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SWP Comment

NO. 46 JULY 2021

Nord Stream 2 and the Energy Security Dilemma

Opportunities, Options and Obstacles for a Grand Bargain

Maria Shagina and Kirsten Westphal

Washington and Berlin have settled their differences over the gas pipeline through the Baltic Sea. For the time being, this has halted the spiralling energy security dilemma. While Washington is sending a clear signal that constructive relations with Berlin are important, the German government is now called upon to implement a variety of measures. Still, the project remains a political issue. Kyiv and Warsaw have already signalled their opposition. A grand bargain that is not only bilaterally agreed upon but also involves Ukraine and commits Russia has not yet been achieved.

Politically, the Biden administration and German government have reached a joint agreement. It will enable the completion of the controversial Nord Stream 2 gas pipeline. Construction of the pipeline is to be finished by the end of August. The first string is already complete, and less than 40 kilometres still need to be laid on the second string. The construction and welding work will be followed by pressure tests on both strings, which will take another two to three months. This means that, technically speaking, gas could flow through the pipeline as early as the end of this year. The last open questions concern the application of the amended EU gas directive, the approval of an operating regime and technical certification. In the eyes of many observers, the final decision-making phase in the conflict over Nord Stream 2 has now begun.

The bilateral agreement now revives US relations with Germany, while extraterritorial sanctions against Europeans remain an option of last resort. The declaration makes clear that Washington and Berlin will work together constructively. Both begin by assuring that they are prepared to impose new sanctions “should Russia attempt to use energy as a weapon or commit further aggressive acts against Ukraine.” In such a case, Germany would lobby the EU accordingly. Both emphasise the energy security of Ukraine and Central Europe, as well as the principles of EU regulation. Berlin also commits to the implementation of these principles with regard to Nord Stream 2. Furthermore, Germany pledges to apply all available leverage to extend gas transit through Ukraine for up to ten years. Germany will contribute at least \$175 million to a Green Fund to support Ukraine’s



energy transformation and security. This sum is expected to grow to at least \$1 billion when including private sector capital. Germany will provide additional funds of \$70 million for, among other things, the coal phase-out. In addition, as part of the Climate and Energy Partnership, Germany and the US will support energy transformation, infrastructure development and resilience in Ukraine and Central and Eastern Europe, including through the Three Seas Initiative. The agreement also mentions technological know-how, assistance with market regulation and Ukraine's integration into the European power grid, for which EU funds will also be provided.

Germany and EU Gas Market Developments

The compartmentalisation of gas relations with Russia has been a long-standing paradigm in Germany that is backed by a market-based approach and the wish to 'de-politicise' the pipeline. The German government has viewed the project through economic and regulatory lenses since it started in 2015, as it shared the assessment that Nord Stream 2 would improve flexibility and liquidity on the gas market.

In security and foreign policy circles, including those of the coalition parties, there are major reservations about the project. Here, calls have become more pronounced to enact a moratorium on the project to achieve a consensus in the EU and to assess the project's impacts on the security situation and transatlantic relations. Nonetheless, the legal and economic conditions have already been set.

The market regime has favoured EU consumers over the past decade, but it has not changed the fact that three large pipeline suppliers — Russia, Norway and Algeria — dominate the market or that Europe is the market of last resort for liquefied natural gas (LNG). In today's tight market, Russia's Gazprom is exploring its market position, not only in order to profit from high prices, but also to pursue its

long-term strategy of maintaining a 30 percent market share in the EU while also backing the 'Northern route' from Bovanenkovo through the Baltic Sea into North-West Europe. This is the shortest route, with favourable and foreseeable transport conditions (at least along large parts of its non-regulated sections). It also cuts less into Russia's own rents and revenue streams than other routes.

However, a negative downward spiral of self-fulfilling prophecies seemed to unfold in the summer of 2021. Nord Stream 2 has been drawn into a classic energy security dilemma, with all sides pursuing their security interests and preparing for the worst. Germany has faced a difficult predicament (see SWP Comment 32/2021). A clash between Russia and the US over the German gas market seemed inevitable.

The endgame saw more twists play into the hands of Russia's Gazprom. Over the course of the first half of 2021, security of supply within the EU gas market increasingly caused headaches as it turned from an over-supplied gas market into a tight market. Ten years of relatively low gas prices and the Covid-19-induced price slump in 2020 led to a buyers' market that was expected to last beyond 2025. This favoured EU market competition and regulatory strength. But recently this has changed, as the market tightens and the pendulum of market power swings toward suppliers.

Gas supplies are constrained as a number of factors converge. Cold temperatures from February through May 2021 prolonged the heating season in Germany and elsewhere. Yet, LNG was redirected to Asia as its price was 80 percent higher than in the EU, or it did not even reach Europe as US LNG exports plunged by two-thirds in February 2021. This emptied European gas storage facilities. The demand for LNG surged in Asia, and heat waves in North America resulted in greater energy demand. European gas production has continuously decreased over the past few years, and Norway's deliveries were lessened due to maintenance that had been postponed during the pandemic. The spot market prices and

prices for forward contracts for next winter surged to more than €30/MWh by the end of June 2021, or \$11 per mmbtu, compared to \$2 per mmbtu in June 2020, with day-ahead prices jumping to €37.75/MWh in early July in Germany. Prices surpassed levels unseen since 2008. All in all, the second quarter of 2021 raised concerns for the upcoming winter.

Thus, close attention has been paid to Gazprom's supplies. While observers report that the company has delivered almost 20 percent less than in 2019 (pre-Covid), the company itself reports record sales to Europe. In this respect, the market reacted nervously this summer to Gazprom's abstention to book additional interruptive transport capacity.

Part of the December 30, 2019 trilateral political agreement between Russia, Ukraine and the EU, which prevented a gas conflict at the last minute, is also an agreement between Gazprom and Naftogaz on the organisation of gas transit. Accordingly, for a \$7.2 billion payment from Gazprom, Naftogaz books annual transport capacity for Russian gas at 65 billion cubic metres yearly (bcm/y) for 2020 and 40 bcm/y for the periods of 2021-2024. Capacity was reduced in the contract from 2021 onwards because it was assumed that Nord Stream 2 would be completed by 2020. However, this was prevented by US sanctions. The ship-or-pay agreement does not provide seasonal flexibility as it is calculated on a daily basis of 178 million cubic metres per day (mcm/d) in 2020 and 110 mcm/d for 2021-2024. In addition, the Ukrainian Gas Transmission System Operator (GTSOU) has offered 15 mcm/d of firm capacity since February 2021 for monthly bookings, which Gazprom has consistently booked since then. Yet, the additional 63.7 mcm/d of interruptible capacity that has been offered by GTSOU since May 2021 has come into focus. Although it was expected that Gazprom would book the latter in view of price increases, this has not been the case. According to GTSOU, the volumes are in line with the interconnection agreement with Gazprom for the Sudzha and Sokhra-

nivka interconnection points. It is unclear why the additional firm volumes have been limited to that amount since 2020 and the interruptible capacities are not offered at a discounted rate like they usually are. A shame and blame game between Moscow and Kyiv has commenced. In any case, 2 bcm less gas arrived from Russia in July 2021 due to maintenance work on Yamal from 6 to 10 July and on Nord Stream 1 from 13 to 23 July.

Besides, Gazprom has not booked annual capacities through Poland's Yamal, suggesting that it aims to have Nord Stream 2 go online soon. Moreover, Germany's gas storage facilities are only at 50 percent compared to previous years. The large storage facilities operated by Gazprom's subsidiary Astora in Rehden and Jemgum in Germany and in Haidach in Austria, are very empty compared to previous years. Besides, stored gas in these facilities has obviously been used to fulfil delivery obligations over the summer. The fact that storage levels are particularly low in the south will be an early test for the new German market area, which will begin on 1 October 2021.

The missing piece of the puzzle relates to gas prices in Europe, which are at a 13-year high. Future gas prices for the winter are either at the same level or slightly lower than spot and summer prices (backwardation) at major trading hubs. The low storages are a function of the non-existent summer-winter spread, as traders that are only eyeing optimisation of revenues (after a year of loss in 2020) may have little incentive to prepare for security of supply out of their own pockets.

There are no signs that Gazprom is not fulfilling its contractual obligations under long-term delivery contracts, but it seems unwilling to provide swing supplies. Given the high prices, Gazprom stands to increase its profits by 43 percent in 2021 compared to 2020, all without increasing its volumes.

Security of supply will become, as it looks as of mid-July 2021, an issue this autumn and winter. For the EU, LNG supplies help to diversify, but they come with a significant price tag and time lag. Strong

demand for LNG in Asia is expected to last into the next year. Extreme price spikes in the winter could be a consequence, as European storages usually have an important function in balancing the global market. Asia does not have significant storage facilities. In sum, many traders seem to be betting on Nord Stream 2 coming into operation by the end of the year. For them, the pipeline will put Northwest Europe into a more comfortable supply position and will have a price dampening effect.

In the end, the market has begun to favour Russia. Russia already cut supplies during the 2014-15 winter season to prevent gas from flowing back to Ukraine, and it could well be that Moscow will play its trump card against Western Europe in the conflict over the pipeline this autumn. Voices calling for a moratorium have been continuously raised in Germany, too. The country is facing elections on 26 September 2021. The election programmes of the liberal democrats (FDP) and the Greens call for a moratorium and end to the project, the programmes of the social democrats (SPD) and the conservatives (CDU/CSU) make no mention of the pipeline. In any case, Germany's future federal government may take a different position than the current one, which, however, will provisionally remain in office until the – possibly protracted – coalition negotiations have been concluded. Still, the administrative procedures of the project are already underway.

The amendment of the EU's gas directive in February 2019, was a move to 'de-politicise' and have the issue dealt with by the German administration. Yet, this sets into motion a trajectory with no obvious room for a backstop, let alone a moratorium. On 11 June 2021, Nord Stream 2 AG – the project developer – applied to the German Regulatory Authority (BNetzA) for a certification as an independent transmission system operator. This was done under German Energy Act §4b. The German Federal Ministry for Economics and Energy must submit its assessment as to whether granting the certification would jeopardise the energy security of Germany or the EU

within a period of three months. According to Energy Industry Act §4a, the BNetzA has four months, until 11 October 2021, to draft a decision and to send it to the European Commission (EC) for an opinion. The EC, in turn, has two months to draft an opinion with recommendations. The BNetzA then has another two months to publish its decision and all related opinions and documents. Given these timeframes for the regulatory process, it could take until February 2022 for a first decision. Prior to this, the Energy Supervisory Authority of the Federal State of Mecklenburg-Western Pomerania needs to approve commissioning. Moreover, the technical certification of the constructed pipelines still needs to be completed. Originally, the Norwegian firm DNV GL was responsible for this certification, but withdrew when facing the risk of US sanctions in January 2021. It is unclear which company will complete the certification according to international standards as well as those of the German Association for Gas and Water (DVGW).

Nord Stream 2 AG is still litigating three cases against the amendment of the EU's gas directive before the courts. Warsaw and Kyiv, for their part, may also take legal action against the decision, as shown by example of OPAL, a Nord Stream 1 connecting pipeline. After the ruling of the European Court of Justice on 15 July 2021, the transit flows through OPAL remain restricted to 50 percent, limiting gas transit flows to 12 bcm/y. Thus, legal disputes around the pipeline will continue for some time, also depending on the EU's stance and the EC's issued opinion. The most important question here is related to the actual physical gas flows of Nord Stream 2 through Germany's coastal waters, to which the amended gas directive must be applied. It remains unclear whether, when and how much gas will flow, and under which (preliminary) conditions. Tight market conditions may come into play favouring Nord Stream 2's speedy technical certification and (preliminary) operation.

Given the promotion of "molecules of freedom" under the Trump administration,

the Kremlin might gladly be willing to show that “energy security can only be achieved in close partnership with Russia”. Berlin is in a difficult position as it can neither rely on Moscow’s cooperative approach in gas matters nor assume that it will be easy to accommodate Ukraine’s interests to the largest extent possible, a precondition set by the US.

Ukraine’s Position on a Grand Bargain

From the very beginning, Ukraine was an opponent of the controversial Nord Stream 2 pipeline. Launched in 2015, the project raised legitimate concerns with respect to its compatibility with EU sanctions introduced after Russia’s annexation of Crimea in 2014. But it was only in 2019 when Kyiv began to actively lobby against Nord Stream 2 in Washington and Brussels. Despite the topsy-turvy US-Ukrainian relationship under the Trump presidency and the lack of coordination within Ukraine, Kyiv managed to lobby for the introduction of US sanctions under the Protecting Europe’s Energy Security Act (PEESA) in December 2019. Ukrainian officials celebrated the interim victory, as construction on the pipeline was suspended for a year and a half. US sanctions were also instrumental in Naftogaz’s signing of the gas transit agreement with Gazprom for the 2020-2024 period.

With the election of the Biden administration, Ukraine had high hopes that the US would apply all sanctions powers at its disposal to halt the construction of the pipeline. There was an expectation that, unlike Trump, Biden would be consistent in his pushback against Russia and its diversification pipeline. Kyiv read the US’ statements about Nord Stream 2 being “a bad deal for Europe” as a confirmation of its beliefs that Washington would not allow the project to move forward. Kyiv was slow to come to the realisation that Biden favoured diplomacy over economic coercion on the matter. By February 2021, it was

clear that the Biden administration was reluctant to use extraterritorial sanctions against its allies as it prioritised the revival of the transatlantic relationship with Germany. As part of the PEESA sanctions package, the US targeted Russian pipe-laying vessels but spared European entities involved in the project. It was later revealed that the US consulted with Ukraine on this decision and did not face any objections. The Ukrainian officials were certain that US sanctions would suffice to block the pipeline, prompting Kyiv to postpone any serious elaboration to contingency plans.

Ukraine’s reading of the situation changed from overly optimistic to disappointed when the Biden administration decided to waive sanctions on Nord Stream 2 AG and its CEO Matthias Warnig. This decision caught Ukraine by surprise, not least due to the fact that, unlike before, Kyiv was not consulted. In an interview on the affair, President Zelensky expressed resentment and disillusionment: “Unfortunately, [the decision] is definitely not aimed at supporting Ukraine. [...] I truly thought that when it came to Nord Stream 2, the United States remained the last standing outpost, so to say.” Zelensky claimed that Biden offered him “direct signals” that the pipeline would be blocked. Despite the US’s bitter move, Kyiv still counts on Washington — this time on strong bipartisan support in Congress — to halt the construction and operation of the pipeline.

Since then, Ukraine’s current strategy regarding Nord Stream 2 remains largely unchanged: opposing the pipeline and lobbying for more US sanctions while working on a contingency plan in the background. Svitlana Zalishchuk, the newly appointed international affairs advisor to Naftogaz, reaffirmed that Ukraine’s last hope to stop the pipeline lies in Washington and not in Berlin. Kyiv hopes that US Congress will increase pressure on the Biden administration to impose more effective sanctions, including those that work to hinder the certification of the pipeline and repeal the waivers. In addition, Kyiv sees a new opportunity in fighting Nord Stream 2

with the Global Magnitsky Act. The US Senate Foreign Relations Committee unanimously supported a bill to assess corruption with regard to the Nord Stream 2 project. The bill, still subject to full approval by Congress, envisages the introduction of sanctions on entities involved in corrupt activities throughout the project. Naftogaz CEO Yuriy Vitrenko alluded that the sanctions could target Russian oligarchs such as Arkadiy Rotenberg and Gennadiy Timchenko, both of whom are the key sub-contractors of Nord Stream 2, but already sanctioned by the US.

Ukraine's strategic miscalculation of the Biden administration's priorities has left it in a bind. Banking on US sanctions left Ukraine truly unprepared for the eventuality of a completed Nord Stream 2. Unsurprisingly, Kyiv has been totally opposed to the idea of a grand bargain between Germany and the US. For Ukraine, the issue of Nord Stream 2 has become an existential threat. Its attention has shifted beyond the \$1.5-3 billion per year loss in gas-transit revenue as it has now come to focus on security concerns. Kyiv fears that once the construction of the pipeline is completed, Russia will be unconstrained in its ability to launch a full-scale invasion of Ukraine. This line of argumentation has not found support within Germany's current government, where it is perceived as speculation.

As the construction of Nord Stream 2 reaches its end, Kyiv has belatedly embarked on its elaboration of a plan B. Public discussions on the topic have revealed divisions between Ukrainian diplomats, policy-makers and experts: some argue that it is in Ukraine's best interest to take an active stance in the negotiations to secure better terms; others adamantly oppose a grand bargain, arguing that agreeing on a compensation package would be perceived as a concession to Russia.

The discussed options for the plan B are wide-ranging and include market, legal and geo-economic instruments. Firstly, by leveraging EU energy market rules, Ukraine seeks to challenge Russia's monopolisation of gas flows from Central Asia. Naftogaz is

ready to take legal action against Gazprom by way of international arbitration, attempting to challenge Russia's monopoly-like selling behaviour with regard to the sale of Central Asian gas. Ensuring that Nord Stream 2 is complying with the EU's Third Energy Package is another part of Ukraine's strategy to utilise market instruments to limit the impact of the Russian pipeline. The second option, which is gaining traction in Kyiv, is to move gas purchases to the Russian-Ukrainian border and allow European companies to book capacities directly via the Ukrainian gas transmission system. In Vitrenko's view, this would be the best assurance for Ukraine that gas transit through the country remains guaranteed. Ukraine's third option is to capitalise on its vast gas stores in times when the EU's decarbonisation policy will require more underground storage facilities. Finally, joining the Three Seas Initiative could help Ukraine to enhance its energy connectivity with Central Europe and diminish the historical reliance on the "East-West" axis.

From Ukraine's point of view, opposing the pipeline should go hand in hand with preparing contingency plans. Both strategies are viewed as complementary. By continuing to oppose the project and lobby for more sanctions, Kyiv hopes to increase pressure on Russia, thus creating greater room for manoeuvre with regard to its contingency plans.

Having faced a bitter misunderstanding with Berlin's current government, Ukraine is putting its hopes in Germany's federal elections in September 2021. According to opinion polls, the Green Party is likely to supersede the SPD, a strong supporter of the pipeline, in a new government coalition. The Greens have adamantly opposed Nord Stream 2 on environmental grounds and due to its negative security effects on Ukraine. This potential change in Germany's political landscape makes Kyiv reluctant to negotiate a compromise with the current government in Berlin. Kyiv is keen to postpone negotiations, hoping that the

Greens, as a part of the new government, will stop the pipeline.

The announcement of the US-Germany agreement confirmed Ukrainian fears that the fate of the pipeline would be decided without taking Ukraine's interests to heart. As the deal was signed without Ukraine's consent, Kyiv fears it is losing its voice in the Nord Stream 2 debate.

What's Next?

While the US-Germany deal has been signed, it is still far from a grand bargain. A consensus in the EU has not yet been achieved, and Brussels's role goes well beyond issuing an opinion on the application of the Gas Directive. The EU has to join forces to integrate Ukraine into the Green Deal, as envisaged in the US-German agreement. Domestic political pressure in Washington, Berlin and Kyiv will make agreeing on the ultimate deal a challenging task. It will require a great degree of flexibility for all sides, forcing concessions on important and sensitive issues and compelling the parties to engage with Russia. This grand bargain also presupposes a conciliatory approach on the part of Russia.

The agreement between the US and Germany has outlined a broad range of important long-term measures to offset the negative impacts of Nord Stream 2. Kyiv, however, is focusing on short-term and concrete security guarantees. Seeing itself trapped in a traditional energy security dilemma makes it unlikely to accept the long-term prospect of energy transformation, especially as security concerns and energy interests interact. In the short-term, the effectiveness and credibility of the joint declaration will be tested. From Ukraine's point of view, despite the promised sanctions in the case of Kremlin aggression, the concrete "shut-down" mechanism is missing. This, of course, is and remains legally and economically almost impossible to implement.

For Ukraine, accepting the deal as it stands proves to be problematic. Ukraine

already objected the deal, citing insufficient security guarantees to limit the threats of Nord Stream 2. Albeit to no avail, Kyiv has been seeking to shift the discussion to hard security issues such as Russian de-occupation of Ukrainian territories, discussion of energy in the Normandy format and weapons deliveries. Agreeing to financial compensation is seen by Ukraine as unacceptable, as this could be conceived of as a concession to Russia. Instead, Kyiv has embarked on a strategy to directly engage with the European Commission, effectively side-lining talks with Berlin. Ukraine has invoked Article 274 of the Ukraine-EU Association Agreement, which stipulates that the parties shall consult or coordinate with each other over infrastructure developments.

The compromise around Nord Stream 2 is not an end in itself, but a means to avoid further escalation. Extending the current gas-transit agreement beyond 2024 seems to be something that Washington, Kyiv, Berlin and Brussels can agree on, but it would require Moscow's cooperation. Chancellor Merkel has already called President Putin, but Foreign Minister Lavrov has already criticised Berlin's commitments.

The devil lies in the details of quantities, post-2024 tariffs and durations, but also direct gas imports. From Germany's perspective, more transparency is needed around the Ukrainian-Russian interconnection agreement. Ukraine also needs to prove and establish itself as an attractive transport corridor, and storage and trading hub. From the Ukrainian point of view, the acceptable option would be to extend gas transit for the next 15 years at a capacity of 45-50 bcm/y with financial guarantees from (non-Russian) European banks and companies without resuming gas imports from Russia. A lower capacity would make it technically difficult and expensive to use the gas transmission system and large storage facilities, as well as to realise reverse flows and backhaul from Europe. However, if existing long-term contracts with South-Eastern Europe are still taken as a basis, the transport volumes are much lower, at

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20 bcm/y. The creation of an international consortium with the involvement of European and American companies in managing the Ukrainian gas transmission system is an attractive option solely for Ukraine that lacked US-German agreement. Germany does not find this option appealing; it questions the need to invest excessive funds into the Ukrainian gas transportation system given the EU's decarbonisation goals. Recent scandals involving Naftogaz's corporate governance add to scepticism over Ukraine's ability to conduct reform and modernise its transmission system.

For Germany, parts of the compromise seem evident: Ukraine will be integrated into the European energy market, and it will become a partner in the energy transition, e.g., for hydrogen. Ukraine would be a partner in the Green Deal. For Ukraine, this is not part of the deal. Kyiv is keen on partaking in the EU's decarbonisation plans, but it does not see European investments in Ukraine's green projects as mitigating the threats emanating from Nord Stream 2.

As the US-Germany agreement has failed to properly engage Ukraine, bipartisan opposition to the pipeline in US Congress will only rise. Members of US Congress urged the Biden administration to take Ukraine's security concerns into account when it came to Nord Stream 2, and implored him to reschedule Zelensky's visit to Washington. Planned for 30 August, the visit will not allow Zelensky to seek support in Congress due to a recess. In early June 2021, a House of Representatives panel adopted an amendment which would prevent the Biden administration from waiving congressionally mandated sanctions. In parallel, Republican Senator Ted Cruz is withholding his confirmation of all 13 of Biden's nominees to key State Department positions until the sanctions waivers are reversed. The next PEESA sanctions report is due on 17 August. The Biden administration is expected to prolong the existing

waivers and could potentially include new ones to resolve the remaining certification issue.

In Germany, the federal elections in September are likely to lead to a new government coalition, with the Green party, a fierce opponent of Nord Stream 2, being a strong contender. Still, regardless of the composition of the next government, Russia will remain a challenge. The situation may call for less of an explicit "compartmentalisation of energy ties" and more for an implicit "management of confrontation". In doing so, Germany may be able to use energy affairs to ensure that its relations with Russia remain within certain parameters while balancing cooperation, confrontation and competition with Russia in the neighbourhood. This will require a long-term strategy and the careful selection of areas in which engagement with Russia would be in Germany and the EU's interests (see SWP Comment 34/2021). Above all, however, energy relations between Central Europe, Eastern Europe and Ukraine must contribute to European cohesion within the Green Deal. Here, the joint declaration by Washington and Berlin could well point the way forward.

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