



Council of the
European Union

074550/EU XXV. GP
Eingelangt am 11/08/15

Brussels, 11 August 2015
(OR. en)

6446/14
DCL 1

ENER 57
COEST 41

DECLASSIFICATION¹

of document:	ST 6446/14 RESTREINT UE/EU RESTRICTED
dated:	12 February 2014
new status:	Public

Subject:	Recommendation for a Council Decision authorising the opening of negotiations on an Agreement between the European Union and the Republic of Azerbaijan on a legal framework governing the control of DESFA by SOCAR
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Delegations will find attached the declassified version of the above document.

The text of this document is identical to the previous version.

¹ Document declassified by the European Commission on [...].



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THE EUROPEAN UNION**

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COVER NOTE

from:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	12 February 2014
to:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union

No Cion doc.	COM(2014) 68 final
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Subject:	Recommendation for a Council Decision authorising the opening of negotiations on an Agreement between the European Union and the Republic of Azerbaijan on a legal framework governing the control of DESFA by SOCAR
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Delegations will find attached Commission document COM(2014) 68 final.

Encl.: COM(2014) 68 final



EUROPEAN
COMMISSION

Brussels, 12.2.2014
COM(2014) 68 final

Recommendation for a

COUNCIL DECISION

**authorising the opening of negotiations on an Agreement between the European Union
and the Republic of Azerbaijan on a legal framework governing the control of DESFA
by SOCAR**

EXPLANATORY MEMORANDUM**1. CONTEXT OF THE RECOMMENDATION****1.1 The immediate reason for the present recommendation**

Within the context of the restructuring plan for Greece, the Hellenic Republic Asset Development Fund ("HRADF") is privatising certain assets currently owned by the Hellenic Republic ("HR"). These include the shares currently owned by the HR, through HRADF, in the Hellenic Gas Transmission System Operator S.A. ("DESFA"), the Greek gas transmission system operator ("TSO").

HRADF has retained as the preferred bidder for DESFA the State Oil Company of the Azerbaijan Republic ("SOCAR"), an undertaking established in Azerbaijan and controlled by the Republic of Azerbaijan. HRADF and SOCAR intend to enter into a share purchase agreement ("SPA") whereby, if and when all conditions precedent² are met, SOCAR will acquire 66% of the share capital and voting rights in DESFA upon closing of the SPA ("the Operation"). Also in view of the rights retained by the HR under the shareholders agreement ("SHA") that will be entered into by SOCAR and HR, SOCAR will acquire sole control of DESFA subsequent to the closing of the SPA.

1.2 The current regulatory framework

Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC³ ("Directive 2009/73/EC") provides for common rules for the internal market in natural gas. In short, this Directive sets out the regulatory framework enabling the full liberalisation of the EU gas markets, in particular as regards gas production and supply. The same Directive also sets common rules for certain non-liberalised parts of the value chain in order to ensure that competition in the liberalised parts takes place on a level playing field. In the latter category fall the common rules applicable to certain types of gas infrastructure, including gas transmission systems, and their owners and operators, such as DESFA.

The common rules regarding gas transmission systems include an unbundling regime pursuant to Article 9 of Directive 2009/73/EC, seeking to ensure that TSOs are operated independently from the upstream and/or downstream interests of its owners. In order to ensure compliance

² Conditions precedent include merger control clearance and certification as meant under Article 10 and Article 11 of Directive 2009/73/EC.

³ OJ L211 of 14.08.2009 p. 94

with the common rules applicable to TSOs, Article 10 of Directive 2009/73/EC foresees a so-called certification procedure whereby the national energy regulator ("NRA") verifies compliance by the TSO with the requirements as laid down in Article 9 of Directive 2009/73/EC. In case the TSO is or will be controlled by a (legal) person or persons from a third country, Article 11 of Directive 2009/73/EC foresees that, in addition to compliance with Article 9 of Directive 2009/73/EC, it must establish during the certification procedure that granting the certification will not put at risk the security of energy supply of the Member State concerned and the European Union whilst taking into account, *inter alia*, rights and obligations of the European Union arising under international law, including agreements concluded with one or more third countries to which the European Union is a party and which addresses issues of security of energy supply.

The Commission provides an opinion on a draft certification decision drawn-up by the national regulator, who then adopts a final certification decision after which the TSO can be designated.

1.3 The application of the regulatory framework to the present case

Article 9 of Directive 2009/73/EC lays down the general principles for unbundling implying that (legal) persons that control a transmission system cannot at the same time, directly or indirectly, exercise control over companies that perform the function of production or supply of gas and/or electricity. SOCAR is a company that *inter alia* produces and supplies natural gas.

However, Article 9 also foresees the possibility of applying alternative unbundling models provided the conditions set out in Article 9(8) are met, as they are in the case of DESFA. Consequently, DESFA foresees the application of the unbundling conditions set out in Chapter IV of Directive 2009/73/EC i.e. it envisages the application of the so-called Independent Transmission Operator or "ITO" model. The application of this model means that SOCAR, despite being active in the production and supply of gas, can acquire control over DESFA provided that during the certification procedure it is established that it complies with all conditions of the ITO model and continues to do so as long as it owns DESFA.

Article 10(3) of Directive 2009/73/EC requires TSOs to notify to the NRA any planned transaction which may require a reassessment of its compliance with the requirements of Article 9 of the same Directive. Consequently, the projected operation whereby SOCAR acquires control over DESFA requires a reassessment of DESFA's compliance with, in particular, all conditions related to the ITO model.

SOCAR is established in and owned by the Republic of Azerbaijan. In such cases, Article 11 of Directive 2009/73/EC foresees that the NRA (Article 11(4)) and the Commission (Article 11(7)), in addition to the TSOs compliance with Article 9, also assess whether granting

certification will put at risk the security of energy supply of the Member State concerned and the European Union.

Article 11 stipulates that the certification shall be refused if it has not been demonstrated that the control by a third country person will not put at risk the security of energy supply of the Member State concerned and the European Union. In considering that question, the NRA and the Commission shall take into account the rights and obligations of the European Union with respect to that third country arising under international law, including any agreement concluded with one or more third countries to which the European Union is a party and which addresses the issues of security of energy supply.

Recital 22 of Directive 2009/73/EC further clarifies that *"The security of energy supply is an essential element of public security and is therefore inherently connected to the efficient functioning of the internal market in gas [...]. Functioning open gas markets and, in particular, the networks and other assets associated with gas supply are essential for public security [...]. Persons from third countries should therefore only be allowed to control a transmission system or a transmission system operator if they comply with the requirements of effective separation that apply inside the Community. Without prejudice to the international obligations of the Community, the Community considers that the gas transmission system sector is of high importance to the Community and therefore additional safeguards are necessary regarding the preservation of the security of supply of energy to the Community to avoid any threats to public order and public security in the Community and the welfare of the citizens of the Union. The security of supply of energy to the Community requires, in particular, an assessment of the independence of network operation, the level of the Community's and individual Member States' dependence on energy supply from third countries, and the treatment of both domestic and foreign trade and investment in energy in a particular third country. Security of supply should therefore be assessed in the light of the factual circumstances of each case as well as the rights and obligations arising under international law, in particular the international agreements between the Community and the third country concerned. Where appropriate the Commission is encouraged to submit recommendations to negotiate relevant agreements with third countries addressing the security of supply of energy to the Community or to include the necessary issues in other negotiations with those third countries."*

Currently, no agreement exists between the Republic of Azerbaijan on the one hand and the European Union and/or Greece on the other hand addressing issues of security of energy supply.⁴

1.4 The concerns that need to be remedied by the IGA

DESFA owns and operates the gas transmission network in Greece, the interconnections of this transmission network with neighbouring countries, including Turkey and Bulgaria, as well as the Revithoussa LNG terminal. Moreover, the DESFA gas transmission network can in the future and is currently already projected to be connected with other infrastructure pertinent for the transportation of gas to Greece as well as other EU Member States and members of the Energy Community. Reference can be made in this context to the projected Trans Adriatic Pipeline ("TAP") that will connect the DESFA transmission network with Italy and Albania and will reinforce its interconnection with Turkey as well as interconnectors at earlier planning stages, such as the Interconnector Greece Bulgaria ("IGB") that will increase the gas transmission capacity from Greece with Bulgaria. These interconnections affect the EU Member States and members of the Energy Community immediately interconnected with the DESFA network, but also those countries that are or can be provided with natural gas through these countries, such as EU Member States Romania and Hungary, and Members of the Energy Community.

DESFA therefore plays a pivotal role for the importation of gas into the EU and its transportation to other EU and Energy Community Member States and, hence, constitutes a strategic asset affecting the security of energy supplies of the European Union.

Greece, through its connection to Turkey, is currently the sole entry point into the EU for gas produced in Azerbaijan, including gas produced by SOCAR. The projected TAP pipeline and upstream connections will significantly increase the volumes of Azeri gas that can be imported into the EU. The DESFA network, however, enables the import of gas from other sources as well, including Russian gas (through Bulgaria), LNG (through the Revithoussa LNG terminal) and in the future gas from different sources available in Italy (through the TAP pipeline on which commercial and physical reverse flows are due to be offered).

⁴ Currently existing legal instruments are (i) Agreement between the government of the Hellenic Republic and the government of the republic of Azerbaijan on the promotion and reciprocal protection of investments (Signed 21 June 2004, entry into force 3/9/2006) (ii) Partnership and Cooperation Agreement between the European Communities and their Member States, of the one part, and the Republic of Azerbaijan, of the other part (Signed 18/05/2004, entry into force 01/11/2005). None of these instruments cover the projected subject matter of the IGA.

Whereas the unbundling rules in Directive 2009/73/EC should ensure that the transmission system is operated independently from production and supply interests of related undertakings, the third country clause prescribes an additional test in case a TSO is controlled by a person or persons from a third country. That test is meant to ensure that the security of supply of the Member State concerned and of the EU is not put at risk.

In the present case, such a risk could *inter alia* result from:

- (1) The adoption by the Republic of Azerbaijan of governmental acts that render it impossible or difficult for SOCAR or DESFA to comply with the Third Package requirements, other relevant EU law⁵ and Treaty obligations by creating legal uncertainty or conflicts of law between Azeri and EU law;
- (2) Creation of legal uncertainty or conflicting laws rendering actual enforcement in case of non-compliance, *inter alia* by EU energy regulators or EU Courts, difficult or impossible;
- (3) The exercise by the Republic of Azerbaijan of its ownership rights in SOCAR resulting in SOCAR or DESFA acting contrary to Third Package requirements, other relevant EU law and Treaty obligations;
- (4) Acts by the Republic of Azerbaijan, or threats thereof, that directly or indirectly sanction the enforcement of EU law against SOCAR or DESFA, including measures regarding the supply of natural gas to the EU or conditions thereof.

1.5 The need for an intergovernmental agreement ("IGA")

In view of the potential risks identified above, the conclusion of an intergovernmental agreement ("IGA") is considered necessary with a view to enable a possible certification of DESFA as an ITO controlled, via SOCAR, by the Republic of Azerbaijan, pursuant to Article 11 of Directive 2009/73/EC. The IGA should ensure by means of a legally enforceable agreement under international law that DESFA's ultimate owner, the Republic of Azerbaijan, will act in its capacity as sovereign state as well as in the exercise of its ownership rights in SOCAR in full compliance with the EU regulatory framework.⁶

The present proposed Council Decision seeks to take measures "*regarding the preservation of the security of supply of energy to the Community to avoid any threats to public order and*

⁵ Such as regarding data processing and the protection of critical infrastructure.

⁶ To the extent pertinent, similar conditions may be imposed upon SOCAR as a condition for certification by means of other legal instruments.

*public security in the Community and the welfare of the citizens of the Union.*⁷" Consequently, the proposed measure seeks to prevent any possible negative impacts of the projected acquisition of DESFA by SOCAR.

2. LEGAL ELEMENTS OF THE RECOMMENDATION

2.1 European Union competence for concluding an IGA

The subject matter of the proposed IGA falls entirely within the scope of internal common rules:

- (1) Directive 2009/73/EC is part of the Third Energy Package. It lays down common rules for the gas markets in general and TSOs in particular.

In general, Directive 2009/73/EC lays down the regulatory framework for the operation of the EU gas markets, including public service obligations, authorisation of market access, unbundling of TSOs and DSOs, new infrastructure, market opening, regulatory oversight and rights and obligation of market participants and for TSOs such as related to unbundling, third party access and network investments.

More specifically as regards the unbundling of TSOs, Article 9, Articles 14 to 16 and Chapter IV (Articles 17 to 23) of Directive 209/73/EC provide for detailed conditions for the application of the unbundling rules. In addition, Article 10 of Directive 2009/73/EC lays down the procedure for certification that ensures compliance with the unbundling rules. Article 11 foresees an additional procedure applicable if the owner of the network stems from a third country and imposes the need to assess whether certification puts at risk the security of supply;

- (2) Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 ("Gas Regulation")⁸ provides in Article 8(6) for the adoption of network codes that regulate in detail many matters related to TSO's operations as well as in Article 3 the certification procedure;
- (3) Council Directive 2008/114/EC of 8 December 2008 on the identification and designation of European critical infrastructures and the assessment of the need to

⁷ Recital 22 of Directive 2009/73/EC
⁸ OJ L211 of 14.08.2009 p.36

improve their protection⁹ ("Directive 2008/114") lays down common rules regarding measures to protect critical energy infrastructure exists.

Since the subject matter of the envisaged IGA fall within the scope of internal common rules - the criterion that ensures exclusive competence for the European Union for the conclusion of an international agreement under Article 3(2) TFEU as also interpreted by the Court of Justice in the ERTA case law¹⁰ -, the European Union has sole competence in concluding an IGA with the Republic of Azerbaijan aimed at ensuring that the latter will act in its capacity as sovereign state as well as in the exercise of its ownership rights in SOCAR in full compliance with the EU regulatory framework for gas markets.

Furthermore, the suggested content of the IGA in essence seeks to ensure that the EU regulatory framework is properly applied and enforceable within the EU. Consequently, the conclusion of the international agreement can be considered necessary to enable the European Union to exercise its internal competence, providing additional justification under Article 3(2) TFEU for the exclusive competence for the European Union for the conclusion of an international agreement.

2.2 Content of the recommended IGA

The IGA should include guarantees by the Republic of Azerbaijan on the following points:

- (1) SOCAR's ownership of DESFA is exclusively governed by EU law and Greek law;
- (2) The Republic of Azerbaijan accepts the sole jurisdiction of EU courts related to the application of the unbundling rules and other regulatory rights and obligations resulting from Greek and EU law upon DESFA;
- (3) There can be no adoption of legislative measures by the Republic of Azerbaijan affecting SOCAR and/or exercise of control of the Republic of Azerbaijan in SOCAR that results in non-compliance by SOCAR or DESFA with their obligations under EU law, notably the exercise of powers of the national regulator as defined under EU law in order to monitor and enforce the legal obligations on DESFA and SOCAR;

⁹ OJ L 345, 23.12.2008, p. 75–82

¹⁰ Case 22/70 *Commission v Council* [1971] ECR 263, concerning a European Road Transport Agreement (ERTA). See also Case C-471/98, *Commission v. Belgium* ('Open Skies'); Opinion 1/03 [2006] ECR 1150, on the Lugano Convention, paragraphs 116 and following; Case C-45/07, *Commission v Greece*, Judgment of 12 February 2009, paragraphs 16 and 17.

- (4) The Republic of Azerbaijan will not render, allow SOCAR to render or seek to render, the delivery of natural gas to the EU or the conditions thereof dependent upon matters concerning the application of Greek or EU law to DESFA;
- (5) The Republic of Azerbaijan will fully respect and ensure full compliance with EU and Greek law applicable to DESFA, including EU internal market rules and EU legislation regarding data processing and the protection of critical infrastructure.

3. BUDGETARY IMPLICATION

The recommended course of action has no budgetary implications.

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Recommendation for a

COUNCIL DECISION

authorising the opening of negotiations on an Agreement between the European Union and the Republic of Azerbaijan on a legal framework governing the control of DESFA by SOCAR

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 218(3) and (4) thereof,

Having regard to the recommendation from the European Commission

Whereas:

- (1) It is the intention of the State Oil Company of the Azerbaijan Republic ("SOCAR"), an undertaking established in Azerbaijan and controlled by the Republic of Azerbaijan, to acquire control of Hellenic Gas Transmission System Operator S.A. ("DESFA"), the Greek gas transmission system operator.
- (2) Article 11 of Directive 73/2009 stipulates that in such cases it needs to be ascertained that the control by a person or persons from a third country or third countries of a transmission system owner or operator will not put at risk the security of energy supplies to the European Union.
- (3) The facts in the present case imply that (i) the network as operated by DESFA constitutes a strategic asset affecting the security of energy supplies of the European Union (ii) the Republic of Azerbaijan and SOCAR have strategic interests that are not necessarily aligned with the objective of EU legislation applicable to gas transmission networks. This raises concerns with regard to security of energy supplies that need to be remedied.
- (4) DESFA will, via SOCAR, ultimately be controlled by the Republic of Azerbaijan and, hence, the appropriate legal instrument to remedy concerns in the present case is an intergovernmental agreement.
- (5) The subject matter of the intergovernmental agreement is fully covered by the scope of EU legislation. Moreover, the international agreement is necessary to enable the European Union to exercise its internal competence. Consequently, it falls within the

sole competence of the European Union to conclude such an intergovernmental agreement.

- (6) Negotiations should therefore be opened with a view to concluding an intergovernmental agreement between the European Union and the Republic of Azerbaijan on a legal framework governing the control of DESFA by SOCAR aimed at ensuring that the intended acquisition does not put at risk the security of energy supplies to the European Union.

HAS ADOPTED THIS DECISION

Article 1

The Commission is hereby authorised to negotiate, on behalf of the European Union, an Agreement between the European Union and the Republic of Azerbaijan on a legal framework governing the control of DESFA by SOCAR.

Article 2

The negotiating directives are set out in the Annex.

Article 3

The negotiations shall be conducted in consultation with the *[to be inserted by the Council]* acting as special committee.

Article 4

This Decision is addressed to the Commission.

Done at Brussels,

For the Council

[...]

The President

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