

APPENDIX: GAS TRANSIT IN EURASIA: TRANSIT ISSUES BETWEEN RUSSIA AND THE EUROPEAN UNION AND THE ROLE OF THE ENERGY CHARTER

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Soviet/Russian gas supplies to Europe commenced in 1968. Today we celebrate their 'golden jubilee'. And through all this 50-years-long period transit issues matter, though with different sensitivity, and they have been addressed with different transit-risk-mitigating solutions. International law mechanisms such as ECT-related instruments have been just a part of such solutions.

1. THREE MAJOR COMPONENTS OF TRANSIT RISK IN THE CROSS-BORDER GAS VALUE CHAIN

The very fact of transit per se, non-dependent the name of the transit state, creates additional transportation risks both for the producer/exporter and for the importer since both bear supply obligations within the long-term gas export contracts (LTGEC) which usually shall be a long-term one for investment-protection purposes of the producer. There are three groups of transit risks through the territory of *any* transit country: (i) legal/regulatory/contractual; (ii) technical; (iii) political.

First, any sovereign state possesses its sovereign right to establish within its territory such transit regime (access to and use of transmission grids at its territory) as it considers appropriate, including establishment of different external limitations for transportation/transit operations between foreign to

1 Detailed and extended bibliography of this author on the ECT-related issues, including on the issues of transit, is presented at his website at www.konoplyanik.ru/. This chapter presents a much shortened version of the initial manuscript 'Gas Transit in Eurasia: transit issues between Russia and the European Union and the role of the Energy Charter' which is placed at <https://www.e-elgar.com/commentary-on-the-energy-charter-treaty-companion-site>.

this transit state parties of the LTGEC. This is why in any transit state a 'contractual mismatch' problem might appear, e.g., a need for correlation in terms of timing/duration and volumes/throughput capacities between transit contracts providing access to transportation capacities, on the one hand, and underlying supply contracts (usually LTGEC), on the other hand.

Secondly, since transit component of the gas value chain is beyond the reach of the parties to LTGEC, this means that technical conditions of the transit system, which directly influence on stability and reliability of supply, are also dependent on the third country, i.e., transit state and its transportation system owner/operator (TSO). Adequate maintenance of the transit system is key to the technical stability and reliability of transit. If such maintenance is not adequately provided, this creates technical risks for the producer and the consumer of non-fulfilments their contractual supply obligations due to lower technical conditions of transit infrastructure beyond their reach. This facet of transit risk reflects its technical component.

Thirdly, political component of transit risk. If political relations between transit states and its neighbours (either seller or buyer under LTGEC) worsen, this creates additional risk to secure, reliable, non-interruptible supply flow up to interruptions of supplies of non-technical character.

This means that contrary to perception that transit risk is primarily a political issue, in this author's view, the basic component of multi-facet transit risk development is the sovereign one (legal, regulatory, contractual), then comes technical aspects of transit risk, and the political component of transit risk is the element of last order in its hierarchy.

2. SOVIET/RUSSIAN GAS SUPPLIES TO EUROPE: TRANSIT RISKS UPSTREAM OF DELIVERY POINTS

Delivery points (DPs) for Soviet/Russian gas supplies to the EU have been historically located at the Eastern border of the then EU-15 which means at the Western border of the COMECON. This was caused by the then political split of Europe: the USSR could have assured uninterrupted supply only within the area of its political influence (in USSR/COMECON), while West European wholesale buyers could do so downstream of such DPs on cross-border EU routes to their end-users. This predetermined the important role of transit immediately from the beginning of Soviet/Russian gas supplies to the EU, both upstream and downstream of DPs.

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During the Soviet era transit risks through COMECON had been eliminated to zero level since all its states were under the political and economic dependence of the USSR. Soviet sole exporter (Soyuzgazexport) owned the gas in the pipe, and it had operational control over the transit flows usually without owning and/or leasing transit capacities but possessing them in its disposal through the COMECON mechanisms of the 'socialist economic integration'. In the West, a wholesale buyer of Soviet gas (vertically integrated company/VIC) usually owned/leased the transit pipelines thus possessing legal ownership of both the pipe (capacity) and the gas in it (commodity) and thus such VIC also concentrated management of both commodity and capacity in one hands.

Since the early 1990s the legal and economic environment for transit flows has been changing in both segments of Soviet/Russian gas export value chain, upstream and downstream to/from DPs. This happened first due to political changes in the former COMECON/USSR area, then due to EU expansion and EU internal energy market development and its liberalizations trends.

Following the dissolution of COMECON and USSR at the end of 1991, new independent sovereign states have appeared (former Republics of the USSR) and former COMECON states have received real (factual) sovereignty compared to a nominal (virtual) one during USSR/COMECON time.

After 1992 Soviet Gas Ministry and Soyuzgazexport were no longer to be solely responsible (and possessing operational capacity to implement this responsibility) for reliable gas supplies between Russia up to DPs at the then EU-15 border. Since that time secure Russian gas supplies to Europe depend on a number of *de jure* and *de facto* sovereign 'third' states between Russian border and these DPs since it were these states and their respective entities who owned and controlled the infrastructure within their sovereign territories. So management of commodity and capacity in the area upstream to DPs was disunited since capacity has come under operational control of the former Soviet entities after political changes in Eastern Europe. This gave rise to the so-called 'contractual mismatch' problem in Russian gas value chain to the EU upstream of DPs.

This explains why in the 1990s Russian monopoly gas exporter Gazprom has been trying to enter into privatization processes within the former COMECON countries with the aim of buying (preferably controlling stocks in) equity in Eastern European TSOs and thus to receive ownership control over the transit pipelines. In such a manner Gazprom has tried to prolong the former management model of providing secure and reliable transit to the EU

(to have operational control of both commodity and capacity within the territories of the third states), which his predecessor in external gas trade has been effectively using through the USSR time.

3. SOVIET/RUSSIAN GAS SUPPLIES TO EUROPE: TRANSIT RISKS DOWNSTREAM OF DELIVERY POINTS

Downstream of delivery points of Russian gas to the EU the changing nature of transit problems have occurred due to legal changes as result of EU liberalization trends. Second EU Energy Package (SEP, 2003) has introduced 'unbundling'. This disunited 'commodity' and 'capacity' markets thus giving operational responsibility and management for the 'pipe' and the 'gas in the pipe' to different non-affiliated entities. Since then management for secure non-interruptible supplies has not been concentrated in single hands of VICs, as before. This created the risk of mismanagement of the supplies with now two contractual components in different hands. SEP also introduced mandatory third-party access (MTPA) as an obligatory access regime to transportation capacities.

In combination with unbundling, MTPA created the problem of contractual mismatch (long-term access to infrastructure for transit flows to match existing LTGEC supply obligations), which has been since one of the major risks for the long-term transit supplies, especially through the linear transit systems, i.e., for external gas supplies to the EU and for financing of their development. This has objectively increased transit risks (which generated risks for secure and non-interruptible supply), since the risk of 'contractual mismatch' has appeared also within the EU area.

Third EU Energy Package (TEP, 2009) has introduced a completely new architecture of the emerging common internal EU gas market based on a 'pool' system with intentional upside-down development of internal EU gas regulatory system based on an increasing 'short-termism' approach similar to international oil market and/or US gas market development trends: towards spot and futures transactions away from longer term contracts, to growing trades at the hubs/exchanges away from replacement-value-based commodity pricing (i.e., from former dominant in contractual pricing indexation to backstop commodities aimed at maximization of marketable resource rent), entry-exit auction-based cross-border transportation tariffs, etc.

Since 2003 EU authorities have been regularly stating that there will no longer be transit within the EU since the concept of a single internal EU market was

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introduced in SEP. In the light of this, on 30.06.2004 the EU Gas Transit Directive of 1991 was repealed. Since that time the term 'transit' is no more in use within the EU. All transportation within the EU is considered to be as if it is internal domestic transportation. But this does not abolish the existence of 'contractual mismatch' problem in cross-border transportation within the EU, which is common to any cross-border transportation where ownership (operational control) of the pipe (capacity) and the gas in the pipe (commodity) belongs to different entities.

According to TEP (and its following key documents such as Gas Target Model, Network Codes, etc., developed through 2010–16), the internal EU market does not represent a single homogenous one-market-zone structure, in which case there would have been no 'transit' inside such a single zone, as was attempted in 2003 and which was the basis for repealing Gas Transit Directive. Instead, it consists of a number of market zones with 'entry-exit' tariffs at their cross-border points; different individual TSOs are responsible for internal transportation (access to transmission capacities) within their zones on the long-distance cross-border route of Russian gas to its DPs which have been now located deep inside the 'new' EU-25/27/28. So 'transit', as crossing of two and/or more interconnection (cross-border) points within a gas value chain, does factually exist in the EU although the term 'transit' is not in use. This means that the substance of the 'transit' problems within the EU (which is the problem of minimizing risks of the long-term supplies through cross-border capital-intensive immobile infrastructure in the third countries) does not disappear and is still in place. And the major one among those – is the risk of contractual mismatch for term (long-, medium-, short-term) supplies.

Most of the states upstream of DPs of Russian gas are the EU Members States (MSs) since 2004/2007 and thus implies EU *energy acquis*. Since 2006, a number of non-EU countries signed Energy Community Treaty which obliged them to imply EU *energy acquis* (competition and energy laws) even not being EU MSs. Now the EU rules are to cover the area through the whole gas value chain at the main transit corridor of Russian gas to the EU from the Russian border (Ukraine is in the process of enforcing EU *acquis* in its territory) and further downstream to end-users.

This has created, both under SEP-2003 and TEP-2009 (but has not diminished and/or nullified), new type of 'transit' risks for Russian (and/or any other) gas within the EU (or 'internal EU cross-border transportation' risks, I

call them 'liberalization risks'), i.e., within the sphere of contractual responsibility of Russian exporter for secure gas supplies to the DPs of Russian gas within the EU.

All transit risks are of multilateral nature (since they refer to 'third countries' in the gas value chains beyond seller/producer and buyer/consumer reach). So the way to deal with them most effectively was not by the means of multiplicity of corresponding bilateral instruments, but by the means of the multilateral international law instruments with the aim to create common rules of the game and the level playing field in the area of energy/gas transit.

But among the available instruments of international law, EU's *acquis communautaire* is not diminishing, but creating new (additional) transit risks within EU area, at least for external suppliers to the EU that shall, first, supply on the long-term basis due to necessity to diminish investment risks related to development of production and long-distance transportation infrastructure, and, secondly, which DPs have been placed deep within the EU territory.

4. GATT/WTO VS. ENERGY CHARTER (ECT AND DRAFT TRANSIT PROTOCOL) FRAMEWORK

Among multilateral instruments of international law dealing with transit, the correlation between Article V of GATT/WTO 'Freedom of Transit', Article 7 'Transit' of the ECT and draft Energy Charter Protocol on Transit are worth mentioning.

The concept of freedom of transit originated in the Barcelona Convention and Statute on Freedom of Transit (1921) and is embodied in Article V of GATT (1947), providing for transit via the most convenient routes with no distinction based on the place of origin, departure, entry, exit or destination, or relating to the ownership of goods or means of transport. Article V of GATT emphasizes comparative characteristics of transit compared to other means of transportation of goods to their final destinations and not on regulation of transit per se within/through the transit state.

Moreover, the GATT transit provisions were negotiated in the 1940s. Most goods traded then among Contracting Parties were transported by 'mobile' carriers such as vessels, trucks, trains, which presented mostly discrete transactions of single volumes of goods via the routes which can be changed rather flexibly. The processes of the continuous flows of traded goods through the fixed ('immobile') infrastructure such as pipelines and electricity grids, that

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rigidly bound together production and trade/transportation processes/facilities into one indissoluble technological chain, were much fewer. GATT Article V does not therefore address some pertinent issues linked to transit per se, especially through fixed (immobile) infrastructure, i.e., through oil and gas pipelines and electricity grids.

The ECT Contracting Parties felt however that additional disciplines were needed to clarify specific issues related to energy transit, especially through fixed infrastructure, in addition to the generic rules of GATT Article V. The ECT-1994/1998 applies by reference the rules of GATT-1947 (and WTO-1995 by the Trade Amendment-1998) to Energy Materials and Products (EMP) which include by definition those EMP that are being traded/transported/transited only through fixed infrastructure, like electricity, or through both mobile and fixed infrastructure, like oil, gas or coal. So ECT Article 7 'Transit' addresses explicitly energy transit by fixed infrastructure, as defined in this Article.

Most decisions on transit of EMP needing fixed infrastructure are long term since they are usually linked to the supply decisions with LTGEC. Spare capacity in fixed infrastructure is expensive and, therefore, usually of a temporary nature. In case of bottlenecks and congestion, existing capacity may be allocated through non-discriminatory congestion management mechanisms. Congestion can in principal be overcome by investment into additional capacity, but only taking into account the time necessary for planning, authorization and construction. As ECT Article 7 does not address in detail the implications of these issues and other aspects, there was a wish of ECT Member States to detail them in a special Transit Protocol.

Negotiations on the draft Energy Charter Protocol on Transit (TP) started in 2000 and in two years had resulted in considerable progress. At the Energy Charter Conference in December 2002, all 51 Member States agreed on a text of the draft Transit Protocol, however, subject to a solution of three issues which stayed open between the EU and the Russian Federation: two issues relating to transit per se and one broader (non-transit-specific) issue stemming from the specificities of the EU as a Regional Economic Integration Organisation (REIO). The points of substance that remained open concerned:

- (1) non-discriminatory use of available capacity and the rules of handling congestion implied in the discussion of cost-reflectiveness of transit tariffs if established at auctions;
- (2) the issue stemming from the longevity of transit decisions. Originally it was labelled as Right of First Refusal (which reflected one of the debated

- solutions, broadly used outside the EU, of the contractual mismatch issue, but not acceptable for the EU), later – as avoidance of contractual mismatch (which reflected the issue per se);
- (3) the EU-specific issue of application of the draft Transit Protocol inside the EU (in line with the EU concept, since SEP-2003, that there is no longer ‘transit’ within the emerging internal single EU market; since SEP-2003 till TEP-2009 this was considered by the Commission and presented by EU authorities to the outside world to be organized as a single homogenous market zone). The point was whether to apply definition of ‘transit’ to the crossing of the EU entire territory as REIO, as proposed by the EU in the draft Transit Protocol (Art. 20), and thus to narrow down definition of ‘transit’ as made in the ECT, or to apply definition of ‘transit’ both to the crossing of each single EU member country and/or of the EU as a single area, as defined in the ECT (Art. 7). This issue stems, inter alia, from the fact that each EU Member State has signed and ratified ECT in its double-capacity: as individual ECT Contracting Party and as a member-state of the EU which, in turn, is itself a separate Contracting Party of the ECT.

Further to this three open issues related to the draft Transit Protocol, Russian Federation has been continuously raising its concerns regarding different (from the EU interpretation) or unclear interpretation of some key transit-related provisions of the ECT regarding:

- (1) implementation of MTPA within the ECT area (despite clear and definite wording on this of ECT Understanding IV(1)(b)(i));
- (2) correlation between tariffs for transit, export, import and domestic transportation, whether they shall or shall not be equal (ECT Art. 7.3);
- (3) conciliatory procedure of transit-related dispute settlements, including establishment of interim tariffs by conciliator and definition of conciliator per se, i.e., whether it shall be a single person or can be a collective entity (ECT Art. 7.7);
- (4) role of long-term contracts which are fundamental for long-term transit solutions.

The above-mentioned demands of the Russian Federation to address its transit-related concerns regarding interpretation of the ECT Article 7 and other transit-related issues of the ECT were not included by the Energy Charter Conference into three open issues between Russia and the EU since they related to the ECT and not to the draft Transit Protocol, although it was proposed to solve these issues in the course of finalization of the Transit Protocol (the legal status of the Transit Protocol allows such a scenario) as a

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'package' which Russia always presented as an obligatory prerequisite for its further consideration on ECT ratification.

5. DIFFERENT PURPOSE OF RUSSIA AND THE EU ON PROSPECTIVE IMPLEMENTATION OF ENERGY CHARTER TRANSIT PROVISIONS (WHY THE BALANCED SOLUTION ON TRANSIT WAS NOT REACHED)

It seems that from the very beginning of the Energy Charter Process Russia and the EU have both had different visions and different purposes of prospective implementation of the Energy Charter transit instruments, both in regard to the ECT and its draft Transit Protocol. This finally prevented either of the two parties and the whole multilateral Charter community to reach balanced solutions on all open transit issues and/or their mutually acceptable interpretation.

Major disputed issues between Russia and the EU in this regard were reflections of this different purposed visions.

Russia aimed at minimizing existing (since early 1990s) transit risks with the help of Energy Charter transit-related instruments, both upstream and downstream of its DPs. First of all – to exclude the appearance of (and if not possible – to minimize the) contractual mismatch problem and thus to secure non-interruptible transit flows to the EU of Russian gas under LTGEC schemes.

The EU would like, first and most, to 'open' internal Russian GTS for transit of Central Asian gas to the EU via Russia (and through the whole former USSR/COMECON area), i.e., to obtain access to the existing Russian pipeline network as a shortest route for prospective supplies of cheap Central Asian (mostly Turkmen) gas to the EU. This will enable EU companies to obtain triple value, since:

- (1) production costs of Turkmen gas (produced in the South) are cheaper than of Russian gas (produced in the North/Arctic) due to natural factors;
- (2) the same with transportation costs to the EU (different length of transportation routes to the EU from the corresponding wellheads in Russian Nadym-Pur-Taz and Yamal areas in Northern Siberia and in Turkmenistan);
- (3) the EU delegation has been insisting on such interpretation of ECT Article 7.3 (referring to GATT/WTO Art. 5 and EU acquis and its

practical implementation in the EU) that as if tariffs for transit, export, import and domestic transportation shall be equal; the latter will enable EU companies to obtain access to Russian GTS with transit flows at discounted domestic tariffs introduced for the owner of the Russian GTS (Gazprom) under the Russian law 'On Gas Supply' (and it was only after ECS has undertaken a special study in which it was proven that in the EU itself domestic tariffs differs from transit ones, this point of Russia-EU disagreement was clarified on the basis of the Russian vision).

The external trade concept of Turkmenistan authorities has been always to sell its gas on its external border thus transferring delivery obligations to the final foreign destination (and thus the corresponding transit costs and risks) to the buyer. So the EU was aiming to receive access to the existing system of gas pipelines 'Central Asia – Centre [of the European part of Russia]', which were developed in Soviet times, and then further on through the Ukrainian transit corridor to the final destinations in the EU. This means: through the same pipelines and through existing DPs of the Russian gas in the EU, i.e., to create competition between Russian and Turkmen gas in the same pipelines, at the same DPs, at the same markets in the EU.

This would have been good for the EU, since it would diminish commodity price of delivered gas in result of competition between two key suppliers in the same pipeline system. And that would be a 'cheap' solution for the EU to enable competition between two major (existing and potential) gas suppliers to the EU: there would be no need to invest in alternative supply routes, but just to use 'positive discrimination' instruments by implementing MTPA in the existing Russian GTS to its owner and the incumbent supplier Gazprom based on pro-competitive, in line with the EU evolving internal legislation, interpretation of the Energy Charter multilateral instruments.

But this would not be good for Russia since it would provide access to its pipeline system on the discounted basis for its foreign competitor at the same EU market. On top of this, it would have created the problem of contractual mismatch in regard to Russian transit supplies to the EU.

This was an attempt of implementation by the EU of the 'multiple supplies/suppliers' concept within the same pipeline route (existing transportation capacities) using corresponding interpretation of the Energy Charter documents.

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Unfortunately, it was not possible (and, probably, would not be possible for the time being) to successfully finalize the draft Energy Charter Protocol on Transit, mostly because the party most interested in it – the Russian Federation – had first withdrawn from provisional application of the Treaty in August 2009, and then, in April 2018 (just on the eve of the tenth Anniversary of ECT entering into force), it precisely informed ECS Secretary General that it was recalling its signature under the ECT. Thus Russia has moved from the signatory to observer status in the Energy Charter process without an opportunity to take a decisive role in its further development. In 2015 Russia has not taken part in signing International Energy Charter.

The formal explanations for leaving ECT since 2009 were mostly transit-related, further to finally unsuccessful results of bilateral Russia-EU consultations on ECT transit-related issues, and to negative consideration of Russian authorities on effectiveness of ECT instruments (although Russia has not applied them in a formal way) during the January 2006 and January 2009 Russia-Ukraine gas transit crises. Although the *Yukos* case, per se, seemed also to play the role.

The Russian Federation has demonstrated that it lost its confidence in the ECT instruments and since then it has been mostly relying on the development of alternative pipeline solutions without (if/when/where possible) transit component on their routes thus developing diversification as a means for addressing transit problem under ‘multiple pipelines’ concept.

But it also seems that the EU, which has been mostly interested in implementing ECT transit rules (in a way how EU delegation had interpreted them according to dominant ‘export of EU *acquis*’ concept in international EU policy) within Russia and not within EU territory (as the REIO clause has shown), has also lost interest in the ECT, mostly due to the internal EU legal conflict between more-and-more liberalized rules of the internal EU energy market and the fixed ECT rules.

This means that two major historical players within the Energy Charter process – Russian Federation and the EU, – although for different reasons, have lost interest in this process without finding a mutually beneficial solution to the transit problem which is a key element in providing secure, stable and reliable supplies of Russian gas to the EU through the cross-border long-distant capital-intensive immobile infrastructure within the ‘Broader Energy Europe’. This means that the game is not over yet. ‘Show must go on!’