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Commission v. Gazprom: The antitrust clash of the decade?

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1. Introduction

It may well be that the Gazprom antitrust case[1] launched by DG Competition on September 4th will turn out to be the landmark antitrust case of this decade, as *Microsoft*[2] was of the last decade. The argument of this paper is that, for a host of political and economic reasons, this case is likely to be hard fought by both sides to a final prohibition decision and then onwards into the EU courts. In the process, the European gas market and the powers of DG Competition in the energy field are likely to be transformed.[3]

In an ordinary energy antitrust case, the most likely option would be a quiet private settlement by an Article 9 'commitment decision'.[4] That option is much less likely to be a realistic one in this case. The political and economic circumstances of this case are exceptional. Gazprom is under a substantial degree of structural and market pressure; its potential antitrust liability is significant and DG Competition is determined to ensure a genuine open single market in gas. It is open to question as to how far the Gazprom board and the Kremlin would ever be prepared to sufficiently compromise with the Commission in order for a Commitment Decision to be agreed.

[1] "Commission Opens Proceedings against Gazprom", 4 September 2012, Commission Press Release, IP/12/937.

[2] The Microsoft case law consists of the original prohibition decision including a fine of €497 million and a series of compliance orders in March 2004 (Case COMP/C-3/37.792, *Microsoft*), fixing penalty payments for non-compliance in July 2006 (involving an additional fine of €280.5 million) and February 2008 (involving a further fine of €899 million), as well as judgment in favour of the Commission in September 2007, Case T-201/04 *Microsoft v. Commission*. The final judgment (again in favour of the Commission) with respect to the non-compliance cases was handed down in the summer of 2012, Case T-167/08 *Microsoft v. Commission*.

[3] The author suspects that given the potential resistance from Gazprom to comply with EU law even on the territory of the member states, DG Competition will need to fully explore the potential of the Union's antitrust case law and legislation with respect to enforcement.

[4] Commitment decisions can be taken in antitrust cases where an investigated party is willing to cooperate with the Commission. Decisions are adopted under Art. 9 of Regulation 1/2003 (the Union's core procedural regulation). For a discussion of the law on commitments, see H. Schweitzer, "Commitment Decisions in the EU and in the Member States: Functions and Risks of New Instruments of Competition Law Enforcement within a Federal Enforcement Regime", *E-Competitions Bulletin*, 2 August 2012.

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The case therefore may well be subject to a full European antitrust process; a prohibition decision with fines attached, a series of legal challenges by Gazprom to the EU General Court and onward to the European Court of Justice. Given the political resistance already evident in Moscow in the preliminary blocking statute,[5] there is also the potential for a series of parallel Commission non-compliance cases as in *Microsoft*.[6] There are also grounds for believing that the Gazprom case may well generate interest in the Central and Eastern European Baltic states[7] in deploying their own regulatory and civil law procedures against Gazprom. These national processes would be engaged against Gazprom in respect of antitrust liabilities incurred under national law prior to their accession to the European Union.[8]

The potential landmark nature of the case flows first from the mixture of core antitrust issues, from illegal resale clauses to abusive denial of third party access to exploitative pricing, combined with a host of structural supply security and geostrategic questions. Secondly, its importance derives from the prospect that the case may lead to the dismantling of the Gazprom model as a network of long-term supply contracts linked to oil arranged with vertically integrated domestic energy incumbents and its final replacement with a single interconnected European gas market relying on gas to gas competition in a number of hubs.

The Kremlin should really be deploying the antitrust case to force Gazprom to reform. Because of increased global gas liquidity, the economic crisis and consequent lack of affordability of the EU's climate change strategy, the size of the European gas market will enlarge over the next decade. Russian gas companies could have a major role in an enlarged European market. However, to prosper in such an enlarged European gas market, the Russian market must itself be liberalised.

As the case proceeds, it may well be that the modernisers in the Kremlin administration may obtain the upper hand and will be able to seek a settlement with the Commission. If they do not, then there is likely to be a major prohibition decision resetting their terms of business in the European Union, a host of ancillary litigation and at the end a very different European gas market from the one in which Gazprom currently operates.

This paper is divided into six sections. The second section looks at Gazprom's current market and structural vulnerability in the context of the shale gas revolution; section 3 puts the case in the context of the European Commission's programme for the creation of a single market in gas, energy liberalisation and the maintenance of free competition across the Union. Section 4 examines the allegations made against Gazprom by the Commission and their implications. The 5th section considers the initial Russian reaction. And, in conclusion, the final section offers some proposals for the Russian government to reform its gas market, which may also then provide a basis for settlement with the Commission. The conclusion also considers the implications for EU-Russian relations should there be no settlement.

2. Shale gas and the market vulnerability of Gazprom

2.1 The power of Gazprom?

The received view of Gazprom across the continent and beyond is as both an extremely commercially and politically powerful company. Its market dominance in the Central and Eastern

[5] "Kremlin shields Gazprom from EU probe", *Financial Times*, 11 September 2012.

[6] And potentially the prospect of significant penalties as in the *Microsoft* case for non-compliance.

[7] Hereafter when referring to Central and Eastern Europe, the Baltic states are included within the term.

[8] The Commission case only deals with antitrust liabilities from the 1st May 2004 when eight Central and Eastern European States entered the Union. However, as a result of the Europe Agreements signed in the early and mid-1990s the then Candidate Member States were required to adopt homologue competition law provisions into their national legal orders. Hence if there were continuing antitrust offences committed by Gazprom at the time of the launch of the Commission's investigation, national authorities could seek to investigate the period prior to 1 May 2004 in parallel with the Commission's investigation. However, what is not possible is for the Commission to investigate alleged antitrust offences prior to 1 May 2004. See Case C-17/10 *Toshiba Corporation and others v. Úřad pro Ochranu Hospodářské Soutěže*, ECJ 14 February 2012, nyr.

Europe States, its role as a key supplier of energy to Germany,[9] Turkey[10] and Italy[11] reinforce that view of its commanding role on European gas markets. That commercial power has been matched by the exercise of political power: The study by Larsson of politically motivated cut-offs in the Central and East European states between 1991 and 2004[12] demonstrates that the overwhelming majority of those cut-offs were gas related. More recently, the European Union has been affected by political disputes between Gazprom and the Ukrainian authorities, which have resulted in cut-offs and reduced gas flows to the Union in 2006[13] and 2009.[14]

This economic and political power is underpinned by a network of long-term supply contracts with vertically integrated national energy incumbents. These long-term contracts include take and pay clauses and, allegedly, resale prohibition clauses. The contracts are not only for very long terms, often over 15 years, but also for the overwhelming majority of the customers' requirements, in some cases as much as 100%. In addition, for most customers across the Central and Eastern European states, there are no alternative or only limited sources of gas to Gazprom supplies. Almost all pipelines run from East to West, as they were designed by Soviet planners, with little interconnection at all, until recently, between states across the region and with Western Europe. Gazprom and its allies have also sought to acquire downstream assets, which has had the effect of further underpinning their market power.[15]

2.2 The impact of the shale gas revolution on the global LNG market

It is now however very seriously open to question how far Gazprom will be able to sustain its commercial and political power. The principal immediate threat to Gazprom is the impact of the shale gas revolution. This threat does not stem directly from shale gas production in Europe but rather from the impact of shale gas on the global LNG market. The initial damage to Gazprom from shale gas emanated from the 'shutout' effect of US shale gas production. Essentially, shale gas production undermined the market for LNG in American markets and, as a consequence, led to the dumping of LNG on European spot markets. Gazprom had to offer significant price discounts in 2010 to a number of key customers in order to reduce its losses.[16]

The impact of LNG dumping was blunted on European markets due to market liquidity draining away as a result of the Fukushima disaster, as Japanese demand for natural gas leapt after as the nuclear power station fleet was switched off. However, the trend toward greater access LNG resources for Europe is still clear. The growth in LNG production from shale and non-shale gas resources worldwide is growing rapidly with more production on its way from Australia, Canada and Qatar[17]. Australia may well replace Qatar as the world's largest LNG producer. Worse still for Gazprom it is open to question how much LNG China will need as the decade progresses. The current Chinese five year plan provides for 6.5bcm by 2015 and ambitiously seeks to produce 60 to 100bcm by 2020.[18] There is a real danger for LNG producers that the US experience of continental wide 'shutout' could be repeated in China and elsewhere as shale gas production gets underway at scale across the globe.

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9 Reuters, "Russian Gas Exports to Europe up 8% in 2011" (Germany 34bcm).

10 Ibid. (25bcm).

11 Ibid. (17bcm).

12 R.L. Larsson, *Russia's Energy Policy Security Dimensions and Russia's Reliability as an Energy Supplier*, Swedish Defence Research Agency (FOI), Stockholm, 2006.

13 J. Stern, *The Russian-Ukrainian Gas Crisis of January 2006*, Oxford Institute for Energy Studies (OIES), Oxford, 2006.

14 J. Stern, S. Pirani and K. Yafimava, *The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment*, Oxford Institute for Energy Studies (OIES), Oxford, 2009.

15 K.C. Smith, *A New Stealth Imperialism: Russian Energy Politics in the Baltics, Poland and Ukraine*, CSIS, Center for Strategic and International Studies, Washington, D.C., 2004, and Larsson, op. cit.

16 Reuters, "Gazprom adjusts gas pricing to defend market share", February 2010.

17 *BP Energy Outlook 2030*, London, January 2012. The Outlook projects growth at 4.5% annually to 2030.

18 "China sets Target for Shale Gas Development", *Financial Times*, 16 March 2012.

2.3 Shale gas liquidity leading to coal dumping in Europe

Gazprom and all other gas suppliers are already faced with a knock-on effect of the shale gas revolution; coal displaced in US markets is now finding its way into Europe.[19] With low US gas prices coal which as recently as 2005 made up 50% of US power generation, is now hovering just above 30%[20] (which in large part explains why the US is cutting its CO_2 emissions more rapidly than Europe).[21] This has pushed the price of US coal down and into exports. One of the strategic threats for Gazprom (and other gas supply companies) is that US-style 'shutouts' are repeated round the world as shale gas production takes off and Europe becomes a dumping ground for cheap coal.

2.4 Potential for shale gas to be exported as LNG from the US

In addition, to the prospect of 'shutout' for LNG producers from domestic shale gas production, there is also the prospect of shale gas being exported as LNG. For Gazprom, the greatest danger would be significant exports of US shale gas into the European market. The difficulty here for Gazprom is that there is a compelling commercial incentive for US shale gas to be exported as LNG.[22] Although some sections of US industry have called for an export ban of shale gas in order to maintain low US gas prices, the overwhelming economic logic is for shale gas to be exported as LNG. The response to those seeking to maintain a ban on exports is that current US gas prices at $3.20 MMBTU (European prices range $10-14 MMBTU) are too low for many even cost-conscious US producers to maintain production. If US industry wants stable long-term gas prices, prices have to rise to still world competitive levels of $4 to $5 MMBTU to maintain production. As a consequence, there is a very compelling case to encourage a significant degree of shale gas export as LNG in order to provide greater profitability to US producers. In addition, such exports would add to US federal and local tax revenues and generate greater incomes for holders of the sub-soil rights.[23]

2.5 The impact of further offshore resources in or near Europe

What also has to be factored into the calculations of supply liquidity are the prospects for the enormous East African and Eastern Mediterranean offshore gas resources, which are in the process of being developed.[24] Nearer to home there is also the prospect of developing shale gas offshore in the North Sea.[25] It is possible that for instance in the case of the

[19] The first quarter of 2012 alone saw a 49% increase in US coal exports to the European Union (see http://www.eia.gov/coal/production/quarterly/pdf/t9p01p1.pdf).

[20] R. Martin, "In Europe, Coal Regains its Crown", *Forbes*, July 2012.

[21] International Energy Agency, "Global Carbon Dioxide Emissions Increase by 1.0Gt in 2011 to Record High", May 2012 (*www.iea.org/newsroomandevents/news/2012/may/name,27216,en.html*).

[22] It could be argued that US LNG will largely go to Asia given current Asian demand. However, when one takes account of a) Chinese projections of domestic shale gas production, b) Chinese domestic pipeline and gasification capacity, c) Australian, Canadian and Qatari liquefaction capacity and d) the potential of East African offshore gas resources, it is difficult to see how, even with the increase in the capacity of the Panama Canal from 2014, there can be a major Eastern Seaboard-Asia LNG trade from the proposed Eastern Seaboard liquefaction plants. There is in fact a good case for the alternative scenario of an over-supplied Asian market providing LNG via the Panama Canal into Europe.

[23] 15 natural gas export licence applications are being considered by the US Department of Energy. Of those 15, only one has been cleared so far, the Sabine Pass project run by Cheniere Energy. However, it is expected that after the Presidential election, these export licence applications will be considered by the new administration.

[24] For East Africa, see R. Sorkhabi, "East African Margin & SW Indian Ocean Basins Project Report 2011-2012", Energy and Geoscience Institute (EGI), University of Utah, 2012. For an overview of the prospects and difficulties of developing the Eastern Mediterranean resources see, D. Natali, "The Eastern Mediterranean Basin: A New Energy Corridor", Institute for National Strategic Studies (INSS), National Defense University, Washington, D.C, July 2012.

[25] Reuters, "UK has vast shale gas reserves geologists say", April 2012.

African offshore developments that capital may switch from some of the more expensive proposed Australian gas field developments to cheaper East African offshore prospects. The net effect of these discoveries will still be greater gas liquidity as the decade proceeds.[26]

2.6 The trend towards greater gas liquidity

Therefore, even without a single shale gas well in Europe coming into commercial production, Gazprom faces a significant impact from shale gas. There may well be instances of supplies scarcity, as after Fukushima, but the trend towards greater supply liquidity is clear. What also cannot be discounted is significant shale gas development in Europe itself. It would only take one major member state to develop shale gas commercially and reap the 'on-shoring effect' of energy-intensive manufacturing to trigger reconsideration of the value of shale gas production in many European capitals.[27]

Much greater global gas liquidity coupled with access to varied sources of gas supply – LNG, shale gas as LNG and eventually European shale gas – puts Gazprom's market model under immense pressure. LNG fuels the European spot market price which creates both an alternative source of supply and an alternative pricing model for European gas. EU third-party access rules allow energy-intensive users access to the spot market, and as more gasification terminals come on stream, many more customers will seek cheaper spot market price gas.[28]

Gas market liquidity and diversity therefore pose an existential threat to the traditional Gazprom model of a network of long-term supply contracts with domestic dominant incumbent. Those contracts, with their resale prohibitions; take-and-pay clauses and price indexation to the oil price, and usually for most of a customer's supply over a long time period (more than 15 years) are already under pressure from these new market developments.

3. The Gazprom investigation in the context of antitrust

It is difficult to allege that DG Competition is somehow unfairly focusing its attention on Gazprom. The Gazprom investigation is part of a much larger programme initiated in the late 1990s to bring about a fully functioning and operational single market in gas. This programme includes the first,[29] second[30] and third[31] energy packages and the Sectoral Inquiry into the electricity and gas markets launched in

[26] There is a similar issue with regard to deep water Caspian gas. One question hovering over the Southern Corridor is whether gas from the deep water Caspian will be economic to develop in a more liquid European market. It may well be that if the Southern Corridor is developed, then the gas may be sourced in greater quantities from Iraq than from deep water Caspian.

[27] What is often overlooked in the debate on shale in Europe is the immense multiplier effect on the US economy from shale gas development. It is not just access to lower fuel prices for consumers. It is also a major stimulus to energy-intensive manufacturing leading to a rebuilding of US manufacturing competitiveness. If one major member state were to develop shale gas with some determination and at scale, that state would gain a significant competitive advantage over the other member states. It is likely that in such circumstances that a number of states would reconsider their position with regard to shale gas development. For an assessment of the impact of shale gas on the US economy, see IHS Global Insight, *The Economic and Employment Contributions of Shale Gas in the United States*, Washington, D.C., 2011.

[28] There are currently 20 LNG gasification terminals in operation in Europe of which six are undergoing expansion of gasification capacity. Foreign investment decisions have been taken on a further six and they are now in the process of construction. A further 32 LNG gasification plants are being considered across the continent. Even by 2015, it is estimated that there will be 259bcm of gasification capacity across the European Union. For further information, see Gas Infrastructure Europe (www.gie.eu).

[29] Directive 98/30/EC of the European Parliament and of the Council concerning the Common Rules for the Internal Market in Natural Gas, OJ 1998 L204/1.

[30] Directive 03/55/EC of the European Parliament and of the Council concerning the Common Rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC, OJ 2003 L176/57

[31] Directive 09/73/EC of the European Parliament and of the Council concerning the Common Rules for the Internal Market in Natural Gas and Repealing Directive 03/55/EC, OJ 2009 L211/94.

June 2005.[32] The Sectoral Inquiry was a major investigation into anti-competitive activity across the European electricity and gas markets. The evidence provided by DG Competition, which was largely overlooked by the media and most commentators, indicated that there was widespread anti-competitive activity across both sectors.

This evidence amounts to a standing indictment of the capital misallocation, consumer loss and damage to competitiveness caused by the vertically integrated national energy champion model adopted in so many member states.[33] The Commission identified very high levels of market concentration notwithstanding the liberalisation process already undertaken. Significant evidence of vertical foreclosure of national markets, combined with lack of cross-border sales and of market transparency and defective price formation. It also found little competition in downstream markets and that balancing markets favoured domestic incumbents.[34]

The Inquiry also provided the Commission with good reasons to press ahead in prosecuting energy companies for breach of the competition rules and evidence with which to do so. Over a dozen major European energy companies were prosecuted including EDF,[35] GDF/Suez,[36] E.ON[37] and RWE.[38]

For the Commission the Gazprom case is therefore an issue of completing a wider investigation into the enforcement of the competition rules in the context of the object of creating a liberalised European gas market. The Commission has finally turned eastward to apply those rules to the member states that joined in 2004 and 2007.

We know that the Commission received at least one formal complaint from the Lithuanian government with respect to exploitative pricing in their gas market. Lithuania is a 'gas island'. It currently receives all of its gas from Gazprom. The price it pays for its gas varies but in recent years it has been significantly higher than prices paid by Gazprom customers in Western Europe.[39] In the autumn of 2011, DG Competition also undertook a number of unannounced inspections or 'dawn raids' of the business premises of Gazprom in the Czech Republic and Germany, as well as at a number of other energy companies with contractual relations with Gazprom across the Central and Eastern Europe states.[40]

One particular lesson can be learnt from the existence of the dozen or so cases in which DG Competition has actually prosecuted energy companies by filing a prosecution document (the Statement of Objections). In most cases rather than an issuing a prohibition decision, DG Competition used the threat of the publication of a 400+ page prohibition decision to encourage settlement via a Commitment Decision. For example, E.ON and RWE were both faced with a prohibition decision which, if published, would have set out chapter and verse the nature of their breaches of EU antitrust law. Worse still, publication would have provided energy-intensive customers of E.ON and RWE with a route map to bring civil claims for damages. One major issue for energy companies is that, unlike

[32] *Sector Inquiry Pursuant to Article 17 of Regulation 1/2003 in the European Electricity and Gas Markets, Communication by Ms. Neelie Kroes in Agreement with Mr Piebalgs*, Brussels June 2005.

[33] In fact, the mirror image of the Gazprom model.

[34] Communication from the Commission, Inquiry Pursuant to Article 17 of Regulation (EC) No.1/2003 into the European Gas and Electricity Sectors (Final Report). COM (2006) 851 Final, January 10th 2007, 5-9. For a more detailed analysis, see DG Competition Report on Energy Sector Inquiry, SEC (2006) 1724, 10th January 2007, Part 1 Gas Market Report.

[35] EDF, *Long-Term Contracts in France*, COMP/39.386, March 2010.

[36] E.ON/GDF, *Market Allocation in European Gas Markets,* Case COMP/39.401; GDF *Foreclosure,* Case Comp/B-1/39.316.

[37] E.ON/GDF, op. cit. and *E.ON Gas Foreclosure,* Comp/B-1/39.317.

[38] RWE, *Gas Foreclosure,* COMP/39.402.

[39] "Vilnius to Hit at Gazprom in EU Complaint", *Financial Times,* January 2011.

[40] *EU Competition Law-Dawn Raids, Gazprom Case*, 27th September 2011 (http://www.graystoncompany.com/gco/gaco-blog/entry/eu-update-competition-law-dawn-raids). This blog provides a useful map indicating the location of the Commission's unannounced inspections under Art. 20 of Regulation 1/2003 (known as dawn raids) in September 2011 in respect of the Gazprom investigation.

other forms of abuse of dominance and even price-fixing cartel cases, the damages claims could potentially be very large. This is because of the length of period for which many of the alleged anti-competitive activities have been going on.[41] In some cases, there are allegations that the cases stretch back to the 1970s.[42]

Not unreasonably and as a consequence, E.ON and RWE were happy to seek a formal Commitment Decision which meant that the full nature of the allegations against those firms did not enter the public domain. However, the price was high. In both cases, DG Competition insisted on the 'unbundling' of their electricity and gas networks. The question that has to be asked in the case of Gazprom is whether the Gazprom Board and the Kremlin will be willing to give DG Competition its 'pound of flesh'. There is likely to be a very significant gap between the price that they are willing to pay for a settlement and the price that DG Competition is willing to accept, even when facing the prospect of publication of a prohibition decision, fines and civil damages.[43] If this view of the case is correct, then a settlement via a Commitments Decision will be difficult to secure.

It is also difficult to believe that political pressure on DG Competition will have much influence. In neither *GE/Honeywell* nor *Microsoft,* both commenced when the United States was at the height of its political and economic power were affected by US political pressure. Equally, DG Competition's record within the European Union is one of a determination to ensure full application of the competition *acquis* even against ingrained and powerful member state views in favour of corporate champions in sectors from airlines, to chemicals to energy markets. Even in the course of the economic crisis, DG Competition has not flinched from continuing to apply the competition rules in full. The European Union has seen no equivalent to the US National Industrial Recovery Act 1933 which suspended the operation of the competition rules in specific market sectors during the Great Depression.[44]

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[41] It is not sufficient to defend Gazprom from claims going back many years to argue that such claims can only start from accession. This is true of EU competition claims. However, from the mid-1990s at the latest, all accession states that joined the European Union in 2004 and 2007 had to introduce into national law by virtue of the Europe Agreements, homologue antitrust provisions mirrored on EU antitrust law. Hence it is conceivable that claims could be made going back to the mid-1990s. There would, however, be the prospect of a defence for Gazprom based on limitation periods applicable under national law. One of the major issues for any national court case for damages would be whether there was a continuing breach of national rules which would then permit a claim to be made for the period before 2004 or 2007 when only national law would apply.

[42] In the *GDF/E.ON Market Allocation* case, the core allegation concerned an initial agreement dating back to 1975, *GDF/E.ON*, op. cit.

[43] Plaintiffs seeking to obtain civil damages against Gazprom may be able to extend the rule in Case C-360/09 *Pfeiderer AG v. Bundeskartellamt,* ECJ, 14 June 2011. In that case the Court indicated that EU law does not prohibit access to leniency documents (documents obtained in respect of a price-fixing cartel) by plaintiffs seeking damages. The issue the Court ruled was one for national law. There is a difference between documents obtained under a leniency application and deployed in a prohibition decision and obtaining documents under a Commitment Decision. One can argue that the operation of Commitment Decisions would be undermined if documentation obtained for that purpose were available for damages claims. The difficulty is that the same argument could be made for leniency applications. In the United States, the government has taken steps to limit leniency applications liability in order to maintain the incentive to come forward. The underlying argument is the same for both cases that plaintiffs have a right to damages under EU law and if public authorities (either EU or national) have documentary evidence that would assist their case, there is a lawful EU right to obtain that documentation, subject only to legitimate business confidentiality.

[44] Although the US judiciary has referred to the Sherman Act as the "Magna Carta of Free Enterprise" in *United States v. Topco Associates Inc* (1972) 405 US 596, 610, per Justice Thurgood Marshall, the Sherman Act is not part of the US Constitution and is not entrenched within the American legal system. This does mean that under extreme political stress, as during the Great Depression, the antitrust regime can buckle. Such buckling is far more difficult to achieve within the EU's legal order because of the constitutional status of Arts 101 and 102. Being entrenched within the EU's legal order, it is much more difficult for any of the core parts of the law to be overridden by Parliament or Council and political

In the energy sector specifically, DG Competition has admirably held the line and continued to prosecute the major European energy companies in the teeth of political opposition from a number of powerful member states. If DG Competition could withstand political opposition from within the European Union, they will be surely in a better position to withstand opposition when it comes from Gazprom and the Kremlin. Furthermore, given the complaint from Lithuania, and the support Lithuania has received from several other member states, DG Competition has to be aware of the danger of any sub-optimal resolution of the case resulting in a challenge to any weak Commitment Decision. It would be an unimaginable political disaster for DG Competition to have member states launching an application to challenge a Commitment Decision or bringing an action for failure to act.

More fundamentally, the difficulty here for Gazprom is that, if these allegations are true, they involve substantial 'hard-core' offences under European antitrust law. DG Competition then has no alternative but to apply the *acquis.* Denial of third-party access; suppression of market access; prohibition on resale and exploitative pricing are all serious antitrust offences. The Commission cannot simply 'turn a blind eye' as a result of political pressure coming from within or outside the Union.

4. The Gazprom case

The launch of DG Competition's case against Gazprom involves in essence three principal allegations with respect to resale obligations, suppression of alternative competition and pricing. Whilst the allegations may appear technical, if proved they could have a major negative impact on Gazprom's current business model and operations.

4.1 Allegation of resale protection: The 'destination clauses'

The first allegation is concerned with resale prohibition or destination clauses. These are clauses and/or market practices that have the effect of preventing the resale of gas contracted from Gazprom to third parties. This is a particularly onerous provision because the long-term supply contracts are also subject to take-and-pay clauses, which force Gazprom customers to take all quantities of gas that have been contracted for even if there is not a market for such gas. Furthermore, the contract will usually be for a very high percentage of total consumption.

Such clauses will be viewed by DG Competition as hard-core antitrust restrictions to the extent they have the effect of splitting up the single market and undermining the creation of a single market in gas. This is due to the fact that resale clauses essentially prohibit onward sales across national borders, which is an inherent restriction on the free movement of goods across the single market. If such clauses or practices are found, DG Competition must seek their termination.

If the case consisted only of resale prohibition clauses, then DG Competition and Gazprom could relatively easily undertake a settlement, as was done informally at the beginning of the century with respect to long-term supply contracts with Western European customers.[45]

4.2 Allegations concerning denial or limits on third-party access

However, the second head of allegations is potentially much more serious: prevention of the diversification of the supply of gas. This includes denial of third-party access to pipelines as competitors of Gazprom seek, and are refused, access to sell their gas. This could have been achieved by Gazprom's ownership of downstream assets, or through its minority shareholdings in downstream assets combined with its market power derived from its monopoly or quasi-monopoly supply of gas.

What will be particularly interesting to see is what other prevention or restriction of supply issues arise from the case. These could include seeking as a dominant company to impede alternative supply projects not under its control

pressure comes finds it much more difficult to gain traction.

45 "Commission reaches breakthrough with Gazprom and ENI on territorial restriction clauses", Commission Press Release, 6th October 2003, IP/03/1345.

such as LNG gasification stations or proposed new pipelines. These issues will depend on the evidence available to DG Competition as a result of the unannounced raids it carried out on Gazprom's premises and that of other energy firms and information obtained via complainants.

The difficulty for Gazprom is that unlike Section 2 of the Sherman Act, which deals with abuse of dominance via claims for monopolization, the EU's abuse of dominance provision has a much wider reach. The EU General Court and the European Court of Justice have resisted taking a narrower economic approach to the interpretation of Art. 102 TFEU, the abuse of dominance provision. They have reiterated the existing case law which emphasises the 'special responsibility' of dominant companies to respect competition and competitors and the traditional 'as if' standard which requires dominant companies to act as if there is competition in the market. This standard of responsibility may well be difficult for Gazprom to entirely reconcile with its current business practices.

4.3 Allegations of unfair pricing

The third issue raised is unfair pricing, in particular, the linking of the price of gas to oil (oil price indexation). Price indexation in long-term gas contracts is perceived to be at the very heart of Gazprom's ability to maintain revenues and pricing power. However, it is open to question whether it is acceptable under EU antitrust law. The questions to be decided by DG Competition are whether or not a dominant company in the gas supply sector can link its prices to oil when there is no basis in modern gas markets for such a link and, whether such a link constitutes of itself an abuse of dominance.

Historically the link made some sense as oil was also used for heating and power generation. However, since the oil price shock of 1973 non-transportation utilization of oil has declined dramatically in significance. Only 2.6% of Europe's power generation is from oil, whereas, power generation from gas is 23.6%[46] and represents more than 70% of total gas consumption.

If indexation were to be found to be abusive the consequences could be profound and go well beyond the markets of the Central and Eastern Europe states. In the first place such a ruling, if upheld by the EU courts, would potentially be applied by arbitration panels seeking to dispose of arguments between Gazprom and Western European energy companies challenging indexation under arbitration clauses. Arbitration panels have an obligation to apply EU antitrust law in cases where the governing law of the case is the law of a member state, and where as a consequence EU law would also apply. The danger therefore is of a significant spill over into many other disputes over indexation, at least where Gazprom reaches the dominance threshold.[47]

It is also likely that any European ruling against indexation will be used worldwide to challenge its legitimacy. For instance, it is likely that China, currently in negotiations with Gazprom over the price it is willing to pay for gas from Eastern Siberia, will deploy antitrust arguments to seek to avoid prices linked to oil. It could also spur a new round of arbitration cases as Gazprom's customers in Western Europe begin to argue that a Commission decision outlawing indexation and upheld by the EU courts constitutes a major structural change or 'event' in the market triggering a price review under their existing contracts.[48] This could then result in almost every existing long term supply contract with Gazprom being challenged via arbitration panels across the continent.

The timeline for such a case of this complexity and weight is probably approximately two years to a prohibition decision and a further two years before disposal of the main issues in the EU General Court. There may be both an appeal on

[46] Gross Electricity Generation by Fuel in 2010, 82, Energy in the EU 2012, Eurostat Luxembourg (http://ec.europa.eu/energy/publications/doc/2012_energy_figures.pdf).

[47] The bright line test for dominance is usually thought of applying at above 40%. Depending on market conditions, such as barriers to entry and concentration dominance can fall below and above 40%.

[48] For a discussion of price review triggers, see B. Holland and P.S. Ashley, "Natural Gas Price Reviews: Past, Present and Future", *Journal of Energy and Natural Resources Law*, Vol. 30, No. 1, 2012.

point of law to the European Court of Justice, which could take a further two years. In addition, as in *Microsoft,* if there is resistance to any prohibition there could be a number of satellite decisions and cases to the main decision.

5. Russia's initial reaction

The initial Russian reaction has been to introduce a Federal Decree under which all 'strategic enterprises' to obtain consent for their foreign economic activity with the government.[49] Strategic enterprises and their subsidiaries will in future only be able to disclose information to foreign governments and international organisations with the consent of the Russian government. Consent will also be required to amendments to contracts and commercial pricing policy.

Practically this blocking statute is likely to have very little effect. In the first place DG Competition has already raided Gazprom's offices in the Czech Republic and Germany. It has also been able to obtain information from other energy companies Gazprom does business with and from complainants. In respect of the Federal Decree it looks like a case of shutting the door after the horse has bolted.

Even after the Decree, it is open to question how effective it will be. While there is European Union case law that state compulsion provides a defence to EU competition obligations this would not necessarily cover all information gathering exercises.[50] DG Competition may decide not to ask Gazprom officials to answer questions under threat of enforcement sanctions under Art. 18 of Regulation 1 given the Federal Decree.[51]

However, there is nothing to stop DG Competition issuing Art. 18 decisions against Gazprom allies and commercial partners within the European Union. It is also open to question how far any Federal Decree would be given effect to in the European Union in respect of Member State registered companies operating within the Union. In addition, it may in fact encourage DG Competition to undertake more unannounced inspections against Gazprom instead.[52] The point about raids is that they can be carried out without the co-operation of the officials and employees of the business with the Commission calling upon the police power of the local Member States to undertake its search.[53]

Equally it is open to question how effective state consent to contractual changes and pricing policy can be in protecting Gazprom from DG Competition's investigation. Again the Federal Decree may in fact encourage DG Competition to take more coercive structural measures against Gazprom rather than seeking contractual amendments.[54]

For instance if DG Competition is faced with evidence of suppression of alternative competitors via Gazprom's ownership and

[49] *Presidential Decree to help Gazprom in Standoff with European Commission*, ITAR-TASS, 12 September 2012 (http://www.itar-tass.com/en/c39/518529.html).

[50] There is little case law on the position of foreign sovereigns who issue compulsory rules binding their companies to breach the competition rules. Respected commentators suggest that in such circumstances the state compulsion doctrine that applies to national measures would apply to measures of a foreign sovereign. They would however have to be compulsory, i.e. requiring a company to act in a way that infringed the competition rules. See E. Roth, *Bellamy & Child EU Law of Competition*, para11.004, Oxford, 2008.

[51] Art. 18 permits the Commission to seek answers to questions in respect of antitrust investigation under the threat of significant financial sanctions against the target company. These Art. 18 requests are usually made following an unannounced inspection on the business premises of the target company.

[52] Under Arts 20 and 21 of Regulation 1/2003.

[53] Bellamy & Child, op. cit., para 13.045

[54] Under Article 7 of Regulation 1/2003 the Commission's power to terminate infringements includes the power to impose 'behavioural or structural remedies which are proportionate to the infringement committed and which are necessary to bring the infringement to an end'. The limit to any structural measures lies in the strength of the link between the antitrust offence and the proposed measures. For instance, if it was demonstrated that downstream assets owned or controlled by Gazprom were a significant facilitator in respect of denial of third party access to competitors then one option for the Commission to consider would to order the sale of such assets. For further discussion see Bellamy & Child, op. cit., para 13.128.

control of pipeline assets, it can order sale of those assets if it finds it difficult to negotiate with Moscow because of a blocking statute. It can take such action under Art. 7 of Regulation 1 when there is a connection between the assets and the antitrust behaviour uncovered in the investigation. This would suggest that Gazprom's pipeline assets in the affected regions of the EU, including potentially minority shareholdings in pipeline assets, could be required to be sold. Given that the assets are on the territory of the member states, it is difficult to see how any Russian Federation statute blocking such sales would be given effect by the EU courts. In addition, the Commission can avoid direct conflict with a blocking statute[55] by appointing a monitoring trustee. Such a trustee was appointed in the *Microsoft* case.[56] The trustee could police the pipeline assets of corporate allies, other Russian energy companies and favoured customers of Gazprom for whom there is evidence that they have or are likely to take instructions from Gazprom.

A particular difficulty here is that any attempt to invoke state compulsion would only apply prospectively. It is doubtful that either the European Commission or ultimately the European Court of Justice would accept the application of a retrospective state compulsion doctrine. If this view of the approach of the Commission and Court is correct, DG Competition would be able at least to fine Gazprom for past behaviour whatever the contents of this or any future Federal Decree.[57]

There is also the further difficulty that most of the acts that DG Competition allege occurred in whole or in part on the territory of the member states and involved Gazprom-controlled companies registered in EU or EEA states. The Commission and the Court may well take the view that the Federal Decree when applied to such acts is a direct interference in the national sovereignty of the member states.

This view of the impact of the Federal Decree is likely to be reinforced with respect to the argument that the EU institutions and its member states have a sovereign right to structure and re-structure their energy supply as they see fit. Attempts by a foreign government to seek to maintain a particular energy system on the territory of other states is an interference with those states' sovereign rights.

The argument here is underpinned by two observations. First, although the defence of the Commission's position can be made under the traditional territoriality principle of jurisdiction, the Commission recognises a broader-based 'effects'-like jurisdictional doctrine. Drawing from the *Wood Pulp*[58] and *Gencor*[59] case law, the EU courts have developed a doctrine of extra-territoriality. This doctrine permits European Union law to extend to operations, agreements and practices which although they are initiated outside the Union are implemented or have an immediate, substantial and foreseeable effect on the territory of the member states.

The Russian Federation could seek to argue as in *Gencor* that as a matter of comity to take account of important policy concerns of other states where the contested practices were initiated, European antitrust law should not be applied. There are a number of problems with this approach. First, although a balancing of interests comity doctrine has been recognised by some US superior courts, it has not been recognised by the EU courts.[60] Second, as discussed above, it is

[55] There may well a formal conflict in that a 'no asset sales' rule may apply in the blocking statute. However, as argued above, such a rule would be seen as interference in the sovereignty of the member states and would not be applied by the EU courts.

[56] Bellamy & Child, op. cit., para 13.130.

[57] There is little law on this point. However, as a matter of principle, it is difficult to see how the EU Courts would accept retrospective compulsion doctrines as a defence to antitrust liability. In the only case on the books – *AROW/BNIC* OJ 1982 L379/1 – a Commission decision applied the antitrust rules in full where a state had attempted to retrospectively immunise acts in contravention of those rules.

[58] Joined Cases C-89/85 *et seq* [1988] ECR 5193.

[59] Case T-102/96 [1999] ECR II-753.

[60] See *Timberlane Lumber Co v. Bank of America* [1976] 549 F.2d 597. This case should now be read alongside the US Federal Statute, the Foreign Trade Antitrust Improvements Act 1982, adopted post-Timberlane and the ruling of the US Supreme Court in *F.Hoffman La Roche Ltd v. Empagran SA* [2004] 542 US 155. The nearest explicit discussion comes in *Eastern Aluminium* OJ 1985 L92/1. In that case, the Commission indicated that it would be appropriate to

difficult to see how the Commission and the EU Courts would permit the sovereign rights of a foreign state to prevail on the territory of the member states over such a primary objectives of European Union law as the creation of a single market in gas, free flow of gas across national borders, market liberalisation and full application of Union antitrust rules. The difficulty with any comity argument in the Gazprom case is that it would be to accept a Russian argument for a largely extra-territorial application of Russian objectives on the soil of the member states.

Thirdly, to the extent that the EU itself is making some extra-territorial claims, it is also worth pointing out that the Russian competition law applies the same EU extra-territorial jurisdiction. This existence of a Russian 'effects doctrine' significantly weakens the Russian case against the Commission's jurisdiction in the Gazprom case, to the extent that the Union makes such claims in the case.[61]

The second observation is to look at the one country that maintained a principled stand against extra-territorial antitrust claims of the United States for over a century. It is worth contrasting the approach of the United Kingdom which for more than 100 years maintained a principled stand against the United States with respect to the US effects doctrine. The UK even adopted what is the world's most sophisticated antitrust blocking statute in the Protection of Trading Interests Act 1980.[62] The UK's position was credible in international law as it has based its position on the traditional territoriality principle and sustained it for decades. It never made extra-territorial claims itself. By contrast, as explained above, the Russian government makes the same claims as the European Union and has done since the modern inception of Russian competition law in the 1990s. It is difficult for the Russian Federation therefore now to turn round and run a compelling territorial argument calling for restricted sovereignty with regard to the impact of EU antitrust laws on one of its major companies.

There will no doubt be an extensive debate and argument over the application of the competition rules in a context of a foreign state supporting an alleged antitrust delinquent. However, what the Kremlin seems to have overlooked is the damage the wrangling over the case is likely to have Gazprom's already-precarious hold over Central and Eastern Europe states.

The greatest commercial danger is that just as with the 2009 gas cut-off, Russian over-reaction in the Gazprom case will undermine the company's market position. Once the member states see more threats and threats of non-compliance with EU law coming out of Moscow, they will start accelerating their search for new gas sources, be it shale gas, LNG or new pipeline sources. In other words, by taking an aggressive confrontational approach to DG Competition's investigation, Gazprom would actually be undermining its own market position.

show self-restraint in the exercise of jurisdiction when it would require undertakings to act contrary to the requirements of national law or the important interests of non-member states. It went on to suggest however that such interests would have to be so important that they would prevail over the Treaty-based objectives of European competition law. The difficulty, it is submitted, with that approach from the perspective of Gazprom is that *Eastern Aluminium* was decided prior to the collapse of the Soviet Union when the Community had to grapple with applying the competition rules with respect to entities from an avowedly non-market state command economy. By contrast, the Russian Federation is formally committed to an open market economy, reinforced by its 1991 enactment of a competition law and the improvements in the law over the last two decades. It is difficult to see therefore how the application of core competition rules by the European Commission to entities that operate within the territory of the member states would ever be able to mount a successful claim to their own state interests to be prioritized over those of the Union.

[61] Art. 3(2) on the Federal Law on Protection of Competition reads: "Provisions of this Federal Law are applicable to the agreements reached between Russian and (or) foreign persons or organisations outside the Russian Federation, as well as to actions performed by them, if such agreements or actions affect the state of competition in the Russian Federation." Translation from the Russian Federal Antimonopoly Service's website (http://en.fas.gov.ru/legislation/legislation_50915.html).

[62] A.V. Lowe, "Blocking Extraterritorial Jurisdiction: The British Protection of Trading Interests Act 1980", *American Journal of International Law*, 1981.

6. Settlement proposals and conclusions

As a matter of enlightened self-interest, the Kremlin should be seeking to use the Gazprom case to force change within the company and in the broader Russian gas market. Leaving Gazprom as the dominant player in the exploration, production, wholesale and retail levels of the market, combined with its export and pipeline monopoly is not good for Russian economic development or for Russian consumers. The ability of gas independents such as Novatek to challenge Gazprom will always be limited under current market and regulatory conditions.

Aside from the immediate inefficiencies in the Russian gas market derived from such market dominance, there is the broader problem of the declining Nadym pur Taz fields where approximately 80% of Russian gas is produced. One major new field is being brought on-stream. However, according to the IEA, Russia will have to replace 635bcm of production by 2035, that is, approximately 80% of current production. The cost of new investment in gas fields and transmission networks is put at $730 billion.[63]

By contrast the main focus of current Gazprom investment policy is to build Nordstream 3 and 4 and Southstream. These are essentially diversionary pipelines which do not tackle the scale of investment required in new fields and transmission upgrade to the main Russian pipeline network, the UGSS.

Furthermore, the threat of cheaper gas supplies entering Europe as LNG or domestic shale gas, and the prospect of gas or coal dumping should make the Kremlin question mammoth development projects like Bovanenko.[64] The danger for Gazprom is that if it continues with a high-priced energy development strategy, it will find it difficult to raise the investment for its new fields or face the prospect of huge losses on its gas sales.

[63] IEA, *World Energy Outlook 2011*, 310, Paris.

[64] For a discussion of Russian resources, see Y. Grama, "Analysis of Russian Oil and Gas Reserves", *International Journal of Energy Economics and Policy*, Vol. 82, 2012.

There is an alternative. Gazprom has huge gas resources, including shale gas and secondary conventional fields, around its existing pipeline infrastructure. There is a compelling argument to develop these cheaper to develop resources than resources in the high north or in the Arctic Sea.

However, to develop these resources, a degree of market efficiency, high-level technology and market competition would be necessary to ensure effective development. In other words a liberalised market structure would be required which would put a premium on efficiency and innovation. The real question here is whether the Kremlin would be willing to contemplate some degree of market liberalisation for access to cheaper and more substantial gas resources.

There is also a major opportunity for the Russian gas market if the Kremlin decides to liberalise. The shale gas revolution does not only affect Gazprom, it also is having a profound effect on the European energy market. Current climate change strategy is running into the sand, in the face of rising costs and economic crisis. The Union is going to be forced to develop an alternative approach around deploying more gas and reducing coal in order to cut CO_2 emissions in the short to medium term.[65] It is also likely that Europe will follow the US example of increasingly switching to gas transportation. As a consequence, the size of the gas market will expand in Europe. For the Russian gas market, such an expansion would be a significant opportunity to increase gas sales.

The Kremlin should be giving serious consideration to negotiating a Commitment Decision with DG Competition that puts

[65] The advantage of gas during the economic crisis is underlined by the European Gas Advocacy Forum in their paper "Making the Green Journey Work", Brussels, 2011. That paper points out that CCGT gas turbines in Europe have a load factor of approximately 45%. If the load factor was raised from 45% to 65% to 70%, and assuming the equivalent amount of coal fired generation was removed, the CO_2 abatement would be on the order of 300 million tonnes annually, approximately one-third of CO_2 emissions from coal and lignite in the European Union. To achieve the same CO_2 abatement by deploying current renewable technology would cost approximately €80-120 billion of new capital expenditures.

pressure on Gazprom to face up to liberalisation. This would involve as part of the decision accepting the unbundling rules; selling or isolating downstream assets from supply operations and providing more gas into existing hubs. Internally, the case should be made to liberalise the market in order to keep prices low domestically and enable Russian gas to be competitive on the European market.

Sadly, it looks unlikely that the Kremlin will act in Russia's own enlightened self-interest. If the Federal Decree is any guide, there is likely to be resistance at every stage of the EU's antitrust process. The recent Rosneft/BP-TNK deal suggests that the focus of Russian power and interest is now concentrated entirely upon the oil industry. The Kremlin's strategy may come down to the view that oil prices will not move far from $100 per barrel a day and the industry will be able to deliver approximately 10 million b/d. As a consequence, rather than seeing the Russian gas market as something that is core to the state's revenues, it may instead be seen as source of power that is to be defended. In that case, the consequence may be that EU-Russia relations are in for a rough ride.

We therefore face the prospect of DG Competition legitimately applying the procedures, legislation and case law of the Union's antitrust *acquis* in a methodical evidence-based manner. At each step of the process, an increasingly exasperated Kremlin will be furiously lobbying major EU capitals to bring the process to a halt. The explanations from London, Berlin and Paris as to the application of the rule of law and the autonomy of the Commission will be disbelieved. There is therefore the prospect that in a stand-off between the Venusian Europeans and the Martian Russians[66] we will see a slash-and-burn gas policy from an uncomprehending and furious Moscow. In turn, DG Competition in Venusian mode will respond by assessing any acts by Gazprom in terms of compliance or non-compliance with the Union's antitrust *acquis*. This Martian incomprehension and fury, responded to with Venusian legality and evidence-based procedure is not likely to end well or assist EU-Russian relations in the short term.

If this latter scenario comes to fruition, Moscow should understand that threats of serious or actual disturbance to gas supplies to the member states will be self-defeating. Faced with threats from Moscow, the member states will indeed start drilling for shale gas at scale; the US Congress will permit large-scale exports of shale gas to permit LNG 'freedom carriers' to arrive in Europe; the 32 planned LNG gasification terminals will move rapidly to final investment decisions and offshore exploration in the Eastern Mediterranean will proceed at speed. The Kremlin in the years after 2012 may finally achieve President Ronald Reagan's goal of reducing Russian gas to the supply of last resort, while at the same time all but eliminating Russian influence across the region.

[66] With apologies to Professor Robert Kagan and his work, *Of Paradise and Power: America and Europe in the New World Order*, New York, NY: Random House, 2003.

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