

Russia-EU, G-8, ECT and Transit Protocol

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The beginning of 2006 was marked by two important events in the international energy sphere directly relevant to the development of transparent, predictable, and reliable rules of the game in the global energy sector. On January 1st Russia's Presidency of the "Group of Eight" (G-8) began with energy security as one of the keynote themes. On January 4th, an agreement was signed between Russia and Ukraine, ending a several month long dispute over gas transit tariffs and export prices between the two countries.¹ Both events stressed the important role of the Energy Charter as an international organization in ensuring international energy security, and prompted an additional focus of the international community to the ratification of the Energy Charter Treaty (ECT) by Russia.

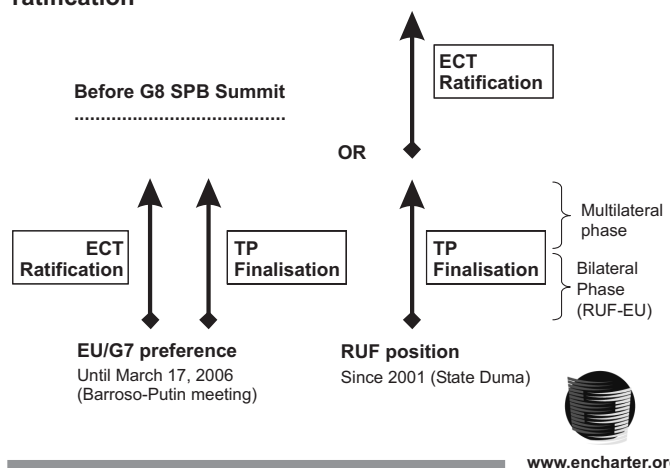
Against this background, individual G-8 countries urged Russia to ratify ECT and/or to declare its intention to ratify at the G-8 Summit in Saint Petersburg in July of 2006. These calls reached their climax in mid-March at the Moscow G-8 Energy Ministerial. The EU representatives have been demanding from Russia that ratification of the ECT will go *in parallel* to the finalisation of the Energy Charter Protocol on Transit (TP). However, Russian State Duma had already formulated in 2001 that a successful finalization of TP would be a precondition to ECT ratification by Russia. That means that under Russia's view, the finalization of the TP and ratification of the ECT procedure are not parallel, but are rather *consecutive* processes (Figure 1). That has been clearly and regularly voiced by the Russian Minister of Industry and Energy, Victor Khristenko,² despite regular and sometimes not only unclear, but rather contradictory statements regarding ECT ratification by some other Russian officials from the Government, Presidential Administration, State Duma and state companies.

Legally speaking, since TP is a separate legal document complimentary to ECT, it cannot be signed and ratified by a country which has not signed and ratified the ECT. Therefore, from a first glance, demand of Russia's parliament is excessive and not based on pure legal fundament. However, Russia has been continually expressing concerns regarding potential broad interpreta-

tions of some clauses in ECT Article 7, "Transit", which will (might) contradict Russia's economic interests and thus would prevent the ratification of ECT. The only way to solve this problem is to clarify the ECT interpretations regarding transit in TP. Since we live in the real world it needs to be understood that this political demand of the State Duma, based on this country's economic interests, should be implemented if one would expect Russia's ratification of ECT. In this case, Russia would first sign TP and then simultaneously ratify both ECT and TP (see Figure 1).

The Russian side is of the opinion that TP finalization may become a necessary, though not sufficient, condition for ECT ratification. Conditions, which may become barriers to Russia's ratification of ECT, were first outlined this year at the conference in MGIMO (Moscow) in April by Andrei Kondakov, Russian sous-cherpa within the G-8. In addition to an unfinished TP, he noted two more matters: trade in nuclear materials and the Supplementary [Investment] Treaty. These two issues have been regularly mentioned since then by other Russian officials,

Figure 1. Two views on how to proceed with Russia's ECT ratification



¹ For detailed analysis by the same author of the economics of the Jan. 4, 2006, agreement within the Energy Charter framework – see "Nefi, Gaz i Pravo", №№ 3-4, 2006.

² Most recently – at the Black Sea Economic Cooperation (BSEC) Energy Ministerial in Sochi, September 27, 2006.

including Russian President Vladimir Putin at the Russia-EU Summit in Sochi on May 25, 2006. After the latter, the momentum of the finalization of TP has suddenly slowed.

Transit Protocol progress

In December 2002, the Energy Charter Conference (ECC) considered multilateral phases of TP negotiations to be finalised with only three outstanding issues left to be resolved between Russia and the EU. Bilateral consultations between the two restarted in October 2004. Nine informal bilateral expert meetings took place since then, including five in 2006.

After a penultimate meeting in mid-May, it seemed that of the three issues outstanding between Russia and EU only one was still left open; how to provide long-term transit solutions for the corresponding long-term supply contracts (in terms of access to transportation infrastructure for the transit volumes for the duration of the corresponding supply contracts) without creating incremental risks for the suppliers. A mechanism of addressing this issue has been agreed in principle both for systems with regulated and negotiated access to transportation capacities, though it has not yet been finalized in legal terms. The other two issues were formulated and provided for examination in the capitals of the two parties:

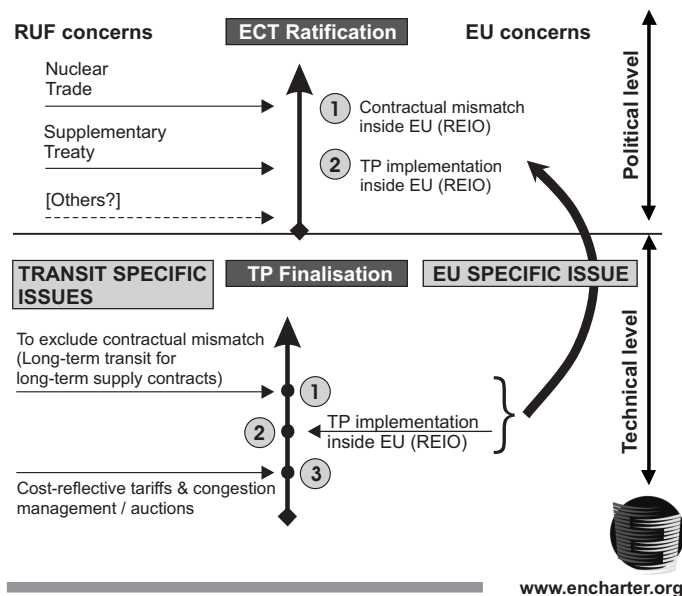
- (a) transit tariff development methodology, including the issue on how to match cost-re-

flectiveness (which means capital plus operating costs plus reasonable rate of return – ROR) as a principle of establishment of transit tariffs and congestion management instruments inclusive of auctions (tariffs established through auctions do not usually reflect the cost, including ROR, of the provided transportation service; their value in this case reflect demand-supply correlation and thus might include excessive ROR for the pipeline/transportation systems owners/operators), and

- (b) TP applicability within the EU as a REIO (Regional Economic Integration Organization) based on the 'bench-marking' approach; i.e. that TP substantive provisions were to serve as a binding bench-mark for the corresponding EU's *acquis* rules within the expanding EU's single internal energy market. That means that EU's *acquis* would continue to be implemented within the EU for the transportation flows but in case the shipper will consider that the rules of the *acquis* fall below the standards provided by the provisions of the TP to the detriment of the shipper, the latter would be in a position to bring the case to the arbitration according to the TP/ECT dispute settlement rules and the court decision in favour of the shipper, in case it would be proved that *acquis* provisions fall below the TP/ECT standards, would be enforceable.

But at the latest informal expert meeting (June 8-9), the EU has stepped back from the earlier proposed "bench-marking mechanism" implying that in practice the rules of the TP would only apply to rather exceptional cases of transit across the whole EU, such as gas deliveries to Switzerland (i.e. to less than 1% of the whole Russian gas export to Europe). As a result, no earlier expected final progress was reached on the issue of the 'contractual mismatch' (for the situations when volume and duration of the transit arrangements would not correspond to the volumes and duration of the underlying supply contracts) as well. It was proposed to hold another meeting between the two parties on the 'political' level in order to provide political guidance for the experts on how to proceed further with TP. It was understood as well that the two yet unresolved issues of TP (which are not generic transit issues like congestion or cost reflective tariffs, but rather EU-specific issues, and thus political bilateral issues between EU and Russia) are now incorporated into a broader 'package' between two parties on the Energy Charter issues, including those that were repeatedly mentioned earlier this year by the official Russian representatives regarding ECT ratification (Figure 2).

Figure 2. Finalisation of Transit Protocol & ECT ratification by Russia: current status



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EU dilemma

After the experts' meetings it seemed that the experts had addressed all issues stemming from the nature of transit and found solutions for them, mainly for the rather complicated issues of dealing with short- and long-term congestions and with cost-reflective tariffs. The remaining issues are of a more political nature inherent to internal organisation of the EU, and thus presents rather bilateral political issues between Russia and the EU.

Bringing two yet unresolved issues of TP at last moment from a 'technical' to a 'political' level can be seen, on the one hand, as an attempt by the EU to balance two of Russia's concerns related to ECT ratification (see Figure 2). On the other hand, this step-back by the EU may reflect the major challenge that this contracting party of the ECT is facing nowadays. EU thinking on external policy issues is dominated by the idea of "exporting" the benefits and regulatory model of the EU internal market, which has been developed mostly in the interest of the energy importing consumer-states. EU enlargement is an obvious and highly successful example of expanding the full *acquis* to ten new EU member-states. Another example is the EU-SEE Energy Community Treaty which applies the energy part of the *acquis* to another 8 states of South-East Europe. The EU's Neighbourhood Policy and the idea of "common spaces" with Russia (at least how the latter is understood from the EU side) are watered-down versions of the same philosophy of "exporting EU's *acquis*".

It seems that the purpose of transit negotiations from the EU side is to address the transit-related issues outside the EU and to solve them – within the ECT process – by "exporting" the EU's *acquis* to as broad of an area as possible as a universal solution of those problems.

The EU claims that the *acquis*, together with the single market, have the potential to solve transit issues; the EU claims that within the single market no transit is left. However, the *acquis* does not work for transit issues outside of the single market as the *acquis* delivers a framework for the regulation of the energy sector, but is silent on transit issues.

The Energy Charter does not fit easily within this way of thinking, since all ECT member states are "rule-setters" and all decisions have to be based on a consensus among a diverse group of Eurasian countries, including the owners of energy resources, energy consumers and transit states.

The non-EU ECT member states, especially resource-rich/exporting Russia (as well as Asian countries), would not be ready and/or willing to adopt the "export" of the EU's *acquis* as a "common denominator" of the Energy Charter process since the latter is based on developing a common minimum standard applicable to all its members. Moreover, in relation to internal EU energy market, the *acquis* itself is in the process of being developed, with the Second Gas Directive being just three years old. Today it does not adequately cover all the issues in question, which stimulate incremental interest in TP for Russia and other existing and prospective external suppliers. They are interested in TP as an instrument for mitigating transit risks not only outside the EU, but also for long-term deliveries to borders within the EU when existing and new Russian (and of other nationalities) long-term supply contracts expire.

Unless a way can be found to balance the EU external strategy with such an inter-governmental Energy Charter approach, until then, *inter alia*, TP finalization will continue to be slowed down.

Russia – EU Nuclear Trade

Russia has renewed its complaints about the exclusion of bilateral Russia-EU trade in nuclear materials from the ECT. In connection with this, the Russian side notes that whereas previously the limitations applied to 15 EU countries, and later to 25, presently they apply to more than 30 European states. Clearly, it has to do with the EU's enlargement, including the establishment of the EU-SEE Energy Community Treaty.

Indeed, the corresponding EU-Russia Bilateral Declaration (an integral part of the "Final Act of the December 17, 1994, Energy Charter Conference" which include *inter alia* ECT itself), excluding EU-Russia trade in nuclear materials from the scope of the ECT, was agreed upon in 1994 on the understanding that a bilateral arrangement (under the scope of EU-Russia Partnership and Cooperation Agreement) would soon be forthcoming (as was indicated in PCA Art.22 – prior to January 1, 1997). But progress has been extremely slow and such a bilateral arrangement does not exist until nowadays. Russia's concerns were expressed both in mid-1997 and early-2001, when debates on ECT ratification took place in the State Duma. EU enlargement has the potential to threaten the traditional Russian export market for nuclear fuel as Russia's existing long-term supply contracts with the new member states expire.

Russian insistence on this point should not necessarily be seen as a desire to bring this issue back within the scope of the Treaty, but rather as an attempt to try to find a solution to a stalled EU-Russia issue within the bilateral framework (as was agreed back in 1994), and thus to use the EU's strong political interest for ECT ratification by Russia as a driving force for finding this solution, most probably within the forthcoming renegotiation of the currently expiring PCA.

Supplementary Investment Treaty

Another Russian complaint related to the ECT is caused by the situation with the Supplementary [Investment] Treaty [to the ECT] (ST). The ECT itself has determined that negotiations on ST would start in 1995 with the aim to conclude them not later than 1 January 1998 (ECT Art. 10(4)). The ST was to expand the national regime for investment (provided in ECT for the post-investment phase, i.e. when the investment is already made) to the pre-investment phase as well. The complaint was addressed to the EU, on whose initiative the negotiations on the ST were put on hold in 1998 due to the cessation of works on the multilateral agreement on investments under OECD framework. It has been suggested most recently that Russia has an interest in the renewal of the ST negotiations. One can assume that the reason for this claim is to use ST as an instrument for promoting access of Russian companies to the mid- and down-stream energy market of the EU.

But, firstly, the existing ECT and a still not finalized ST should be viewed as independent legal instruments. Linkage between finalization of ST and ECT ratification could have been understood if the former were to clarify issues of principal importance to Russia, which were not clear enough in the ECT (like in the case with transit). But the ST was supposed to expand the application of national treatment for investments from the post-investment phase (ECT case) to pre-investment phase as well.

Secondly, the current situation regarding the acceptability of the ST for Russia could be reversed. Discussions around a new version of the Russian draft law on subsoil, in particular proposals to put in place some restrictions against foreign investors related to their access to natural resources, serve as a clear demonstration that the country

is not prepared to apply national treatment to investments at pre-investment phase (i.e. to provide the same treatment

to national and foreign investors at the stage of access to natural resources).

Thirdly, the reciprocity approach would demand that both Russia and the EU implement the same level of non-discrimination towards investors from other parties by granting them access to both domestic markets and natural resources. The more discrimination is foreseen towards foreign investors in granting access rights to Russian energy resources, the less non-discriminatory access to European midstream and downstream energy markets might be implemented for Russian companies.

Under this background, the inclusion of ST into "negotiating package" might be, most probably, considered to be just a negotiating tool, and thus need not stimulate the EU to try to find another "political concern" in order to balance Russia's pre-conditions for ECT ratification.

There have been mixed statements on Russia's ECT ratification during recent months. However, recently the tone of those statements (excluding the voices of the most radical ECT opponents from the State Duma and Gazprom) has moved in a direction that can be interpreted as a formulation of a negotiating package on Russia's possible ratification of the ECT. Both objections – related to Russia-EU trade in nuclear materials and the Supplementary Treaty – could be treated as a part of the negotiating package, being composed by Russia for the debate on the ECT ratification with the EU, rather than the faults of the ECT per se. Perhaps the voices of the most radical ECT opponents need to indicate the initial position for prospective trade-offs in an attempt to receive the higher 'price' for ECT ratification? Against this background, a commitment on Russia's ratification of the ECT could become part of a broader political package, agreed later in 2006 or 2007 between the EU and Russia. This scenario is possible, but, as ever, it is contingent upon a satisfactory conclusion of the Transit Protocol negotiations.³

In order to report to the annual Energy Charter Conference, to be held on November 20, 2006, the situation with the TP, the Chairman of the Energy Charter Conference has invited official delegations from both Russia and the EU for a formal bilateral consultations in mid-October with the aim to take stock of where the parties stand on the draft TP, to provide information on the state of play to all participants in the Charter process, and to decide on the way forward. □

³ The most recent official explanation of the Russian position on the RF-EU bilateral TP consultations is presented in the article of Mr. Sukhoparov, Head, Department for International Cooperation, RF Ministry of Industry and Energy, that is available at that Ministry web-site dated August 17, 2006.