



www.gasandoil.com/ogel/

Issue : Vol. 2 - issue 1

Published : February 2004

Oil, Gas & Energy Law Intelligence

Energy Charter Protocol on Transit: On the way to Agreement - What Kind of Treatment will be Accorded to Russian Gas in EU Countries? by A. Konoplianiuk

About OGEL

OGEL (Oil, Gas & Energy Law Intelligence): Focussing on recent developments in the area of oil-gas-energy law, regulation, treaties, judicial and arbitral cases, voluntary guidelines, tax and contracting, including the oil-gas-energy geopolitics.

For full Terms & Conditions and subscription rates, please visit our website at www.gasandoil.com/ogel/.

Open to all to read and to contribute

Our aim is for OGEL to become the hub of a global professional and academic network. Therefore we invite all those with an interest in oil-gas-energy law and regulation to contribute. We are looking mainly for short comments on recent developments of broad interest. We would like where possible for such comments to be backed-up by provision of in-depth notes and articles (which we will be published in our 'knowledge bank') and primary legal and regulatory materials.

Please contact **Editor-in-Chief** Thomas Wälde at twwalde@aol.com if you would like to participate in this global network: we are ready to publish relevant and quality contributions with name, photo, and brief biographical description - but we will also accept anonymous ones where there is a good reason. We do not expect contributors to produce long academic articles (though we publish a select number of academic studies either as an advance version or an OGEL-focused republication), but rather concise comments from the author's professional 'workshop'.

Editor-in-Chief

Thomas W. Wälde

twwalde@aol.com

Professor & Jean-Monnet Chair
CEPMLP/Dundee and Principal
Thomas Wälde & Associates

© Copyright OGEL 2004

OGEL Cover v1.1

ENERGY CHARTER PROTOCOL ON TRANSIT: ON THE WAY TO AGREEMENT What Kind of Treatment Will Be Accorded to Russian Gas in EU Countries?

By Andrei Konoplyanik
*Deputy Secretary General
Energy Charter Secretariat*

The latest session of the Energy Charter Conference in December 2002 has marked a stride forward towards completing negotiations among 51 European and Asian nations, in their 3rd year now, to hammer out a legally binding Transit Protocol to the Energy Charter Treaty (ECT). All delegations to that round of the talks decided that the draft Transit Protocol had been agreed upon to an extent requiring no further negotiating – except for the following three related issues, namely: the right of first refusal; the clause on a Regional Economic Integration Organization (REIO); and transit tariff setting procedures.

Remaining snags

The purpose of the Transit Protocol is to provide a clear-cut set of multilateral international rules for the transit of energy resources and thereby to lower the level of political and financial risks associated, among others, with those oil and gas projects which require transit flows across Eurasia. This will, for its part, make trans-border energy supplies on the emergent Eurasian energy market more secure and stable, diminish the cost of raising capital (equity and debt financing), increase the investment appeal of projects for the production and transportation of energy resources, and make them into more competitive options for consumers. Therefore, the Transit Protocol, just as the other legally binding documents relevant to the Energy Charter, is geared to ensuring not only the security and reliability of energy supplies, but also the consistency of demand by means of economic leverage. In other words, it is designed to benefit not only those consuming, but also those producing and supplying, energy resources. The Transit Protocol will provide that minimum level of non-discrimination in the course of transit supplies, which has been recognized as such by ECT nations.

Among other things, the Transit Protocol defines the term “available capacity”, and includes provisions on methods to fix transit tariffs, on the grant of access for third parties to existing pipelines, and on the inadmissibility of any unauthorized “taking” of energy resources during their transit. Following the attainment of final agreement on the remaining issues, the legal fine-tuning of its provisions, and its translation into all official ECT languages, the Energy Charter Conference will complete the Transit Protocol approval.

Before this happens, consultations have been carried on regarding those issues on which some delegations as yet have reservations. Final agreement is still elusive on ways to implement the REIO clause, included in the document on EU initiative, whereby the provisions of the Transit Protocol will not extend to the movement of energy resources within the EU, which will be subject to the latter’s own laws. Conferring will also continue on the right of first refusal, wanted by Russia for transit energy suppliers, under which those of them having long-term supply contracts, as well as short-term agreements on transit through third countries that are about to expire, will enjoy the priority right to renew such agreements before the corresponding transit capacity is offered to other parties. The tentative consensus achieved on transit tariffs should be approved in the capitals of the respective countries.

Considering that the EU delegation keeps insisting on the REIO clause staying put in the Transit Protocol (a prospect which the Russian side has so far presented as an undesirable development) and that the Russian delegation, for its part, has persevered in its efforts for the Transit Protocol to provide for the right of first refusal (that is, in turn, opposed by the EU, especially the European Commission Competition Directorate), it stands to reason, as far as I am concerned, to speak of the

possibility of what in chess is known as an "exchange of positions", especially if it proves possible to find additional arguments for the Russian delegation regarding the REIO clause. This clause, which is sometimes also called the "EU integration amendment", remains – for Russia - the thorniest of the three issues still to be settled.

REIO clause: geographical and legal aspects

The integration processes under way in Europe have influenced on the EU negotiating positions, prompting modifications of an economic nature – following political changes, for example, on transit problems. After the first two years of the negotiations, for instance, the EU proposed an article setting out an "integration amendment", which boiled down to requiring that for the purposes of transit, the territories of EU countries should be seen as together constituting an integral space, meaning that "transit" during supplies, say, from Russia to France should end on the outer boundary of the (expanding) European Community, i.e. presently on the Eastern border of Germany and later on the Eastern border of Poland (the "geographical aspect" of the problem is graphically illustrated by Figure 1, "EU Integration Amendment: Geographical Aspects").

According to the EU's explanations and interpretation of its "integration amendment", the EU treatment of domestic operations to transport energy materials and products will be at least as favorable as, if not more advantageous than, that required under the Transit Protocol. This will be ensured by the internal legislation of the EU, which is based on the principles of non-discrimination and the free movement of goods within the Community, as well as by the legally binding obligations formalized by the WTO and ECT. In accordance with a judgment passed by the EU High Court in Luxembourg in 1983, the treatment of freight movement across EU territory may not worsen with time.

The Energy Charter Secretariat, which also performed a legal review of the REIO clause, concluded that the triple-tier legal system, comprising EU laws, WTO disciplines, and the ECT, will ensure that energy materials and products originating from one Contracting Country should enjoy treatment at least as favorable as that accorded to similar products from the EU (see Figure 2: "EU Integration Amendment: Legal Aspects"). The EU confirmed that it goes along with the Secretariat's conclusions. Furthermore, the Russian delegation also expressed its agreement with such views in the course of debates at the March 2002 round of Transit Protocol negotiations.

However, it has since continued to insist (for example, in its papers distributed in time for the June and October 2002 negotiating sessions) that "notwithstanding EU declarations on energy imports being treated at least as favorably as domestic energy materials and products and on existing and future EU legislation being consistent with the principles of non-discrimination and open, competitive markets,... Russia views the inclusion of the REIO clause in the Transit Protocol to be undesirable". In the Russian side's opinion, the REIO clause "effectively excuses the EU of its obligations under the Transit Protocol,... and agreeing to it would compel Russia to subordinate itself to existing EU legislation, as well as future EU legislation, as amended, of course, without Russia's participation, throughout the expanding territory of the Community, irrespective of whether this is to Russia's advantage or disadvantage" (June 2002). In its comments prepared for the October round of the negotiations, the Russian delegation noted that "even today, EU legislative acts contain provisions which we see as unacceptable. These include, but are not limited to, the denial of a right of first refusal during the allocation of transit capacity and the establishment of transit tariffs by means of a mechanism for the distribution of resources in short supply, in other words, through auctions".

Considering that the parties have in principle agreed on transit tariffs, it would be safe to assume that should the EU accept the Russian side's persistent request that the Transit Protocol retain the provision on the right of first refusal, Moscow's objections to the REIO clause would effectively be for the most part removed.

In its arguments against the "EU integration amendment" being included in the Transit Protocol, the Russian delegation stresses, as a rule, the geographical aspects of the problem, reasoning that the

REIO clause ostensibly leaves 95% of Russian transit outside the frameworks of the Transit Protocol. Such claims, in my opinion, are not quite correct, the more so as the most daunting problems faced by Russia in connection with transit operations are encountered en route to rather than on the EU markets.

Under the REIO clause, no EU country signing the ECT as a REIO member treats supplies across any other EU country as transit, with transit only constituted by the movement of energy resources through the entire REIO territory. Within ECT frameworks, the EU is the only REIO. Therefore, only the movement of energy materials and products across the entire EU is regarded as transit. The Russian delegation routinely responds with the following example: should the REIO clause be included, the only case of transit through EU territory will be Russian gas supplies to Switzerland (which today account for 0.4% of total Russian gas exports). Those supplies which will end within the EU will not be considered transit, even if crossing one or more countries grouped in the REIO, i.e. the EU. If Russia supplies gas, say, to the Pyrenees, transit will be constituted by supplies from the Russian border to the outer boundary of the EU. With the EU being in the process of expansion (see Figure 1) and getting ever closer to the Russian frontiers, the Russian negotiators argue, the result is that there is effectively no transit on EU territory and, hence, no need for the Transit Protocol.

I do not agree that Moscow does not need the Transit Protocol, considering that, firstly, Russia experiences recurrent export problems with Ukraine and Belarus all the time. Secondly, the number of ECT signatories currently growing primarily with the accession of Asian nations. The ECT membership thus expanding to the south and south-east in a reflection of natural development of energy markets in general and the Eurasian market in particular. So new problems with new transit operations are simply bound to occur there. Therefore, the Transit Protocol retains its significance, although geographically, transit within an individual group of countries, as represented by the EU, is ceasing to exist as a legal notion, having been absorbed by the more general "free movement of goods".

The issue of possible additional transaction costs resulting from the change-over from "transit" (as regulated by the Transit Protocol) to "internal transportation" (as unilaterally regulated by EU countries), which was raised by the Russian delegation at the June 2002 round of the talks (but has never been suggested for further discussion at subsequent negotiations), is, I believe, more important than the geographical aspects of the "EU integration amendment", which are regularly pointed out as an example and are more obvious. As a result, in the opinion of the Russian delegation, the approval of the REIO clause will entail extra export risks owing to transition from a sphere governed by civil law to that subject to public law (similar to switch-overs from concessions or production-sharing agreements to licenses in the mineral extraction industry), and spell high export transaction costs.

It is not necessarily that transaction costs will increase should the REIO clause be approved. However, all Contracting Countries should satisfy themselves that this is indeed so (or not). Furthermore, negotiators during the October 2002 session of the Transit Working Group voiced a number of considerations which, I believe, make it possible for Russia to expect a number of positive effects from the approval of the "EU integration amendment".

EU integration amendment: any pluses for Russia?

The possible advantage of the REIO clause for Moscow, as far as I can see, may be due to Russia not being obliged under Article 7(3) of the ECT, "Transit", to treat gas transiting through its territory on a par with that in domestic transportation, as unlike the EU, these operations are not legislatively subject to the same treatment. This means, on the one hand, that one of Gazprom's objections to the ratification of the ECT (namely: that the ECT amounts to an obligation to agree to the transit of Central Asian gas across Russian territory at the low/subsidized domestic transportation rates) is irrelevant. This also means, on the other hand and perhaps more importantly, that Article 7(3) of the ECT will be applicable in EU countries – both following the approval of the

REIO clause and/or without it – to all types of transportation on EU territory, as EU laws use the term "free movement of goods". At the same time, so as to determine that transit deliveries are not subject to discrimination, the self-same Article 7(3) of the ECT in non-EU countries will apply to the "transit-import/export" combination, while being inapplicable to the "transit-internal transportation" combination (see Figure 3, "Is There a Benefit for Russia From the REIO Clause?"). In other words, the purposes of the Transit Protocol, in those countries which are outside the EU the notion "internal transportation" is divided by a kind of "Chinese Wall" (double red dashed line on the Figure 3) from the notions "import", "export" and "transit".

How can the REIO clause benefit Russia in these conditions? It will help in that Russian transit gas supplies across EU territory will be subject to treatment at least as favorable as the best of the three arrangements known – according to Russian terminology – as transit, import/export, and internal transportation, as all of them pursuant to EU laws are treated as "free movement of goods". The "model" (benchmark) regime for transit will be the best of that applying to all types of transportation on the expanding territory of the EU. In contrast, transit deliveries of any foreign gas across Russian territory will not be subject to a similar requirement, as such transit supplies should be accorded such treatment as may not be worse than that offered for Russian imports or exports (see Figure 4, "REIO Clause: Transit and Transportation (EU/non-EU)"). This follows from a key provision of the 1958 Treaty of Rome establishing the EU, that on the free movement of goods on the territories of EU countries, whereby a sole/uniform regime is applicable to all types of transportation of energy materials and products within the EU, including:

- those originating from/heading for destinations outside the EU (exports);
- originating outside/heading for destinations within the EU (imports);
- originating and heading for destinations within the EU (internal transportation); and
- originating and heading for destinations within different EU countries (transit – prior to the implementation of the REIO clause).

At the same time, outside the EU (for example, in Russia), "transit", "internal transportation", "exports", and "imports" are operations which are not at all equivalent and do not all fall under "the free movement of goods" category, as each is subject to its own regulation (see Figure 4).

Therefore, the zone of non-discrimination against Russian gas on EU territory will be much larger than that of non-discrimination against any foreign gas on Russian territory. This is especially important considering that transit supplies through Russia should become, commercially, ever more significant for Gazprom and other (future) owners of gas transport systems, turning into an important independent line of gas business.

Figure 1. EU Integration Amendment: Geographical Aspects

Explanations:

(lines) – principal gas transportation routes

(blue) - 15 EU member countries

(pick) - 10 hopeful EU member countries

(red) - 5 potential candidates to join the EU

(green) – ECT participants which are neither existing or candidate members of the EU

(brown) – observer nations in the EC process

(yellow) – other countries

(Figure 2: EU Integration Amendment: Legal Aspects

(Figure 3: Is There a Benefit for Russia From the REIO Clause?

(Figure 4: REIO Clause: Transit and Transportation (EU/non-EU)