



INSIDE THIS ISSUE:

- Key features of the Third Energy Package
- How the key provisions of the Third Energy Package were implemented in Serbian Energy Law
- South Stream pipeline project – a brief history
- Exemption of South Stream from the Third Energy Package on the EU level?
- Serbian legal system and South Stream pipeline
- Turkish Stream: A possible substitute?
- Conclusion

Serbia adopts rules preventing South Stream pipeline?

Shortly before end of 2014, Serbian National Assembly adopted new Energy Law (“Official Gazette of the Republic of Serbia” no.145/2014, “Energy Law”), the main feature of which was, as we noted in the December edition of Client Alert, the harmonisation of Serbian energy legislation with the Third Energy Package of the EU. The subject matter of this Legal Insight shall, however, be a deeper analysis of the possible legal consequences of the adoption of the Third Package rules for Serbia with regards to the cancellation of the South Stream project by Russian Federation and recent headlines about the construction of a new pipeline project - Turkish Stream.

Key features of the Third Energy Package

- Consisting of: Directives 2009/72/EC and 2009/73/EC (“Electricity Directive” and “Gas Directive” respectively), Regulation (EC) No 714/2009, Regulation (EC) No 715/2009 and Regulation (EC) No 713/2009;¹
- Electricity and Gas Directives aim to provide the effective regime of “unbundling” of transmission/transport system operators (“TSOs”) and of distribution system operators (“DSOs”);² along with granting third party access (“TPA”) to

¹ See <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=OJ:L:2009:211:TOC>, accessed 20 January 2015

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the transmission and distribution systems in accordance with published tariffs, applicable to all customers (Article 32 of the Gas Directive);

- “Unbundling” can be defined as “structural separation between transmission activities and production/supply of vertically integrated companies”;³
- The unbundling regime encompasses three models: ownership unbundling model, the independent system operator (“ISO”) and the independent transmission operator model (“ITO”);⁴
- Ownership unbundling: each undertaking which owns the transmission system acts as a TSO; the same person is not entitled to exercise control over an undertaking performing any of the functions of gas production or supply and to exercise control or any right over a TSO or a transmission system;⁵
- Main aim of the unbundling regime: ensuring fair competition on the energy and gas market.

“..the same person is not entitled to exercise control over an undertaking performing any of the functions of gas production or supply and to exercise control or any right over a TSO or a transmission system”

How the key provisions of the Third Energy Package were implemented in Serbian Energy Law

- Definition of a vertically integrated company: a company or group of companies where the same entity has the right to direct and indirect control and where energy subject and group performs, among other activities, TSO activities, DSO activities, natural gas storage and operation of natural gas storage and at least one of the following activities: production of energy and natural gas, supply or public supply of energy/natural gas
- Clear obligation of separate accounting for each specific energy activity, including energy supply under regulated prices and jointly for other activities not defined as energy activities in Energy Law; income from ownership of transport or distribution system must be specified in invoices;
- Transposed provisions of the Third Energy Package related to the unbundling models;
- Serbia is the first country in the region which has fully implemented the Third Energy Package, with effect from 1 January 2015.⁶

² European Commission, Commission Staff Working Paper: *Interpretative Note on Directive 2009/72/EC concerning Common Rules for the Internal Market in Electricity and Directive 2009/73/EC concerning Common Rules for the Internal Market of Natural Gas, the Unbundling Regime*, p. 4, Brussels, 22 January 2010, available at: http://www.hep.hr/hep/propisi/DGTRENBiljeska_Unutarnje_razdvajanje2009_72_73.pdf, accessed 20 January 2015

³ European Commission, *Internal Energy Market Rules: Electricity, Screening Exercise: Serbia*, Brussels, 29 April 2014, p.6, available at: http://www.seio.gov.rs/upload/documents/skrining/eksplanatori/prezentacije/pg15_21/15_21_2.pdf, accessed 20 January 2015

⁴ *Interpretative Note on Directive 2009/72/EC concerning Common Rules for the Internal Market in Electricity and Directive 2009/73/EC concerning Common Rules for the Internal Market of Natural Gas, the Unbundling Regime*, p. 4.

⁵ *Ibid.* p.8.

⁶ See <http://inserbia.info/today/2014/12/serbia-electricity-gas-markets-to-be-liberalized-from-january-1/>, accessed 27 January 2015



South Stream pipeline project - a brief history

The project was envisaged with the aims of “strengthening European energy security, meeting increased demands for natural gas in Europe”⁷ and eliminating gas transfer risks. South Stream pipeline was supposed to be comprised of offshore (running under the Black Sea) and onshore sections (touching Austria, Bulgaria, Croatia, Greece, Hungary, Italy, Republic of Srpska (entity within Bosnia and Herzegovina), Serbia and Slovenia).

Its construction began in 2012 in Anapa (Krasnodar area on the Black Sea) in Russian Federation.⁸ The (symbolic) construction of Serbian part of the pipeline system began in November 2013.⁹ However, President of the Russian Federation, Vladimir Putin, following the development of the crisis in Ukraine and strained relations with the EU, announced the abandonment of the project on 1 December 2014, allegedly because the European Commission refused to grant exemption for the project, deemed as contrary

to the Third Energy Package rules.¹⁰ On the EU side, Jean-Claude Juncker, President of the European Commission, dismissed the claims that “EU competition rules had killed” the project and said that the issues it was facing were not “insurmountable”.¹¹

Several months before Mr. Juncker’s statement, however, the Commission was of the view that South Stream violated the unbundling regime of the Gas Directive, TPA rules and tariff structure of the Third Energy Package, and also that all bilateral agreements for the construction of the pipeline, including the one between Serbia and Russian Federation, were in breach of the EU law and had to be renegotiated.

Another epilogue of the Russian Federation – EU clash over the pipeline was a lawsuit filed by Russian Federation against the EU before World Trade Organisation over the Third Energy Package.¹²

⁷ <http://www.south-stream.info/pipeline/significance/>, accessed 27 January 2015

⁸ <http://www.gazprom.com/about/production/projects/pipelines/south-stream/>

⁹ http://www.b92.net/biz/vesti/srbija.php?yyyy=2013&mm=11&dd=24&nav_id=781301

¹⁰ <http://www.ft.com/intl/cms/s/0/10f5bb96-795c-11e4-a57d-00144feabdc0.html#axzz3Q2UCXh6>, accessed 27 January 2015

¹¹ <http://www.reuters.com/article/2014/12/04/us-russia-europe-pipeline-eu-idUSKCN0J118720141204>, accessed 27 January 2015

¹² <http://www.globalresearch.ca/gas-pipeline-wars-the-eu-threatens-to-obstruct-gazproms-south-stream-project/5386475>, accessed 27 January 2015

Exemption of South Stream from the Third Energy Package on the EU level?

The abovementioned exemption of South Stream from the Third Package rules might be a possible way for continuation of the project, of course provided the political will of both sides existed in the future. The conditions governing exemptions from unbundling and TPA rules of the Gas Directive are laid down in Article 36 of the Directive and are as follows: (i) the investment must enhance competition in gas supply and enhance security of supply; (ii) the level of risk attached to the investment must be such that the investment would not take place unless an exemption was granted; (iii) the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built; (iv) charges must be levied on users of the infrastructure; and (v) the exemption must not be detrimental to competition or the effective functioning of the internal market in natural gas, or the efficient functioning of the regulated system to which the infrastructure is connected.

Out of the five conditions, it seems that those involving competition (the first and the fifth) might be the most difficult to sustain. In addition, the decision on that would not only involve national regulatory bodies, but also the European Commission, as provided by Article 36, which could decrease the chances of exemption of South Stream from the main Third Energy Package rules for being granted. In any case, Russian Federation has not even submitted such a request.

Serbian legal system and South Stream pipeline

Bilateral agreement between Serbia and Russian Federation on cooperation in oil and gas field (Law on Ratification of the Agreement between the Government of the Republic of Serbia and the Government of Russian Federation on Cooperation in Oil and Gas Industry Fields, "Official Gazette of the Republic of Serbia", no.83/2008, "Agreement") was concluded in 2008, a year before the EU adopted Third Energy Package. It governs the construction of the gas transit pipeline (albeit not explicitly named "South Stream"), construction of underground gas storage near exhausted gas field "Banatski Dvor" and the reconstruction and modernization of the technological complex of Serbian Oil Company, Naftna Industrija Srbije AD. The initial validity period of the Agreement is 30 years, with the possibility for extension. It contains no provisions on unbundling, TPA or tariff structure. Energy Law of 2014, as we explained, adopted the provisions of the Third Energy Package, meaning that the South Stream pipeline, if eventually carried out¹³, might be incompatible with the Energy Law.

However, even if Russian Federation had not cancelled the South Stream project, the question would have remained about the fate of South Stream project in light of the ongoing accession procedure of Serbia to the EU. If, for the sake of the argument, politics were left aside and only law assessed, the situation appears to be unclear. Serbian Constitution seems to provide that ratified international agreements prevail over "ordinary" laws (although this is ambiguous), which indicates that the Agreement would prevail over Energy Law and that Serbia should carry out its obligations regarding the South Stream. Even if Serbia were an EU member with obligations to comply with the Third Energy Package itself, it would not *per se* mean that it would have to terminate the application of the Agreement, due to the fact that Third Energy Package cannot be considered *lex posterior* to the Agreement, since the Russian Federation is not bound by it.

¹³ Interestingly, Bulgaria has announced that the works on the construction of the pipeline shall not be halted, as it doing otherwise could violate the Shareholders' Agreement in South Stream Bulgaria AD: <http://www.novinite.com/articles/166145/Bulgaria+Unable+to+Halt+South+Stream+Construction'+Ex-Energy+Minister>, accessed 27 January 2015. Serbian Government, at least for now, seems to look for another options for securing energy stability of the country, such as connection to TAP pipeline: <http://www.blic.rs/Vesti/Ekonomija/521603/ALTERNATIVA-Umesto-Juznog-toka-gasna-konekcija-NisDimitrovgrad>, accessed 27 January 2015

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The possible outcome of this clash would most likely depend on the international forum engaged with resolving the dispute, if one ever arose. If the Court of Justice of the European Union happened to be such a body, the Third Energy Package obligations would prevail and South Stream would have to be halted, especially since the then-European Court of Justice declared that the EU law prevails even over obligations of states under Chapter VII of the UN Charter.¹⁴

The possibility that any other international court or arbitral tribunal could pronounce on the issue of prevalence of Third Energy Package over the Agreement is far-fetched, one reason for this being the complete lack of any third-party dispute settlement mechanisms in the Agreement, and the other the fact that the 1995 bilateral investment treaty between the Russian Federation and then-Yugoslavia, would require that an aggrieved investor has Russian nationality, under the presumption that an investment took place on the Serbian section of the pipeline.

Turkish Stream: A possible substitute?

Following the death of South Stream, the quest for a new pipeline project involving Russian gas began shortly. The alternative, the so-called Turkish Stream, would use the existing pipes under the Black Sea, and transport the gas to a hub on Turkish-Greek border, thus avoiding Ukraine. Memorandum of Understanding was signed between Turkish state oil company Botaş and Russian giant Gazprom. Debt-stricken Greece and Russian Federation are expected to sign the intergovernmental agreement on the construction of the pipeline.¹⁵ Former Yugoslav Republic of Macedonia, Serbia and Hungary are also interested to participate in the project, which could, in words of Russian Energy Minister, be extended so as to bring the gas to Baumgarten in Austria, as was originally envisaged for the South Stream.¹⁶

Until recently, both EU and Gazprom officials indicated that the Third Package rules shall be adhered to with regards to Turkish Stream.¹⁷ But, European Commission sent a Statement of Objections to Gazprom, with allegations of abuse of dominant position on the Central and Eastern European market, to which Russian company has 120 days to respond to.¹⁸ Gazprom's "reaction" was a threat of suspension of the gas supply to Europe if the EU stopped the Turkish Stream project.

Leaving this political dimension aside, if Turkish Stream materializes and Serbia eventually decides to participate in the project, it would have to, at least on the basis of current applicable law, do so in accordance with the Third Package rules. In addition, the country would have to surmount a practical problem - how to finance the Serbian section of the pipeline.¹⁹

Conclusion

The South Stream is currently no more than a dead letter and Serbia continues its struggle to fulfill its obligations on its path to the EU. Therefore, there is, for now and despite the fact that 1) Third Energy Package is now essentially part of Serbian domestic legal system and 2) bilateral agreement between Serbia and Russian Federation on cooperation in oil and gas field still remains in force, no possible clash between international obligations of Serbia towards either the EU or Russian Federation with regards to the South Stream pipeline project.

However, if the Turkish Stream ever comes to life and Serbia decides and finds funding to participate in it, the legal situation, at least on the basis of currently applicable law, is reasonably clear – it would have to adhere to the Third Package rules.

¹⁴ See *Kadi and Al Barakaat International Foundation v. Council and Commission* cases

¹⁵ See <http://rt.com/business/251769-russia-greece-gas-deal/>, accessed 23 April 2015

¹⁶ http://www.b92.net/biz/vesti/svet.php?yyyy=2015&mm=04&dd=14&nav_id=980551, accessed 23 April 2015

¹⁷ See above, notes 15 and 16

¹⁸ http://europa.eu/rapid/press-release_IP-15-4828_en.html, accessed 24 April 2015

¹⁹ http://www.b92.net/biz/vesti/svet.php?yyyy=2015&mm=04&dd=23&nav_id=984253, accessed 24 April 2015. The news is inconclusive with regards to whether this was actually a type of Gazprom's reaction to the Commission's anti-trust procedure.

Ask a question

We shall gladly respond to any questions you may have.

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