

# Russia and the Energy Charter Treaty: Common Interests or Irreconcilable Differences?

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## Abstract

Russia hosted the G8 Summit in July 2006 with global energy security high on the agenda. Russia's policy in dealing with its energy resources, particularly in light of its gas pricing dispute with the Ukraine earlier this year, has been the subject of much publicity and comment. Russia's commitment to the Energy Charter Treaty, which it has signed but still not ratified, is being questioned. The G8 talks were expected to be "very difficult, very tense, full of contradictions".<sup>1</sup> Although the tone in St Petersburg was amicable, the talks confirmed the radically different views of "energy security" taken by Russia on the one hand and the EU on the other. As ever, there are complex factors at play. Doran Doeh, Sophie Nappert and Alexander Popov of Denton Wilde Sapte try to unravel the knot.

## Background

In January 2006, the temporary disruption of Russian gas supplies to Ukraine put the remainder of Europe on alert. Russia was perceived as volatile and willing to compromise security of energy supply, which the Energy Charter Treaty (ECT)

### MEMBERS OF THE ENERGY CHARTER CONFERENCE

Albania, Armenia, Austria, Australia\*, Azerbaijan, Belarus\*, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Cyprus, Denmark, Estonia, European Communities, Finland, France, Georgia, Germany, Greece, Hungary, Iceland\*, Ireland, Italy, Japan, Kazakhstan, Kyrgyzstan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Moldova, Mongolia, Netherlands, Norway\*, Poland, Portugal, Romania, Russian Federation\*, Slovakia, Slovenia, Spain, Sweden, Switzerland, Tajikistan, The former Yugoslav Republic of Macedonia, Turkey, Turkmenistan, Ukraine, Uzbekistan, United Kingdom.

\* denotes state in which ratification of the Energy Charter Treaty is still pending.

### OBSERVERS TO THE ENERGY CHARTER CONFERENCE

States: Algeria, Bahrain, People's Republic of China, Canada\*\*, Islamic Republic of Iran, Republic of Korea, Kuwait, Morocco, Nigeria, Oman, Pakistan\*\*, Qatar, Saudi Arabia, Serbia and Montenegro\*\*, Tunisia, United Arab Emirates, United States of America\*\*, Venezuela.

International Organisations: ASEAN, EBRD, IEA, OECD, UN-ECE, World Bank, WTO, CIS Electric Power Council, BSEC, BASREC.

\*\* denotes observer state which has signed the 1991 Energy Charter Declaration.

Source: [www.encharter.org](http://www.encharter.org)

was intended to promote, for political purposes. The EU, which relies on Russia for 25% of its gas needs, started looking nervously at the terms of the ECT and the significance of Russia's unwillingness to ratify it up to now.

From Russia's point of view the interruption was an aberration after decades of continuous supply, even in difficult periods of the Cold War and following the collapse of the Soviet Union in 1991. The cause of the disruption was not Russian failure to put the relevant volumes of gas into the pipes going to western Europe, but theft of the undelivered gas in Ukraine. Having continued to subsidise deliveries to Ukraine for nearly fifteen years, Russia was seeking to obtain a market price – which Ukraine refused to pay. Ukraine was using its position as a transit state to choke off supplies to western and central Europe from Russia. If anything, Russia was playing by the rules and Ukraine was not. The ECT as such seemed to be of little relevance or assistance to Russia in the dispute with Ukraine.

However, key issues relating to transit have never been included in the ECT. These –

<sup>1</sup> "Summit set for angry clash over energy", *The Times*, 25 May 2006.

Transit Protocol – have been subject to ongoing discussions for many years, largely because Russia and the EU have been unable to resolve their differences over it.

This article seeks to examine some of the difficulties facing Russia in considering ratification of the ECT.

## The Energy Charter Treaty

The ECT is the first multilateral instrument aimed at promoting and protecting investment, security of supply and transit in the energy sector. It advocates transparency and non-discrimination in the treatment of foreign investment, freedom of transit and a commitment to the progressive liberalisation of international trade in the energy sector.

### Who has signed, who has ratified and who has not (either or both)?

Fifty-two States, including Ukraine and the EU as a unit, have signed the ECT and eighteen others are observers.

Pre-eminent amongst the states which have not signed is the United States of America.

Also missing are Algeria and Libya, both major suppliers of gas to the European Union. Russia and Norway, the other major external suppliers of gas to the EU, have signed but not ratified.

Also notable is the large number of producer countries which have observer status but have neither signed nor ratified the ECT – including Algeria, Iran, Kuwait, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Venezuela. None of these states has signed the 1991 Energy Charter Declaration either.

When comparing those who have signed and ratified with those who have either not signed or not ratified, it is hard to escape the inference that the ECT is regarded favourably by countries which are primarily consumers but that that most producers (with the exceptions of the UK, the Netherlands and Kazakhstan) have serious reservations about it.

### Effect of signature without ratification

The effect of signature without ratification, in public international law terms<sup>2</sup>, is that Russia is “provisionally applying” the treaty. In other words, Russia, having signed up to the terms of the treaty, must not to act in a manner that is contrary to

the treaty’s aims and terms.

At the G8 Summit, Russia confirmed that it would not ratify the ECT in its present form. Provisional application therefore remains the order of the day.

The legal concept of provisional application means that the substantial provisions of an international treaty are applied pending its formal entry into force. Provisional application of the ECT is provided in its Article 45(1). There is an opt-out clause at Article 45(2) for those members unwilling to apply the treaty provisionally.

*“(1) Each signatory agrees to apply this Treaty provisionally pending its entry into force for such signatory... to the extent that such provisional application is not inconsistent with its constitution, laws or regulations.*

*(2) (a) Notwithstanding paragraph (1) any signatory may, when signing, deliver to the Depository a declaration that it is not able to accept provisional application. The obligation contained in paragraph (1) shall not apply to a signatory making such a declaration. Any such signatory may at any time withdraw that declaration by written notification to the Depository.*

...

*(3) (a) Any signatory may terminate its provisional application of this Treaty by written notification to the Depository of its intention not to become a Contracting Party to the Treaty. Termination of provisional application for any signatory shall take effect upon the expiration of 60 days from the date on which such signatory’s written notification is received by the Depository.*

...

*(7) A state or Regional Economic Integration Organisation which, prior to this Treaty’s entry into force, accedes to the Treaty in accordance with Article 41 shall, pending the Treaty’s entry into force, have the rights and assume the obligations of a signatory under this Article.”*

Russia did not register a Declaration of Non-Application pursuant to Article 45(2). However, it made clear that it has substantial problems in agreeing the Transit Protocol and that these are fundamental to Russia’s failure to ratify.

To understand Russia’s position fully on transit issues it is important to appreciate that Russia is both:

<sup>2</sup> Article 25, Vienna Convention on the Law of Treaties 1969 (VCLT).

- (1) a producer which requires transit to the countries of western Europe through the territories of some of its former satellites in central Europe and some of the states of the former Soviet Union to the west of Russia (some, but by no means all, of which – former satellites and FSU states – take a politically antagonistic attitude to Russia), and
- (2) a transit state for producers in states of the former Soviet Union to the south of Russia, mainly in the Caspian region.

### Issues over the Transit Protocol

Three issues arise in relation to the Transit Protocol.

First is the right of first refusal on renewal of transit terms for an existing user. A right of first refusal for Russian gas producers (i.e. Gazprom) having long-term contracts with European consumers to prolong agreement on gas transit within third countries would clearly be to Russia's advantage in Europe. However, the EU Competition Directorate is opposed to this. The EU proposes to apply this right only to the existing Russian supply contracts, thus excluding future contracts within EU territories. Russia views this proposal as offering no assurance that its interests will be protected by contracts concluded in future.

Second is the Regional Economic Integration Organisation (REIO) clause. The EU proposes that it should be treated as a single unified territory for the purposes of the Transit Protocol. The consequence of this for Russia would be that transit rights under the ECT would end at the Polish and Slovakian borders, and those of the Baltic states. Regulation of transportation of oil and gas inside the EU would be treated as an internal matter and subject to regulation by EU legislation, the ECT and World Trade Organisation (which Russia is still negotiating to join). In Russia's view, the effect of the REIO clause would be to change the character of transportation in the EU from transit to internal transportation. Russia would be required to abide by laws of a consumer club of which it is not a member and which it cannot control or, possibly, even materially influence. The converse recognition of the CIS as an REIO is not on offer – hence the issue of use of Russian pipelines by central Asian countries.

The third issue is access to pipelines and particularly tariff-setting procedures. The draft Transit Protocol provides for these to be determined on a basis which is non-discriminatory and cost-based,

free of distortions resulting from abuse of dominant position by pipeline owner. Given the difficulty of valuing the capital value of pipelines inherited from the Soviet Union and Gazprom's position as the holder of the trunk gas pipeline system in Russia, this begs a lot of questions that are not readily resolvable.

### Law on Gas Exports

The recently passed new Law on Gas Exports<sup>3</sup> provides for Gazprom to have a monopoly over exports of gas from Russia, subject to certain limited exceptions relating to existing commitments. Whilst this law was passed ostensibly in a spirit of economic nationalism not unlike that currently informing debate in some west European countries, there are other serious issues which are relevant. An examination of these also casts light on the difficulties Russia has in ratifying the ECT as a whole, particularly with the Transit Protocol not agreed.

### Practical Issues on gas

Gazprom currently has three sets of customers to satisfy:

- ! customers in western and central Europe to which it has long-term contractual obligations but who pay "market" prices for gas;
- ! customers in Russia, who pay prices considerably lower than the customers in western and central Europe – industrial purchasers as well as households;
- ! customers in the former Soviet Union, who have since the break-up of the Soviet Union also paid prices much lower than in western and central Europe but whom Russia and Gazprom are trying to move towards a more "market" based structure.

In addition, looking forward, there are three other markets which Gazprom needs to consider:

- ! Pipeline gas markets in the Far East, mainly China;
- ! LNG markets in the Far East, mainly Japan;
- ! LNG markets in North America.

So far as the last three categories are concerned, these are markets for the future, to be satisfied either out of new production or after existing contracts have expired. The key issues relate to the exist-

<sup>3</sup> Federal Law of the Russian Federation dated 18 July 2006 No. 117-FZ *On Gas Exports*.

So far as western and central Europe are concerned, Gazprom clearly has an incentive – by virtue of both the price it receives and its legal liability under the contracts – to meet its contract requirements. While it is not clear that there is actually a properly functioning market for gas in western Europe – indeed this is a major issue within the EU which the European Commission is addressing with increasing robustness – these customers are paying Gazprom prices that it regards (and Gazprom is in a unique position to take a view on this) as competitive.

Customers in Russia and the rest of the former Soviet Union are not. Whereas, for consumers in western Europe, the opening up of markets for gas and electricity has (where such markets have been opened, as in the UK) led to much lower prices, the only direction that prices could move in, if markets are opened in Russia and the former Soviet Union, is upwards. This may involve considerable social hardship as well as loss of competitive edge in those few industries, other than natural resources production itself, where these countries are able to compete.

It is particularly ironic for Russia that steel mills in Ukraine, some of which are even less energy efficient than Russian mills, compete for the same international contracts, and yet the Ukrainian mills have enjoyed – and continue to enjoy – the benefits of cheap gas supplied either from Russia or from central Asia through Russian pipes. At the same time, many gas deposits in Ukraine have until recently remained uneconomic to exploit. Gas producers in Ukraine have been heartened in recent months by the prospect of higher gas prices resulting from Russian price pressure on Ukraine.

There is, of course, a social issue, particularly so far as Ukraine is concerned, which is how to accommodate higher energy prices without causing an economic collapse. As Ukraine moves increasingly into the orbit of western Europe and the US, Russia feels less obligation to carry the burden of this. There is no suggestion that the EU is willing to subsidise Ukraine in the way that Russia has for the past 15 years – so what will happen to Ukraine?

So far as Russia is concerned, it too continues to suffer from the problems of transition from the Soviet system, and, although huge strides forward have been made in the past 15 years, it may take many decades before the transition is fully complete. In the long run, Russia will need to move away from reliance on cheap energy but, having only just got over a decade of enormous economic shocks, a gradual transition seems to be in its best interests.

So long as the central Asian gas producers – Kazakhstan and Turkmenistan – are unable to access the rest of the world except through Russia, their only issue is whether to produce or not produce and what price they are willing to produce at (or forego if they do not). The result is that central Asian gas is much cheaper than Russian gas. The central Asian gas can, then, be used to subsidise Russian consumers and those of the other countries of the former Soviet Union who require cheap gas. This was the basis for the compromise with Ukraine in January.

If Gazprom is short of gas in future, it retains the option to increase prices to central Asian producers and to those producers in Russia whose reserves are stranded (or flared) at lower prices.

Why should Russia give up these advantages? What is it being offered in return? There are no clear answers to this coming from the proponents of the ECT and they must answer it if a compromise is to be reached.

President Putin put it in the following way:

*“The Energy Charter envisages mutual access to production and transport infrastructure. Of course we can allow our partners into both types of infrastructure, but then we have to ask the question: Where will they admit us? Where’s the extraction or transport infrastructure?”*

*We have trunk pipelines, which our partners simply don’t have. We’re not against working on these principles, but we need to understand what we are going to get in exchange.” □*