

# **Russian Gas to Europe: From Long-Term Contracts, On-Border Trade and Destination Clauses to . . . ?**

By A Konoplyanik\*

*In the coming decades Europe will remain strongly dependent on external energy supplies, and particularly on gas supplies from Russia. The author analyses the economic and political background of current contractual structures of Russian gas supplies to the EU in its historic context. He argues the objective character of these structures which consists of four major elements: long-term 'take-and/or-pay' contracts (LTCs); on-border (EU-15) trade; destination clauses; and the major role of transit. New contractual structures, which are influenced first of all by developments in the internal EU gas market, need to reflect the balance of interests of exporters, importers of gas and of transition states. The author analyses the still-important role of LTCs, both in external Russia-EU gas trade and in internal EU gas trade. He analyses the effect of the recent*

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*cancellation of destination clauses in Russian Gazprom's LTCs with ENI (Italy) and OMV (Austria). He explains the economic consequences of EU enlargement on Russia-EU 'on-border' gas trade and on gas transit in particular. The author analyses the role of the Energy Charter draft Transit Protocol in minimising transit risks; outlining three outstanding issues between Russia and the EU, which are to be settled by the two contracting parties to successfully finalise multilateral Transit Protocol negotiations.*

As is well known, Europe will remain strongly dependent on external energy and, in particular, gas supplies for at least a few decades. According to official EU Commission estimates, the proportion of imports in energy and gas supplies to the Union will reach around 70 per cent in the period 2020-2030. The most recent EU document in relation to this issue is the new Directive on Gas Supply Security of April 2004.<sup>1</sup> This only gives reference to the Green Paper of 2000 on security of energy supply, which is the most relevant EU document in this regard (other more recent EU documents also only give reference to it), which says:

'As long-term growth begins to revive, the overall energy dependence of the EU is likely to rise once again, reaching 70 per cent within 20 to 30 years. . . . dependence could reach . . . for gas 70 per cent . . . Enlargement will only serve to reinforce this trend. Natural gas imports to the applicant countries may rise from 60-90 per cent of demand. . . . At present, the EU is moderately dependent on imported natural gas, which supplies 40 per cent of consumption. To try and offset the likely increase in this dependence (to 70 per cent) over the next 20 to 30 years, the Union has several options . . . .'<sup>2</sup>

A later Communication from the Commission to the European Parliament and the Council of 2002 provides the same figures – 70 per cent for the Union's external energy dependence in gas by 2020.<sup>3</sup> The International Energy Agency (IEA) in its most recent forecast (World Energy Investment Outlook 2003) presented similar figures to the EU official estimates.<sup>4</sup>

Among the major external suppliers Russia has been and will remain the major one. 'In geopolitical terms, [as stated in the Green Paper] 40 per cent

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1 Council Directive 2004/67/EC of 26 April 2004 concerning measures to safeguard security of natural gas supply.

2 Green Paper, 'Towards a European strategy for the security of energy supply', 29 November 2000 (COM (2000) 769 final).

3 Communication from the Commission to the European Parliament and the Council (COM (2002) 488 final) dated 11 September 2002 – 'The internal market in energy: Coordinated measures on the security of energy supply'.

4 IEA World Energy Investment Outlook 2003 (IEA/OECD, Paris, 2003).

of natural gas [imports come] from Russia. The European Union does not yet have all the means to change the international market.<sup>5</sup> According to recent Centre for European Policy Studies (CEPS) estimates, Russia will provide around 250 BCM, which will be equal to about half of Europe's demand for imported gas (525 BCM), in 2020. Of that 525 BCM required for import to Europe in 2020, 400 BCM are not yet contracted, including a bulk of prospective Russian supplies.<sup>6</sup> The new contractual terms for this as yet uncontracted supply are crucial both for exporters and importers.

Russia/USSR has been a reliable trade partner throughout the historical period of Russia/USSR-EU trade relations. As stated in the EU Green Paper of 2000, 'It should be noted, moreover, that despite various difficulties the USSR and subsequently Russia always fulfilled its supply obligations under its long-term contracts with the European Union'.<sup>7</sup> But, according to general development trends in the world/international energy markets and owing to further liberalisation trends within the internal EU energy markets, the contractual structures of the energy and gas markets are not fixed once and for all – they have been evolving as well.

What will be the contractual conditions of the new Russian supplies to Europe? Will they be the same as existing ones? The answer is: most probably not. The reason is that the current contractual structure of Russian gas supplies to Europe reflects the realities of the political picture and dominant market development trends of the recent past, when this contractual structure was established. Taking into consideration the objective development trends in energy markets, including gas markets (in particular, an increasing typology of contracts and diminishing duration of contracts within the time frame<sup>8</sup>), and political changes in the countries where these supplies have originated from and are destined to go (ie within the post-USSR and European spaces), it can be concluded that corresponding contractual changes are inevitable. But they need to be adequate to the changes in market structures and to

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5 Green Paper, 'Towards a European strategy for the security of energy supply', 29 November 2000 (COM (2000) 769 final).

6 P Cayrade, 'Investments in Gas Pipelines and LNG Infrastructure. What is the Impact on the Security of Supplies?' CEPS. INDES Working Papers, No 3, March 2004.

7 Green Paper, 'Towards a European strategy for the security of energy supply', 29 November 2000 (COM (2000) 769 final).

8 A Konoplyanik, 'Energy Security and the Development of International Energy Markets' in *Energy Security: Managing Risk in a Dynamic Legal and Regulatory Environment* (B Barton, C Redgwell, A Ronne, D N Zillman, eds, International Bar Association/Oxford University Press, 2004), pp 47-84; A Konoplyanik, 'Time rules the move from monopoly to competition' (2002) 4(3) *Oil & Capital* 40; and a number of other writings in Russian on this and related issues, available at [www.enippf.ru](http://www.enippf.ru).

reflect the balance of interests of both producers (exporters) and consumers (importers) as well as transit states. If such changes generate incremental risks within one or another segment in the gas value chain, those risks need to be adequately addressed and redistributed between all the players involved.

One of the strongly debated current issues relating to the contractual structure of Russian gas supplies to Europe is the problem of the so-called 'destination clauses' (territorial sales restrictions). These provisions are an integral part of the existing Russian export gas supply contracts to Europe and face strong opposition from the EU Commission as being in contradiction to its competition laws. For some time, the Commission has been aimed at a forced removal of 'destination clauses' from all existing gas import contracts with Russia, Algeria and Norway.

The Commission (Directorate-General on Competition – DG COMP) opened the files on the 'destination clauses' issue in 2001 in relation to Russian gas supplies to Italy, Austria and Germany. After some strong and lengthy debates on this issue, corresponding changes have been incorporated into Russian/Gazprom's contracts relating to gas supplies to Italy (with ENI, 2003) and Austria (with OMV, 2004). Similar negotiations are still under way with Germany (with EON/Ruhrgas). Whether the problem of 'destination clauses' is considered to be solved and the 'model' precedent established is hard to say. This author's answer is: 'not yet'. The problem is deeper than it seemed to be at first glance and does not relate only to the problem of 'destination clauses' as such since the latter, owing to objective reasons, reflect only an integral part of the broader package.

This article will examine the problem of 'destination clauses' in more detail, looking at three groups of issues relating to Russian gas supplies to Europe:

- (1) How they have been organised and why.
- (2) Whether and how they are being reorganised and why.
- (3) Whether current changes reflect the balance of interests for the exporter-importer (producer-consumer).

That will provide the opportunity to understand clearly the economic background of the current contractual structures of Russian gas supplies to Europe in order to:

- (1) find a balanced solution in their updating adequate to and in correlation with objective changes in the (broader European) gas market developments; and thus
- (2) provide secure and effective gas supplies to Europe as it enlarges within as yet uncontracted import demand quantities.

## **Major elements of Russian gas exports to Europe**

The organisation of Russian gas exports to Europe can be described by the presence of four key features united in one package:

- (1) long-term 'take and/or pay' contracts (LTCs TOP);
- (2) on-border (on the external border of the EU 15) sales;
- (3) 'destination clauses' (territorial sales restrictions);
- (4) key role of transit (both in physical and contractual terms).

This system reflects the historical balance of interests in the organisation of gas trading between exporters (USSR/Russia) and importers (Europe/EU).

'Destination clauses' are only one integral element in this package and thus are subject to the so-called 'matrix effect' known from elementary mathematics: when one element in the matrix is changed, that leads to corresponding changes of the sums in the respective rows and columns, and of the sum total of the whole matrix, which in turn results in establishing a new balance within the new matrix. So the change of only one element leads to a change in the whole picture. And that is why only complex changes to the whole package will result in the establishing of a new balance of interests.

### **Long-term contracts**

#### ***Russian LTCs to Europe***

The current organisation of Russia's gas supplies to Europe is the result of investment decisions taken some decades ago. The export-oriented infrastructure for Russia's gas supplies to Europe was created mostly during the USSR period. The famous 'gas to pipes' deal of the 1970s – a set of investment projects according to which supplies of pipes and compressor stations (including computer facilities) from the European contractors, mostly from Germany, Italy and France (the then US Presidents Carter and Reagan established an embargo on corresponding US supplies to the USSR), for the newly built export pipeline to Western Europe – was to be compensated by supplies of Soviet gas to those countries. The contractual structure of those deals was based on long-term 'take and/or pay' contracts, which were needed to guarantee the long-term flow of revenues to pay back the cost of credits and supplies received for the development of the project.

As is well known, the long-term 'take and/or pay' contract is a financial tool required by the financial community (banks and other financial institutions). They serve a buyer's geographical market area on an exclusive (monopoly) basis. Seller(s) assume reservoir and delivery risk, while buyers

assume market risk. Since the 1970s, owing to objective reasons reflecting natural developments in both international energy and financial markets, there has been a clear shift from 'equity financing' to 'debt financing' as a dominant means of raising finance for the development of new oil and gas projects. Since that time, more and more oil and gas investment projects have been developed under 'project financing' instruments, especially in upstream markets.<sup>9</sup> The volume and value (cost) of financing is dependent on future revenues and risks relating to those revenue flows. Revenue flow is a function (product) of the volume of supplies multiplied by the price of the commodity and thus is dependent on 'volume' and 'price' risks. On the one hand, the LTC TOP is an effective mechanism of supply risk ('volume risk') reduction since it guarantees the volume of commodity to be supplied during the contractual period. On the other hand, the LTC TOP along with adequate pricing mechanisms incorporated into such contracts present an effective mechanism of 'price risk' reduction.

In the first half of the 20th century (up to the 1950s-60s), ie at the early stages of development of energy markets, the LTCs TOP were an integral trade part of the concessions and production-sharing agreements (PSA) that were the dominant financial/investment instrument for the development of upstream projects in oil and gas. That was the period of the absolute dominance of long-term contracts. Prices in these contracts at that time were usually fixed for the whole duration of the contract, since that was a period (especially in its end) of relatively stable oil prices and fixed exchange rates (ie prior to the establishing of the floating US dollar exchange rate).

Since the late 1970s/early 1980s (and prior to the 'exchange (spot/futures) pricing', which has not yet reached most countries, except the United States and the United Kingdom) prices in the gas LTCs TOP were no longer established directly. In contemporary long-term contracts, the gas price is a 'formula price' and is based on the so-called 'escalation' formulas, which tie down the gas price to the prices of other primary energy resources competing with gas on a given market in a given end-use sector.

For example, if Russian gas is supplied to German power plants, then its price may be tied down to the prices for coal and residual fuel oil (RFO) on the German market. Most frequently, gas prices are tied down to exchange (spot/futures) quotations for RFO and crude oil, which hinge on global expectations of the world oil market players. At the stage of 'exchange pricing' of the energy markets development, the pricing mechanism of LTCs TOP

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<sup>9</sup> Hossein Razavi, *Financing Energy Projects in Emerging Economies* (PennWell Publishing Company, Tulsa, Oklahoma, 1996); A Konoplyanik, 'Financing Russian Oil and Gas Sector: The Effects of International Law Instruments' (2003) 4(6) *Journal of World Investment* 941.

will be decoupled from 'escalation formulas' and will be based on a combination of spot/futures/options with hedging instruments. But the long-term contracts as such would continue their existence – until the risks related to being a party to them do not exceed the risks related to being a party to a shorter-term contract. The combination in one tool of the mechanisms of reduction of both 'volume' and 'price' risks makes the LTCs TOP an effective financial instrument for new upstream (production and transport) projects developments. It is a popular method of risk reduction for project financing in long-term capital-intensive greenfield upstream projects, especially in new regions with no (or a lack of) production and transport infrastructure. This mechanism was used to finance the 'Southern' (through Ukraine, in the 1970s) and the 'Northern' (through Belarus, in the 1980s) major routes of Soviet/Russian gas supplies to Europe. Recently, a major part of a Russian LTCs TOP to Europe was prolonged owing to its upcoming expiry, and new LTCs TOP were signed.

### *LTCs within the EU market*

Long-term contracts are not only a major characteristic of Russian gas supplies to Europe. The European gas market itself has been developing based on long-term take-or/and-pay gas supply contracts and nowadays the LTCs TOP is the core element of domestic European gas supplies as well. LTCs supply more than 90 per cent of Continental European countries' gas imports and will continue to be an integral part of the EU gas market contractual structure in the foreseeable future (see Table 1).

The European Commission has argued strongly and for a long time against long-term contracts as preventing competition, and has even established in its first Gas Directive restrictions on suppliers with LTCs TOP by allowing refusal of access to the network for them.

'As competition increases with the progressive development of the internal market for gas, prices are expected to fall. This could give rise to serious financial difficulties for gas companies having entered into take-or-pay obligations at higher prices. The gas directive does, however, provide specific safeguard mechanisms if such a situation should arise. In case of serious economic difficulties related to take-or-pay obligations, access to network may, as a last resort, temporarily be refused thereby protecting the market of a supplier.'<sup>10</sup>

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10 European Commission, *Opening up to choice – Launching the single European gas market* (Luxembourg; Office for Official Publications of the European Commission, 2000), p 17.

	Italy	France	Germany	Spain	Belgium	Greece
Total supplies in 2002 (BCM)	72.5	44.2	94	23	17.5	2.1
Share of imports in total supply (%)	80	96	82	99.5	100	100
Share of LTC in total supply (%)	N/A	94	N/A	44	91	100
Average residual duration of contracts (years)	14	15	11	N/A	N/A	13

Source: ECS calculations

Fortunately, the Commission has finally agreed that the LTCs TOP plays an important role in gas supplies – though with not yet fully defined observations. Item 25 of the 2003 Gas Directive states: ‘Long-term contracts will continue to be an important part of the gas supply of Member States and should be maintained as an option for gas supply undertakings in so far as they do not undermine the objectives of this Directive and are compatible with the Treaty [of Rome, 1958, establishing the EU], including competition rules.’<sup>11</sup>

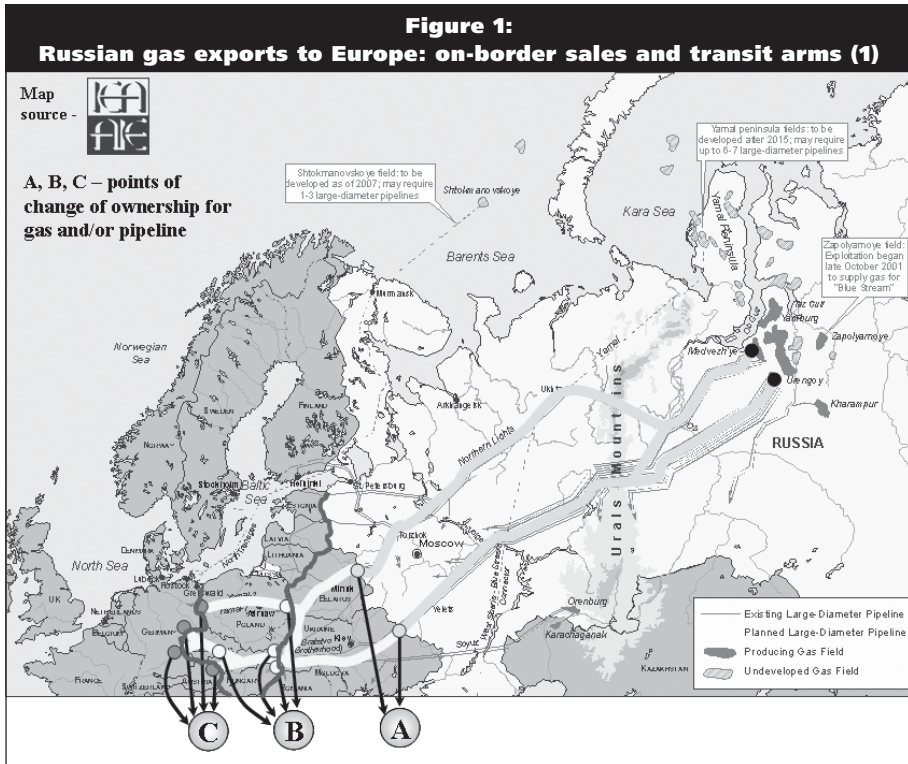
### On-border trade

Two major routes of export pipelines from Western Siberia to Europe are the Southern, through Ukraine and further through Slovakia and the Czech Republic, and the Northern, through Belarus and further through Poland. Russian gas is exported to the European Union under long-term contracts that provide for delivery points at a few locations on the EU 15 external border (on the Eastern borders of the European Union prior to its enlargement on 1 May 2004), eg in Baumgarten on the Slovak-Austrian border or in Waidhaus on the Czech-German border, etc (points labelled ‘C’ at Figure 1).

Such a contractual structure has a clear economic explanation under given historical circumstances. The USSR signed its long-term contracts with European companies during the Cold War, when two political systems had been separating Europe into the NATO zone in the West, and the COMECON zone in the East. Under these circumstances, the USSR could have guaranteed security of its supplies to Europe (in order adequately to face delivery risk) only within the territories under its direct and/or indirect control, ie

<sup>11</sup> Directive 2003/55/EC of the European Parliament and of the Council (26 June 2003) concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC.





throughout the journey of gas from Western Siberia to the external border of Western Europe. And the European companies could have provided control over Soviet gas supplies within the territories of the Western European states only. That is why when Soviet gas was supplied to France, delivery points (where title of ownership on gas supplied was changed from a Soviet to a foreign entity and until which point the delivery risk is taken by supplier) were established at the Czech-German border, to Italy at the Slovak-Austrian border, and so on. So the USSR/Russia (in the face of its economic agent, which, during the USSR period was the Ministry of Gas Industry of the USSR and the Foreign Trade Association 'Soyuzgasexport', and, since the USSR collapsed, has been the Russian quasi-state company Gazprom and its external trade arm 'Gazexport') has taken responsibility for gas supplies within the route from Western Siberia and up to the delivery points at the EU 15 border, and Western companies have taken responsibility from those delivery points up to the consumers of that gas.

In the 1990s, the political situation in Europe changed – both the USSR and COMECON collapsed and new independent states appeared on the political map of Europe. But the delivery points of the now Russian gas to Europe have been the same since they were an integral part of the LTCs

TOP that were signed earlier, before the collapse of Soviet Union. They are still in place and will stay in place until their new expiry dates in the years to come. That means that after EU enlargement took place on 1 May 2004, the main delivery points of Russian gas to Europe have automatically ‘moved’ inside the EU area. A new dimension of Russian gas supplies to Europe has appeared that was not in place before this date: there were no Russian gas supplies (in *legal* terms) within the EU 15, but within the EU 25 there are – crossing the territories of some new EU accession states. At the points labelled ‘B’ in Figure 1, only the title of ownership of the pipelines has changed (transferred from the companies of the corresponding CIS states to the companies of the corresponding new EU Member States), but the title of ownership for the Russian gas being shipped through these pipes still remains with Gazprom, while at the points ‘C’ both the title of ownership for the pipelines and for gas inside these pipelines has been transferred to European companies.

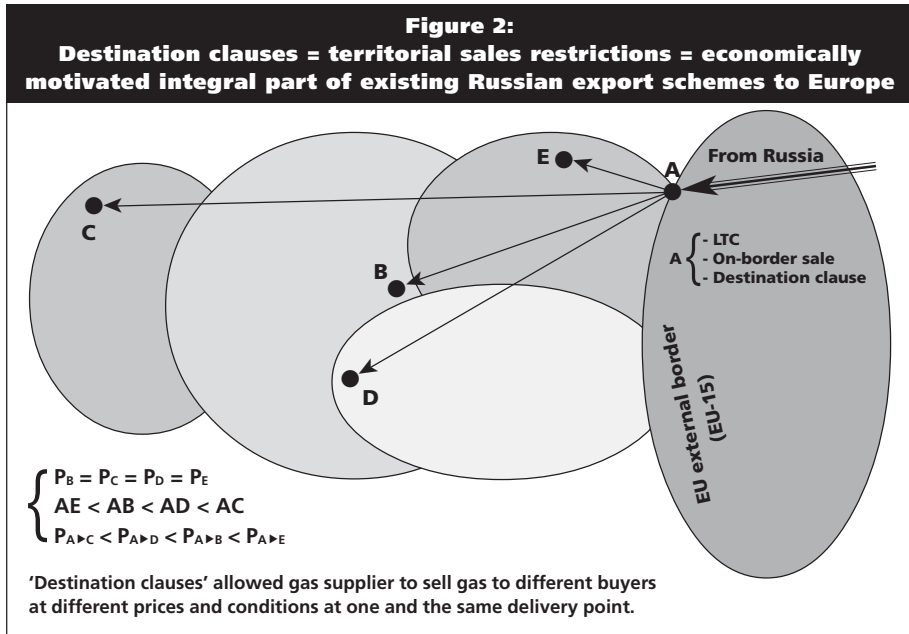
EU enlargement has established a new reality in the Russian gas trade with Europe – since 1 May 2004, Russian gas (in legal terms) has been trading within the EU territory. That has led to a new issue between Russia and the European Union, which needs to be clarified: has this new reality generated new risks within existing gas supplies for any contracting parties? Which particular type of risks (if any) has it created? What is their origin? For whom precisely have they appeared? How is it possible to secure, prevent or spread these risks among the participants?

The article will address this issue in more detail in its final part.

### **Destination clauses**

‘Destination clauses’ (or territorial sales restrictions) are an economically motivated integral part of existing Russian export schemes to Europe. ‘Destination clauses’ allowed a gas supplier to sell gas to different buyers at different prices and conditions at one and the same delivery point. ‘Destination clauses’ restrict onward sales and limit use of gas sales only to contractually specified geographical market areas and thus prevented gas-to-gas competition including, first of all, for gas supplies originating from the same source.

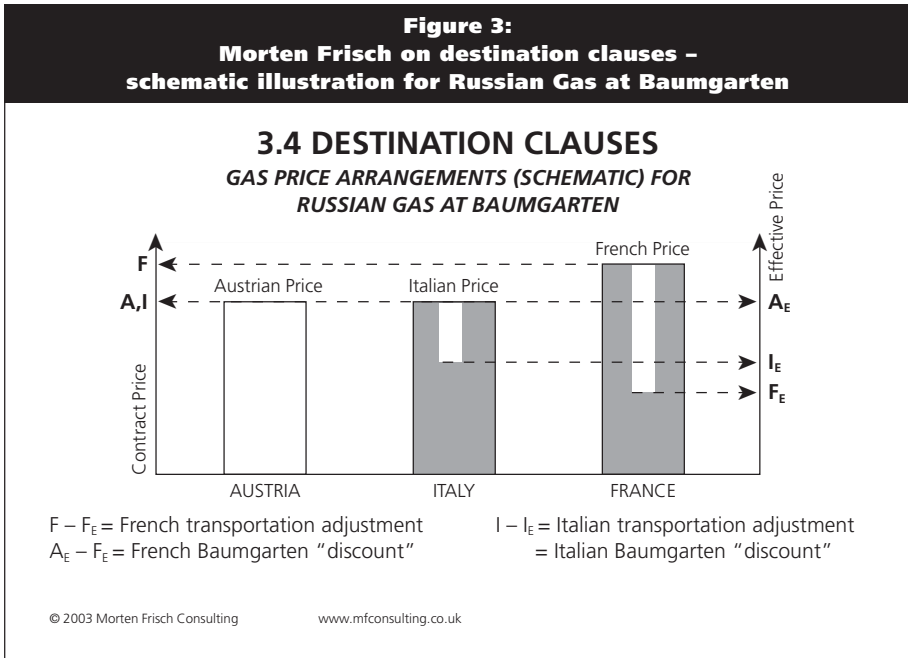
An illustrative economic background of ‘destination clauses’ is shown in Figure 2. ‘Destination clauses’ have been an instrument used to reduce market risk under supplies based on LTC TOP with fixed delivery points on the external border of the area while the physical supplies are shipped further within this area. ‘Effective’ export prices at delivery point ‘A’ for supplies to markets B, C, D and E are calculated at a net-back formula (price at the



consumer market less cost of transport from delivery point 'A' to the particular market). Generally, the longer the distance from the delivery point to the particular market, the lower the 'effective' price of gas at this point for the supplies to this specific market. 'Destination clauses' prohibit reselling by the importer of the gas at a cheaper effective price, ie destined for a market which is more distant from the delivery point, at the closest to the delivery point market for which the supplies' effective price is the highest at this delivery point.

Let's take a specific example. Baumgarten is the delivery point for Russian gas supplies to Austria, Italy and France – three countries located at different transport distances from this delivery point and having different energy price levels and energy pricing environments within their domestic markets. As shown in Figure 3, taken from a presentation by Morten Frisch at the 'Eurasian Natural gas: Opportunities and Risks' Conference organised by the Energy Charter Secretariat in November 2003,<sup>12</sup> the price at the French market (F) is higher than in Austria (A), which in turn is higher than in Italy (I). Owing to the different distances of these markets from the delivery point, the effective price at this point for deliveries to Austria (Ae) is higher than to Italy (Ie), which in turn is higher than to France (Fe).

12 M Frisch, 'The forced removal of destination clauses: European gas security of supplies implications', presentation at 'Eurasian Natural gas: Opportunities and Risks' Conference, organised by the Energy Charter Secretariat on 12-13 November 2003, Brussels.



‘Destination clauses’ prevent buyers of Russian gas for deliveries, say, to France from reselling it in/to Austria (perhaps even at the same point – in Baumgarten) or in/to Italy and thus from receiving a windfall profit (or undue benefit) caused by the presence of the different prices from one supplier to different destinations in one and the same geographical location. The absence of ‘destination clauses’ within supplies with fixed contractual volume obligations will establish gas-to-gas competition in this delivery point between contractual arrangements from the very same supplier.

When there is enough transmission capacity within a given transport system and enough opportunities to change destinations of supplies within this system – gas-to-gas competition will lead to diminishing of prices in the consumer market, when there is not enough capacity – it may lead to chaos or to discrimination of some players/participants in the gas value chain. Let’s look at a theoretical example – the absence of ‘destination clauses’ in Baumgarten for Russian LTC TOP gas supplies to the three above-mentioned EU states. Buyers of Russian gas in this case, while having choice, would first try to sell as much gas as possible at the nearest delivery point to the Austrian market where the effective selling prices for Russian gas among the three destinations are the highest and thus the ‘price rent’ of reselling it would be the highest as well. That would lead to a redistribution of gas flows between the three countries and create an over-supply of gas in Austria (and will move prices in the Austrian market down) and an under-supply of gas in

France and Italy (and will move prices at those two markets up). That would in turn change the gas price correlations in the three markets in question and would stimulate the reverse redistribution of gas flows from Austrian market to Italian and French ones. But would there be enough pipelines with adequate capacities for quick changes of gas flows in Europe between the different countries in the opposite directions (in this case between the three above-mentioned states)? Would an effective TPA exist within the EU market that would enable such fluctuations in the directions and volumes of the gas flows? Since these fluctuations would be rather short term, would an effective mechanism of short-term trade in gas (including effective congestion management) be in place in Continental Europe? The author's answer is rather negative (see below) – at least for the moment.

That is why it is impossible in principle to cancel all the 'destination clauses' in all the long-term contracts just for technical and logistical reasons – that might stimulate a number of blackouts in gas similar to those that Europe has experienced recently in electricity (eg in the United Kingdom, Italy and Switzerland). That is why, in this author's view, the European Commission has been trying to deal with 'destination clauses' on a case-by-case basis.

In 2003-2004, under the strong influence of the Commission, significant changes were incorporated into two major Russian gas contracts for supplies to EU states relating to destination clauses: with Italian ENI (2003) and with Austrian OMV (2004). Let's analyse them, bearing in mind the explanations above.

#### *2004 OMV-Gazprom deal*

Russian gas supplies to Austria are equal to 5.5 BCM/year, which amounts to two-thirds of its domestic demand. Supplies are based on LTCs TOP with a delivery point at Baumgarten. Destination clauses were included, anticipating a restriction to use the gas in Austria only.

In May 2004, OMV and Gazexport agreed to roll over existing gas supply contracts to 2012 and up to 6.5 BCM/year. The pricing formula was changed: the current price reference benchmark has now switched from the official German Wiesbaden index to Rotterdam oil product prices (which reflects the switch from local market energy price fluctuations to global oil market price behaviour, ie it reflects the further internationalisation of contractual gas structures). Contracts have been adjusted to the 'conditions of the liberalised gas market', ie 'destinations clauses' are scrapped – as preventing free competition – and OMV is no longer restricted to using gas in Austria.

Taking into account the explanations shown in Figure 3, we can conclude that the 2004 OMV-Gazprom deal on 'destination clauses' – taken as a separate

case – has no immediate negative consequence for Gazprom since its ‘effective’ gas price in Baumgarten for deliveries to Austria is the highest compared to deliveries to France and Italy. So any reselling to other neighbour markets of Russian gas supplies originally destined for Austria will not generate – in the given circumstances – any windfall profit (or undue benefit) for the buyers of Russian gas at the expense of its producer/exporter. That is to say, the market risk will stay with the buyer/importer of Russian gas.

### *2003 ENI-Gazprom deal*

Russian gas supplies to Italy are equal to 16.9 BCM/year, which amounts to one-quarter of domestic demand. Supplies are based on LTCs TOP with a delivery point at Baumgarten and are shipped on further to Italy via the TAG pipeline. Destination clauses were included anticipating restriction to use the gas in Italy only.

The 2003 EU Commission-ENI-Gazprom solution presents a package stipulating the deletion of destination clauses from all *existing* gas supply contracts. Two delivery points will be envisaged in the new contracts instead of one as in the existing contracts. ENI is free to resell gas to any destination, including outside Italy. ENI committed to offer significant gas volumes to customers outside Italy over a five-year period, starting on 1 October 2003. If sufficient volumes have not been sold during the first half of the period (until 1 April 2006), ENI is to organise an auction at Baumgarten. ENI would refrain from introducing consent clauses in its new contracts in Italy. ENI is to promote a capacity increase in 2008-2011 of its majority-controlled TAG pipeline (through which 100 per cent of Russian gas to Italy has been supplied) and is to promote an improved TPA to use TAG for transit.<sup>13</sup>

In view of the explanations shown in Figure 3, we can conclude that the 2003 EU Commission-ENI-Gazprom solution provides negative consequences for Gazprom since its ‘effective’ gas price in Baumgarten for deliveries to Italy is lower compared to that of deliveries to Austria. At least that would present undue preferences to ENI in case of immediate reselling at the auction at the delivery point in Baumgarten of the gas bought from Gazprom if the incremental profit received from the auction were to come solely to ENI.

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<sup>13</sup> Commission press release on territorial destination clauses with Gazprom and ENI, IP/03/1345, 6 October 2003, Commission Staff Working Paper, ‘Energy Dialogue with Russia. Update on progress’, 28 January 2004, SEC (2004) 114, Annex 6.

Is this conclusion correct? Has ENI received undue advantages? Is the deal balanced, including the time-balance of cost-benefit effects as well ('destination clauses' are deleted from *currently* existing contracts, while TAG capacity improvements and TPA are to be delayed in the *future* period of 2008-2011)? Would an 'incremental-profit-sharing' mechanism (similar to the Algerian LTC model) if used at the proposed auction to start on 1 April 2006 would be a fairer solution?

According to some experts, the removal of destination clauses should be strictly tied to and conditional on the introduction of full and unrestrictive TPA in the EU gas transmission system. Removal of destination clauses without unrestrictive transmission system TPA would give gas importers undue advantages over gas exporters.<sup>14</sup>

But today an unrestrictive TPA to gas transmission systems within the European Union is a stated political aim and established legal obligation – which has not yet been implemented in full in practice. It is likely that it will not be implemented in full in the near future – that is how the European gas community itself sees the picture.

At the March 2004 FLAME Conference (perhaps the most important and reputable annual gas event within the European Union) a polling session took place aimed at providing an expert view of the European gas community present at that conference on the prospects of internal EU gas market developments. According to FLAME Conference organisers, around 250 conference delegates participated in the poll representing all segments of the gas business, gas business regulation, academia and consultancy in Europe. Some of the results of the polling session are as follows.

In reply to the question 'How would you characterise Europe's gas market in 10 years' time?', 64 per cent of respondents chose the answer: 'dominated by a few fully integrated energy companies' and 15 per cent chose: 'dominated by a few large international gas buyers'.

In reply to the question 'When do you believe that European long-term contract gas prices will become decoupled from oil and determined by spot/futures prices?', 24 per cent of respondents said 'before the end of 2010', 36 per cent said 'before the end of 2015' and 24 per cent said 'never'.

In reply to the question 'By the end of 2008 what will be the volume of gas sold at hubs as a percentage of total EU gas sales?', 35 per cent of respondents chose the answer '6-10 per cent' and 37 per cent chose '11-20 per cent'.

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14 M Frisch, 'The forced removal of destination clauses: European gas security of supplies implications', presentation at 'Eurasian Natural gas: Opportunities and Risks' Conference organised by the Energy Charter Secretariat on 12-13 November 2003, Brussels.

In reply to the question ‘Why do you think that traded markets across Europe lack liquidity?’, 41 per cent of respondents chose the answer: ‘access to pipeline capacity’ and 30 per cent: ‘refusal of major companies to participate significantly.’<sup>15</sup>

The results of the FLAME 2004 session show that, according to the European gas business community, and despite the activities of the Commission aimed at further liberalisation of the internal EU market, the internal EU gas market within the next 5-10 years will continue to be monopolised by a few international (Western) energy companies and access to pipeline capacities (lack of effective TPA in practice) will remain a major problem.

That is another argument for a conclusion on the unbalanced character of the ‘destination clauses’ solution in respect to Russian LTCs TOP gas supplies to Europe. We will have to wait and see what the solution will be for the Gasprom-E.ON/Ruhrgas deal . . .

### **Transit**

About two-fifths of the world’s production of oil, one-fifth of gas and one-fortieth of electricity are exported, ie are being sold with the crossing of at least one border. Only a limited portion of external trade in oil is related to transit supplies which predetermines crossing of at least two borders since the bulk of oil export is undertaken by sea in oil tankers. The role of transit in the trade of electricity in the global context is even less significant, though its transit might be crucial for some individual states, ie for the Central Asian states of the FSU in the Fergana Valley region – the result of straight-forward electricity grid layout in the USSR period. At the same time, for gas export the transit component is key. Transit accounts up to 40 per cent in international gas trade or about seven per cent of global gas production.

For Russia, the problem of accomplishing the transit supplies of its energy exports is more important than for any other energy-exporting country, including those that are competing with Russia in Europe, especially in gas. Direct supplies amount to only about 40 per cent in the case of Russia’s gas export, compared to two-thirds in the case of Norway and three-quarters in the case of the Netherlands. The portion of direct supplies in Algerian gas export is only five per cent higher than in the case of Russia, but Russian gas has a higher portion of transit through the territories of two and more countries (see Table 2).

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15 Flame Industry Insights (Deloitte & Touche LLP, 2004).



<b>Table 2: Role of gas transit for its main existing exporters in Europe (2000)</b>					
Country-exporter	Direct supplies % of volume of exports	Transit through the territory of: % of volume of exports			
		one country	two countries	three countries	four countries
<b>EXISTING EXPORTERS</b>					
Netherlands	76.2	13.8	10.0	–	–
Norway	67.7	7.5	21.4	3.4	–
Algeria	44.9	14.8	9.6	24.3	6.4
Russia	39.5	9.4	11.4	28.1	11.6

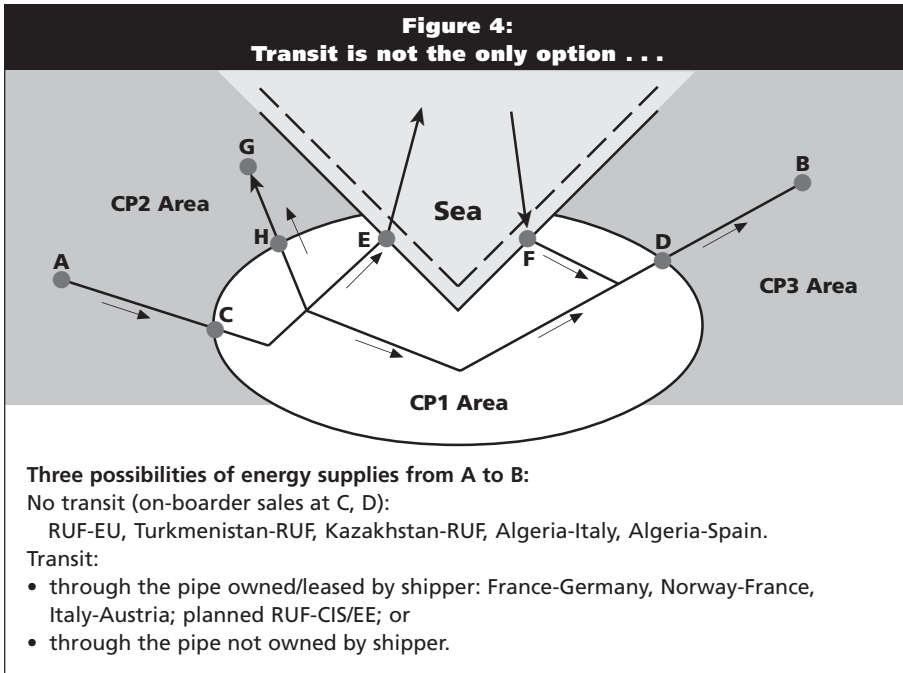
That is why transit issues and Energy Charter Transit Protocol negotiations have been important for Russia. As was stated by the State Duma of the Russian Federation at the Parliamentary Hearings on the ratification of the Energy Charter Treaty in January 2001, successful finalisation of the Energy Charter Protocol on Transit, taking full consideration of Russia's interests, is essential for eventual ECT ratification by Russia, which signed the Treaty in 1994 but has yet to ratify it.<sup>16</sup>

In legal terms, there are three different options for carrying out supplies of energy materials and products (EMP) from the territory of one contracting party (say, from point A located within the CP2 Area) to the territory of another (say, to point B located within the CP3 Area) if there is at least one more contracting party (CP1 Area) in between them (see Figure 4).

***Option one: without transit at all***

In this case on-border sales will take place at delivery points C and D in Figure 4, at which points both the title of ownership for the pipeline and for the gas in this pipeline is transmitted from one legal entity to another. Under such conditions all Russian gas supplies to the EU 15 have been taking place, as was shown above. Recent long-term gas supply agreements of Russia with Turkmenistan and Kazakhstan have been based on on-border sales terms as well. But on-border sales are not only a prerogative of the Russian supply contracts to Europe, they are also an integral part of, say, the Algerian supply schemes to Italy and Spain.

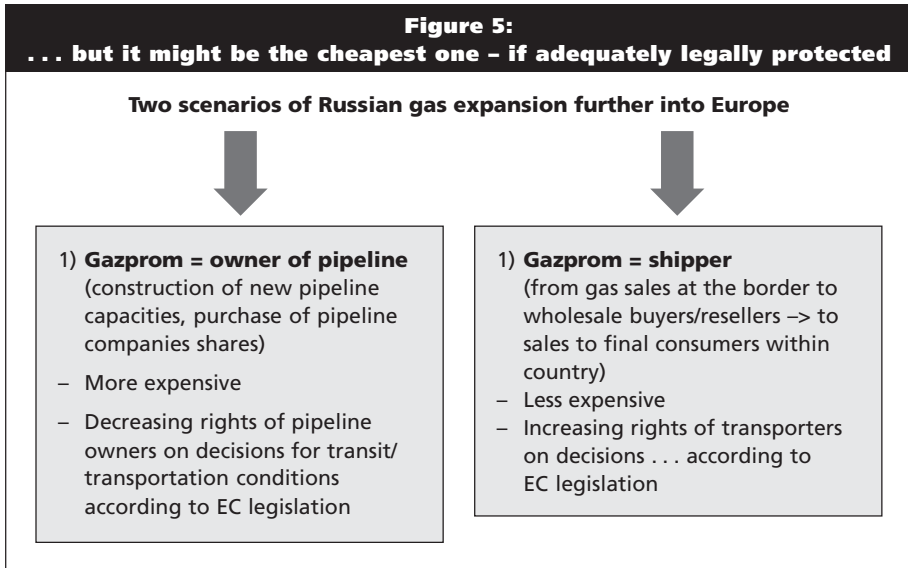
<sup>16</sup> A Konoplyanik, 'We must ratify Energy Charter Treaty – but not yet', *Oil & Capital. Russia & CIS Energy Magazine*, April 2001, pp 6-8.



Another option to escape transit is to bypass the neighbouring states with pipeline layout through international waters where it is possible. This task is solved for instance by the ‘Blue Stream’ pipeline, which directly connects Russia with Turkey through the Black Sea. The route of the Northern-European gas pipeline project also aims to connect Russia with Western Europe through the Baltic Sea.

***Option two: transit through the pipe that is owned/leased by the shipper of gas***

Under this scheme the gas originating from Russia and destined for France has been shipped by Gas de France from the delivery point at Waidhaus on through the territory of Germany to the French border; or gas destined for Italy has been shipped by ENI from the delivery point at Baumgarten and through the territory of Austria through the TAG pipeline partly owned by ENI. A similar scheme is used in supplies of Norwegian gas to France through the pipeline leased by the Norwegian supplier. Gazprom has been implementing the same approach throughout the 1990s in the FSU and Central Europe, trying (in some cases successfully, in other cases – not yet) to purchase stocks in the pipeline companies of the countries that historically have been transit states for Russian gas supplies to Europe (Slovakia and the Czech Republic, Poland, Belarus and Ukraine).



***Option three: transit through the pipe not owned by the shipper of gas***

Options two and three are the cases for the international law regulation by the Energy Charter Transit Protocol. Its successful finalisation would not prohibit all the other ways and means of carrying out supplies from point A to point B (see Figure 4) except the transit ones, but would provide more legal guarantees for transit as the cheapest way of carrying out cross-border supplies. Between two transit options, option two is certainly more costly than option three (see Figure 5). Finally, it is for business to decide which of the three above-mentioned options to carry out for cross-border gas supplies.

**Energy Charter Transit Protocol**

The aim of the Energy Charter Transit Protocol is to establish a clear set of intergovernmental 'rules of the game' governing cross-border flows of energy in transit via pipelines and grids, building on the existing transit-related provisions of the 1994 Energy Charter Treaty. The Transit Protocol will thereby lower the level of political and financial risks associated, among others, with those oil and gas projects that require transit flows across Eurasia. This will make trans-border energy supplies within the developing Eurasian energy market more stable, diminish the cost of raising capital (equity and debt financing), increase the investment availability for upstream (production and transport) projects in energy, and make them more competitive both in the energy and capital markets. Therefore, the Transit Protocol, as well as

**Table 3:**  
**ECT transit protocol: major issues addressed**

- **Obligation to observe Transit Agreements.**
- **Prohibition of unauthorised taking of EMP in transit.**
- **Definition of available capacity in energy transport facilities used for transit.**
- **Negotiated TPA to available capacity (mandatory TPA is excluded).**
- **Facilitation of construction, expansion or operation of energy transport facilities used for transit.**
- **Transit Tariffs shall be non-discriminating, objective, reasonable and transparent, not affected by market distortions, and cost-based including reasonable ROR.**
- **Technical and accounting standards harmonised by use of internationally accepted standards.**
- **Energy metering and measuring strengthened at international borders.**
- **Coordination in the event of accidental interruption, reduction or stoppage of transit.**
- **Protection of International Energy Swap Agreements.**
- **Implementation and compliance.**
- **Dispute settlement.**

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 economic means. In other words, it is designed to benefit not only consumer-states, but also producer- and transit-ones. The Transit Protocol will provide a commonly accepted minimum level of non-discrimination in the course of transit supplies, which has been recognised as such by all ECT nations.

Among the Protocol's key features are its definition of the concept of 'available capacity for transit' in national pipeline and grid systems; the obligation it contains for signatory states to negotiate access to such 'available capacity' in good faith and on a non-discriminatory basis with interested third parties; and its establishment of the rule that transit tariffs must be non-discriminatory, cost-based and free of distortions resulting from any abuse of a dominant market position by pipeline or grid owners (see Table 3).<sup>17</sup>

The history of the Energy Charter draft Transit Protocol began in March 1998 when six Caspian/Central Asian states highlighted the necessity to create a commercially attractive environment for investments in oil and gas pipeline projects, by addressing political considerations and the technical, financial,

<sup>17</sup> It is not author's aim to discuss in detail the substance and development of Transit Protocol negotiations. To read in more detail about the Energy Charter Treaty and draft Transit Protocol one can visit the Energy Charter website at [www.encharter.org](http://www.encharter.org), where both documents have been placed as well as a number of publications by the ECS staff on the issue.

commercial and legal issues for the realisation of such projects. In February 2000, negotiations started on this legally-binding agreement under international law among the governments of 51 European and Asian ECT member states.

In December 2002, the multilateral phase of Transit Protocol negotiations was considered to be finished with only three outstanding issues left open, which related almost exclusively to differences in position between Russia and the European Union on:

- the European Union's proposal for a Regional Economic Integration clause (REIO clause);
- the Russian proposal for a so-called 'Right of First Refusal' for existing transit shippers; and
- the issue of methodology of transit tariffs calculations.<sup>18</sup>

In June 2003, delegations of two contracting parties reached draft agreement on these three issues, but it was not confirmed by their capitals and in autumn 2003 the consultations were suspended (one of the major reasons was the overlapping agendas of the Russia-EU negotiations on the draft Transit Protocol and on Russian accession to the WTO). In June 2004, bilateral consultations between Russia and the European Union on these three outstanding issues were resumed; the first round took place on 15 October 2004.<sup>19</sup> Since then, a series of informal expert meetings have taken place (most recently on 30 June 2005), which demonstrated definite progress towards compromised solutions between the experts of the two parties.

### **Gas transit and the problem of contractual mismatch**

A natural question arises: in which geographical areas does the transit (in legal terms) of Russian gas to Europe exist? The answer is not obvious, since it is a mistake to consider that the 'transit' leg of Russian gas supplies to Europe is a distance between the external border of Russia and the external border of the particular EU state that is the final destination of the Russian gas supplies, and thus all the countries between Russia and the final destination are considered to be 'transit states'.

Figure 1 shows principal – Ukrainian (Southern) and Belarusian (Northern) – routes used to export gas produced in Russia to the European Union. There are several key points worth marking out on these routes.

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18 A Konoplyanik, 'Russian Gas to EU Markets - 1: Thorny issues impede progress toward final Transit Protocol' (2003) 101 *Oil & Gas Journal* 60; *ibid* 'Russian Gas to EU Markets - 2: Compromise is best course for Russia, EU in Protocol negotiations' (2003) 101 *Oil & Gas Journal* 68.

19 See A Konoplyanik, 'Transit Protocol Finalization', *Petroleum Economist*, July 2004, p 34.

Let's first have a look at this picture, based on the realities of the political map of Europe prior to 1 May 2004.

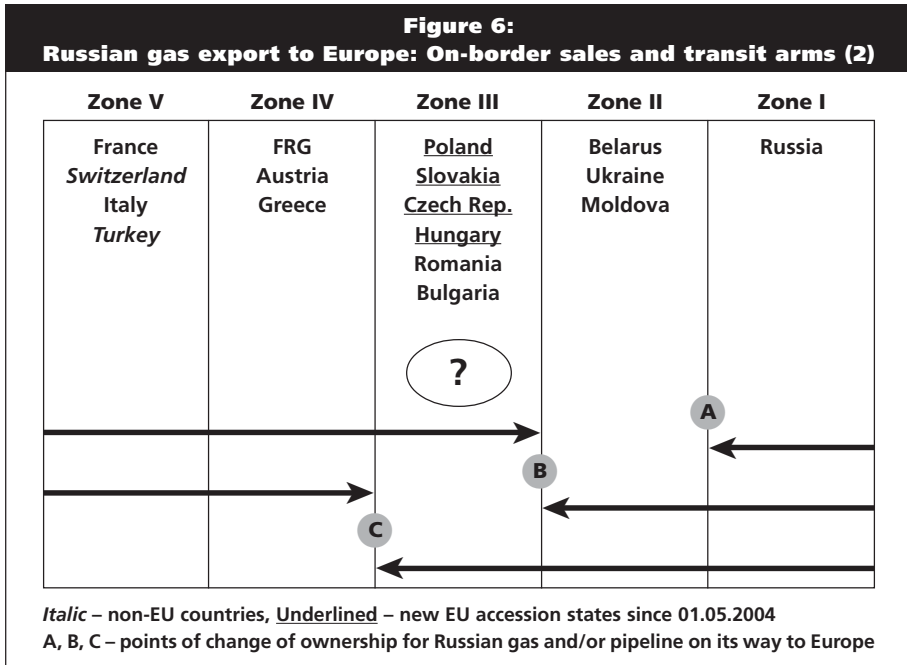
'A' points are located on Russia's borders with CIS countries. There, title to the corresponding pipelines passes from Gazprom to companies in the respective CIS countries, but Gazprom retains ownership rights to the gas further shipped through the territories of Russia's neighbours. It is also there that the international transit of Russian gas to Europe (across such CIS countries) commences.

'B' points are located on the borders between CIS countries (the former USSR frontier) and Eastern European nations (former COMECON members). There, title to the corresponding pipelines passes to companies of the respective Eastern European countries, but Gazprom still retains ownership rights to the gas that has been shipped further to Europe. Also at those points, the latter's transit leg through the territories of CIS countries is replaced by a transit leg across the corresponding Eastern European countries.

'C' points are located on the Eastern European countries' borders with EU nations. It is there, on the EU 15 outer boundaries, that Russian gas has been sold to its Western European customers – companies in EU nations. It is also there that the 'transit' (in legal terms) of Russian gas through European countries has been ending (prior to 1 May 2004), and title to both the corresponding pipelines and to the gas itself passes to the respective Western European businesses – companies in EU nations.

After 1 May 2004, when EU enlargement took place and ten new EU Member States entered the EU family, including the former transit states for Russian gas to Europe, the delivery points 'C' of Russian gas to the European Union – which prior to 1 May were located at the external border of the EU (EU 15) territory – became located within the EU (EU 25) territory. And the points 'B' became the points located at the new external border of the new EU (EU 25) territory.

After EU enlargement, the provisions of the 1958 Treaty of Rome, establishing the common internal European market, including, *inter alia*, 'free movement of goods', and other provisions of the EU *acquis communautaire*, became dominant in the territories of all the new EU Member States, as they have been dominant within the territories of the old EU members. According to the REIO clauses (Article 20(1)), proposed by the EU in the draft Transit Protocol, Transit in case of REIO means transit through the territory of the whole REIO and not through the territory of its individual states (in the case of Figure 4 if the symbol 'REIO' would relate under REIO clause to the CPI Area, that would mean not the Area of the individual EU Member State, but the Area of the whole REIO, ie the Area of

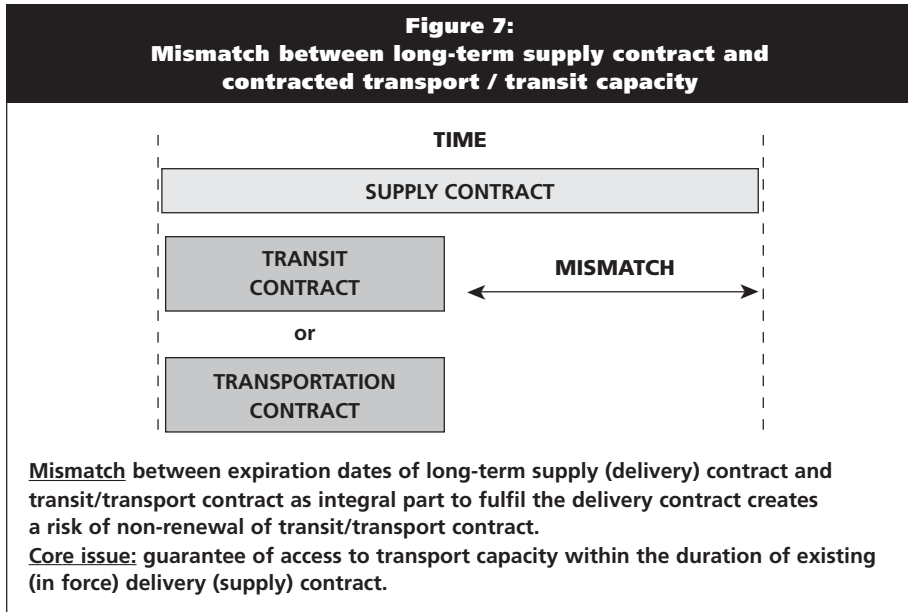


the European Union as a whole).<sup>20</sup> That means that according both to the concept of ‘free movement of goods’ in the Treaty of Rome, on the one hand, and to the REIO clause in the draft Transit Protocol, on the other hand, there is no ‘transit’ within the European Union. That, in turn, means that, according to the draft REIO clause proposed by the EU in the draft Transit Protocol, there are no more transit supplies of Russian gas within the new EU Member States where Russian gas (in legal terms) is still physically available, ie that Russian gas supplies between points ‘B’ and ‘C’ (see Figure 1) are not ‘transit’ any more.

That means that prior to 1 May 2004, transit states for Russian gas supplies to Europe were all the states of Zones II and III, including both former CIS and Eastern European former COMECON countries; after 1 May 2004, they were only the states of Zone II (see Figure 6).

EU enlargement might have some economic consequences for Russian gas transit supplies to Europe within the acting long-term contracts – in

<sup>20</sup> That and other consequences of Transit Protocol implementation for Russian gas supplies to Europe were analysed, *inter alia*, in A Konoplyanik, ‘Energy Charter Protocol on Transit: On the way to Agreement – What Kind of Treatment will be Accorded to Russian Gas in EU Countries’, *Oil, Gas & Energy Law Intelligence (OGEL)*, Vol 2, issue 1, February 2004, [www.gasandoil.com/ogel](http://www.gasandoil.com/ogel); *ibid* ‘Stiff Competition Ahead – As Russia moots Ways to increase Presence on European gas Market’, *Oil, Gas & Energy Law Intelligence (OGEL)*, Vol 2, issue 1, February 2004, [www.gasandoil.com/ogel](http://www.gasandoil.com/ogel).



cases of mismatch between the expiration date of supply and related transit agreements. The nature of such potential problems relates to a potential mismatch between expiry dates of the longer-term gas supply contracts, on the one hand, and of the shorter-term transit contracts, providing access to the transport capacities within these transit states, which enables implementation of such supply contracts, on the other hand. In the particular case of Russian gas supplies to Europe that means a mismatch between longer-term Russian gas supply contracts (LTCs TOP) with the EU companies, on the one hand, and shorter-term transit contracts with the corresponding companies of the transit states, or, as in the case of new EU Member States, shorter-term transport contracts with the pipeline owners of these states.

A mismatch between expiry dates of long-term supply (delivery) contracts and transit/transport contracts as its integral part to fulfil the delivery contract obligations creates a risk of non-renewal of the transit/transport contract, especially in cases when supply and transport are legally separated business operations (ie as a result of unbundling). A core issue regarding the problem of mismatch is the guarantee of access to transport capacity for the shipper within the duration of the existing delivery contract, ie supply contract being in force (see Figure 7).

There are two main avenues for solving the problem of mismatch: to exclude mismatch completely; and/or, when mismatch still exists, to use mechanisms minimising risks related to it.



In the first case there are two possibilities:

- (1) to reduce the duration of supply contracts to the duration of transit/transport contracts. Diminishment of the average duration of supply contracts is a natural way of energy market development: according to Hirschhausen and Neumann, it has diminished from 30 to 15 years between 1980-2003.<sup>21</sup> The strong recent fight of the European Commission against LTCs has also been moving – nominally – in this same direction (although market evolution of contractual structures has not been done by the administrative restrictions for particular types of contract); or
- (2) to increase the duration of transit/transport contracts to the duration of supply contracts. That is the way in which Gazprom has been moving in Eastern Europe/CIS (recent long-term transit agreements signed with Poland, Czech Republic, Ukraine, Turkmenistan/Uzbekistan/Kazakhstan).

In the second case, there might also be a few ways to solve the problem. The one that has been discussed for quite a long period of time in the course of Transit Protocol negotiations is a so-called 'Right of First Refusal' (RFR). It has been proposed by the Russian delegation as a universal solution to the problem of mismatch, but was strongly opposed by the European Union, which has quite clearly stated that RFR would never apply within the European Union as it is incompatible with EU competition laws. As a working compromise, an EU delegation has preliminarily agreed that RFR might apply only to existing Russian supplies within ex-EU territories within the ECT member states.<sup>22</sup> But the question was left open regarding existing/potential solutions of the mismatch problem if arising within the European Union. The author would assume that within the European Union there might be some relevant instruments in addressing the problem of mismatch (other than RFR considered to be inappropriate within the European Union) that would not violate the provisions of the *acquis communautaire*.

As was shown above, within the European Union, long-term contracts provide the bulk of gas supply (see Table 1). That means that the problem of mismatch within the European Union not only might exist in theory, but does exist in business practice. That was stated more than once by the representatives of the European gas companies during the Energy Charter Secretariat's Conference 'Energy Transit in Eurasia: Challenges and

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21 C Hirschhausen and A Neumann, 'Less Long-Term Gas to Europe. A Quantitative Analysis of European Long-Term Gas Supply Contracts', *Oil, Gas & Energy Law Intelligence (OGEL)*, Vol 3, issue 1, March 2005, [www.gasandoil.com/ogel](http://www.gasandoil.com/ogel).

22 Regarding the debate on RFR see *op cit*.

Perspectives', held on 19-20 October 2004 in Brussels. The problem of access to transport capacity within the European Union was frequently mentioned, as was shown above, as the major problem by the European gas community at the FLAME 2004 Conference.

Moreover, the Commission has recognised that in relation to the opening up of EU energy markets, the overwhelming majority of EU Member States still have to transpose the new EU rules. Thus, on 13 October 2004, the Commission sent letters of formal notice to 18 Member States for failure to transpose into national law two EU Directives on the internal market: in electricity (Directive 2003/54/EC of 26 June 2003), and/or in gas (Directive 2003/55/EC of 26 June 2003). The countries in question are Germany, Belgium, *Estonia*, Finland, Ireland, Italy, *Lithuania*, *Latvia*, *Malta*, United Kingdom, *Czech Republic*, *Slovakia*, Sweden, Greece, *Poland*, Portugal, Spain and Luxembourg (in italics – new EU Member States).<sup>23</sup>

The above-mentioned means that the issue of access to transport capacities within the duration of long-term supply contracts within the European Union is a valid one for consideration. In this regard some natural questions arise to which answers from the European Union could be very helpful, at least for the successful finalisation of Transit Protocol negotiations:

- Does the problem of access to transport capacity exist within the European Union?
- Does the mismatch between duration (expiration dates) of supply contracts and transport contracts exist within the European Union?
- Is there a risk of non-renewal of transport contracts within the duration of long-term supply contracts within the European Union?
- What are the procedures for renewal of transport contracts within the duration of long-term supply contracts (if any) within the European Union?
- Do these procedures adequately address the risks faced by shippers and (in the case of new investments) by the financial community?

Let us hope that corresponding answers will, as soon as possible, help both Contracting Parties to reach a compromise regarding the evolving contractual structure of Russian gas supplies to Europe, that this compromise will adequately reflect the valid long-term economic, financial and legal concerns of both parties, and will present a balanced solution for the whole Energy Charter community.

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<sup>23</sup> European Commission Press Release, Brussels, 13 October 2004.