

⁴³ P. Offenber, *The European neighborhood and the EU’s security of supply with natural gas* (Berlin: Jacques Delors Institut, 2016), pp.13–15.

the various states could not agree on the applicability of the TEP to the underwater part of the South Stream Project.⁴⁴

One of the major issues appeared to be the difficulty in reaching a consensus on the relationship between IGAs and the TEP. In June 2014, the European Commission claimed that certain IGAs were inconsistent with the TEP's "unbundling" rules, in addition to the rules on non-discriminatory access of third parties to gas supplies and the tariff structure.⁴⁵ The Commission sent a letter of formal notice to Bulgaria, asking the country to cease its implementation of the South Stream Project, which caused the Bulgarian Ministry of Economy and Energy to stop all activities regarding the construction of the pipeline until it was determined that this complied with the requirements of the European Commission and the TEP. On 18 August 2014, the Bulgarian Minister of Economy and Energy, V. Shtonov, sent a letter to the Bulgarian Energy Holding, informing BEH that it should cease all tender procedures and contracts under the South Stream Project.⁴⁶

The difficulty of ensuring further cooperation in connection with pipeline construction was discussed in the Russian Federation Parliament. According to the President of the Russian Federation, Vladimir Putin, Russia "didn't give up South Stream, [it was] not allowed to implement it".⁴⁷ It is therefore arguable that this statement is not merely political one; it might also have some justification in international law.

IGAs made in connection with the construction of the South Stream Pipeline are governed by the UN Convention on the Law of Treaties (signed in Vienna, 23 May 1969) to which all states that entered into IGAs with the RF are parties. According to the European Court of Justice (ECJ), the Convention "expresses ... general customary international law".⁴⁸ The Convention is also based on the principle *pacta sunt servanda* (every treaty in force is binding on the parties to it and must be performed by them in good faith) (art.26). A party therefore cannot invoke provisions of its own laws as justification for failing to comply with the terms of a treaty (art.27).

IGAs made in connection with the South Stream Project were entered into for a term of 30 years and do not provide the parties with a right to early unilateral termination. As a result, amendment or termination is only possible with the agreement of both parties. In accordance with art.42(2) of the Vienna Convention, "the

termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the present Convention".

Although the EU is not party to the Vienna Convention, under art.3(5) TEU, "the Union shall contribute to the strict observance and the development of international law, including respect for the principles of the United Nations Charter".⁴⁹ Therefore, the rules of the Vienna Convention (to the extent that the rules express the customary international law) are binding on the EU, which cannot obligate its Member States to undertake any acts that would be contrary to international law, such as the termination of agreements that do not specifically provide for unilateral action of this type.⁵⁰

Nevertheless, regardless of the seemingly "lawfulness" of this approach in theory, an analysis of state practice illustrates that the problem is more complex than first appears. Indeed, although the provisions of IGAs should, theoretically, have priority over the obligations of states in an inter-governmental organisation (for example, the TEP), the fact that the relevant IGAs are in breach of EU legislation (even if the breach is "hypothetical") means that the European Commission, in accordance with case law approved by the European Court of Justice, can initiate amendment or denunciation procedures in connection with the IGAs.⁵¹ If this is indeed the case, and any subsequent ruling of the Commission is not observed, the Member State concerned will be regarded as having breached its obligations under both TEU and TFEU. In summary, the numerous legal issues, in particular the difficulty of reaching an agreement on the relationship between EU law and IGAs, together with a number of "political" factors, have meant that it has not been possible to conclude the realisation of the South Stream Project.

The South Stream Project suspension: liability for damages

It must be stressed that the legal status of the South Stream Project was defined not only in terms of public international law but also in the context of private law. The commencement of construction works would not have been possible had it not been for the completion of private law contracts between the legal entities participating in the project.

⁴⁴ P. Offenberg, *The European neighborhood and the EU's security of supply with natural gas* (Berlin: Jacques Delors Institut, 2016), p.17.

⁴⁵ Brussels opens infringement procedure against Bulgaria over South Stream, available at <https://seenews.com/news/brussels-opens-infringement-procedure-against-bulgaria-over-south-stream-media-423705#sthash.DrnaD5QF.dpuf> [Accessed 10 July 2018].

⁴⁶ Bulgaria to stop all activities regarding the South Stream Project implementation at <http://tass.ru/ekonomika/1386864> [Accessed 10 July 2018].

⁴⁷ Meeting with the CEOs of the international information agencies.

⁴⁸ *Commission v Finland* (C-118/07) EU:C:2009:715; [2009] E.C.R. I-10889 at [39].

⁴⁹ Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union—Consolidated version of the Treaty on European Union—Protocols—Declarations annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12012M%2FTEXT> [Accessed 10 July 2018].

⁵⁰ I. V. Gudkov, "Russian-EU Energy dialogue: the acute issues of law and policy" [2014] *The whole Europe* No.7(89), available at <http://alleuropalux.org/?p=6471> [Accessed 10 July 2018].

⁵¹ A.A. Anufrieva and A.S. Ispolinov, "EU law and International Law: the impact of the new approach of the EJC to the treaties concluded by the EU member states with third countries" [2011] *Eurasia Law Review* No.3 (34) 66–71, available at https://www.google.ru/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=0ahUKewi81auZ4cTZAhUDaVAKHUX6BuwQFgggYMAI&url=https%3A%2F%2Fistina.msu.ru%2Fdownload%2F9104789%2F1eXqUW%3AkxiFp_assFN10XZhrUOJr_n1jmU%2F&usq=AOvVaw39Rp8rk8IT6NnWMBWWEim [Accessed 10 July 2018].

Suspending operations on the South Stream Project has created a considerable number of the legal issues. One such issue is the remaining in force of IGAs in the absence of either denunciation or suspension by any of the parties concerned (although considered by the European Commission to be inconsistent with EU law).⁵² Indeed, suspending the project is at odds with the object and purpose of applicable IGAs (the construction of the South Stream Pipeline System). The performance by EU Member States of their obligations under IGAs could result in infringement proceedings by the Commission in the European Court of Justice (the argument being that those states were in breach of EU law, and, in particular, the TEP). Accordingly, the IGAs no longer have their primary objective, which raises the issue of whether or not art.61 of the Vienna Convention (supervening impossibility of performance as a basis for terminating or withdrawing from an agreement) and art.62 (which particularises when a fundamental change of circumstances, having regard to those circumstances that existed when the treaty was executed, and which was not foreseen by the parties, might be invoked as a basis for withdrawing from an agreement⁵³) might apply to relevant IGAs. Article 62 develops the concept of the *rebus sic stantibus* clause, which can be used to justify a state withdrawing from its obligations under treaties in the event of a fundamental change of circumstances (contrasted to those existing at the time of the execution of the treaty).⁵⁴ With regard to states discontinuing work on the South Stream Project, it is helpful to refer to the opinion of Soviet legal scholar, V.M. Shurshalov: “Irrespective of the term of the treaty, the latter stops to apply once the conditions surrounding the conclusion thereof cease to exist, since the object and purpose of the treaty in question generally express the changing needs of the international life.”⁵⁵ The issue of *rebus sic stantibus* was also considered by H. Lauterpacht, who noted that, for the principle to apply, it was sufficient that the purpose of the treaty had become unattainable “in general, having regard to the object of the transaction”.⁵⁶ It seems, however, premature to make predictions based on art.62 given that interested parties still discuss, from time to time, the possibility of restarting the project.

According to *Der Standard* newspaper, in 2017, the Austrian energy group, OMV, and PJSC Gazprom entered into negotiations for the possible recommencement of the South Stream Project. These discussions, according to various commentators⁵⁷, are not merely theoretical (such plans, if implemented, would be beneficial for both parties). If the construction of the pipeline is continued, Russian gas will be transmitted to Europe via Austria’s main gas pipeline hub in Baumgarten. According to Vladimir Feigin, President of the Institute of Energy and Finance, this could allow the Austrian company to become a “Europe-wide player” and Austria itself to contribute to South-Eastern European integration. Furthermore, the negotiations could stimulate competition between the South Stream and Turk Projects, which, in turn, could cause potential partners (Austria and Turkey) to offer better terms of cooperation.⁵⁸

The possibility to restart works on the construction of the pipeline has also been discussed by state authorities. According to the statement of the Russian President in Saint-Petersburg, 9 August 2016, the revival of the project would require Bulgaria to provide the Russian Federation with the “most reliable” guarantees possible.⁵⁹ Some lawyers are also of the opinion that, because the titles of IGAs do not specifically refer to the South Stream Project, they can be re-used (if amended accordingly) as a framework for the construction of another similar pipeline.⁶⁰

Another issue connected with the suspension of the South Stream Project is the mechanism for the recovery of damages in international law. However, even if the TEP is declared inconsistent with WTO rules, the panel recommendations may not serve as grounds for awarding damages to aggrieved parties as “the main objective of the dispute settlement procedure is not the punishment of the party at guilt but ensuring that the legislation of the WTO Member State conforms with the WTO agreements”.⁶¹ The issue of damages will only be addressed if a party whose interests have been affected by the non-execution of the DSB decision intends to suspend concessions or other obligations.⁶²

At the same time, private law issues are particularly acute as suspension of the project has potentially caused considerable damage to companies that cannot obtain

⁵² See, e.g. Brussels opens infringement procedure against Bulgaria over South Stream; *Commission Staff Working Document Impact Assessment—Accompanying the document Proposal for a Decision of the European Parliament and of the Council on establishing an information exchange mechanism with regard to intergovernmental agreements and non-binding instruments between Member States and third countries in the field of energy and repealing Decision No.994/2012*, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52016SC0027> [Accessed 10 July 2018].

⁵³ The Vienna Convention on the Law of Treaties 1969 (Vienna 23 May 1969), available at http://www.un.org/ru/documents/decl_conv/conventions/law_treaties.shtml [Accessed 10 July 2018].

⁵⁴ A.N. Talalaev, “The Vienna Convention on the Law of Treaties 1969: Commentary” N. V. Zacharova (ed) [1997] M.: Jurid.lit 336.

⁵⁵ V.M. Shurshalov, “Grounds of the validity of international treaties” [1957] M. 7. cited from A. N. Talalaev, “The Vienna Convention on the Law of Treaties 1969: Commentary” N.V. Zacharova (ed) [1997] M.: Jurid.lit 336.

⁵⁶ H. Lauterpacht, *The Function of Law in the International Community* (Oxford: Clarendon Press, 1933), xxvi, 470 (reprinted in 2000 by The Lawbook Exchange), p.276.

⁵⁷ A. Schnauder, “OMV und Gazprom basteln wieder an South Stream” (2017) *Der Standard*, available at <https://www.pressreader.com/austria/der-standard/20170613/281938837896919> [Accessed 10 July 2018].

⁵⁸ S. Guneev, “An expert view on the South Stream project prospects: competition is beneficial”, available at https://ria.ru/radio_brief/20170613/1496422438.html [Accessed 10 July 2018].

⁵⁹ “Putin: Russia needs reinforced concrete guarantees to continue the South Stream project”, available at <https://mir24.tv/news/14862395/putin-rossii-nuzhny-zhelezobetonnye-garantii-po-yuzhnomu-potoku> [Accessed 10 July 2018].

⁶⁰ J. Stern and K. Yafimava, “The EU Competition investigation of Gazprom’s sales in central and eastern Europe: a detailed analysis of the commitments and the way forward” OIES PAPER: NG 121—Oxford Institute for Energy Studies, 2017, p.13.

⁶¹ A.S. Smbatyan, *International trade disputes in the GATT/WTO: selected decisions (1952–2000)* (Walters-Kluwer, 2006).

⁶² A.S. Smbatyan, *International trade disputes in the GATT/WTO: selected decisions (1952–2000)* (Walters-Kluwer, 2006).

compensation using the mechanisms available in international law. Because of this, some of the aggrieved parties have initiated international arbitration proceedings. An example of this is the current dispute between Gazprom subsidiary, South Stream Transport BV, and the Italian company, SpA, regarding the termination of a contract for the construction of the South Stream Pipeline.

According to PJSC Gazprom IFRS consolidated interim condensed financial information 2017,⁶³ on 16 December 2015, South Stream Transport BV, a subsidiary of the group, was served with an official notification by the Secretariat of the Arbitration Court of the International Chamber of Commerce, detailing that Saipem SpA had submitted a request for arbitration proceedings against South Stream Transport BV. The reason provided was what was described as a unilateral termination by the latter of the agreement dated 14 March 2014 for the construction of the “South Stream” Pipeline. In its notice of arbitration, Saipem SpA claimed compensation from South Stream Transport BV for work performed, reimbursement for expenses incurred and for the termination of the agreement in an amount of around €760 million plus interest. On 16 February 2016, South Stream Transport BV sent a response to the notice of arbitration, rejecting all of the claims made by Saipem SpA and declaring its intention to file a counterclaim. On 30 September 2016, Saipem SpA submitted its claim in its entirety, with all attachments. The amount of its claim was reduced to the amount of €679 million. On 10 March 2017, South Stream Transport BV filed a defence to the claim, along with testimony and experts’ opinions that underpin its defence, together with a counterclaim in the amount of about €730 million. The parties are currently undergoing a mutual information disclosure procedure. The hearings are scheduled for June 2019.

As a preliminary comment, the likelihood of the parties being awarded damages by an arbitral tribunal constituted under the rules of the ICC, which is one of the most respected international arbitral institutions in the world, depend primarily on the wording of the relevant contract. If this does not contain a compensation clause, in the event that the contract is unilaterally terminated by one of the parties, Saipem could potentially recover damages. On the other hand, it remains possible that the parties followed ICC drafting guidance and included, in the contract, a provision similar to ICC Force Majeure Clause 2003 para.3[d], according to which the concept of “force-majeure” covers “act[s] of authority whether lawful or unlawful, compliance with any law or governmental order, rule, regulation or direction, curfew restriction, expropriation, compulsory acquisition, seizure of works,

requisition, nationalisation”. If that is the case, this could prove to be a barrier to Saipem’s claim for damages (subject, of course, to the provision of satisfactory documentary evidence to substantiate the various claims).

Another option for PJSC Gazprom is to initiate investment arbitration proceedings with a view to recovering damages from Bulgaria as a host state in accordance with the Agreement between the Government of the Russian Federation and the Government of the Republic of Bulgaria on the Promotion and Reciprocal Protection of Investments (8 June 1993). That said, on 14 February 2017, PJSC Gazprom waived its right to claim \$70 million (stipulated in the Protocol between Gazprom and Bulgarian Energy Holding (27 August 2012)) or any other damages in connection with the cancellation of the Bulgarian section of the South Stream Project (cl.I.3 of Gazprom Commitment proposal, Case AT 39816). This “waiver” is one of the concessions that PJSC Gazprom made within the context of the EU’s anti-trust/cartel case regarding Gazprom’s dominant market position (*Case AT 39816*).⁶⁴ A request for investment arbitration could arguably be used by PJSC Gazprom to recover damages before the commencement of any anti-trust case by the European Commission (before the commencement of the investigation by the Commission, there was opinion on the possibility of the company having its rights protected using the relevant mechanism, including the one set out in the Energy Charter Treaty (ECT)).⁶⁵ Finally, another somewhat discussion-provoking issue is the possibility of private investors who sustained losses as a result of the enactment of EU law making use of the art.26 mechanism; in other words, initiating arbitration proceedings against the EU itself as a party to the ECT.

Final remarks

Although the energy inter-dependence between Russia and the EU remains the main focus of their energy cooperation, the international legal issues that arise in the light of political tensions caused by EU sanctions and what have been described as restrictive measures by the Russian authorities⁶⁶ is something of a barrier to cooperation between states in this area. This, in turn, has a potentially negative impact on any entities engaged in relevant economic activities. Having regard to these issues, some exponents of the Russian doctrine of international law have come to the conclusion that the EU actions “shift ... Russian supply priorities to the East rather than the West”.⁶⁷ Indeed, one must inevitably take into account the economic possibilities connected with the construction of the Power of Siberia Pipeline, which will provide Russian gas with access to China.

⁶³ See e.g. *PJSC Gazprom IFRS consolidated interim condensed financial information 2017*, available at <http://www.gazprom.ru/ff/posts/57/287721/gazprom-emitent-report-4q-2017.pdf> [Accessed 10 July 2018].

⁶⁴ *Case AT 39816*, details available at http://ec.europa.eu/competition/elojade/iseff/case_details.cfm?proc_code=1_39816 [Accessed 10 July 2018].

⁶⁵ See, e.g. J. M. V. Camallonga and J. L. Iriarte, “Investment arbitration as a possible remedy for investments affected by Bulgaria’s suspension of the south stream pipeline project” [July 2014] International Law Firm, available at <https://www.lupicinio.com/wp-content/uploads/2014/07/Investment-arbitration-as-a-possible-remedy-for-investments-affected-by-Bulgaria%E2%80%99s-suspension-of-the-south-stream-pipeline-project.pdf> [Accessed 10 July 2018].

⁶⁶ See, e.g. International Trade Issues Revisited (materials of the governmental meeting) (2018), available at <http://government.ru/news/33014/> [Accessed 26 August 2018].

⁶⁷ G. M. Veliaminov, *International Law: Essays* (M.: Statute, 2015), p.1006.

Nevertheless, the European gas market remains the priority for the Russian suppliers, which therefore calls for a deeper analysis of the legal issues regarding the realisation of certain European pipeline projects.

Among the key factors that contributed to the discontinuance of the construction of the South Stream Pipeline are the following (including but not limited to):

- (1) issues relating to the adoption, and entry into force, of the TEP:
 - states not reaching a consensus on the legal status of the TEP and its relationship with IGAs governing the construction of the South Stream Pipeline, together with the issue of the conformity of IGAs with the TEP in the light of customary international law (in addition to the issue of the conformity of EU rules with rules of the general international law);
 - states not invoking the liability of the EU for effectively putting them in a position where they were in breach of their obligations under IGAs (see the UN International Law Commission, *Responsibility of International Organisations* (2008)); it would have been preferable, from the point of view of international law, for these issues to have been resolved, particularly where there is potentially a conflict between national interests and EU policy); and
 - the issue of conformity of the TEP with WTO rules given the nature of the certification procedure applied to the gas transmission system operators controlled by persons from third countries; and
- (2) issues relating to the application of the TEP to the South Stream Project (irrespective of any issues of conformity with the international law):
 - the TEP's "unbundling" rules, which impacted on PJSC Gazprom's activities relating to pipeline construction and operation;
 - the possibility of PJSC Gazprom applying for an exemption from the "unbundling" rules art.36 (including the potential impact for the Russian Federation's legal position regarding conformity of the TEP with WTO rules);

- the application of the TEP to the underwater section of the project; and
- the lack of legal certainty in terms of defining the project as an upstream pipeline network or a transmission pipeline network (if the South Stream Project qualified as an upstream pipeline network, its operation would not be subject to the certification procedure).

It should be noted that, not only was the legal status of the project defined within the context of international law, but also within the context of the contractual mechanisms that enabled the beginning of the construction of the pipeline. These contractual mechanisms involved a range of foreign trade contracts, the parties to which suffered potentially significant losses when the project was suspended (which, in the absence of efficient mechanisms in international law, are now the subject of international arbitration proceedings). One such dispute concerns the Gazprom subsidiary, South Stream Transport BV, and the Italian company, Saipem, regarding the termination of the contract for the construction of the South Stream Pipeline. Both companies claim compensation for work performed, reimbursement of expenses incurred and for the termination of the agreement. They are currently undergoing a mutual information disclosure procedure.

The likelihood of the parties being awarded damages by an arbitral tribunal constituted under the rules of the ICC, which is one of the most respected international courts of arbitration in the world, depend on the precise wording of the contract. If the contract does not contain a compensation clause and is found to have been unilaterally terminated by one of the parties, Saipem could potentially recover compensation (subject to relevant documentary evidence). When determining precisely what caused the damages claimed in any case (and whether or not there is a basis for an exemption from contractual liability), the international arbitration tribunal must take account of the following: (1) consent of the EU Member States to the construction of the South Stream Project; (2) contracts and treaties particularising such consent; (3) action taken by states in preparation for project implementation (and the beginning of its construction, including the costs incurred); and (4) the time that legislation was adopted that adversely impacted on project implementation.

In the author's opinion, it can therefore be concluded that the current discontinuance of South Stream Project is associated with a number of issues relating to EU–Russia energy cooperation. These issues can only be solved through dialogue in full compliance with international law. It is hoped that lessons learnt from the suspension of the South Stream Project will help to avoid

legal uncertainty and disputes in connection with any future pipeline construction projects to which Russia and

EU Member States are parties.