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Energy Charter Treaty: Past, Present and Future by A. Konoplyanik

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Russia and the Energy Charter Treaty: Past, Present and Future

*Andrey Konoplyanik**

Contents

On July 30, 2009, the then Russian Prime Minister Vladimir Putin signed Government Order No. 1055-r discontinuing the provisional application by the Russian Federation of the Energy Charter Treaty (ECT)[1]. On August 24, 2009, in accordance with Article 45 (3-a) of the Treaty, Russia notified in writing the depositary of the Energy Charter (the government of Portugal) of its intention not to become a Contracting Party to the ECT. Sixty days later, Russia ceased to be a party applying the ECT on a provisional basis. On October 19, 2009, it became (along with Australia, Iceland, and Norway) a country that has signed but not ratified the Treaty, i.e. made a step back, as it were, while remaining within the Treaty (as the Signatory of the ECT) and the Charter process nonetheless.

Is there a reasonable ground for this step and who wins from my country's termination of the provisional application of the only multilateral interstate instrument protecting investments in the energy industry? In this paper the author examines the reasoning behind the Energy Charter developments in regard to the evolution of Russia's position to the Energy Charter process and the Treaty, up to the moment of this country's withdrawal from the ECT provisional application.

1. Financing of energy investment projects

Energy markets require the highest level of legal regulation since energy investment projects (in comparison with other sectors of economic activities – manufacturing, agriculture, services, etc.) have the maximum capital intensity (value of absolute and unit capital investments) per project, longest project lifecycle, longest payback periods, presence of geological risks, immobile character of fixed infrastructure, and other characteristics making economics of such projects more complicated if compared with other sectors of the economy. Since the 1970s, new upstream projects in energy sectors have been generally located in more difficult natural environments and often in undeveloped regions. This means that, apart from objective appreciation[2], these projects carry the burden of general economic infrastructure that needs to be put in place for development of the new regions.

The fact that energy investment projects are generally immobile, i.e. they require creation of fixed infrastructure, means that after the launch of the investment process the investor is, in principle, unable to wind down and transfer production facilities, e.g. energy production and

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His publications, presentations, and interviews regarding this and other subjects can be found at www.konoplyanik.ru.
In this paper, the author does not intend to argue with earlier articles on the subject of Russia and the Energy Charter, even if he does not agree with many important provisions of those articles. He would thus like to present his own vision of the issues in question.

[1] The text of the ECT and related documents can be found at:
http://www.encharter.org/fileadmin/user_upload/document/RU.pdf

[2] At the turn of the 1960s – 1970s, the tendency towards reducing marginal upstream costs was replaced by their increase in all major production regions. See: Ж.-М.Шевалье. Нефтяной кризис (пер. с фр.). [G.-M. Chevalier. Oil crisis (translation from French).] - М.: Mysl, 1975; А.Конопляник, Ю.Куренков. Динамика издержек производства, цен и рентабельности в мировой нефтяной промышленности. [A. Konoplyanik, Yu. Kurenkov. Dynamics of production costs, prices, and profitability in the world oil industry.] – *Mirovaya ekonomika i mezhdunarodnye otnosheniya*, 1985, No. 2, p. 59-73.

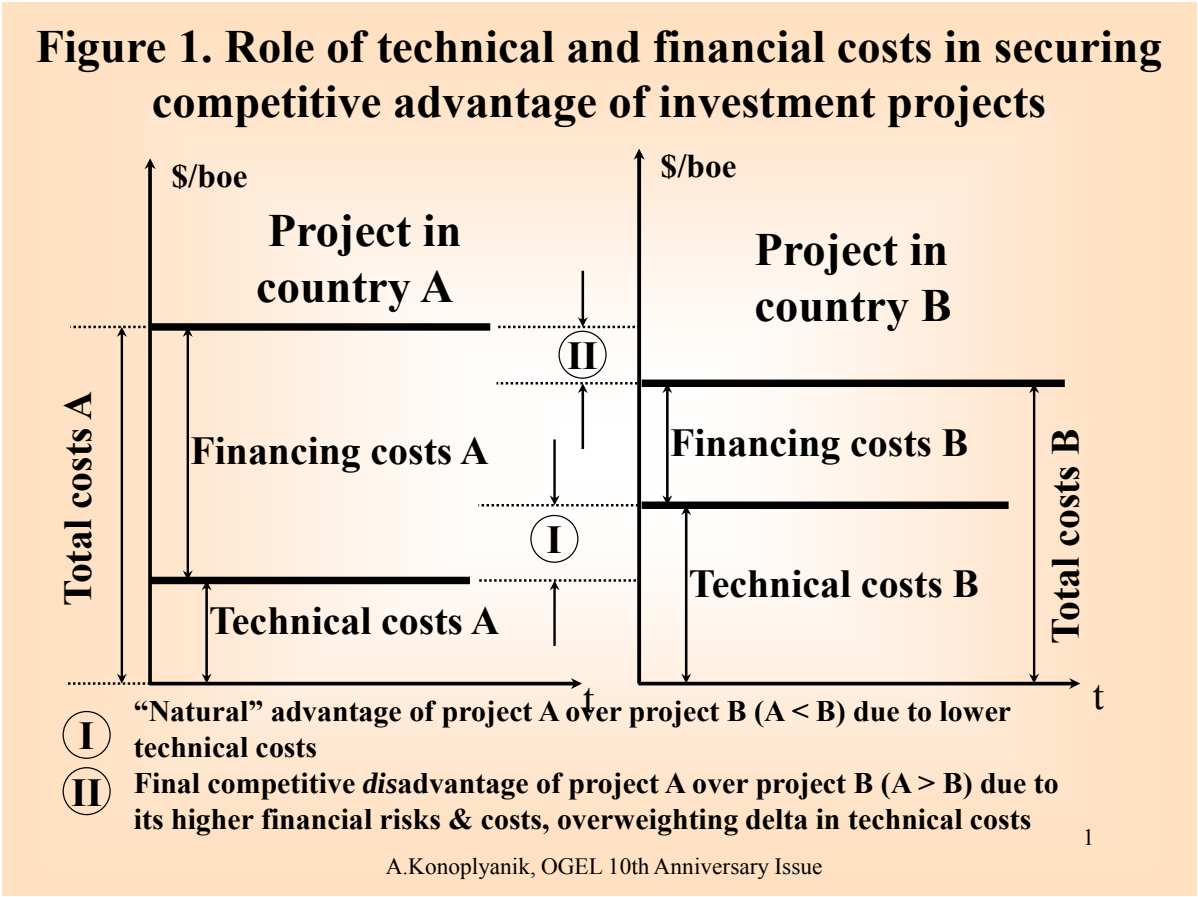
delivery/transportation facilities, to another country or region, which makes these projects even more vulnerable to a number of noncommercial risks. Therefore, these sectors require a high level of legal and fiscal stability and risk management in the context of very high noncommercial risks of losses of invested or even borrowed (debt) capital.

To minimize and diversify the objective high risks (in comparison with other sectors), energy investment projects are primarily financed by borrowed funds (externally raised by their sponsors) rather than from internal investment sources of project sponsors themselves. Since the 1970s, mineral resources development worldwide has been financed predominantly on the basis of the so-called "project (debt) financing" when the majority of project investments are provided by their sponsors using borrowed funds (raised at capital markets) secured by future profits to be generated by the project yet to be developed. The equity/project financing ratio in oil and gas investment projects has changed from 100:0 before the 1970s to 40-20:60-80, or even a greater gap between them, at present, normally 30:70[3]. Thus, the comparative competitiveness of investment projects (other factors being equal) is determined not only by the level of "technical" costs of production and delivery of the manufactured product (energy produced) to the customer, but also by the level of "financial" expenses associated with investment risks and, therefore, with the cost of raising capital.

The main principle of project financing is that the credit rating of an investment project cannot be higher than the rating of the company that implements this project, which, in its turn, cannot exceed the rating of the host country where the project is implemented. It is a common situation when due to higher corporate and noncommercial country risks a project with lower technical costs proves to be less competitive than a project with higher technical costs (see Figure 1). With broadening of the project financing implementation area, the share of financial costs (cost of borrowed funds) also grows in overall costs related to energy projects. For this reason, availability and cost of borrowed funds (debt capital) have become major factors of competitiveness of energy projects whose role is increasing over time. Therefore, if a country falls into the category of so-called "speculative" credit ratings[4] (usually due to high noncommercial risks), this means that the cost of commercial borrowed funds for implementation of investment projects in its territory becomes too high or inhibitive.

[3] See, e.g.: А.Конопляник, С.Лебедев. Проектное финансирование в нефтегазовой промышленности: мировой опыт и начало применения в России. [A. Konoplyanik, S. Lebedyev. Project financing in oil industry: world experience and origins of application in Russia.] - *Neft, Gas i Pravo,* 2000, No. 1, p. 25-40; No. 2, p. 23-42; А.Конопляник. Многосторонние международно-правовые инструменты как путь снижения рисков проектного финансирования и стоимости привлечения заемных средств. [A. Konoplyanik. Multilateral international legal instruments as a method to lower risks of project financing and borrowed funds costs.] – *Neftyanoe Khozyaystvo,* May 2003, No. 5, p. 24 – 30 (part I); June 2003, No. 6, p. 18 – 22 (part II).

[4] On the rating scale of major internationally recognized rating agencies, speculative ratings include the level Ba1 and lower at Moody's, BB+ and lower at Standard & Poor's and Fitch-IBCA, respectively; investment ratings are Baa3 and higher at Moody's and BBB- and higher at Standard & Poor's and Fitch-IBCA.



(Figure 1: Role of technical and financial costs in securing competitive advantage of investment projects)

It is characteristic of transitional economies to undergo a period of structural decline resulting from the change (frequently, destruction) of social institutions and economic development models and related financial crisis (usually, fairly continuous). Commitment to finance public expenditure usually results in the soaring tax burden on operating enterprises, which, as a rule, have no funds left even for simple reproduction, let alone extensive investments. It only remains to hope for state-guaranteed financing from international financial institutions. Their resources are objectively limited including limits for crediting a particular country. The main reason is a wide range of high noncommercial risks existing in the country. How to reduce the risks effectively? The answer belongs to the evolution of investor protection and stimulation mechanisms in the energy sector following the evolution of energy markets.

2. *Evolution of investment protection instruments: following the evolution of energy markets - and the ECT*

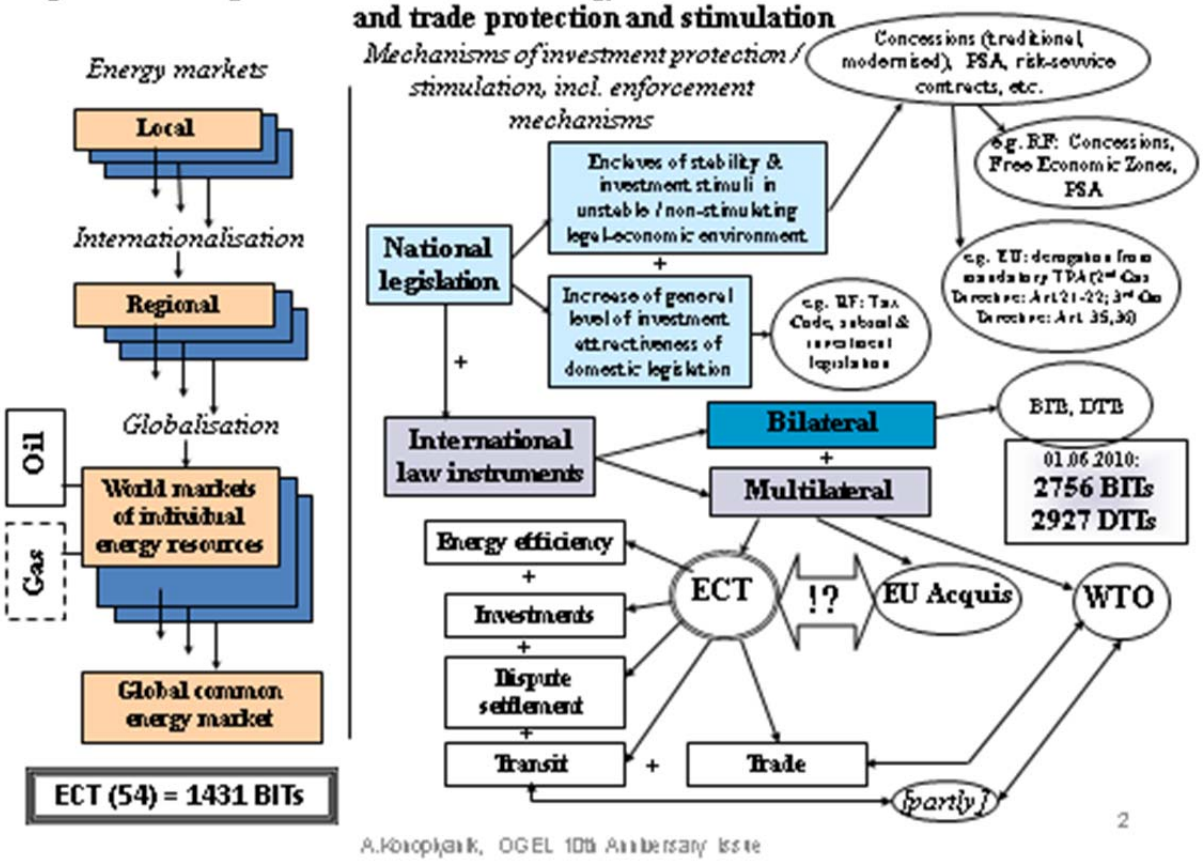
One of the dominant factors of energy market development is their greater internationality and eventual transformation into global markets as a result of the increasingly cross-border nature of energy value chains and formation of the energy infrastructure (mainly fixed infrastructure): local markets of individual countries become integrated by the more-and-more developed and diversified infrastructure first into international markets and then into global markets. Nowadays, there is a well-developed and functioning (whether it is stable and efficient – this is an entirely different matter, especially in the light of 2007-2008 events[5]) global oil market; the global gas market is still in the making, with regional pipeline gas markets being increasingly connected/integrated into a single global gas market by liquefied natural gas (LNG) supply infrastructure. In the long run, formation of a single global energy market can be expected based on the feasible principle of interchangeability (mutual technical substitution) of energy resources in the end-use[6].

With globalization of energy trade and investments and energy markets going further more and more international, investor protection/stimulation mechanisms are evolving as well being adjusted to the state of development of the energy markets. As a common trend, we can consider the evolution of such instruments from those related to specific projects (investments into individual projects are specifically protected) to nation-wide legal instruments (the same equal rules of the game are established for the whole economy) and further to supranational cross-border international legal instruments (the rules of the game are harmonized within a number of countries) – first bilateral, afterwards multilateral ones (see Figure 2).

[5] Author's view on the crisis of the Anglo-Saxon model for open, competitive, liquid and, therefore, highly speculative markets can be found here, for example: А.Конопляник. Кто определяет цену нефти? Ответ на этот вопрос позволяет прогнозировать будущее рынка «черного золота». [A. Konoplyanik. Who determines the oil price? Answer to this question makes it possible to predict the future of the "black gold" market.] – *Neft Rossii, or Russian Oil,* 2009, No. 3, p. 7-12; No. 4, p. 7-11; also in: В.В.Бушуев, А.А.Конопляник, Я.М.Миркин. *Цены на нефть: анализ, тенденции, прогноз.* [V.V.Bushuev, A.A.Konoplyanik, Ya.M.Mirkin. *Oil prices: analysis, tendencies, prognosis*] – M.: Energia Publishing Center, 2013, 344 p.

[6] Author's view on the global energy market evolution can be found here, for example: А.Конопляник. *Россия на формирующемся Евроазиатском энергетическом пространстве: проблемы конкурентоспособности.* [A. Konoplyanik. *Russia in the evolving Eurasian energy area: problems of competitiveness.]* - M.: Nestor Academic Publishers, 2004, 655 p.; *"Мировой рынок нефти: возврат эпохи низких цен? (последствия для России)"*. [A. Konoplyanik. *"Global oil market: return of low prices? (Consequences for Russia)"*.] – RAS, Open seminar "Economic problems of the energy sector", Second meeting, May 26, 1999. – Moscow, RAS edition, 2000, 124 p., and others.

Figure 2. Development of international energy markets and of mechanisms of investment and trade protection and stimulation



(Figure 2: Development of energy markets and investor protection/stimulation instruments)

With a wider variety of energy resources involved in economic circulation, a broader and more sophisticated range of applied technologies, relocation of the main production sites to the regions with less favorable natural, geologic and climatic conditions, and further internationalization of energy value chains, the nature and level of required investment protection and stimulation are also changing. At the previous stages of development of the society, within the earlier social and economic formations, the major instrument of such protection (and assuring the security of raw material supplies to mother countries) was the use of pure force such as seizure of the colonies for a purely raw-exports role and deployment there of considerable military forces to protect production facilities and raw materials transportation routes.

During the course of time, methods of pure force were succeeded by a combination of power, diplomatic and legal instruments. With the development of the institution of private property, the role of legal protection of investor rights at internal markets has become more important. As the state institutions (and later democratic institutions) have been developing and strengthening, and the rule of law has been acquiring greater importance in daily life, including the economic area, application of such instruments has become more effective and their role in the above mentioned combination has been steadily increasing.

Numerous legal instruments of investment protection and stimulation are developing in parallel to the evolution of energy markets – from national to international and global ones. All these instruments together are applied to relations between economic entities (markets participants), between economic entities and individual states (both mother and host

countries), and between individual countries as well. Moreover, every subsequent legal approach usually *supplements* earlier approaches rather than *substitutes* them. Thus, broader competitive opportunities are assured for states and investors to achieve their goals.

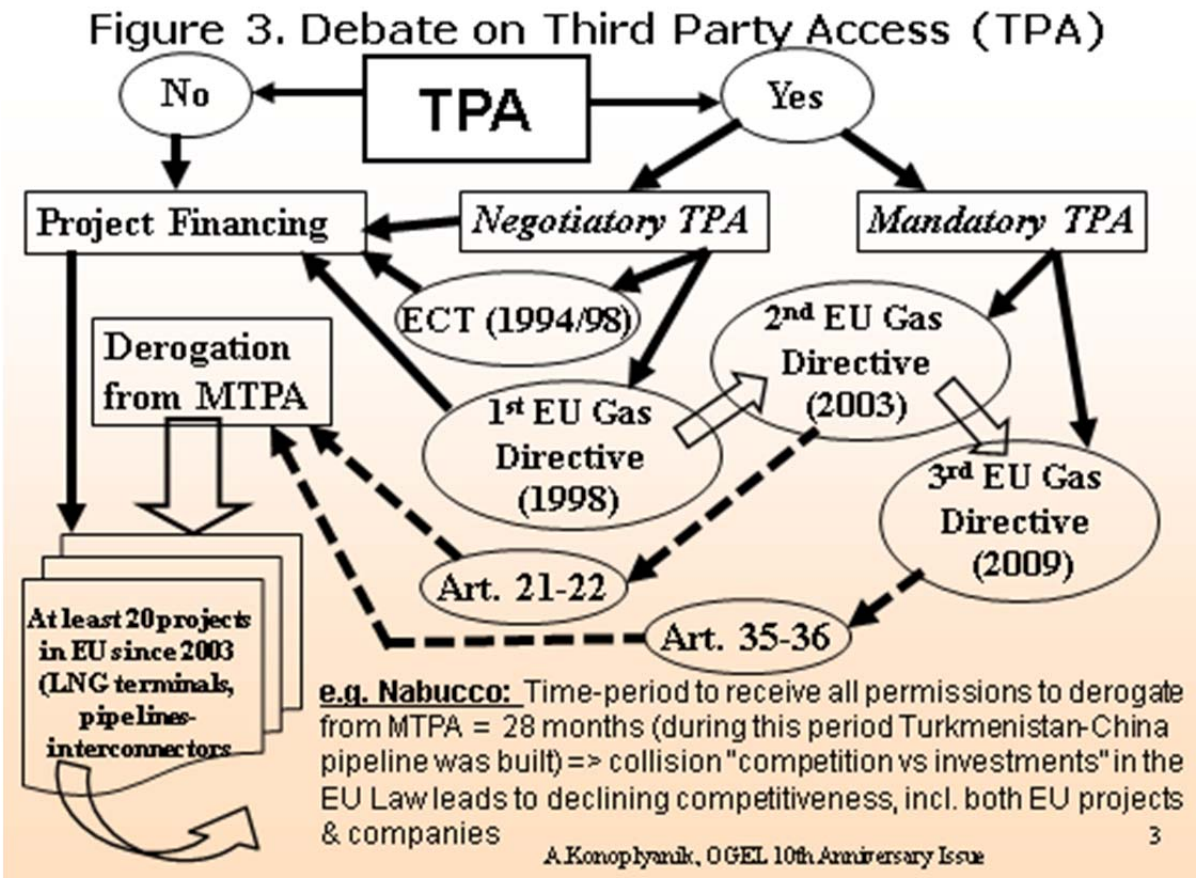
At some point, host states as resource owners start to develop investment protection and stimulation mechanisms on the national level, first within project-oriented legal structures and, as a rule, on demand of investors (usually foreign investors). Thus, development of the economic and legal environment to protect justifiable interests of domestic and foreign investors normally begins with appearance of "enclaves of stability" for individual projects, e.g., concessions and PSAs (production-sharing agreements), which are often given the power of the law. This usually happens in unstable (or in the absence of adequate) legal environment required to minimize noncommercial investment risks. The absence of such environment may result either from the early stage of development of domestic legislation (for example, in developing economies) or from a radical change in the political and social development patterns, which predetermines rejection of the previous approach and the need to develop a new legal system (for example, in transitional economies).

Next steps are usually focused on raising the level of protection of justifiable interests of investors by improving the general quality of national legislation. This is achieved by improvement of general principles of the investment environment existing in a country and further, more balanced approach to particular segments of legislation directly affecting investment activities: subsoil, tax, equity, investment, bankruptcy legislation and so on. At the same time, project-oriented legislation may also be applied, even on a broader scale based on the *"not instead of, but together with"* principle. Furthermore, such project-oriented legislation may cover entire groups of projects (either similar or not) implemented within special ring-fenced territories within which the projects are given more favorable economic conditions. This approach is generally the basis of legislation on special (free) economic zones. Otherwise, there may be targeted measures for further stimulation of investments in individual groups of projects of national economic importance located (usually this refer to upstream projects) in natural conditions that put a considerable strain on their economics (e.g., in undeveloped or remote regions that in addition to the project infrastructure require creation of general economic infrastructure which costs will be nevertheless allocated, as a general rule, with the project costs).

It should also be noted that creation of "enclaves of stability" or "targeted" investment stimulation measures can take place not only in developing and/or transitional economies but also in the countries classified as developed market economies. In my opinion, this is the way to interpret, for example, derogations from the Second (Art. 21-22) and the Third (Art. 35-36) EU Gas Directives[7] related to protection of economically reasonable (in view of project financing requirements) interests of investors. These derogations offer a procedure for temporary (time-limited) exemption from implementation of mandatory third party access (MTPA) to the infrastructure of new investment gas infrastructure projects within the EU. As is known, MTPA has been a legislative rule in the EU since 2003, i.e. it is a general rule which de facto has been discriminating new investments in increasing gas supplies and/or in developing new/alternative transportation routes for the existing and new supplies to the EU. For this reason, such derogations were necessary for long-term capital-intensive investments

[7] Directive 2003/55/EC of the European Parliament and the Council of 26 June 2003 concerning common rules for internal market in natural gas and repealing Directive 98/30/EC, OJ 2003, L176/57; Directive 2009/73/EC of the European Parliament and the Council of 13 July 2009 concerning common rules for internal market in natural gas and repealing Directive 2003/55/EC, OJ 14.8.2009, L211/94.

in creation of the EU gas supply infrastructure in the existing general economic and legal environment of the EU which is in conflict with the principles of project financing (see Figure 3). Almost all new major capital-intensive infrastructure projects since 2003 in the EU (when the Second EU Energy package came in force) – pipelines-interconnectors, LNG terminals, etc., 20 plus in sum-total – were developed based not on the core rules of EU legislation (Directives, etc.), but based on derogation from these rules.



(Figure 3: Debate on third party access (TPA))

Within the globalizing energy world with growing interdependence of the market players, their challenges soon become common within the cross-border energy value chains, and common challenges require common approaches and rules to be addressed. For this reason, further development of legal instruments of investment protection has inevitably reached the international level. Initially, this took place through advanced expansion of the system of bilateral agreements: Bilateral Investment Treaties (BITs) and Double Taxation Treaties (DTTs).

Since the trade flows always precede the investment flows, the DTTs have entered into international practice earlier compared to BITs: the first DTT has appeared in the 1920s, while first BIT – only in 1959. At first, BITs were signed between a developed country and a developing country, usually at the initiative of a more developed country. The developed economy (usually a capital exporter) concluded the BIT with a less developed country (usually a capital importer) to ensure additional higher standards of legal protection and guarantees for investments to be made by the companies of such mother country in comparison to the national legislation of the host country. The developing economy usually

entered into the BIT regarding it as one of the elements of a more favorable investment climate to attract foreign investors.

However, the situation changed in late 1980s and especially during the 1990s, with an increasing number of BITs signed within the group of developing and transitional economies. Thus, the clearly marked dividing line that existed earlier between BIT parties (capital exporters and capital importers) no longer exists, since the countries tend to conclude BITs with a dual goal: to protect domestic investors expanding overseas and attract foreign investments from the BIT partner country. This has dramatically increased the number of BITs concluded since the 1990s and made the BIT practice a "two-way street".

As of June 1, 2010, there were already 2,756 BITs and 2,927 DTTs[8] (Figure 2). However, they were concluded at different times and between different countries and at first were not very unified. This was emphasized by UNCTAD in one of its annual investment reports[9].

Every country, especially more economically powerful, tried to sign bilateral legal agreements based on its own model of such documents to gain advantage in "partnership" with a weaker player. Sometimes such "model" is approved by the national law. This is the reason why the aggregate body of bilateral agreements is neither highly homogenous nor balanced with regard to their terms and conditions. At a certain stage, this required development of model bilateral agreements, which were offered by both business associations and international institutions. However, these agreements, even based on certain model approaches, do not present fully unified (and far less commonly interpreted) and balanced "rules of conduct" within a broader international community. Therefore, at a certain stage, it creates an economic need to form the respective multilateral international legal instruments that would, on the one hand, maintain all advantages of bilateral mechanisms but, on the other hand, would possibly be free of their disadvantages. Thus, at certain stages of market development (including energy markets development), generally when a high level of their internationalization is reached, there appears an objective need to unify the "rules of the game". This applies to both unification of economic deals between enterprises (e.g., contractual relationship and types of international contracts[10]) and relations between the host country and investors (both domestic and/or foreign), including investment protection standards.

The most widely known multilateral agreements include the international code of trade rules GATT/WTO (1947/1995), the Treaty of Rome (1958) which laid the foundation for the EU, and a number of other multilateral agreements related to investments, such as North American Free Trade Agreement (NAFTA), a similar organization of Latin America countries (MERCOSUR), Organization for Economic Cooperation and Development (OECD), and Asia-Pacific Economic Cooperation (APEC). The sectorial Energy Charter

[8] World Investment Report 2010. UNCTAD, 2010, p.82.
[9] World Investment Report 2006. UNCTAD, 2006, p.29.
[10] See А. Конопляник. *"Мировой рынок нефти: возврат эпохи низких цен? (последствия для России)"*. [A. Konoplyanik. *"Global oil market: return of low prices? (Consequences for Russia)"*.] – RAS, Open seminar "Economic problems of the energy sector", Second session, May 26, 1999. – Moscow, RAS edition, 2000, 124 p., same author. *Russia in the evolving Eurasian energy area: Problems of competitiveness.* - M.: Nestor Academic Publishers, 2004, 655 p.; *(chapter 2); Putting a price on energy: international pricing mechanisms for oil and gas.* - Energy Charter Secretariat, Brussels, 2007, 236 p.; А. Конопляник. Кто определяет цену нефти? Ответ на этот вопрос позволяет прогнозировать будущее рынка «черного золота». [A. Konoplyanik. Who determines the oil price? Answer to this question makes it possible to predict the future of the "black gold" market.] – *Neft Rossii, or Russian Oil,* 2009, No. 3, p. 7-12; No. 4, p. 7-11, and others.

(that covers the energy sector to a wide extent), the legally binding Treaty to the Charter, and other related documents within the Energy Charter package can also be included in the list of such strategic multilateral agreements in the global economy.

There are other specialized organizations related to the energy sector or its individual industries: Organization of Petroleum-Exporting Countries (OPEC), Gas Exporting Countries Forum (GECF), International Energy Agency (IEA), International Energy Forum (IEF), United Nations Economic Commission for Europe (UNECE with a broader mandate than the energy sector only), International Atomic Energy Agency (IAEA), plus specialized organizations of regional cooperation (in the Black Sea and Baltic regions) and so on[11]. However, the ECT is the only multilateral legally-binding agreement addressing the broadest range of issues concerning energy investment activities and covering the full investment cycle and the whole energy value chain in the fuel and energy sector (see Figure 4).

Figure 4. Selected international investment-related agreements/organisations

Organisation (number member-states, Jan'2014)	Legal Status	Scope	Invest-ment	Trade	Transit	Energy Effici-ency	Dispute Settle-ment
ECT (52/54*)	LB	Energy	Yes	Yes	Yes	Yes	Yes
WTO (159)	LB	General	(Yes?) (Services)	Yes	*Yes/No***	*No*	Yes
NAFTA (3)	LB	General	Yes	Yes	*No*	*No*	Yes
MERCOSUR (5)	LB	General	Yes	Yes	*No*	*No*	Yes
OECD (34)	LB	General	Yes	*No*	*No*	*No*	*No*
APEC (21)	*Non-* LB	General	Yes	Yes	*No*	*No*	*No*

* Members of the Energy Charter Conference: 52 states plus 2 Regional Economic Integration Organisations
** Application of GATT Art.V to grid-bound transportation systems is under debate
=> Plus specialised energy-related organisations: OPEC, IEA, IEF, UN ECE (broader than just energy), IAEA, ...
=> Plus specialised "regional" organisations: BSEC, BASREC (broader than just energy), EU-SEE Energy Community Treaty, ...
Joachim Karl, then Senior Expert of the Energy Charter Secretariat, now Legal Affairs Officer of the UNCTAD, has helped in preparation of this table

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(Figure 4. Selected international investment-related agreements/organisations)

[11] On complementarity and actual hierarchy of international energy organizations in the sphere of investments, see: А. Конопляник. Когда один договор стоит тысячи. [A. Konoplyanik. When a contract is worth a thousand contracts.] – *Neft Rossii, or Russian Oil,* April 2007, No. 4, p. 7-10, No. 5, p. 10-13; A.Konoplyanik, T.Waelde. Energy Charter Treaty and its Role in International Energy. – *"Journal of Energy and Natural Resources Law"*, November 2006, vol. 24, No 4, p. 523-558; Т. Вальде, А. Конопляник. Договор к Энергетической Хартии и его роль в мировой энергетике. [T. Waelde, A. Konoplyanik. The Energy Charter Treaty and its role in the global energy sector.] – *Neft, Gas i Pravo,* 2008, No. 6, p. 56-61; 2009, No. 1, p. 46-50; No. 2, p. 44-49; No. 3, p. 48-55.

The main practical advantage of the ECT, in my opinion, is that the Treaty within its current composition with 54 signatories (members of the Energy Charter Conference) has the collective legal force of 1,431 BITs. Taking into account the fact that it took almost 40 years to sign this number of BITs, I think it is obvious how many years the ECT has "saved" for the international community to create a more favorable investment climate in its member countries and reduce investment risks and costs of borrowed funds (of raising capital), i.e. in the area of investment stimulation and protection for the projects in the most capital-intensive and high risk industries.

Every stage of the historical development begins at a historically conditioned time, not earlier and not later. Such time for the Charter process and the ECT as its major instrument came in 1990.

3. The Energy Charter: how it all began – interests of the parties involved

The end of the Cold War and the fall of the Berlin Wall marking the removal of the political border between Eastern and Western Europe offered an unprecedented opportunity to overcome the previous economic division on the Eurasian continent. In the energy sector, the prospects for mutually beneficial cooperation between the East and the West were clearer and more vital than in other sectors. Russia and the former USSR republics had huge energy resources, their main export item, but needed considerable investments for their development.

During the last years of the USSR, the country was unable to maintain the achieved levels of production of the main export energy resource, i.e. oil, after it peaked at 628 million tons in 1988. Neither the USSR burdened with external debts, nor (thereafter) the newly independent states - former Soviet national republics were unable to attract multibillion investments on their own to develop huge but mainly difficult-to-access (and, therefore, costly and requiring up-to-date technologies) hydrocarbon deposits. Credit risks of transitional economies at the initial stage of transformation processes are always extremely high. This means extremely high market (commercial) cost of external borrowings for them (no domestic finance was available then yet), especially for development of investment projects in extractive industries characterized by higher financing risks as compared to manufacturing industries.

The situation remained the same in the post-Soviet Russia for almost one and a half decade after the country obtained its autonomy. Until October 1996, Russia had not been assigned any long-term credit rating, which meant the absence of a benchmark for evaluation of the cost of borrowed funds (debt capital) and made financing of investment projects in Russia almost impossible. On October 4, 1996, Standard & Poor's assigned Russia the BB- rating. Three days later Moody's gave its rating which was BB. Both of the ratings fell into the speculative category. After that, Russia dropped in 1998 into the default zone and fell back afterwards to the pre-default speculative ratings. Russia has moved from speculative to investment rating zone only during the current decade. On October 8, 2003, Moody's assigned our country the Baa3 rating. On January 31, 2005, Standard & Poor's rating for Russia was BBB-. Fitch-IBCA assigned the BBB rating on August 3, 2005 (one step above the threshold investment level). At the same time, these ratings mean "reliability below average". For this rating category, the cost of borrowed funds exceeds the then current

LIBOR rate by up to 6 percentage points[12]. The cost of borrowed funds for the speculative ratings assigned earlier to Russia (BB/BB-) exceeds the then current LIBOR rate by up to 14 percentage points[13].

At the same time, developed market economies of the Western Europe had a strategic interest in diversifying their sources of energy supplies to reduce their dependence on the politically unstable Middle East countries. European companies had their own investment resources and were able to draw borrowed funds on acceptable commercial conditions. The companies were ready to make investments into development of new energy extraction regions outside the Middle East. For this reason, there was a recognized need to create a mutually acceptable foundation for development of energy cooperation among the states on the Eurasian continent. Based on these considerations, the Energy Charter process was "born" in 1990.

It stands to reason that multilateral energy cooperation must be founded on an interstate agreement. At the same time, it is also obvious that certain political prerequisites, an open "window of opportunities", are required to reach and sign a multilateral international agreement, especially a legally binding one. This is particularly true for treaties relating to such broad and basic areas of economic activities as the energy sector that provides the basis of economic development, assures the export potential of many countries and includes such "politically sensitive" issues as, for example, state sovereignty over natural resources. These agreements must have the respective political foundation.

For the Energy Charter, the foundation was laid, in my opinion, in 1975 by signing the Final Act of the Conference on Security and Cooperation in (transatlantic) Europe according to the results of the pan-European conference in Helsinki. Two years later, in 1977, at the Congress of the Polish United Labor Party, the Soviet Union represented by Leonid Brezhnev, the General Secretary of the Central Committee of the USSR Communist Party, proposed the initiative to convene a pan-European energy conference. However, the proposal of the USSR was revived only 13 years later and in a somewhat different format. In June 1990, Ruud Lubbers, the Prime Minister of Netherlands (the country presiding in the EU at that time), put forward the idea of creating a pan-European energy community. The Charter process was thus initiated offering the mechanism of assistance to former socialist countries in their transition to the market economy[14]. Within the scope of those pan-European initiatives, Europe was understood as a transatlantic community of states.

Since Lubbers' initiative was put forward by the European Union, the general strategy was formulated so as to combine Western European concerns (security of energy supplies) with Eastern energy assets (abundant oil and gas resources) by facilitating Western (predominantly European) investments in development of energy resources in the East and the transit of Eastern energy to Europe. That approach was beneficial for the European Union for several

[12] Just as a point of comparison: as of early November 2012 the one-year LIBOR values were 0.85 percentage points (p.p.) for USD, 0.52 p.p. for EUR, 1.07 p.p. for GBP.

[13] A. Konoplyanik. "International cooperation in the energy sector and the key role of the Energy Charter process in the international energy security". – Speech at the international conference "International dimension of the energy security of Russia" organized within the MGIMO-BP cooperation project, Moscow, MGIMO (U) Ministry of International Affairs of Russia, April 21, 2006; same author. "The Energy Charter and its key role in global energy security (in the context of Russia's chairmanship in the Group of Eight)". – Speech at the international conference in the context of Russia's chairmanship in the Group of Eight on the subject of "Global security and the Group of Eight: challenges and interests. On the way to St. Petersburg Summit", Moscow, PIR-Tsentr, April 20-22, 2006.

[14] This is why the Energy Charter process was often called "the Lubbers' plan", especially at the initial stage.

reasons: it would assure further diversification of energy flows to the EU, provide new opportunities for oil and gas investments in the East for EU investors, and stimulate Eastern economic development. The latter was in the hope that the expanding eastern border of the European Union would be safer by having more prosperous and settled Eastern neighbors. It was expected to intensify interdependence between East and West in terms of energy and investment flows, which, in its turn, would reduce (if not totally eliminate) the remaining political confrontation within the European continent, which still existed as a consequence of the Cold War.

This approach was also advantageous to FSU exporting countries, not only because they expected additional export earnings and tax revenues from extractive industries, but also because investment projects in the extractive industries generate multiplier effects in the processing industries and the economy in general. The multiplier effects in such a developed industrial country as the USSR might by far exceed direct export earnings from these projects[15].

Naturally, we should not ignore the latent goal of the European Union to increase its competitiveness in the global competition with the USA by securing stable (and, according to expectations, with lower risk – means, lower costs - as compared to the Middle East countries) energy supplies from the FSU countries.

Finally, at that time the EU developed the First Energy Directives, and their provisions were the basis for the Energy Charter instruments: the Energy Charter Treaty (ECT) and Protocols to the ECT. For this reason, there was a high level of correlation and consistency (including their "liberality") of legal "rules of the game" provided for by both multilateral legal instruments: the EU Directives with a narrower geographic scope (in early 1990s, the EU consisted of 15 countries) and legally binding instruments of the Energy Charter with a broader scope (more than 50 countries participated in the Charter negotiations). Thus, the Energy Charter was considered by the European Union from the very beginning as a process of exporting its supranational legislation (the so-called "acquis communautaire") to the East along the main energy supply chains within EU export-oriented, fixed energy infrastructure systems[16].

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[15] Multiplier effects of investment projects in the extractive industries are the subject of a number of papers prepared under the guidance and with participation of late Prof. Alexander A.Arbatov; for example, his pioneer work on the subject: Оценка воздействия на социально-экономическое развитие России крупномасштабных инвестиций в нефтегазовые проекты в рамках шести соглашений о разделе продукции. [Impact on Russia's socio-economic development of large-scale investments in oil and gas projects within the scope of six Production Sharing Agreements.] - M, KEPS-Petroleum Advisory Forum, 1996; and: А.Арбатов. Эффекты видимые и невидимые. [A.Arbatov. Visible and invisible effects.] – *Chevron today*, 2000, No. 2(3), p. 25-29; А.Арбатов, А.Мухин. Социально-экономические эффекты реализации проектов освоения Восточной Сибири. [A. Arbatov, A. Mukhin. Socio-economic effects of East Siberia development projects.] – *Neft, Gaz, Stroitelstvo*, 2000, No. 1, p. 60-63; same authors. Нефтегазовые проекты в России. Аргументы инвестора. [Oil and gas projects in Russia. Investor's arguments.] – *Energy Sector*, 2000, No. 2, p. 90-94. See also: А. Конопляник. Анализ эффекта от реализации нефтегазовых проектов СРП в России для бюджетов разных уровней (к вопросу об оценке воздействия на социально-экономическое положение страны крупномасштабных инвестиций в реализуемые на условиях СРП нефтегазовые проекты). [A. Konoplyanik. Analysis of the effects of oil and gas PSA projects in Russia for budgets of different levels (on the issue of evaluation of impact of large-scale investments in oil and gas PSA projects on the socio-economic situation in the country.] – *Neftyanoe Khozyaystvo,* 2000, No. 10, p. 24-30.

[16] On the hierarchical EU policy of its "export of acquis" and its instruments, including the energy sector, to FSU states, see, e.g.: A. Konoplyanik. Section 2.1: A Common Russia−EU Energy Space (The New EU−Russia Partnership Agreement, Acquis Communautaire, the Energy Charter and the New Russian initiative), p. 45-101.

In other words, in the absence of local national legislations in the new FSU and CMEA sovereign countries, the legally binding instruments of the Energy Charter were supposed to fill the legal vacuum in the most important sphere of new transitional economics, the energy sector, for both East (energy exporters and transit countries and capital importers) and West (energy importers and capital exporters). The legal vacuum was supposed to be filled by the most up-to-date (predominantly liberal) global and European models of the state regulation of the energy sector, primarily, through the mechanisms of stimulation and protection of direct foreign investments: legally binding documents of the Energy Charter were developed based on the EU legal instruments, WTO agreements (at that time called GATT, 1947), North American Free Trade Agreement (NAFTA), and a system of almost 400[17] bilateral investment protection agreements, or bilateral investment treaties (BITs), that existed by early 1990s.

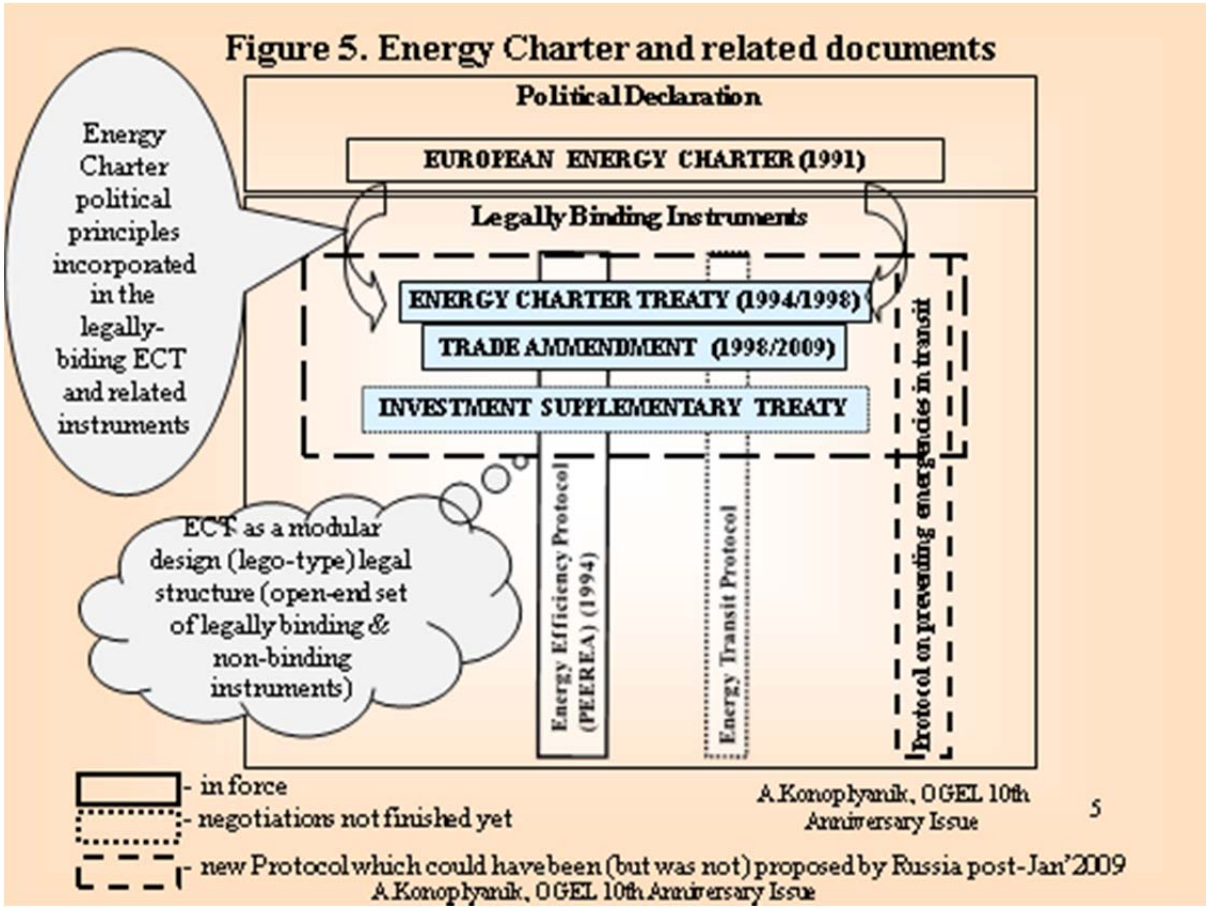
The negotiations began in the summer of 1990 and were completed within a year by signing the political declaration named "European Energy Charter" (which is not a legally binding document) on December 17, 1991 in The Hague (the Netherlands). The declaration was signed by 50 countries from Europe, North America, and Asia. The list of parties to the declaration was defined by the fact that, firstly, on the Western side there were OECD countries[18]; secondly, "Europe" was understood in terms of the pan-European Conference on Security and Cooperation in Europe of 1975, i.e. as "transatlantic Europe". For this reason, despite the term "European" in the declaration's name, the Energy Charter and its instruments have never been considered as merely and exclusively a European initiative and a European-only instrument.

Legally-binding Energy Charter Treaty (ECT) and Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) were signed in December 1994 and took effect in April 1998. In 1998, in connection with creation of WTO on the basis of GATT, the so-called "Trade Amendment" was adopted that came into effect in 2009. There are also some incomplete documents in the Charter package (see Figure 5).

– in: *K. Talus, P. L. Fratini (eds.), EU – Russia Energy Relations, Legal and Political Issues.* - Euroconfidentiel, Brussels, Belgium, January 2010, 404 pp.; A. Konoplyanik. Ukraine's inclusion into the EU Energy Community Treaty with the countries of South Eastern Europe: consequences for all interested parties. – «*Oil and Gas*», September 2010, p. 20-22, 24, 26, 28, 30, 32, 33-36(Ukraine); same author. "Third way" for Russia. Moscow should choose one of three variants of building the common energy space with the EU. – *Neft Rossii, or Russian Oil*, 2009, No.6, p. 16-21; No.7, p. 14-19; No. 8, p. 11-16; No. 9, p. 13-18; A. Konoplyanik. A Common Russia–EU Energy Space: the New EU–Russia Partnership Agreement, Acquis Communautaire and the Energy Charter. - *Journal of Energy and Natural Resources Law*, vol. 27, #2, May 2009, p. 258-291; same author. To bypass the sticking points. – *Politicheskiy Zhurnal,* No. 6-7 (183-184), 21 April, 2008 , p. 40-44.

[17] Bilateral Investment Treaties, 1959-1999. UNCTAD/ITE/IIA/2, 2000, p.1

[18] At that time including developed countries of the Western Europe, North America (USA, Canada), Japan, Australia, New Zealand. All these countries signed the political declaration of the European Energy Charter in 1991.



(Fig. 5: Energy Charter Treaty and related documents)

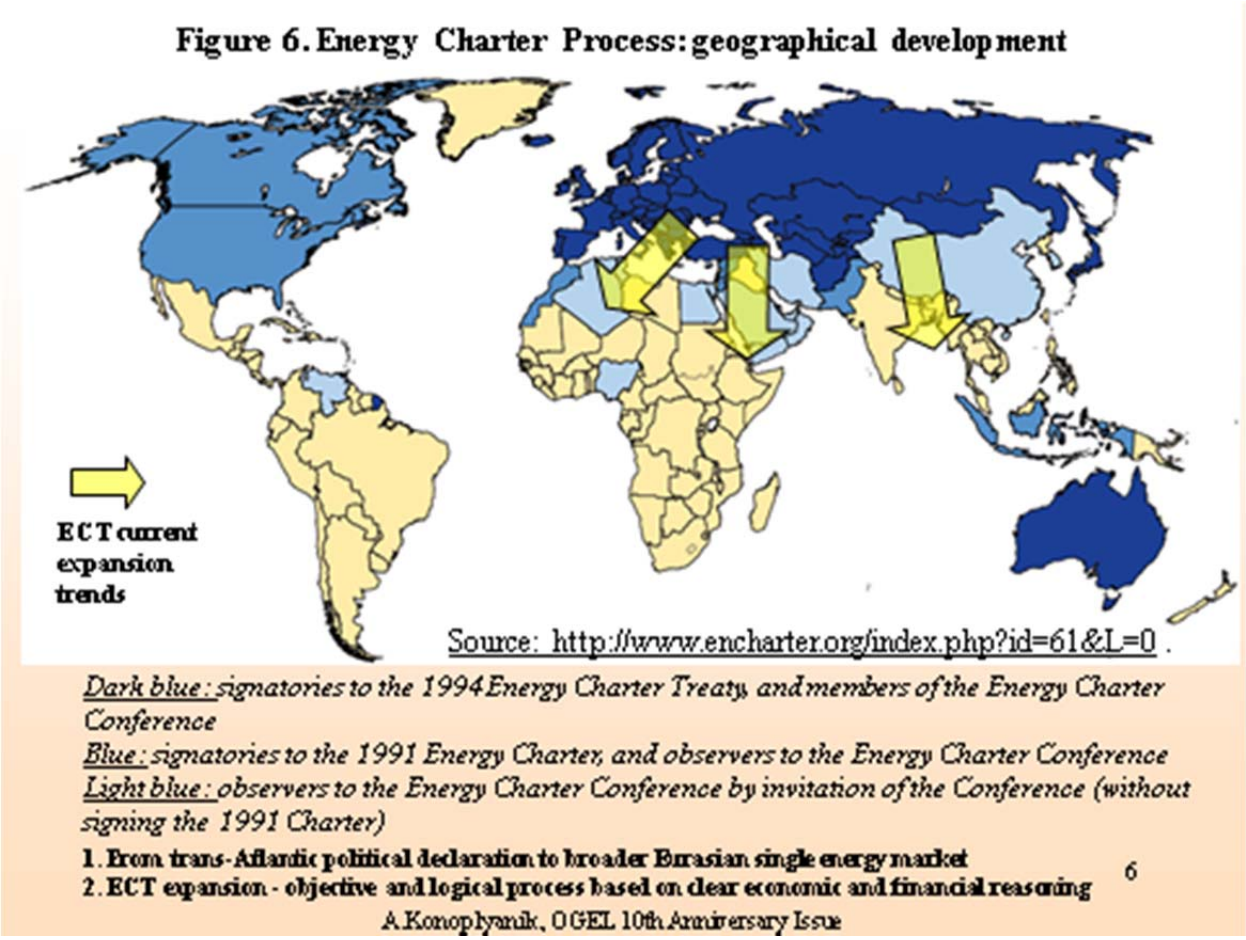
As of today, the Energy Charter Treaty has been signed or acceded to by 52 countries of Europe and Asia[19] (as well as European Communities and the European Atomic Energy Community (EAEC), so the total number of signatories is 54), 46 of which (plus EC and EAEC) have ratified the Treaty, including all EU states. Five states (Australia, Belarus, Iceland, Norway, and Russia) have not yet ratified the ECT, though Belarus applies the Treaty on a provisional basis; Russia also applied the Treaty on a provisional basis until October 2009 when it discontinued its provisional application. The Energy Charter observers are 23 countries and 10 international organizations. Key dates of the Energy Charter development process are presented in Table 1 and its expanding geography – at Figure 6.

Table 1: Key dates in the Energy Charter development process (until Russia's withdrawal from provisional application of the ECT) – the author's vision	
25 June 1990	Ruud Lubbers, Prime-Minister of the Netherlands, has presented EU initiative on forming the Pan-European Energy Community at the European Council meeting in Dublin (Ireland)
17 December 1991	(Political declaration) European Energy Charter is signed in The Hague (The Netherlands)
17 December 1994	(Legally binding) Energy Charter Treaty (ECT) and Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) are signed in Lisbon (Portugal)
16 April 1998	ECT entered into full legal force after 30-th ratification

[19] Pakistan's accession to the ECT as the (now to be 53d) member country was supported by the Energy Charter Conference (the supreme body of this international organization) in November 2006.

23-24 April 1998	So-called Trade Amendment to ECT is adopted, which brought trade-related provisions of the ECT in line with the WTO norms and which also expanded ECT scope to "energy-related equipment"
February 2000	Negotiations on the Energy Charter Protocol on Transit has started
December 2002	Multilateral phase of the negotiations on the Energy Charter Protocol on Transit was finished; three open issues on the draft Protocol were to be first resolved within bilateral consultations between Russia and the EU
December 2004	On the results of the Second five-year Review of the Energy Charter activities, the Energy Charter Conference has decided on regular adaptation of the Energy Charter process to the new challenges and risks of the energy markets development
End-December 2005	On the threshold of the Russia-Ukraine gas transit crisis, informal working agreement was reached by the then acting leadership of the Energy Charter Secretariat with the high-level Ukrainian and the highest-level Russian authorities, that should the two parties not reach their bilateral agreement, they will use the Energy Charter conciliatory procedure for resolution of transit dispute between them; both parties has also informally adopted the candidacy of the conciliator proposed by the ECS; corresponding letter by the newly appointed ECS Secretary General was sent at his first day in the office (3 January 2006) to both parties proposing this already agreed procedure, though it was not used in practice since next day (on 4 January 2006) Russia and Ukraine has come to bilateral settlement of their dispute after three days of termination of supplies
July 2006	G-8 Summit in Saint-Petersburg, which concluding documents regarding enabling international energy security (especially in regard to its investment aspects) were prepared mostly based on and with the use of the ECT and its related documents
April 2007	Special Energy Charter Working Group on Strategy issues is formed to implement/enforce decision of the December'2004 Energy Charter Conference
September 2007	Russia-EU bilateral consultations are finished and transformed into multilateral consultations on the draft solutions reached by Russia and the EU
September 2008	Multilateral negotiations on finalization of the Energy Charter Transit Protocol are resumed
1-19 January 2009	Second Russia-Ukraine gas crisis; on its results Russian highest political leadership has claimed Energy Charter in its incapability/unwillingness to solve the problems, related to violation of the ECT provisions; this was factual blaming of the Energy Charter in lack of dispositive legal capacity and political leadership of its Secretariat in incompetency
21 April 2009	Initiative of the then Russian President D.Medvedev ("Conceptual Approach to the New Legal Base of International Cooperation in the Energy Sphere (Aims and Principles)") based mostly on the Energy Charter documents
June 2009	ECT "Trade Amendment" has entered in full legal force after 35-th ratification
19 October 2009	Russia has withdrawn from provisional application of the ECT
November 2009 г.	On results of the Third five-year Review of the Energy Charter activities the Energy Charter Conference has upgraded/converted its Strategy group into permanent status; the Trade and Transit Group was given one year to finalize negotiations on Transit Protocol; Russia has expressed its support to Energy Charter process

(Table 1: Key dates in the Energy Charter development process (until Russia's withdrawal from provisional application of the ECT) – the author's vision)



(Figure 6: Energy Charter Process: geographical development)

The Energy Charter Treaty can be considered as a multilateral investment agreement with a much broader scope (apart from just investments). The Treaty is different from other bilateral investment agreements by its application to the energy sphere but in a broader sense. During its preparation, the ECT did not draw much public attention, which was primarily focused on WTO and Multilateral Investment Agreement (MAI) negotiations. But with the failure of MAI negotiations in 1998 and the lack of any promising initiatives in this area at that moment within the scope of OECD, WTO or elsewhere, the Energy Charter Treaty became one of the most impressive achievements in the international treaties process of the 1990s.

4. Different aspects of the Energy Charter

The "Energy Charter" is a comprehensive multi-facet notion meaning a process, an international organization, and a system of documents at the same time. This term may include all of the following:

1. A set of multilateral documents of different character, such as:
    a. Political declaration "European Energy Charter" (EEC) of 1991,
    b. Legally binding documents of 1994 (Energy Charter Treaty – ECT, Protocol on Energy Efficiency and Related Environmental Aspects - PEEREA) and

1998 (**A**mendment to the Trade-Related Provisions of the Energy Charter – the so-called "Trade Amendment"),

   c. Other numerous legally binding and non-binding documents: Protocols, Understandings, Decisions, Declarations, Statements, model agreements, etc.;

2. Long-term Energy Charter process with the objective cycle with the following consecutive phases:
   a. Negotiations on development of legally binding documents,
   b. Monitoring of their execution and efficient application,
   c. Multilateral political discussions on compliance of the Energy Charter instruments with new realities of the energy markets development and on agreement of measures to adjust these instruments to such new realities,
   d. New multilateral negotiations on modernization of operating instruments or preparation of new Energy Charter instruments; the whole cycle is repeated at the next level;
3. International organization (Energy Charter Conference) as a political forum; within this forum the working process of different working groups of this international organization is taking place;
4. Energy Charter Secretariat as an administrative body of the multilateral international organization.

The Energy Charter Treaty is a sort of a "constitution" of the Energy Charter process. Only legally binding documents are subject to ratification. At the same time, it is not possible to sign and ratify any legally binding document of the Energy Charter without signing and ratifying the ECT and, prior to that, the European Energy Charter, the political declaration (Art. 33(3) of the ECT). The ECT is the only legally binding international legal instrument relating exclusively to the interstate cooperation in the energy sector and covering, in its essential part, international investments, energy trade and transit, energy efficiency, and dispute resolution procedures[20].

The fundamental goal of the ECT is to strengthen the rule of law on energy issues by creating a level playing field of rules to be followed by all participating governments, thus minimizing the risks associated with energy-related investments and trade.

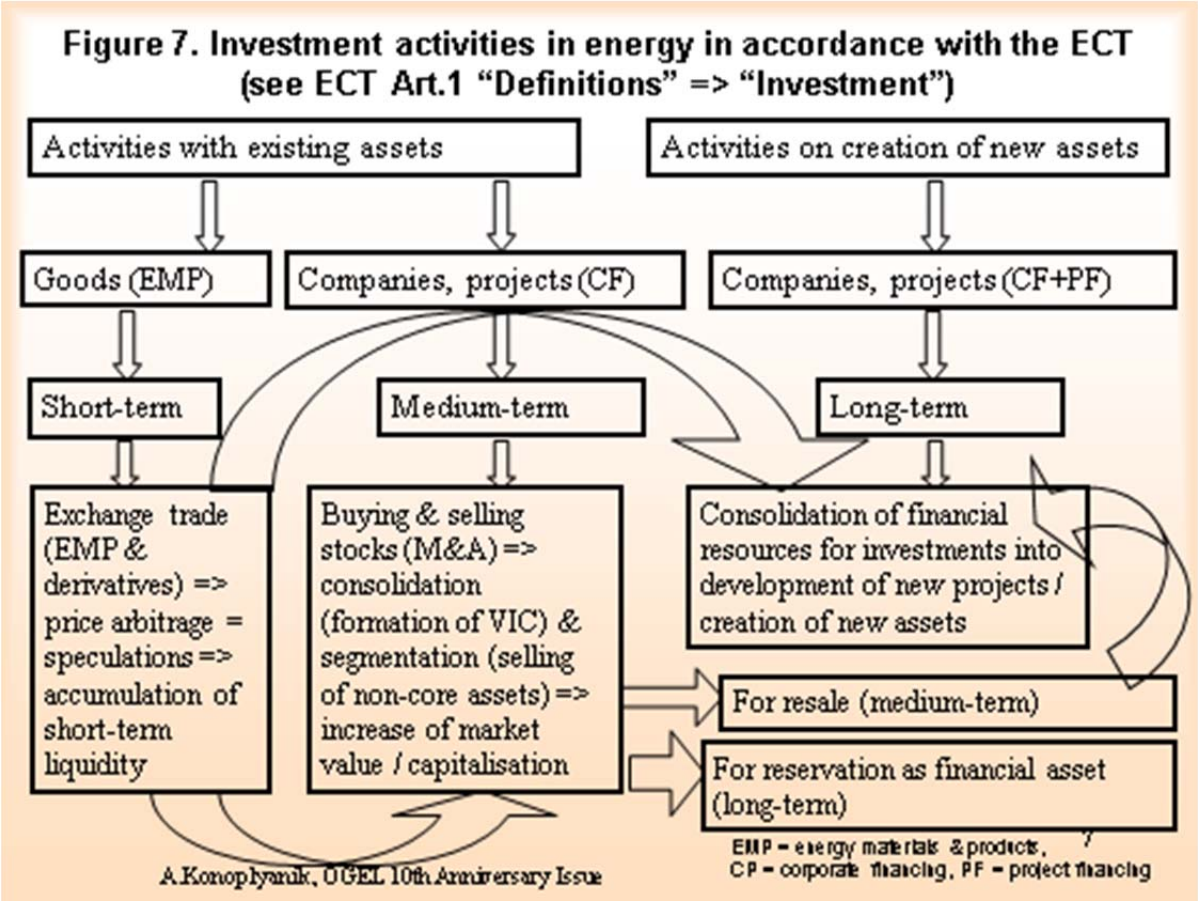
5. ECT and project financing: how the Treaty works

The main part of the ECT outlines the investment protection regime (part III). It is modeled on Chapter XI of NAFTA and on the contemporary BIT types. The section must be considered in combination with Article 26 (part V of the ECT), which allows an investor to

[20] For detailed economic and legislative analysis of the Energy Charter Treaty, its historical prerequisites and negotiations history, as well as Russia's concerns with respect to the ECT ratification, refer to: Centre for Petroleum & Mineral Law & Policy, University of Dundee. *T. Waelde (ed.). European Energy Charter Treaty: An East-West Gateway for Investment & Trade*. (International Energy and Resources Law & Policy Series). London - The Hague - Boston: Kluwer Law International, 1996, 700 p.; *Договор к Энергетической хартии – путь к инвестициям и торговле для Востока и Запада* [*Energy Charter Treaty – An East-West Gateway for Investment andTtrade.*] (edited by T. Waelde – English edition and A. Konoplyanik – Russian edition). - M.: International relations, 2002, 632 p.; brief complex analysis of the ECT is presented in: A.Konoplyanik, T.Waelde. Energy Charter Treaty and its Role in International Energy. – *"Journal of Energy and Natural Resources Law"*, November 2006, vol. 24, No 4, p. 523-558; T. Waelde, A. Konoplyanik. The Energy Charter Treaty and its role in the global energy sector. – *Neft, Gas i Pravo,* 2008, No. 6, p. 56-61; 2009, No. 1, p. 46-50; No. 2, p. 44-49; No. 3, p. 48-55.

litigate directly against the government of the host country violating one of the contracted liabilities under the ECT, immediately before an independent arbitration tribunal (this provision is a legal innovation, a legal novelty of the Treaty).

The fundamental feature of the ECT investment provisions is ensuring a "level playing field" for energy sector investments within the ECT member countries to minimize noncommercial risks associated with energy investments. In this respect, "the energy sector" in the ECT has the broadest possible meaning, including a wide range of energy materials and products (EMP). After the Trade Amendment came into force in June 2009 (see Table 1), the notion also covers energy-related equipment and all parts/stages of the full investment/production cycle in the energy sector. "Investments" in the ECT also have an extensive definition providing investors with stimuli for broadest spectrum of what can be considered as "investment activities" within the energy sector by providing protection to such activities - both the activities with existed assets as well as activities on creation of new assets (see Figure 7).



(Figure 7: Investment activities in the energy sector in accordance with the ECT)

The ECT provides protection of foreign investments in the energy sector based on the principle of non-discrimination. By accepting the ECT rules, a country undertakes to extend the national investment regime or the most favored treatment (whichever is more favorable) to individuals and legal entities of other signatory states which have invested in its energy sector.

The ECT distinguishes between the pre-investment stage (covering issues related to access for foreign investors, i.e. when investments have not been made yet but are in prospect) and the post-investment stage (covering issues arising after the investments have been made). In the first case, the ECT sets only "soft-law" obligations of the parties, i.e. those with a more flexible framework and less specific content such as "shall endeavor" (to provide, to limit). In the second case, the ECT provides for "hard-law" legal obligations presented expressly as a must ("the parties shall encourage and create…", which means that "the parties must (are obliged to) encourage and must (are obliged to) create").

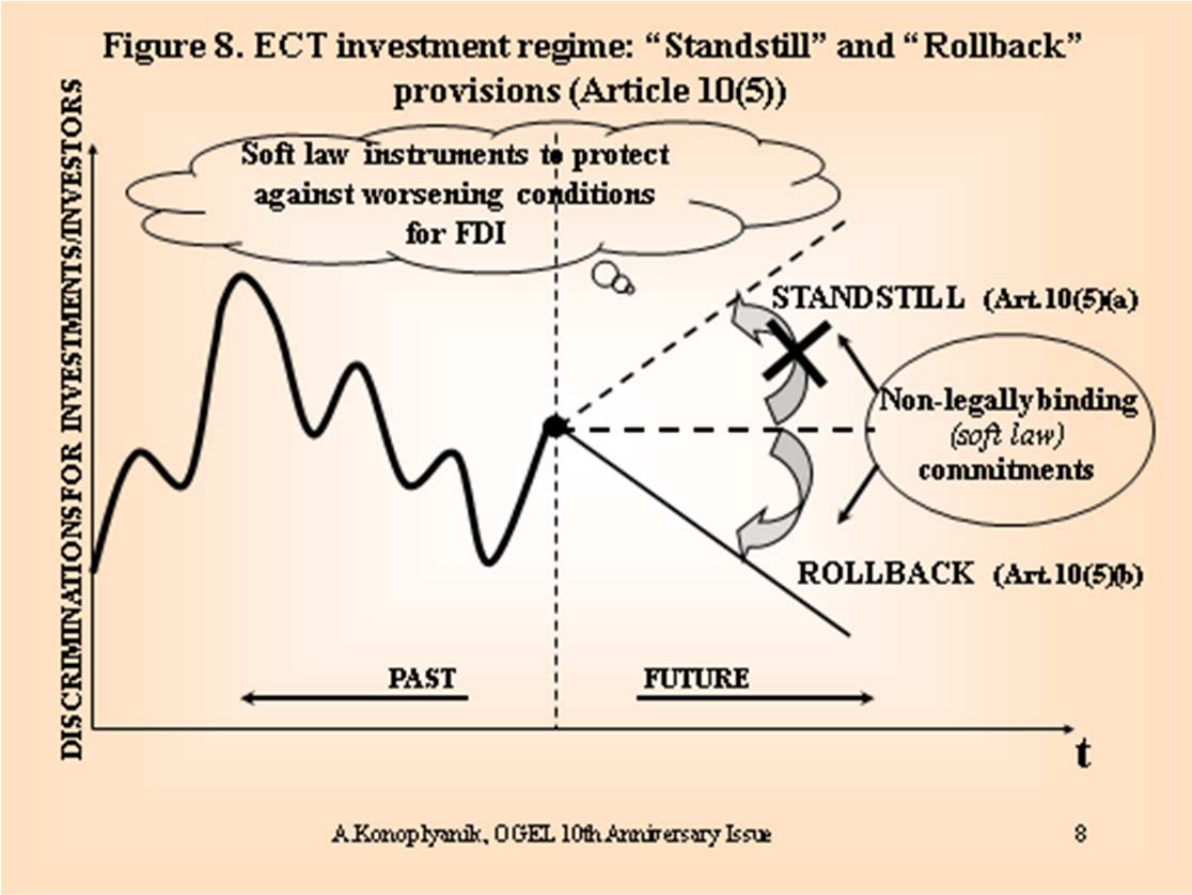
The reason for the distinction is that sovereign host states should be relatively free to make decisions with regard to open access for specific investors and to areas of investments within their sovereign territory. But once an investor is admitted to the internal market, has made his investments, and is thereby exposed to considerable political risk, the much tougher obligations to behave fairly towards the investor apply. Obligation to adhere to providing foreign investors with non-discrimination access to the internal market is realized in the form of two flexible liabilities (see Figure 8), i.e. obligations to pursue the following:

1. Not to impose new restrictions for foreign investors with respect to new investments (the so-called "stand-still" rule), and

2. To gradually eliminate existing restrictions (the so-called "roll-back" rule).

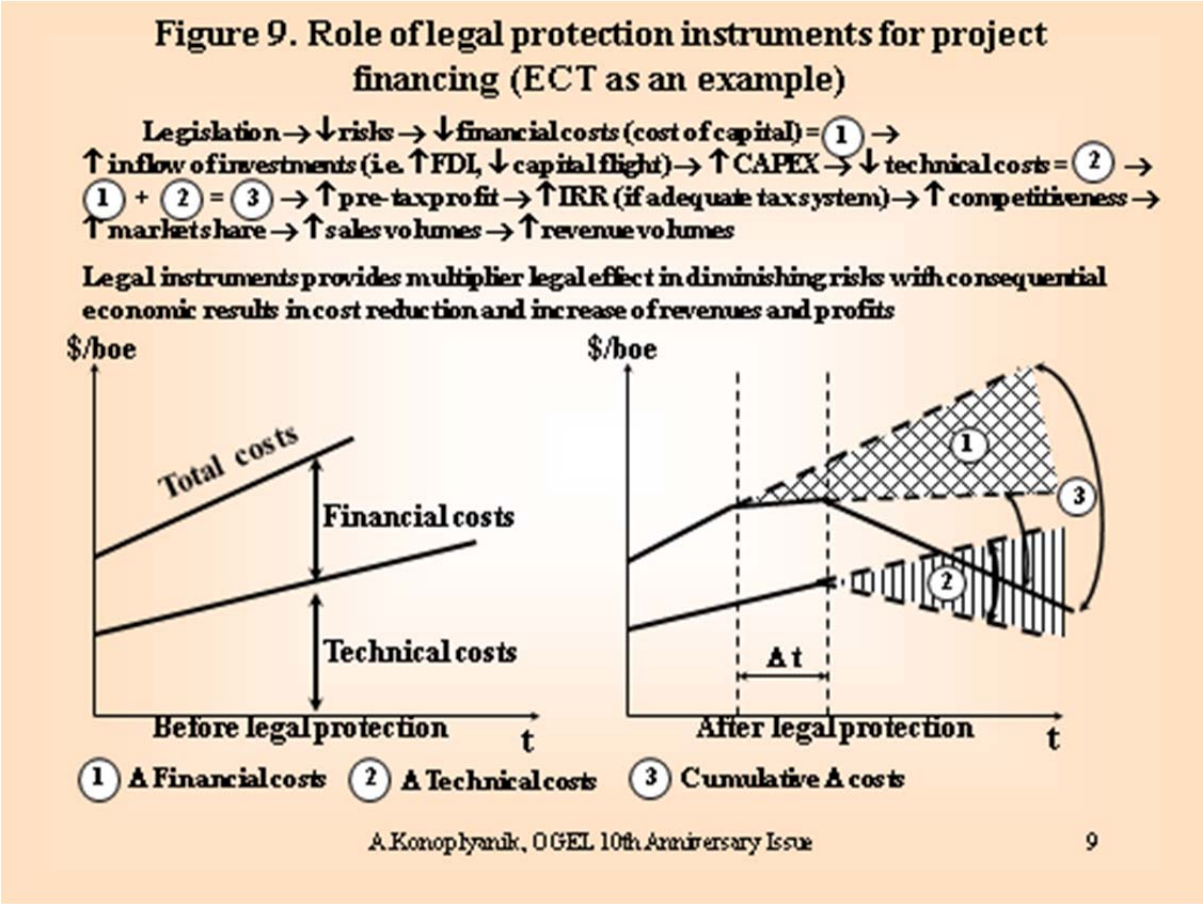
Introduction of these rules reflects the international practice of no less than the last 20 years to consistently liberalize and/or eliminate restrictions for direct foreign investments. However, since 2003-2004 (when oil prices started to soar) there has been a gradual increase in restrictive developments with respect to direct foreign investments in national legislations. The share of these has amounted to 30% against 0-10% in 2003[21].

[21] World Development Report 2010. UNCTAD, 2010, p.76-77.



(Figure 8: ECT investment regime: "Standstill" and "Rollback" provisions (Article 10(5))

Stabilization (non-deterioration) and/or improvement of investment conditions by legally binding (both hard-law and soft-law) provisions of the ECT bring into action the ECT's economic and legal instruments. They lead to lower non-commercial risks and reduced costs of borrowed funds, with corresponding financial and economic effects for an investor and the host country, sort of positive "domino effect" for both parties (see Figure 9).



(Figure 9: Role of legal protection instruments for project financing (ECT as an example))

The ECT is an instrument for project financing efficiency improvement. As an international treaty, it is aimed, however, at achieving business results. As an integral part of the international legislation, which, as is known, prevails over national legislations, the ECT assures reduction of investment risks and, as a result, financial costs of project implementation (the cost of borrowed funds or debt financing) in case of a more protectionist and less non-discriminatory nature of the national legislation in comparison with the ECT. This means improvement of prospects to receive higher and/or faster returns on investments, i.e. projects become more competitive on the capital market. As a result, the country's positive capital balance grows in two directions: through reduction of domestic capital outflow and increase in direct foreign investment inflow.

Inflow of capital in the form of direct investments is transformed into more capital expenditures (CAPEX). Since CAPEX are the carriers of the scientific and technological progress and innovations, a somewhat lagged reduction in technical costs of project implementation thus takes place. Both factors (reduced financial and technical costs) ensure an increase in taxable profit which, in case of an adequate fiscal system, results in a higher internal rate of return (IRR). As a result, the project's competitiveness on the commodities market rises, as does the market share of its output (sales). The company enjoys higher revenue and capitalization, lower lending rates, etc. This means growth of tax revenues and royalty payments for the host country and increase in productive and non-productive expenses from the project within the host country.

Thus, the ECT has the multiplier legal effect on lowering the risks with the resulting economic benefits regarding reduction in costs and growth of profits and revenues. Consequently, competitiveness of investment projects rises, with more direct and indirect investment revenues for the host country.

6. Criticism of the ECT by Russia – reasonable and far-fetched claims

Since the beginning of the ECT ratification procedure in 1996, its opponents in Russia have been raising different objections against ratification. These objections were analyzed by the author in detail earlier[22]. The major part of the ECT opponents relates to foreign investment antagonists per se. They consider FDI presence in Russia and in the energy sector and mineral extractive industries in particular, as a "bargain sale of the Motherland". The most frequently repeated arguments against ECT ratification in Russia boiled down to four of them, of which one related to trade in nuclear materials, and the other three related to natural gas trade. Two "gas" objections concern transit issues and the last one deals with long-term contracts. At the same time, both "transit" objections to the ECT do not relate to Russian gas transit through the territories of foreign states when gas is supplied to Europe (or, at least, they did not relate to it until unfortunate Russia-Ukraine gas dispute/crisis of January 2009 when it was this "fault" of the ECT that was raised by the highest Russia's authorities as a reason for hard criticism of the Charter and withdrawal from ECT provisional application later that year), but focus on prevention (non-admission) of transit gas supplies from the Central Asia via Russia to Europe on the terms (as if presented such interpretation of the ECT rules) which discriminate Russian producers/exporters. Thus, the main objections to the ECT were initially associated with transit issues. As is shown below, two transit objections are valid. A procedural solution was found: development of a Transit Protocol with an acceptable solution in it of the two issues of Russia's concern in substance as a prerequisite (but was it really enough?) for ECT ratification by Russia.

On the eve of the 2006 Group of Eight (G-8) Summit in Saint-Petersburg, in the light of stronger (inherently counterproductive) pressure on Russia from Western countries, some of which were not even the Contracting Parties/Signatories to the ECT, with calls to Russia to ratify the ECT irrelatively to completion of the Transit Protocol, Russia raised further objections to the ratification, namely, incompleteness of the Supplementary (Investment) Agreement (see Fig. 5).

However, some Russian politicians who apparently did not even read the ECT and/or were unaware of the modern practice of preparation and conclusion of multilateral agreements (which always reflect a multilateral achievable and balance of interests, i.e. the minimal set of provisions satisfying all participating parties, and not the set of provision which, as it used to

[22] А.Конопляник. Ратификация ДЭХ Россией: прежде всего, необходимо развеять добросовестные заблуждения оппонентов. [A. Konoplyanik. Ratification of the ECT: first of all, opponents' bona fide ignorance should be assuaged. – Chapter 22 in the book*: Договор к Энергетической Хартии: путь к инвестициям и торговле для Востока и Запада [The Energy Charter Treaty: An East-West Gateway for Investment and Trade]* (edited by T. Waelde – English edition and A. Konoplyanik – Russian edition). M.: Mezhdunarodnye Otnosheniya, 2002; А. Конопляник. Борьба с мифами. О мнимых выгодах и угрозах Договора к Энергетической Хартии. [A. Konoplyanik. Fighting the myths. On imaginary benefits and threats of the Energy Charter Treaty.] – *Politicheskiy Zhurnal,* June, 13 2006, No. 21 (116), p. 32-36; same author. Сила аргумента или аргумент силы. Что дает России Энергетическая Хартия? [Force of argument or argument of force. What is the Energy Charter for Russia?] – *Mirovaya Energetika*, June 2004, No. 6, p. 50-53, and others.

be, a country could impose on a wider community or another country in a bilateral agreement), were dissatisfied by the fact that the ECT did not contain some important, from their point of view, provisions[23] and demanded to refuse to ratify the ECT and rewrite it with the aim to include some amendments and alterations allegedly beneficial for Russia, before the State Duma returns to ECT ratification issue. At the same time, these "politicians" did not even come to think that 46 countries have already ratified the ECT and it is practically impossible to make them walk away from ECT ratification in favor of a new document, allegedly "satisfying Russia" but currently missing, and that such demand is at least unprofessional.

7. ECT, transit and draft Transit Protocol

Since the RF Government introduced the issue of ECT ratification in the RF State Duma in August 1996, Russia's legitimate concerns about the ECT only focused on two matters covered by Art. 7 of the ECT "Transit":

(1) Whether it is possible to interpret the provisions of Art. 7(3) concerning the correlation between the levels of transit tariffs and domestic transportation tariffs in a detrimental to Russia manner; and
(2) The failure of Art. 7(7)(c) to clarify the mechanism of converting the interim transit tariffs set by a conciliator in the course of transit dispute settlement through conciliation to final transit tariffs upon dispute resolution[24].

Therefore, these legitimate concerns of the nation were evidence not that they were unacceptable per se but only that various interpretations were possible for the said ECT provisions, including those that would go against the grain for Russia. It was necessary to make practical decisions[25], which would enable addressing Russia's reasonable complaints without amending the Treaty itself.

In the course of parliamentary debates in January 2001 on the issue of ECT ratification, the Russian State Duma took a pragmatic and legally feasible decision that Russia's legitimate concerns about the ECT transit provisions must be addressed in a dedicated legally binding

[23] The author has, on numerous occasions, including his publications and presentations, argued against the ECT opponents and their objections to the Treaty. See, e.g.: А. Конопляник. Борьба с мифами. О мнимых выгодах и угрозах Договора к Энергетической Хартии. [A. Konoplyanik. Fighting the myths. On imaginary benefits and threats of the Energy Charter Treaty.] – *Politicheskiy Zhurnal,* June, 13 2006, No. 21 (116), p. 32-36; same author. Сила аргумента или аргумент силы. Что дает России Энергетическая Хартия? [Force of argument or argument of force. What is the Energy Charter for Russia?] – *Mirovaya Energetika*, June 2004, No. 6, p. 50-53.

[24] Apart from these legitimate concerns that needed clarification, the opponents of ECT ratification by Russia, whose mouthpiece has been and remains the incumbent deputy chair of the RF State Duma and CEO of Russian Gas Society V.Yazev, have voiced a great many other complaints about ECT, which should be categorized as "myths" due to the fact that the authors of the objections had not read ECT for themselves (a case in point is my debate of many years with Mr Yazev, who stubbornly insisted that ECT required mandatory third-party access to the gas-transport infrastructure whereas ECT explicitly states the opposite in its Understanding IV.1(b)(i) at p.25 of the text in Sept'2004 ECS publication, see www.encharter.org), but judged it based on the interpretation given to ECT provisions by the international media or EU politicians, who discussed not what is set forth in the Treaty but what they would have liked to find there, governed by/based upon the evolution of EU legislation and their ambition to expand its jurisdiction over the EU neighboring countries.

[25] These were what the author of this paper mostly worked to elaborate and achieve when serving as Deputy Secretary General of the Energy Charter Secretariat in 2002-2008.

Energy Charter Protocol on Transit (negotiations on it started in 2000, see Table 1). Pursuant to Art. 1(13)(a) of the ECT, "Protocol" means "a treaty ... in order to complement, supplement, extend or amplify the provisions of this Treaty with respect to any specific sector or category of activity…". Therefore, using the Energy Charter Protocol on Transit to elucidate the interpretation of the provisions of Art.7 of the ECT on transit is quite legitimate and does not require editing/amending the ECT itself. The many years of bilateral informal consultations between Russian and EU experts about the draft Transit Protocol, which were particularly intensive and effective in 2004-2007, produced special mutually acceptable understandings, which had been agreed at the multilateral expert level and set forth therein (but which, however, have not yet been given political support by the stakeholders), with respect to the ECT provisions on transit.

By 2007, all matters in dispute in the Transit Protocol, except for one provision, had been resolved. Differences persisted with respect to the EU proposal (Art. 20 of the draft Transit Protocol) that the movement of Energy Materials and Products within the European Union be not classified as transit (EU argument: no transit can exist - in the legal meaning of the term as set forth in Article 7 of the ECT - within the EU single market). This EU proposal may create additional transit risks for supplies of Russian gas to Europe (for example, the risk of the so-called "contractual mismatch", which is a result of the key novelties implemented by the Second EU Gas Directive (2003): unbundling of vertically integrated companies and mandatory third-party access within the EU territory) because after the EU expansion in 2004-2007 a significant portion of these supply routes – up to gas delivery points – passes through the EU territory[26].

However, the Energy Charter Plus roadmap, which was discussed in 2009 (see below), ushered in a very important and then new idea that would have paved the way to a radical solution of the problem (though this proposal was not recalled by the parties) - the option of incorporating into the Transit Protocol a provision that Article 20 will be automatically deleted from it in the event of Transit Protocol' ratification by Russia. It means that this would apply to ECT ratification by Russia, too, because Russia can only ratify the ECT and the Transit Protocol at the same time (see Table 2). However, the failure by the Russian delegation to attend a number of key meetings (which I called "counteraction by inaction" in one of my papers[27]) made it impossible to continue promoting that roadmap.

[26] For the nature of the risks, refer, e.g. to: А.Конопляник. Об эволюции контрактной структуры поставок российского газа в Европу [A. Konoplyanik. On the evolution of contractual arrangements for supplies of Russian gas to Europe]. – *Perspektivy Energetiki, or Energy Industry Prospects,* 2006, vol. 10, No 1, p. 1-29; same author. Российский газ для Европы: об эволюции контрактных структур (от долгосрочных контрактов, продаж на границе и оговорок о пунктах конечного назначения - к иным формам контрактных отношений?) [Russian gas for Europe: evolution of contractual arrangements (from long-term contracts, border sales and final destination provisoes to other forms of contractual relationship?)]. *Neft, Gaz i Pravo,* 2005, No 3, p. 33-44; No 4, p. 3-12.

[27] А.Конопляник. Противодействие бездействием. [A. Konoplyanik. Voting with Feet (lit. "counteraction with inaction")] *Vedomosti,* 23 October 2002, p.A4.

Table 2. Possible and impossible procedural solutions for ECT & Transit Protocol ratification by Russia
Scenario 1: At first, Russia to ratify the ECT, afterwards Energy Charter community complete, sign and ratify Transit Protocol => Historical EU proposal, not acceptable for Russia. ***Scenario 2:*** At first, to complete, sign and ratify Transit Protocol with due consideration of justified concerns of Russia regarding transit provisions of the ECT and still open issues of draft Transit Protocol. After that Russia will return to ECT ratification issue. => would be preferable for Russia, but it is impossible according to Energy Charter rules (no one state can become a party to an Energy Charter Protocol without ratification of the ECT) ***Scenario 3:*** The only workable and mutually acceptable compromise: Russia ratifies "modified ECT" and Transit Protocol simultaneously. The term "modified ECT" does mean existing ECT being complimented and expanded (based on necessity and pendant to agreement of Energy Charter parties) by the new Protocols and other legally-binding and non-binding instruments. "Modified ECT" does not mean "rewritten" ECT, i.e. it does not mean that ECT legal text per se can be amended and/or changed until the moment when all ECT signatories ratify it. => Energy Charter community should concentrate on practical ways of solving Russia's justified concerns regarding ECT and draft transit Protocol. Nowadays this task is more difficult due to Russia's withdrawal from ECT provisional application. Furthermore, there is no consensus in assessment of legal consequences of this Russian action and related disappointment in the Charter and broader international community.

(Table 2: Possible and impossible roadmaps for ECT and Transit Protocol ratification by Russia)

8. Common misconception 1: as if ECT obliges transit to be provided

Some Russian politicians regularly voice their fears that if Central Asian producers and European buyers make direct contracts for the supply of gas to Europe, the ECT would allegedly require *(oblige)* that Russia enable such companies to use the RF gas transport system (GTS) for transit of cheap Central Asian gas to the EU at Russia's low domestic transport tariffs. The bottom line is that, having crossed over Russia's territory, Central Asian gas will compete against Russian gas in the European market and will have a competitive (price) edge as it is much cheaper to produce and is much closer to the European markets.

This is what is widely believed. However, the ECT has no such requirement, pure and simple. First, Understanding IV.1 (b)(i) of the ECT explicitly states that "The provisions of the

Treaty do not oblige any Contracting Party to introduce mandatory third party access"[28]. Second, it should be understood that transit is only one of three possible (alongside swaps, i.e. replacement transactions, and on-border sales) options to move Energy Materials and Products (EMP) across the territory of a country that separates a producer and an end-user. Therefore, a request from a supplier or end-user, even if backed up by a supply contract made between them, for transit to be provided across the territory of a third country does not constitute for this third country either a necessary or sufficient condition, let alone an obligation, to provide transit. A potential transit country is entitled to choose – and this will be its sovereign decision – whether to make its territory available for transit or provide either of the two other specified options. A refusal to provide transit across its territory, but with an arrangement offered instead to cross it, say, on the terms of "on-border sale", will not constitute a breach of ECT provisions. However, if a country takes the decision to provide transit and enters into talks on the arrangements for the provision thereof, the provisions of Art.7 of the ECT and of the Transit Protocol will apply. However, even when in such talks, the parties may naturally fail to reach agreement on the terms and conditions of transit at the end of the day – and this will also constitute no breach of ECT provisions because the potential transit country has at least five levels of "protection" for its interests in this matter if it does not want to provide new transit to third parties [29].

The ECT says nothing about the duty to grant access to transit facilities for third parties. The Treaty only says that "Each Contracting Party shall take the necessary measures to facilitate the Transit of Energy Materials and Products" (Art. 7(1) of the ECT) – i.e. the existing, rather than new, transit, and "shall encourage relevant entities to co-operate" in the area of transit (Art. 7(2) of the ECT). Art. 7(4) of the ECT says that "…the Contracting Parties shall not place obstacles in the way of new capacity being established, except as may be otherwise provided in applicable legislation ..." (and for a country that applies the ECT on a provisional basis – which has been true for Russia up to October 2009 – the national legislation takes precedence over the ECT in the event of conflict of their laws). Moreover, Art. 7(5) of the ECT says that a transit CP shall not be obliged to permit the construction or modification of transit facilities or permit new or additional transit if it demonstrates to the other CPs concerned that this "would endanger the security or efficiency of its energy systems, including the security of supply".

Therefore, the ECT does not require to give access to Gazprom's GTS; quite the opposite, it enshrines the internationally accepted mechanisms for justified denial of national GTS to new (potential) transit.

[28] This is the clause that made it necessary for the author to engage in a long debate with many opponents of the ECT and the discussion of which gives evidence of whether the opponents of the ECT have read text of the Treaty or not.

[29] This has also been necessary to bring home to ECT opponents on more than one occasion because they, too, apparently neglected to read the Treaty. See, e.g., А.Конопляник. Договор к Энергетической Хартии: "Ратифицировать надо, но не сегодня…" [A. Konoplyanik. Energy Charter Treaty: "To be ratified but not today…"]. *Promyshlenny Mir, or Industrial World,* 2001, No 2, p. 44-48; Same author. Есть только один путь к ратификации ДЭХ. Чтобы договориться, надо понять возражения противной стороны. [Only one way to ratify the ECT. To reach agreement, the objections of the opposite party must be understood.]. *Neft i Kapital, or Oil and Capital,* 2001, No. 3, p. 8-10.

9. Common misconception 2: as if ECT obliges tariffs to be equal

Another complaint about the ECT was that it allegedly requires transit of gas from Central Asia across Russia's territory to be at *subsidized* domestic tariffs for transport. Discussions revealed that it was indeed possible (though far from unconditionally) to interpret the provisions of Article 7(3) of the ECT as providing for equal tariffs for export, import, transit and domestic transportation.

Such interpretation of Article 7(3) of the ECT was put forward, specifically, by the EU delegation – and not only during the talks on the Transit Protocol but also in the course of talks on Russia's accession to the WTO (one of the six points of the so-called "Lamy package" of early October 2003). However, such requirement for equal tariffs in Russia is at least contestable, and in my opinion, simply incorrect[30], all the more so given that (see below) they are not equal even within the EU.

For a long time, the possibility of interpreting Article 7(3) of the ECT as if requiring equal tariffs, has provided grounds for ECT ratification opponents in Russia to call for amending the ECT or for an even more radical measure – to start talks on a new Treaty, which was supposed to replace the "imperfect", in their opinion, ECT as a condition for ECT ratification by Russia.

This proposal, however, falls into the category of pipe dreams. The ECT has been an integral part of international law since April 1998, and will remain in full force and effect for the 46 states that have ratified it. One cannot improve the Treaty except after joining it as a full member, i.e. after ratification. Therefore the parties eventually opted (viva common sense!) for another - practical - approach to address the concerns of the Russian party. First, the ECS conducted a study[31], which showed that five out of the six ECT countries targeted by the comparative review of transit and domestic tariffs had transit tariffs that were higher than the domestic ones, including four EU countries (where, in accordance with the EU delegation's arguments at the talks on the Transit Protocol and on Russia's accession to the WTO alike, the transit tariff should have been equal to the domestic ones): Austria 1.9 times, Belgium 2.8 times, Poland 2.4 times, Slovakia 1.3 times (to put this into perspective: Russia, as evidenced by the same study, 1.6 times), with Germany alone having equal tariffs.

The study established that a wide variety of procedures were used for gas transit tariffication. Neither the ECT nor the draft Transit Protocol, however, imposes any specific procedures for transit tariffication. Therefore, the Contracting Parties are free to develop procedures that are the best for their transportation and transit systems as long as these procedures meet the requirements of transparency, recognition of actual costs, and non-discrimination. Therefore, by way of a solution to the problem of interpreting Art.7(3) of the ECT, the draft Transit Protocol proposed an "Understanding" stipulating that the transit tariffs and domestic transport tariffs are not obliged be equal.

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[30] А. Конопляник. Саммит Россия - ЕС: энергетические итоги. [A. Konoplyanik. Russia - EU summit: energy-related results]. *Neftegazovaya Vertikal, or Petroleum Vertical*, 2004, No 10, p. 10-12; Same author. Каковы "энергетические" итоги Саммита? [What are the energy-related results of the Summit?] *Neftegaz, or Petroleum*, No 3, July 2004, p. 37-42.

[31] Gas Transit Tariffs in Selected ECT Countries. Energy Charter Secretariat, January 2006, www.encharter.org/

Finally, Central Asian gas is no longer cheap. Since 2009, all export gas has been priced both in the EU and in the post-Soviet space using the same methodology – based on the net-back replacement value from EU end-user price, e.g. netted back to delivery points at the former EU-COMECON border. Central Asian countries find it more profitable to export gas using this pricing formula with the delivery points at their national border rather than arrange for transit supplies to Europe. As for West-European companies, they have lost their economic incentives for buying Central Asian gas directly since 2009 because the price edge, the so-called Hotelling rent, is no longer available. The latter is the difference between the "replacement value" of gas in Europe (based on the end-user prices of gas substituting energies which compete with gas), adjusted/netted-back to the border of Central Asian exporting countries (i.e. net of the applicable transportation costs), on the one hand, and the export price at the national border of the Central Asian exporting countries, as calculated to the end of 2008 on the principle of "cost-plus", on the other[32].

It has been therefore my opinion that it makes better sense for Central Asian exporting countries supplying gas to European destinations to sell their gas to their traditional business partners in Russia at their national borders within the infrastructure in place rather than arrange transit for it through Russia and/or sell it to new business partners in Europe, with supplies to be sent through new (not yet completed) pipelines bypassing Russia through the Southern Corridor[33].

10. Common misconception 3: regarding Russia-EU nuclear trade

By way of complaint about the ECT, the opponents of its ratification have repeatedly asserted that the Treaty does not regulate bilateral trade in nuclear materials between Russia and the EU. This being the case, Russian spokesmen have submitted that the situation has been worsening with time: to begin with, the restrictions applied to 15 EU members (EU-15); later, to EU-25/EU-27; and now, to more than 30. To be sure, this is a result of both the EU expansion from 15 to 25/27 member-states, as well as of the EU signing the Energy Community Treaty with nations in South-Eastern Europe (SEE) in October 2005 (effective as of 1 July 2006), which provides for the EU energy legislation (acquis communautaire) (namely EU Gas and Electricity Directives) to apply to 6 SEE states located in the Balkan peninsula, plus Moldova and Ukraine.

The Final Act of the European Energy Charter Conference signed in December 1994 (which includes the ECT and documents related thereto) has indeed as its integral part the Joint Memorandum of the Delegations of the Russian Federation and the European Communities on Nuclear Trade. The EU expansion, naturally enough, expands the jurisdiction of the Memorandum.

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[32] See: А. Конопляник. Российский газ в континентальной Европе и СНГ: эволюция контрактных структур и механизмов ценообразования. [A. Konoplyanik. Russian gas in continental Europe and the CIS: Evolution of contractual arrangements and pricing mechanisms]. INP RAN [Institute for National Economic Forecasts of the Russian Academy of Sciences (RAN INEF)], Open Seminar, Economic Problems of Energy Complex, 99th meeting, 25 March 2009. Moscow, RAN INEF Publishing House, 2010, 110 p.; A. Konoplyanik. The evolution of gas pricing: Europe & CIS. – "*Energy Economist*", Issue 347, September 2010, p.9-11

[33] А. Конопляник. На пороге смены экспортной стратегии. [A. Konoplyanik. Upcoming export strategy change]. *Neft Rossii, or Russian Oil,* 2010, No 3, p. 57-59; A. Konoplyanik. Russia has trumped Nabucco in Central Asia. - *"Petroleum Economist"*, September 2010, p. 24-25.

The Memorandum documents that Russia is interested in increasing the volume of nuclear trade with the EU, and that "representatives of the Commission and of the Russian Government will meet in the near future in order to examine the difficulties encountered by Russian exporters of nuclear materials". These provisions reflect the essentially bilateral relationship between the parties, and in the event of failure by either party to be entirely satisfied with the development of the relationship envisioned in the Memorandum, cannot and must not be regarded as a failure of the multilateral Treaty.

Moreover, by signing, as early as six months before the signing of the ECT, Russia-EU Partnership and Cooperation Agreement (PCA) in June 1994, both countries has agreed to regulate the nuclear trade issues on the bilateral basis and PCA provides a framework for addressing the matters of nuclear trade on a bilateral basis. So what fault the ECT can have in this respect?

11. Common misconception 4: regarding Supplementary Treaty on Investment

Yet one more complaint about the ECT is sometimes linked to the situation with the Supplementary Treaty (on Investment), the talks on which, according to Article 10.4 of the ECT, were expected to start immediately after the signing of the ECT with a view to concluding it by 01.01.1998. The complaint was directed against the EU, which arranged for the Supplementary Treaty to be taken off the negotiation table in 1998 and put on ice due to the suspension of work on the OECD Multilateral Agreement on Investment which was in progress up to that time. The question being raised supposedly shows that Russia is motivated to resume talks on the Supplementary Treaty, to have it drafted and signed. Two considerations come into play in this context, however.

Item one. The ECT in place (which is an integral part of international law) and the as-yet-virtual Supplementary Treaty on Investment are two independent legal instruments. Tying in the completion of work on the Supplementary Treaty with ECT ratification would have made sense (as, for example, it was the case of the Transit Protocol) if it would have proved to be instrumental in addressing the matters of vital importance for Russia as have failed to find adequate coverage in the ECT and would have moved them in the direction benefiting the nation (as the draft Transit Protocol elucidates and develops the provisions of Art. 7 "Transit"). The content of the Supplementary Treaty, however, is predetermined by Art. 10(4) of the ECT - it is only expected to expand the jurisdiction of national treatment of investment from post-investment (as provided for in the ECT) to pre-investment stages in making the investment.

Hence item two. For quite a number of years the situation with Russia's commitment to the Supplementary Treaty is quite likely to be the reverse: the Russian domestic legislative scene suggests that the nation is not ready to apply the national treatment of investment at the pre-investment stage. The revised Law on the Subsoil, the Foreign Strategic Investments Law, the Continental Shelf Law, *etc*. bring it home in no uncertain terms.

12. Common misconception 5: as if ECT is against long-term contracts

This objection of ECT opponents, if made in good faith, is a result of their misunderstanding of market development trends and of mixing together (considering as synonyms) ECT and EU acquis through the whole period of ECT existence until nowadays.

One should distinguish the period before and after 2003. Before 2003, when the First EU Energy Package was in force, there was a full correlation between ECT and EU acquis. After Second EU Energy Package came in force in 2003, deviation (qualitative gap) between ECT and EU energy acquis took place which was further broadened when Third EU Energy Package began to apply within the EU since 2009.

So if any critics towards ECT can take place based on the EU actions/statements – this would be valid only for the period prior to 2003. Afterwards such critics can be addressed towards EU only notwithstanding that it is a Contracting Party to the ECT.

Prior to Second EU Gas Directive, nobody intends or was in a position to target long-term contracts for destruction – they were, are and will be an important and essential element of contractual arrangements in the gas market[34]. If ECT opponents entertained the notion that the EU had intended to make a special effort to scrap such contracts by unilateral administrative actions or introduce at its discretion amendments to this effect to the long-term contracts in place between Gazprom and its European counterparties, then either the EU intentions were misinterpreted or (if the EU intentions were interpreted correctly) the intentions were based on erroneous notions of market dynamics on the part of the EU entities involved.

But already in 2002 Russia and the EU made a joint statement that "providing a secure legal framework and regulatory environment for the supply of gas is of fundamental interest to both the E.U. and Russia. ... Both the E.U. and Russia consider that these (long-term gas - A.K.) contracts have not only underpinned investments in Russia in new capacity in the past, but will remain necessary in the future. The (European) Commission has made it clear that long-term take-or-pay gas contracts are indispensable. The (European) Commission will, together with Russia in the context of the dialogue, closely monitor the developing situation, and the Commission is determined to ensure that contractual and regulatory conditions continue to exist that enable the financing of the major investment necessary to ensure future EU security of gas supplies."[35] Therefore, the perceived conflict over long-term contracts between Russia and the EU within the period when ECT was equal to EU rules and thus when ECT could have been criticized for EU faults by the ECT opponents, can be considered as non-appropriate.

Nowadays, when the whole gas market in the EU has suddenly changed in 2009 its major characteristic features (transformation from undersupplied to oversupplied) due to a number of reasons[36], and the Third EU Energy Package came in force in the same 2009 and it has

[34] See, e.g.: А. Конопляник. Развитие рынков газа, долгосрочные контракты и Договор к Энергетической Хартии [A. Konoplyanik. Development of gas markets, long-term contracts and Energy Charter Treaty]. *Neftegaz*, 2002, No. 4, p. 25-33.

[35] EU-Russia Energy Dialogue. Second Progress Report. Presented by Russian Vice-Prime Minister Victor Khristenko and European Commission Director-General François Lamoureux, Brussels/Moscow, May 2002, Section II.3, Legal security for long term supplies.

[36] See, for instance: A.Konoplyanik. "Russian gas in Europe: Why adaptation is inevitable". - *"Energy Strategy Reviews"*, March 2012, Volume 1, Issue 1, p. 42-56.

established radically new architecture of the EU gas market (entry-exit zones with virtual trading points (hubs) in each zone), which really put under question the continuation of the existing models of long-term gas export contracts with petroleum product price indexation (if without adaptation to the new realities of the gas market), all the claims regarding this should be addressed directly to the EU and not to the ECT anymore.

13. The media as the "collective disorganizer" (fifth column)

The Charter and its instruments are mentioned in the media on a regular basis, including in the headlines of broadsheets. However, the Western and Russian media alike are quite often guilty of loose (for example, with respect to "freedom of transit") and/or incorrect interpretation of ECT provisions (for example, with respect to the required provision of transit rights or access to the subsoil for foreign investors). Or they continue to rehash the old-hat arguments of opponents of ECT ratification by Russia put forward by them many years ago and long rebutted by its advocates (for example, with respect to the ECT's alleged requirements for privatization of the fuel-and-energy sector and/or unbundling of energy companies, or granting of mandatory third-party access, or its alleged agenda of abolishing long-term contracts). All this busy them in this way with imaginary problems and phantom pains. The result is that in their effort to nudge the process of ECT ratification by Russia, the media often use incorrect or spurious arguments as if in support of the ECT, more often than not thus rendering it a disservice.

In the Western media, quotes by European politicians urging Russia to ratify the ECT were normally accompanied by comments, including ones provided by the media themselves, extolling the benefits that ECT ratification by Russia would give to the West. Quite a lot of such comments suggest that the Charter's scope and the Treaty's relation to it are misunderstood. It is quite unfortunate that such comments often misrepresent (intentionally or unwittingly) the provisions of the Treaty - for example, in matters that are of special interest/concern to Russia and Gazprom, bearing as they do on energy transit or access to export pipelines (as was shown above). ECT misinterpretation, presented as the real McCoy, and flying in the face of stated priorities of Russian energy policy, provoked a quite-predictable backlash in Russia – in political and business circles alike.

For its part, in covering the debate centered on the ECT, the Russian media quite often simply reprinted the idle speculations in the Western media, sometimes taking them to a level that was bizarre in its lack of professionalism.

Some Russian politicians, speaking vehemently against ECT ratification in their drive to be "more royalist than the king" and gain "political capital" in the "struggle to protect national interests", would normally also disdain to read the ECT (you need to have a certain background to be able to read and, more importantly, understand this 250-page legal document) and usually responded to run-of-the-mill copy by the media, supplying them, in turn, with opportunities to quote "authorities". This gave rise to a vicious circle, with mythical expectations or blunders of some people causing others to tilt at windmills. That way, the focal point of the debate about the ECT shifted in point of fact into a kind of virtual space, where hot discussions centered on provisions allegedly present in the ECT but in actual fact absent from it.

What makes it particularly sad is that it was this "virtual scene" that I believe created the informational background that prompted Russia to make its decision to roll back provisional application of the ECT.

14. Criticism of the ECT by Russia: 2009 timeline resulted with termination of its provisional application

Be that as it may, however, the criticism leveled at the ECT by Russia's leadership, resulting in the country's terminating provisional application of the ECT, was sparked off not by the complaints about the ECT that had been voiced on more than one occasion but by the January 2009 Russian-Ukrainian gas crisis.

The criticism of the ECT/Charter by Russian leadership was ratcheted up over January to June 2009. The first serious shot against the ECT was fired at this level in the course of Russian-Ukrainian gas crisis in January. The criticism was triggered by Ukraine's infringement of the ECT transit provisions, absence of an adequate assessment of the breach by the European Union and its member states and inaction by the political leadership of the Energy Charter Secretariat before and during the Russian-Ukrainian gas conflict.

On 20.01.2009, during a meeting with the Gazprom Chairman of the Board A. Miller, the then Russian President D. Medvedev expressed criticism of the Energy Charter for its failure to prevent the Russian-Ukrainian gas crisis that ended the day before and called for "new international mechanisms". The President urged "to think about either amending the Energy Charter in place (if allowed by the signatories) or drafting a new multilateral instrument…" The President invited the Government and Gazprom "to think about what mechanism it would make sense in this context to develop and offer to all members of the international community". The President promised to table a number of ideas during the London meeting of the G20 in early April[37].

Having voiced harsh criticism against the Energy Charter (which was actually leveled against the then political leadership of the Energy Charter Secretariat), the Russian President nevertheless outlined an alternative course of action: either revamp the Charter (on a large scale) or draft a new document. On 01.03.2009 in an interview to the Spanish media, the President proposed to "develop a new Energy Charter or a new version of the Energy Charter", in that way confirming the either-or nature of his proposal[38]. I would like to underline, that since the then Russian President (now Prime-Minister) D.Medvedev has been regularly and constantly referring to his legal background, I would assume that he understood the difference between the non-legally binding Energy Charter (political declaration) and legally-binding Energy Charter Treaty.

In late April, however, the import of the presidential intentions changed. On 20.04.2009, while in Helsinki, President Dmitry Medvedev said that "Russia intends to change the legal framework for its relationship with energy users and transit countries". Speaking about the "Energy Charter and other documents", he said that "we have not ratified these documents and do not consider ourselves bound by these decisions" (I still hope that by saying this he, as a person with legal background, understood the essence of "provisional application" clause and its legally binding, though in limited format, character). The President indicated that he

[37] http://kremlin.ru/text/appears/2001/01/211884.shtml
[38] http://eng.kremlin.ru/text/speeches/2009/03/01/1002_type82914type82916_213434.shtml

"will disseminate … a framework document which covers matters of international cooperation in energy"[39].

The following day, 21 April, the official website of Russia's President posted the aforementioned "framework document" [40]. This is a five-page "Conceptual approach to a new legal framework for international cooperation in energy (objectives and principles)" ("Conceptual Approach")[41].

The April initiative of then Russia's President naturally changed the "alternative" nature of criticism against the ECT (improve the Charter process and its instruments or develop a new package of documents) to a "zero-option" approach. After 21.04.2009, the Russian establishment gave voice to the second option only – to develop a new package of documents based on the Russian proposals. The Russian proposals to set up new system *in lieu* of the ECT, however, aroused little if any enthusiasm among potential partners. Brussels and certain EU members said that abandoning the Energy Charter was out of the question. And that made sense – after coming into effect in 1998, the ECT has become part of the system of international law, having been signed by 51 (now 52) countries and ratified by 46.

That notwithstanding, on 29.04.2009, when in Sofia, the then Russian Prime Minister Vladimir Putin said that "unfortunately, the Energy Charter … has failed in its role. The Russian Federation considers, and has always said before that we do not consider ourselves bound by this instrument because we have not ratified it. And today we can say exactly and definitively that we see no point in even keeping our signature on this instrument".[42] On 05.06.2009 in St Petersburg, the RF President D. Medvedev reiterated the Russian position that the Energy Charter is incapable of dealing with all problems in international gas trade. "Was this Energy Charter of any help in the course of the gas conflict early this year? The procedures set forth in this Charter failed; the incentives it offers failed, the Energy Charter Treaty was not applied. This means that we must have some other framework to smooth over conflicts of this nature," he said.[43]

On 29.06.2009, in the course of an interdepartmental conference chaired by then Vice Premier Igor Sechin, its attendees were informed that (despite objections from all major agencies) it had been decided to terminate the provisional application of the ECT by the Russian Federation.

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[39] http://www.1tv.ru/news/polit/142214

[40] http://news.kremlin.ru/news/3812/print

[41] For a critique of the Conceptual Approach and its relation to the ECT, refer, for example, to the following publication by the author: Энергетическая хартия и российская инициатива. Что делать с правовой базой международного сотрудничества [Energy Charter and the Russian initiative. What to do with the legal framework for international cooperation]. *Vremya Novostey, or News Time,* 28 April 2009 ; Energy Charter and the Russian initiative - Future prospects of the legal base of international cooperation. – *Oil, Gas and Energy Law (OGEL), Special Issue on EU-Russia-EU relations*, vol. 7, issue 2, May 2009; Energy Charter Plus - Russia to Take the Lead Role in Modernizing ECT? - Oil, Gas and Energy Law (*OGEL),* vol. 7, 5 August 2009 (reprinted in: OGEL, vol. 7 N4, December 2009); Выход России из временного применения ДЭХ: мифические угрозы оказались сильнее реальных выгод? [Russia's termination of provisional application of the ECT: mythical threats prove stronger than tangible benefits?]. *Neft i Gaz, or Oil and Gas, November* 2009, No. 9, p. 32-35 (Ukraine).

[42] http://premier.gov.ru/events/2670.html

[43] http://www.rian.ru/economy/20090605/173397918.html

And so, finally, a rising wave of criticism has come to its logical end. On July 30, 2009, Vladimir Putin signed Government Order No. 1055-r terminating the provisional application of the ECT by the Russian Federation. On August 24, 2009, pursuant to Article 45 (3-a) of the ECT, Russia notified the depository of the treaty (government of Portugal) in writing that it did not intend to become a Contracting Party to the ECT. Sixty days later, Russia ceased to be a party applying the ECT on a provisional basis. On October 20, 2009, it became (along with Australia, Iceland and Norway) a signatory only but not a ratifier (Contracting Party) of the Treaty, i.e. it took a step back, as it were, nevertheless remaining a party to the Treaty and the charter process.

The world of today, however, has no alternative to the ECT, so, rather than being scrapped, it should be continually improved in line with the development of global energy markets, as envisioned by the December 2004 resolution of the Energy Charter Conference (the supreme authority of the charter process) (see Table 1).

Nevertheless, Moscow discontinued provisional application of the ECT. Without, I hope, burning its bridges because the Russian delegation said in its statement made at the twentieth session of the Energy Charter Conference in Rome 09.12.2009 that "despite terminating the provisional application of the Energy Charter Treaty (ECT), Russia considers the ECT an important multilateral agreement in the energy area"[44]. And, moreover, Russia's signature is still placed under the ECT.

So, what are the implications of Russia's termination of the provisional application of the ECT? It would seem they spell nothing but doom for this country.

15. Termination of provisional application of the ECT by Russia means bad news all round

First, by terminating the provisional application of the ECT Russia played into the hands of anti-Russian interests in global politics, who started arguing once again that Russia confirmed its reputation of a country flouting the rule of law. In economic terms, this will increase the risks of lending to Russia, push up the cost of raising capital under credit lines opened to the country, and diminish the volume of available financing. In the final analysis, this will increase the financial costs (costs of financing) of investment projects in the Russian energy sector. However, the loss of face means nor less, or even more than higher credit exposure.

Second, ECT is the only multilateral instrument available for protecting and encouraging investment in the most capital-intensive and high-risk area of business – in energy. As time goes by, the ECT increasingly protects not only foreign investment in Russia but would have also protected (in the event of ECT ratification by the parliament) Russian investment abroad, first of all against the "risks of liberalization" in the EU market, which have increased following the enactment of the EU's Third Energy Package (covered below), a number of whose provisions are seen by many observers as anti-Russian. The ECT is believed by the Russian party to be inadequate in protecting the interests of producers (a thesis that at the very least needs to be proved, particularly in the context of other instruments for protecting and encouraging investment in the energy industry). As things stand now, however, the ECT is the highest multilateral legally binding compromise achieved by the international community. And incidentally, the ECT will continue protecting European companies against anti-investment measures of the EU Third Energy Package... and not the Russian ones.

[44] http://www.encharter.org/fileadmin/user_upload/Conferences/2009_Dec/Russia_RUS.pdf

Third, Russia's withdrawal from the ECT will not bring about the collapse of the treaty. Its positive aspects (as a risk reduction mechanism) will simply be used by other countries whose costs of financing of their energy projects will go down versus Russia's giving them a competitive edge. By its failure/unwillingness to join the ECT, Russia will, firstly, widen the gap in the level of competitiveness between the Russian investment projects in the energy industry and the competing projects in third countries and, secondly, staying outside, will be unable to influence the rules of the game in this field to accommodate its interests. It may face the same situation as with GATT/WTO: in 1947 the USSR was invited to become involved in developing the rules for global trade – the USSR (Joseph Stalin) declined since (fairly) expected that it would not manage to dominate the process and thus would be one among equals. The GATT rules were then developed without our involvement and with no regard for our interests. So it took Russia 19 years to join this global club that has been set up without us. It seems that regarding ECT current Russian authorities has been experiencing the same approach as USSR authorities has experienced towards GATT almost 70 years ago.

Fourth, Russia's abandonment of the ECT does not mean that this country will succeed within the foreseeable future in arranging the development of an alternative and more effective multilateral instrument. The window of political opportunity that enabled the fast completion of talks and signing of the ECT in the early 1990s has dramatically narrowed today. The current conditions being what they are, the ECT, even as it reads now, will most likely not have been signed. The proper course of action would have been to continue the efforts to gradually improve the multifaceted process of the Energy Charter and its instruments. For this, as noted above, the charter process has inbuilt adaptation mechanisms (see Table 1).

The absence in the ECT of a mechanism for effective prevention of crisis situations and fast resolution thereof, as well as inaction by the political leadership of the Energy Charter Secretariat in the run-up to the January 2009 Russian-Ukrainian gas crisis, should have been used not as an excuse to terminate the provisional application of the ECT but to launch and spearhead the process of upgrading the Treaty-related package of legal instruments, by proposing, among other things, to add a new agreement (Protocol) to it (see Figure 5), which made all the more sense as it had already been drafted by Gazprom then and could have been used as a basis both for negotiating a multilateral or bilateral instrument. Instead of moving through the first (multilateral) option, Russia has chosen a second (bilateral) option and has signed an agreement with the EU to prevent emergency situations in transit on a bilateral basis. However, it seems unlikely that the mechanism for the prevention of emergency situations in transit will work effectively without the involvement of transit countries. That said, the mechanism proposed by Russia could have been used as a starting point for developing a functional mechanism within the framework of a multilateral forum of producing countries, end-users and transit states. The Energy Charter is the only such forum that is based on a multilateral framework of international law in place and includes representatives of all three groupings of the energy supply chain.

Fifth, the abandonment of the ECT today will not bring about its substitute, however feeble, tomorrow or, in all likelihood, the day after. This means that the abandonment of the ECT will, on the one hand, create for Russia a legal vacuum (lack of adequate legal infrastructure) in the most high-risk area of business. On the other hand, after the ECT came into effect in 1998 and while it was provisionally applied by Russia, many Russian ministries and agencies started to use the statutes of the ECT as benchmarks in their rule-making (for example, FAS [Federal Anti-Monopoly Service]). Having abandoned the ECT, Russia will nevertheless

hang on to its legacy, which has been to some extent already incorporated in the Russian legislation. Will Russia have to patch up its legislation, generating additional investment risks (which is always a result of any revision of any laws, however good the intentions of the legislator, whether in Russia or in Europe, whereas what investors need first and foremost is rules of the game that remain the same)?

Sixth, Russia's statement that it does not intend to become a Contracting Party to the ECT either suspends the completion of the Transit Protocol or (as was the case with GATT/WTO) will cause it to be finalized with no regard for Russia's legitimate concerns. The bottom line is that the nation will have no legally binding multilateral instrument (or none that it can accept) needed by it for transit, which instrument it insisted upon and which took ten years to produce (see Figure 5).

At the same time, by proposing the documents that were published 21.04.2009 "to all intents and purposes as a replacement for the Energy Charter" (A. Dvorkovich, Russian Deputy Prime Minister)[45], Russia thus de facto proposes to build two parallel systems for legislative regulation of international energy trade and investment, both of which (as is evident from the analysis of new Russian proposals[46]) being constructed on the principles of the Energy Charter and fully consistent with its purposes. It would seem, however, that one and the same foundation cannot be used to put up two different buildings at the same time, or, more precisely, to build another house on the foundation of an existing house as an annex thereto. I very much doubt that Russia will succeed in motivating other countries to start a new negotiation process (focused on practical results) from scratch based on the new Russian proposals. Nevertheless, I am confident that the international community could accept Russia's proposals as a starting point to bring the multifaceted Energy Charter in line with new circumstances "in order to reflect new developments and challenges in international energy markets" (the requirement was set forth in the Conclusions of the 2004 Political Review of the charter process)[47]. And that has really happened within the Energy Charter Process.

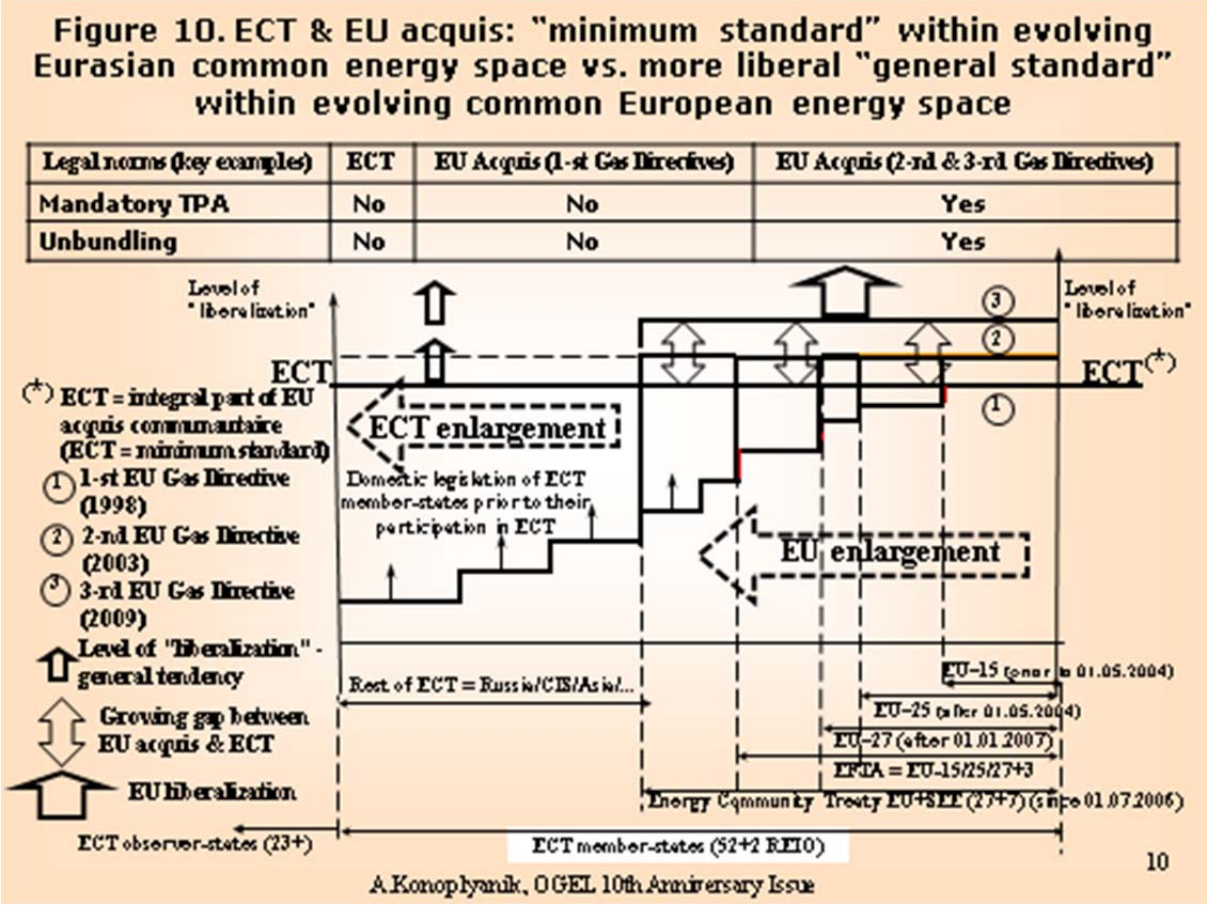
16. ECT as a mechanism for reducing EU "liberalization risks"

The system for the conclusion of EU international treaties with third countries is such that it is extremely difficult, if not impossible, to come to an agreement with the EU on terms other than those fully aligned with the European law. Under Article 300(6) of the Treaty establishing the European Economic Community, the European Parliament, the Council, the Commission or member states may obtain the opinion of the Court of Justice as to whether an agreement envisaged is compatible with the provisions of the EEC Treaty. An adverse opinion of the Court necessitates the ratification of the international treaty by all EU member states, which significantly limits in practical terms the likelihood that the treaty will be signed (it is virtually impossible today to secure 28+1 ratifications in the EU). Similar arrangements are in place for international treaties of individual EU member states: Article 133(6) of the EEC Treaty prohibits member states from entering into treaties at variance with the EU internal legislation[48]. Therefore, the EU uses the system of its international treaties to pursue

[45] http://news.kremlin.ru/ref_notes/186/print
[46] See sources in footnote 39
[47] http://www.encharter.org/fileadmin/user_upload/document/Final_Review_conclusions_rus.pdf
[48] Энтин М Л, *В поисках партнерских отношений: Россия и Европейский Союз в 2004-2005 годах* [Entin, M. L. In search of partnership relationships: Russia and the European Union in 2004–2005]. StP: SKF Rossiya-Neva, 2006, p. 330-331.

the policy of exporting its legislation (export of acquis). Today the ECT is the only bulwark against this drive. Naturally enough, this can hardly be achieved automatically, but by way of an ongoing, uninterrupted, quite often routine technical dialogue between the stakeholders, i.e. at a professional (informal consultations) rather than political (formal negotiations) level.

In the early 1990s, when talks on the ECT were in progress, the EU's First Energy Directives were drafted in parallel (enacted in 1996 and 1998); there are no major conflicts between the ECT and the Directives. Since then the EU has enacted new, more liberal Second Directives (2003) and even more radical Third Directives (effective as of 3 September 2009), which brought about a dramatic divergence in terms of the level of liberalization of "open and competitive markets" between the ECT and the European energy regulations. Simultaneously, starting in the early 1990s (when the USSR and the COMECON system collapsed and the charter process took shape), the EU expanded (from EU15 to EU27, now to EU28), with the resulting expansion of the territorial jurisdiction of acquis communautaire. Faster still is the expansion of the jurisdiction of EU energy acquis, even beyond the EU territory: in 2006 there came into effect the Energy Community Treaty between the EU and countries in South-Eastern Europe (EECT [European Energy Community Treaty - to avoid confusion with ECT in the text]), which expanded the jurisdiction of EU Energy Directives to 6 states of former Yugoslavia (see Figure 10). The EECT has recently been joined by Moldova and Ukraine which expanded its membership now to 28+8=36 member states.



(Figure 10: ECT & EU acquis: "minimum standard" within evolving Eurasian common energy space vs. more liberal "general standard" within evolving common European energy space)

The EU is therefore facing an escalating impersonal "conflict of interest" (conflict of laws) within its space as a result of signing and ratifying the ECT in two dimensions/capacities: on behalf of each individual EU member state and the EU at large as a separate party to the Treaty. On the one hand, EU members are governed by the EU legislation, which becomes increasingly more liberal than the ECT. On the other hand, they are bound by the obligations under the ECT, including in their dealings with third countries. Seeing that for the EU at large (you will recall that the EU members ratified the ECT not only individually but as the EU at large), acquis communautaire is a domestic legislation, and the ECT is an international treaty, then in the event of conflicts of laws, ECT norms shall take precedence over EU law within the EU single market and over the rules regulating this single market.

The ECT is part of the EU legislation. The principle of ECT application is a "minimum application standard": each country may go further in its national legislation than required by the ECT with respect to the level of competition, liberalization and non-discrimination, but it may not require the same from other Contracting Parties/Signatories to the ECT (to implement EU acquis rules within non-EU countries based on the fact that they both are the ECT members) by virtue of the provisions of the Treaty (for it simply has no such provisions), let alone punish them for failing to apply statutes that are more liberal than those of the ECT. The situation being what it is, withdrawal from the ECT deprives non-EU countries of an opportunity to agree with the Europeans on a "new global energy framework" on terms at variance with the EU legislation.

The EU repeatedly forced upon Russia an interpretation of ECT provisions which was to be consistent with the increasingly more liberal internal legislation of the EU but inconsistent with the ECT's principle of minimum standard. The brunt of the adverse consequences of such fast-track forced liberalization to the EU model would be borne by producing countries, which face the task of implementing large-scale capital-intensive projects in production and transportation of gas, first and foremost. Such market liberalization norms, typical of importing countries, as unbundling of vertically integrated companies and mandatory third-party access (MTPA) to energy infrastructure increase the risks of project financing and discourage investment. After all, it is no coincidence that all major capital-intensive gas-infrastructure projects in the EU (LNG import terminals, interconnecting pipelines) have been implemented in recent years not under the EU legislation (Second Gas Directive 2003) but under waivers (exemptions) thereof, as provided for in Art.21-22 of the Directive. The reason being that this is the only way (by abandoning MTPA for the payback period, for example) to improve and accelerate return on investment by providing incentives for infrastructure development in order to increase the quantity and expand the geography of EU imports of energy materials and products (see Figure 3).

I believe that the widening gap in the level of liberalization between the ECT and the EU acquis is, along with Russia's demonstration of a negative attitude towards the ECT, one of the factors in the EU's disillusionment with the ECT and the Energy Charter process alike, and its commitment to the EECT and the expansion of the Energy Community with countries in South-Eastern Europe. The accession to the Energy Community Treaty is the first step in implementing the EU directives in these countries (even if confined to just the Energy Directives for the time being) pending their membership in the European Union. This role of the EECT is not unlike the role that the Energy Charter Treaty (ECT) played in the countries of Central and Eastern Europe following the collapse of the COMECON. The Energy Charter Treaty served as a kind of "training wheels" ("101 course") for implementing the EU First

Energy Directives in the countries of Central and Eastern Europe pending their accession to the EU[49]. The Energy Community Treaty performs a similar function with respect to the EU Second Energy Directives for the former republics of the former SFRY, but the EECT is being joined, one by one, by some former republics from the former USSR.

The difference between the two treaties (both abbreviated the same in English — ECT, which is rather symbolic though might create a lot of misunderstanding for non-professionals) consists in the fact that the Energy Charter Treaty (ECT) is based on the First EU Electricity and Gas Directives (1996[50] and 1998[51]), whereas the Energy Community Treaty (EECT) is based on the EU's more liberal Second Electricity and Gas Directives (2003[52]). Further, the Energy Charter Treaty sets forth the minimum application standards for the contracting parties; the Energy Community Treaty obligates its contracting parties to apply the emerging EU acquis communautaire in full (in November 2011 the EECT member-states took decision to apply not the Second, but the Third EU Energy Directives). Therefore, the EECT provides a mechanism for further expansion and export of acquis communautaire of the EU, and thus the ECT is de facto, since 2003, a mechanism for protecting against the EU liberalization risks. Feel the difference. And for a nation that does not intend to join the EU and/or apply the legislation of the European Union in its territory (such is Russia), to disregard this mechanism is counterproductive, to say the least.

17. ECT and the Yukos case

There were complaints made about the ECT because of the Yukos case[53]: the Energy Charter is alleged to have enabled Yukos shareholders to file an action against Russia under the ECT, and the ECT "needs to be abandoned" in order to scuttle this case and nip others in the bud.

Let us point out that the Yukos case (action by Yukos shareholders against the Russian Federation) was based on Art. 26 of the ECT, which provides that a foreign investor may file an action against the host country directly with an international tribunal (any one of three at his election: ICSID, UNCITRAL, the Arbitration Institute of the Stockholm Chamber of

[49] For more details, see, e.g.: T. Вальде, A. Конопляник. Договор к Энергетической Хартии и его роль в мировой энергетике. [T. Waelde, A. Konoplyanik. Energy Charter Treaty and its role in the global energy industry]. *Neft, Gaz i Pravo,* 2008, No 6, p. 56-61; 2009, p. 1-46; No 2, p. 44-49; No 3, p. 48-55; same authors. Energy Charter Treaty and its Role in International Energy. *Journal of Energy and Natural Resources Law*, November 2006, vol. 24, No 4, p. 523-558.

[50] Directive 96/92/EC of the European Parliament and the Council of 19 December 1996 concerning common rules for the internal market in electricity, OJ 1996 L 27/30.

[51] Directive 98/30/EC of the European Parliament and the Council of 22 June 1998 concerning common rules for the internal market in natural gas, OJ 1998 L 204/1.

[52] Directive 2003/54/EC of the European Parliament and the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, OJ 2003 L 176/37; Directive 2003/55/EC of the European Parliament and the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC, OJ 2003 L 176/57.

[53] The author had to write at length on the subject of the ECT and the Yukos case. See, for example: A. Konoplyanik. The Energy Charter Treaty: Dispute Resolution Mechanisms – and the Yukos Case. – *Russian/CIS Energy & Mining Law Journal,* 2005, N1 (Volume III), p. 27-33; same author. Energy Charter Treaty – and "Yukos case". – *Petroleum Economist,* July 2005, N 8, p. 35-36; A. Конопляник. ДЭХ и "дело ЮКОСа". [A. Konoplyanik. ECT and the Yukos case]. *Neft Rossii,* August 2005, No. 8, p. 83-86; same author. Выход России из временного применения ДЭХ и "дело ЮКОСа": комментарий по итогам процедурного решения арбитражного суда в Гааге [Russia's termination of the provisional application of the ECT and the Yukos case: commentary on the award of the Permanent Court of Arbitration in The Hague]. *Neft, Gaz i Pravo*, 2010, No. 1, p. 42-49.

Commerce) without securing the consent of the respondent government and/or without prior hearing of the action before courts of national jurisdiction in the host country[54]. The plaintiffs file an action under Article 13 of the ECT "Expropriation". They allege discrimination and expropriation (of Yukos assets). Since the referral of the first action to international arbitration pursuant to Art.26 of the ECT in 2001, the Energy Charter Secretariat is aware of over 40 such cases (as of end-January 2014)[55], but the action by Yukos shareholders against the Russian Federation is the largest[56]. Moreover, the damages sought by the Yukos shareholders from Russia keep growing: first 33 bln, then 50 bln, now already 100 bln dollars. The figures seem to have worked their "black magic", after all, to influence the decision affecting the fortunes of the ECT in Russia…

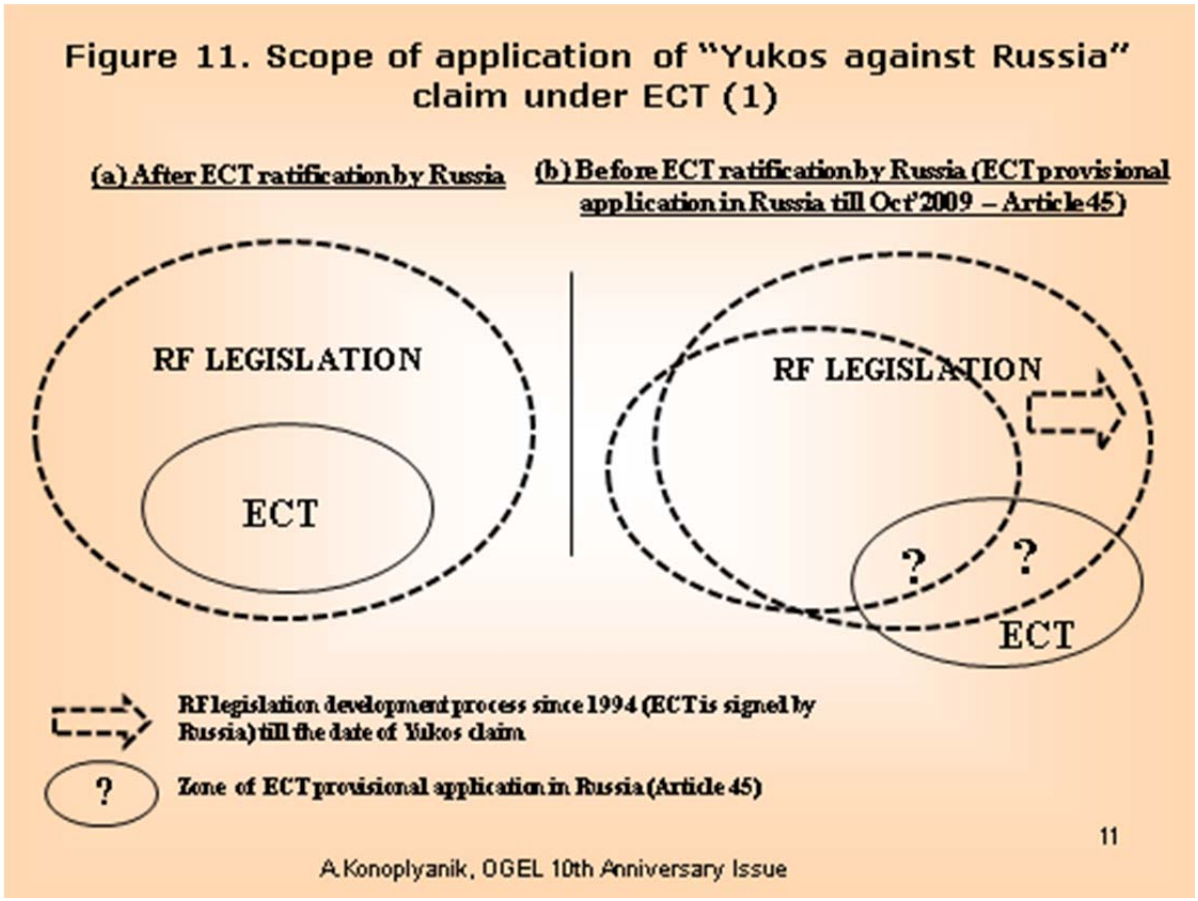
However, the termination of provisional application of the ECT will not help Russia in the proceedings in the Yukos case filed against it by Yukos shareholders with the international arbitration tribunal UNCITRAL (UN Commission on International Trade Law). Be that as it may, it is this illusion that seems likely to have been a driver of the decision to withdraw. The termination of the provisional application has no retroactive effect, and Russia is bound under Article 45 (3-b) of the ECT by the obligations to comply with the investment provisions of the Treaty and the dispute resolution procedures over the next 20 years (to 2029). Therefore, the Yukos case needs to be dealt with not by terminating the provisional application of the ECT but by procedural arrangements in the course of arbitration, especially as the Permanent Court of Arbitration at The Hague handed down 30.11.2009 a jurisdictional ruling under the UNCITRAL arbitration rules, enabling the Yukos case to go forward on its merits.

Article 45 of the ECT, Provisional Application, is key to further proceedings in the case. It is this Article that will determine the following, quite lengthy in my opinion, stage of the arbitration process: a review of the alignment of ECT provisions with the Russian legislation in place at that time, for the provisional application of the ECT by Russia was implemented "to the extent that such provisional application is not inconsistent with its constitution, laws or regulations". Here, this means, first of all, a thorough review of the question as to whether the case (whose details are not officially known to the general public) is actionable under the legal implications of provisional application of the ECT by Russia or not.

Once ratified by Russia, the ECT would have become an integral part of Russia's legislation (see Figure 11-a). Before 20.10.2009, the ECT did not apply to Russia in full force and effect if certain of the ECT provisions (which ones exactly?) were "inconsistent with its constitution, laws or regulations". Therefore, the Russian legislation and the ECT (as applied provisionally) might (must) have had an "area of overlap" where the Treaty's provisions formed an integral part of Russia's laws, and an area where prior to ECT ratification by Russia the Treaty's provisions did not apply to the country's territory (see Figure 11-b). It is necessary to prove the scope of ECT application by Russia by way of provisional application of the Treaty – which will presumably be the focal point of the tug-of-war between the lawyers of both parties to the dispute (the firm Shearman & Sterling LLP for the plaintiff; the firm Cleary, Gottlieb, Steen & Hamilton LLP for the defendant). In dealing with these issues, it is necessary to bear in mind that whereas the ECT is a treaty whose content was fixed when it was signed by the Parties, the development of the Russian legislation is an ongoing process, and over the years since the signing of the ECT in 1994 and till Yukos claim in 2004 and then

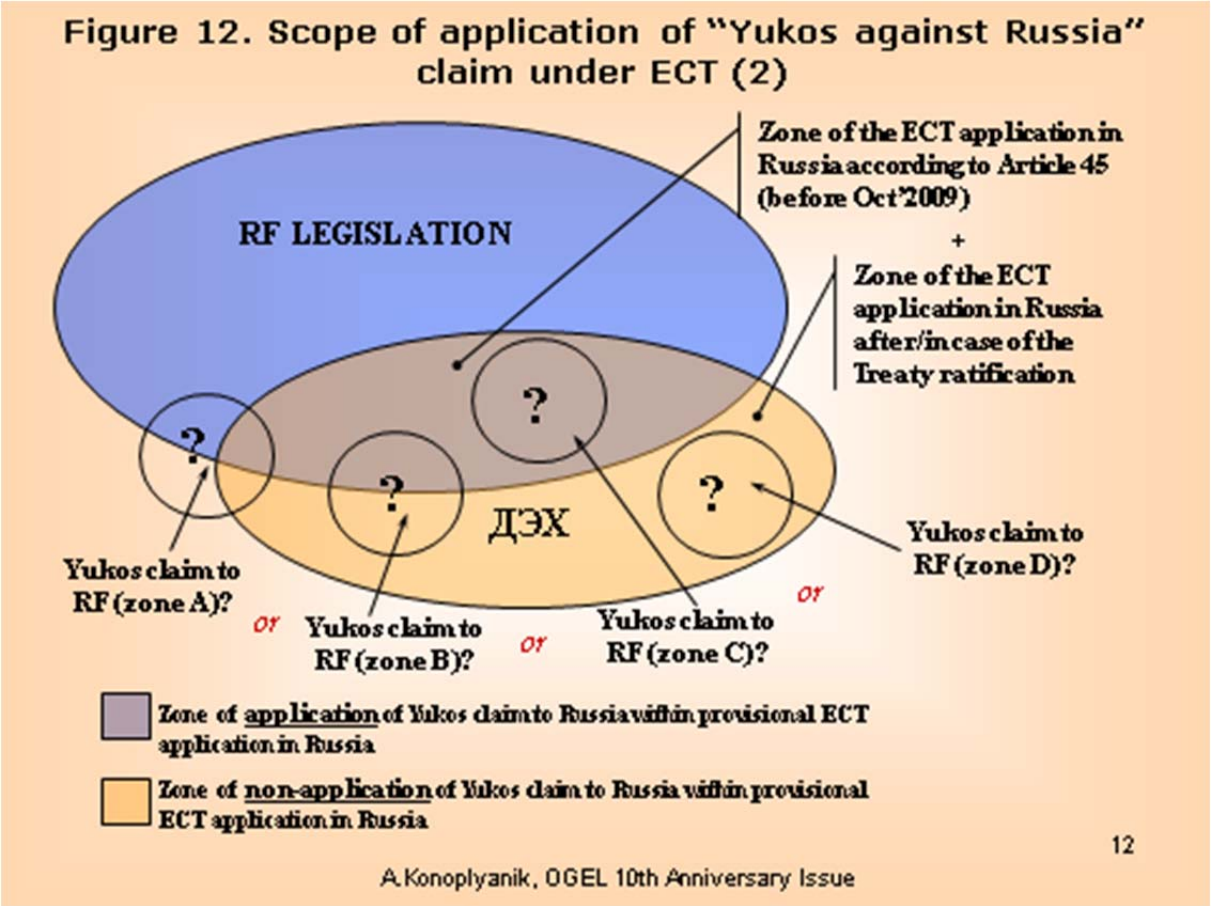
[54] See: А.Конопляник. Договор к Энергетической Хартии: механизмы разрешения споров [A. Konoplyanik. Energy Charter Treaty: dispute resolution mechanisms]. *Neft, Gaz i Pravo*, 2005, No. 1, p. 35-41.
[55] http://www.encharter.org/index.php?id=269
[56] For further details, refer to: http://www.encharter.org/index.php?id=213&L=1

further on, it has undergone major changes. Therefore the boundaries of the "area of overlap" also shift as time goes by (Figure 11-b).



(Figure 11. Scope of application of "Yukos against Russia" claim under ECT (1))

Which area does the Yukos action fall in under the circumstances (see Figure 12)? The area of the ECT provisions that are not applied by Russia until it ratifies the Treaty (zone D at Figure 12)? Or, alternatively, in the area of the provisions that were applied by Russia by way of provisional application of the ECT (zone C)? Or do some of the claims of the Yukos shareholders fall in one area and others in the other area (zone B)? Or do some of the claims fall totally outside the scope of the ECT (zone A)? All of the above has to be proved by the parties in the proceedings.



(Figure 12. Scope of application of "Yukos against Russia" claim under ECT (2))

Pending the outcome of in-depth legal analysis, it is impossible to ascertain the area corresponding to the Yukos shareholders' action (presented in a document of limited size, whose content is officially unknown outside the narrow circle of the parties' lawyers and arbitrators) under the provisional application of the ECT (a document of limited size, which is widely known, accessible, published, distributed, available on the website of the Energy Charter in the public domain) under the evolving Russian legislation (a corpus of legal texts which is practically unlimited in terms of size and which changes in terms of size and content).

One thing is clear: the termination of provisional application of the ECT has no effect whatsoever (in terms of content) on the examination of the case on its merits. But it creates an additional negative informational background for its examination on its merits[57].

[57] See: A. Konoplyanik. Выход России из временного применения ДЭХ и "дело ЮКОСа": комментарий по итогам процедурного решения арбитражного суда в Гааге [Russia's termination of the provisional application of the ECT and the Yukos case: commentary on the award of the Permanent Court of Arbitration in The Hague]. *Neft, Gaz i Pravo*, 2010, No. 1, p. 42-49; same author. Энергетическая Хартия: почему Россия берет тайм-аут [Energy Charter: why Russia takes a timeout]. *Mezhdunarodnaya Zhizn, or International Life*, 2010, No. 1, p. 27-44.

18. To destroy or to upgrade

So, a number of complaints made by the Russian leadership about the process of the Energy Charter and the ECT as its core legally binding instrument are perfectly reasonable: the Treaty has provisions that admit of ambiguous interpretation; the ECT is not enforceable in some areas it covers; the ECT has no mechanisms to force the contracting parties to perform the obligations assumed, to quickly and effectively prevent and resolve on a multilateral basis emergency situations in energy, to impose prompt and effective sanctions for a breach of the provisions of the ECT. All these assertions I find to be quite fair. However, the call for the ECT to be abandoned and for a new instrument to be developed to replace it is the least effective way to address the reasonable complaints of the Russian party about the Energy Charter (if abandonment is a feasible option).

The April 2009 Russia-proposed Conceptual Approach[58] cannot be treated as an alternative to the ECT, but the international community may in all likelihood accept it as an opening bid for improving the process of the Energy Charter as the only versatile mechanism for legislative regulation of international relations in energy.

Once every five years, pursuant to Art. 34(7) of the ECT, a Review is conducted of the Energy Charter activities and a discussion is held of the progress made in adapting it to the new conditions in energy markets (see Table 1). Decisions based on the results of the latest Review were made in late 2009. That Review was a good opportunity to make a great number of demonstrable changes in, and additions to, the Energy Charter process and instruments, which would have made it possible to meet Russia's legitimate concerns[59]. This could not be done without active involvement in the adaptation process, first of all of the party which is most interested since it has proposed early in the year such changes, i.e. Russia itself. What seems to have happened, however, is that Russia's trigger-happy mid-level bureaucrats jumped the gun on the ongoing decision-making process higher up. Thus, with a Russian government edict to terminate the provisional application of the ECT not yet signed, brakes were already applied, bringing to a virtual halt all government activities necessary to continue, let alone step up, the involvement of the Russian delegation in the Energy Charter process, including to promote within the framework of the charter process the April'2009 presidential proposals aimed at enabling Russia to take point on the adaptation of the Charter process.

19. Energy Charter Plus roadmap: a lost opportunity? Not yet…

Russia could have offered the Charter community a roadmap that would have implemented the presidential proposals of 21.04.2009 as part of the Energy Charter process. Up to the release of the government edict of 30.07.2009, the roadmap for reforming the Energy Charter process (code name "Energy Charter Plus"[60]) was discussed informally with some of the key

[58] http://news.kremlin.ru/news/3812/print

[59] See: http://www.encharter.org/index.php?id=22&L=1

[60] The Energy Charter Plus roadmap is described by the author in: А. Конопляник. Выход России из временного применения ДЭХ: мифические угрозы оказались сильнее реальных выгод? [A. Konoplyanik. Russia's termination of provisional application of the ECT: mythical threats prove stronger than tangible benefits?]. *Neft i Gaz,* November 2009, No. 9, p. 32-35 *(Ukraine);* same author. Энергетическая Хартия: почему Россия берет тайм-аут [Energy Charter: why Russia takes a timeout]. *Mezhdunarodnaya Zhizn*, 2010, No. 1, p. 27-44; A. Konoplyanik. Why Is Russia Opting Out of the Energy Charter? – *International Affairs*, 2010, vol. 56, No. 2, p. 84 -96.

players in the process, and through them with spokesmen for some European states, and was supported by them in principle.

The next step forward would have been to develop a detailed game plan based on the Russian proposal of 21 April 2009. The game plan could have become part of a balanced package solution at the next then Energy Charter Conference (the supreme authority of the Charter process) in December of 2009. Such package solution would have accommodated Russia's legitimate concerns about the Energy Charter. Naturally enough, it would have had to be ironed out with other countries in short order for it to be finalized by December. Any progress, however, was effectively put paid to by the Russian government edict of 30.07.2009.

Generally speaking, the termination of provisional application of the ECT does not prevent Russia from joining forces with other countries in implementing the Energy Charter Plus roadmap. Norway, for example, which has also signed the ECT but does not apply the Treaty on a provisional basis, is making quite a strong contribution to the Charter process. It is too much to hope, however, that Russia (read "the nation's leadership") will reverse its attitude towards the Energy Charter any time soon. At least it could not for long (would not have liked to) even to settle its arrears for membership in the Energy Charter process, at least for the full period of its provisional application of ECT (which it has finally done only recently – but only until the time of termination of provisional application of the Treaty).

Be that as it may, however, Russia remains a signatory to the ECT; therefore, all Russia's valid complaints remain on the table, as do the accommodations made for them. Therefore, nothing major prevents Russia in its new status from rethinking the matter of ECT ratification later on. The important thing is to continue its involvement in the Charter process and work for it to incorporate the April 2009 presidential proposals, rather than presenting them as an alternative to the multilateral instrument of international law in place – the only multilateral treaty to protect and encourage energy investment, trade and transit, improve energy efficiency and resolve disputes, for which no substitutes are available. Rather than spurning it, we need to pool efforts to improve, perfect, upgrade, expand the scope and territorial jurisdiction of this unique Treaty and the entire multifaceted Energy Charter process. All the more so as the latest statement by then Russian President D. Medvedev on the Charter subject (made in the course of the press conference following the Russia-EU Summit in Stockholm 18.11.2009) that his April 2009 "energy initiative … was proposed by Russia *in addition* (highlighted by me - A.K.) to the existing energy instruments including the Energy Charter"[61], rather than in lieu of the ECT and instruments related thereto, seems to have opened up new prospects for consolidating the processes involved.

It is only by remaining closely involved in the Energy Charter process that the desired results can be achieved: Russia's legitimate concerns addressed, the multifaceted charter process improved and its instruments adapted to new challenges and risks of the evolving international energy markets.

[61] http://news.kremlin.ru/transcripts/6034/print