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The Energy Charter Treaty Revisited

The Russian Proposal for an International Energy Convention and the Energy Charter Treaty

Kirsten Westphal

The Energy Charter Treaty and the related Energy Charter Process have gone through difficult times. In July 2009, the Russian government decided to withdraw from the Energy Charter Treaty. This became official on October 19, 2009. Russia is a crucial player for the Energy Charter Treaty, mainly because it is the only large energy producer that had signed the Treaty back in 1994 and had provisionally applied it, albeit never ratified it. The Energy Charter Treaty seems to be at a dead end. This is also due to the Treaty having become increasingly insignificant in the EU's tool box. With the Rome Declaration, the Energy Charter constituency made a step forward out of the deadlock on December 9, 2009. At the present stage, the modernization of the Energy Charter Process is on the table, as is the Russian draft for an International Energy Convention. The future of both is open, though, and dependent on the added value attached to each of them.

The Energy Charter Treaty

The European Energy Charter of 1991 and the legally binding Energy Charter Treaty (ECT) of 1994 (in force since 1998) constitute an international set of basic rules for energy cooperation.

In the Charter and in the Treaty, the signatories agreed on the following goals and principles: to build open and efficient energy markets subject to the laws of the market; to establish favorable conditions for foreign and private investments; and to adhere to the principle of nondiscrimination in the areas of investment and trade, as well as the principle of free transit without regard for country of origin, country of

destination, or ownership. The guiding principle of sustainable development is also enshrined in the Treaty.

The Treaty itself rests on the four pillars of investment protection (Section III), trade (Section II), transit (Art. 7), and dispute settlement provisions (Section V). State sovereignty over natural resources is also emphasized (Art. 18). Moreover, there is an additional protocol on energy efficiency and environmental aspects. Essentially, the Treaty has introduced rules and principles of the WTO such as nondiscrimination and the most-favored nation clause into international energy cooperation. Section VII also outlines a conference process that

would enable the contractual partners to negotiate annexes, changes, and additional protocols. This process, with its sub-working groups, has already proven itself as a forum for cooperation—for example, in the area of energy efficiency. The Protocol on Energy Efficiency and Related Environmental Aspects (PEEERA) entered into force with the ECT. In contrast, the Transit Protocol is not (yet) in place. It includes a number of points that had been heavily disputed by Russia.

Fifty-one countries plus the European Communities and Euratom are taking part in the Energy Charter Process. They include the EU member states, Switzerland, Turkey, the CIS countries, and Japan. Five countries (Australia, Iceland, Norway, Belarus, and Russia) have not ratified the Treaty. Since Russia did not file any declaration to the contrary at the time when the Treaty was signed in 1994, it is subject to provisional application under Article 45 of the Treaty. Russia, however, has called this point into question. Its motives are complex. As a consequence, the Energy Charter Process is now composed of countries with different status, a fact that opens questions about diverging rights and duties.

Without doubt it is a weakness that the major North African and Middle Eastern energy producers, as well as the United States, Canada, Indonesia, Venezuela, and Nigeria, are only observers. The main critique of producer countries like Norway is that the Treaty favors foreign investors (and thus the gas-consuming countries), giving them sweeping rights in particular under the dispute settlement process, while the producer countries see their own sovereign rights as being infringed upon. Thus, a need for further discussion of these issues and expansion of the process still exists.

Russia in the Energy Charter Process

Of international significance is Russia's clear withdrawal from the Energy Charter Treaty in 2009, which is evidence that the country no longer intends to ratify the

Treaty in its existing form. The Russian cabinet decided on July 30, 2009, to refrain from participation, and on October 19, 2009, Russia's withdrawal from the Energy Charter Treaty went into effect.

As Europe's most important energy supplier, Russia has played a key role in the conference process since the very beginning. At the end of the 1990s, the question of transit (both the rules contained in the Treaty and the Transit Protocol as an annex to the Treaty) became a crucial point of contention for Moscow, which made resolution of this issue a condition for ratification. Particularly disputed is Article 7 of the Treaty, which establishes the principle of free transit, irrespective of country of origin, destination, or ownership.

The negotiations about the Transit Protocol centered around Article 10, Article 8.4, and the Regional Integration Organization (REIO) clause. The disputes focused on the questions concerning tariffs, access, and availability of volumes in transit pipelines. Russia highlighted the fact that long-term contracts could be mismatched with transit contracts under the Transit Protocol's rules. Gazprom wanted to push through the "right of first refusal," whereby exporters whose transit contracts are about to expire would have priority over competitors in concluding new contracts for the same transport volume. In the case of the REIO clause, the controversy revolves around the EU's demand to be recognized as an economically integrated region so as to be able to choose to implement not the rules of the Energy Charter Treaty but instead the even stricter rules of the EU single market for transport within its territory. This affects Russia, for example on the Polish section of the Yamal-Europe Pipeline, to the extent that transit contracts would be applied for much shorter intervals than the existing long-term supply contracts.

Russia had kept negotiations on the Transit Protocol on hold for more than 10 years, in recent times due to the combination of a politics of symbolism and substantive issues. But the fact that Gazprom

lobbied from the very beginning against ratification while other Russian energy firms were strongly in favor of the Treaty is telling in that respect. The decisive point here is that Gazprom buys and resells Central Asian gas instead of simply providing transit services. The company fears the loss of its strategically important position as the narrow gateway to Central Asian gas. Its strong position as a gas supplier to Europe has been based on the purchase of Central Asian gas—at favorable prices and with variable volumes—depending on actual European demand. However, the situation has changed in the Caspian region with the emergence of China as a purchaser of Central Asian gas and the EU's efforts to secure significant volumes for the Southern Gas Corridor. As a consequence, Russia's payments for Central Asian gas deliveries have increased, as the pricing mechanism has become based on petroleum products. So far, however, Russia has managed to pass the costs on to European markets and has forced Turkmenistan into a "swing supplier position" for the last two years following decreasing European demand for Russian gas.

Another reason for the Russian maneuverings may be found in the Yukos affair, in which Russia has been the target of international criticism since 2002. The investor-state dispute settlement case between former Yukos shareholders and the Russian Federation has moved to the forefront. The background is the pending case on discriminatory measures against and expropriation of Yukos shareholders at the Permanent Court of Arbitration in The Hague under the Energy Charter Treaty. The amount in question is between \$US28 and 50 billion.

During the gas conflict with Ukraine in January 2009, Russia occasionally made use of highly nuanced legal arguments in justifying the stoppage of gas supplies to Ukraine based on national law and prevailing customs regulations, while simultaneously complaining at length about the alleged ineffectuality of the Treaty. The

crucial point is that provisional application of the Energy Charter Treaty is terminated whenever its provisions violate the prevailing national law and constitution. Over time, the Russian argumentation had shifted to claiming that provisional application of ECT Article 45 does not apply to Russia. Thus, the letter with which Russia formally terminated provisional application (which the country claims was never actually practiced) on October 19, 2009, somehow comes as a paradox. How can provisional application that has never been in place be terminated? In any case, the Permanent Court of Arbitration in The Hague took the decision in November 2009 that Russia is bound to the Energy Charter Treaty under provisional application. The former Yukos shareholders (Group Menatep Ltd.) can proceed with the merits phase of their arbitration claim.

For the Energy Charter Treaty and the Russian engagement in the Process, this has had—if anything—a detrimental effect. Russia has kept a very low-key profile in the meetings in the Energy Charter Process since 2009 and has not positioned itself in the modernization process. However, it still provides the Deputy Secretary General.

Dummy or real concern? The Russian proposal(s) for an International Energy Convention

During his official visit to Helsinki on April 20, 2009, Russian President Dmitry Medvedev put forward a document with the cumbersome title "Conceptual Approach to the New Legal Foundation for International Cooperation in Energy (Goals and Principles)." This happened without previous announcement or concomitant diplomacy. The proposal had passed largely without comment by the international community. This was partly related to the 2009 Russian-Ukrainian gas conflict, after which the document had been seen as a further attempt to undermine the Energy Charter Treaty. It took more than one-and-a-half years for Russia to translate the con-

ceptual approach into legal terms. The recent “Draft Convention on Ensuring International Energy Security” was circulated among major partner countries and partner organizations, for example OSCE, UN Economic Commission for Europe, and the Energy Charter, as a “non-paper” with the request for comments by November/December 2010.

For the aforementioned reasons, the Russian proposals of April 2009 and November 2010 for a new international framework can hardly be viewed in isolation from the Energy Charter Process. It may seem strange at first that Moscow is demanding a legally binding framework for energy cooperation. Medvedev’s concept (2009) followed a series of similar statements: Already in January 2009, Vladimir Putin argued for opening negotiations on a new framework for international energy security in his opening address at the World Economic Forum in Davos. Furthermore, the speaker of the energy committee of the Duma, Valery Yazev, was quoted in the Russian press proposing a corporate energy forum, the realization of which would reinforce existing asymmetries between commercially oriented and state-dominated companies.

There are good reasons why Medvedev’s proposal has scarcely been discussed in Europe. Russia has been calling for negotiations on a new energy treaty since 2000. These efforts have been viewed mainly as a tactical maneuver by Moscow aimed at justifying the country’s rejection of the Energy Charter Treaty. After all, up to now Russia has tended to profit from the status quo and from the state of uncertainty around the Energy Charter Treaty and its Transit Protocol.

According to the Russian president, the document that he presented in April 2009 without prior diplomatic consultations in Helsinki is intended to “de facto replace the Energy Charter.” It first describes the goals, then over two pages details the central principles of a new legal basis for global energy cooperation. Annex 1 contains the elements

of a transit agreement (one page) and Annex 2 a list of raw materials for energy production and energy products that should be included in the framework. Medvedev argues that the current bilateral and multilateral agreements are inadequate to prevent and overcome conflict situations. What is called for at present, he says, is the “development of a new, universal, legally binding document” covering all of the major export, import, and transit countries. Another notable feature of this document is the statement that sustainable energy security is indivisible and that all of the actors in the energy sector should therefore share equal responsibility for ensuring energy security at the global level. If one reads Medvedev’s proposal favorably, then one can conclude that the document is in accord with the basic principles of the Energy Charter overall and that many of the points are already formulated in legally binding terms in the Energy Charter Treaty. Furthermore, Annex 2 is also a copy of the Annex EM of the Energy Charter Treaty.

Russia: Critical points revisited

The “Draft Convention on Ensuring International Energy Security” of 2010 reflects the most pronounced Russian positions in regard to international energy security, trade, investment, and transit:

- ▶ *Energy security as demand security*: Russian energy policy in recent years has attempted to redefine energy security as both security of supply and predictability of demand. Yet, this approach ignores the asymmetry between demand and supply regarding policy options available to steer them. At the end of the day, demand is the sum of consumer decisions and can only indirectly be influenced by the state. The question again is obviously how to apply this principle given the uncertainties of demand trends in Europe.
- ▶ *Balancing of diverse interests*: The desire to search for an optimal balance between supply and demand is mentioned explic-

itly in the text, which states that each party should declare whether it is predominantly a producer or consumer of energy. Here, the objectives are clearly to stabilize price levels, earnings, and revenues from energy exports. This objective has become predominant: The year 2008 was a real watershed for energy trade as prices reached record levels of \$147 per barrel in July and then decreased by almost \$100 per barrel in November 2008. Both consumers and producers proved to be sensitive to this price volatility. Yet, there are ongoing international discussions on how to create more transparency and foster a more intensive exchange of information between producers and consumers regarding prognoses and investment programs in the International Energy Forum. Against this background, it is very surprising that the Forum is not included in the list of institutional cooperation partners.

- ▶ *National sovereignty*: This is obviously one of the major issues for the Russian Federation. Revising the text gives the strong impression that the “renationalization of Yukos” and the TNK-BP case seem not to be exemptions, but are rather cases in point: Although “most favored nation treatment” as a WTO principle is explicitly mentioned in the text, the fact that expropriation is possible and that there are several exemptions foreseen—such as preservation of depleting resources and upholding of public order and morality—illustrates that the Russian proposal differs fundamentally from how the EU interprets investment protection and national sovereignty in the ECT.
- ▶ *Dispute settlement*: The Russian proposal foresees a state-to-state dispute settlement either at a state court of the state where the investment is made, or under the UN Commission on International Trade Law or the International Centre for Settlement of Investment Disputes. The proposal to engage in dispute settlement

primarily on a diplomatic level (and optionally with reference to UN trade regulations) is significantly weaker than the comparable, although—on the point of investment—still disputed provisions of the Energy Charter Treaty. This demonstrates the sovereign and far-reaching role that Russia designates to the state in the energy sector.

- ▶ *Asset swaps*: The proposal envisions the exchange of assets between companies as a means of ensuring access to markets and infrastructure. This reflects the rational business strategy of Gazprom to become active along the entire supply chain. What is lacking here, however, is any indication of the reciprocity of the rules, that is, their applicability to the Russian market as well as, for example, access to Russian transit pipelines, which would be obligatory under the principle of universal applicability. Moreover, it is a means to counteract the EU idea(l) of a “functioning internal market.” These exclusive package deals contradict the spirit of a level playing field. Accordingly, as a final consequence, short-term logics of spot markets and gas-to-gas competition correspond to the EU’s competition paradigm much better. Asset swaps with their package deals on different segments of the gas supply chain set up long-term relations and vertical cooperation, thereby paying tribute to the challenges of huge investments to be undertaken and the “old mechanisms” of gas procurement.
- ▶ *Long-term contracts and transport*: The Convention reflects the plea to properly allocate risks among the parties involved. This is influenced by the rapidly changing European gas markets and the oil-indexed long-term contracts with take-or-pay clauses under pressure. The background also involves Russia’s fierce opposition to the EU Third Liberalization Package, which demands a separation of electricity and gas production from supply provision. Russia has been constantly and fiercely arguing for exemp-

tions for import pipelines in order to not just be able to sell the gas at EU borders and to avoid a “contractual mismatch.”

First, the concern is that long-term contracts do not correspond with shipping arrangements in their time frame.

Second, Russia aims to control and make money from the supply chain, thereby limiting the opportunities for newcomers in the gas supply.

► *Transit provisions:* Given the fact that transit issues were at the heart of Russia’s longstanding non-ratification policy, it is quite astonishing that the proposal does not go into more detail on this point, as the negotiations on the Transit Protocol of the ECT have shaped Russia’s opposition to it. Under the Transit Protocol, EU law would be applied (REIO clause) in the realm of the EU. The Russian proposal is diametrically opposed to this and envisions the application of the Convention within REIO and its member states. The environment has changed since the negotiations of the Transit Protocol under the ECT. On the one hand, Nord Stream will soon start to transport gas directly into Western European markets. On the other hand, the European Energy Community, which foresees the implementation of the energy-related *acquis communautaire* in the participating countries, has been expanded to Ukraine. Ukraine still is the major transit country for Russian gas. Against this background, the provisions for transit are surprisingly very vague in the Russian draft.

► *Global outreach:* According to the draft, the Convention enters into force after ratification in three countries. This is far removed from the European understanding of multinational institutions and legally binding treaties.

In sum, there are no surprises from Russia, but rather there is a proposal on the table that reflects the major topics addressed in the last years, though it leaves the question open as to where and whether

the draft should be discussed under an existing framework.

The Energy Charter Process: Lost? Or new momentum?

Without doubt the Energy Charter Treaty is a “child” of the 1990s, when the consumer countries had made significant inroads into producing countries, and the oil prices had been comparatively low—due to a relaxed supply situation and new independent suppliers in the Former Soviet Union entering the scene.

Since then, the market and producer-consumer relations have changed profoundly. Since the turn of the century, the OECD world has been losing relative consumer weight: Demand has been driven by China and India. It is also increasing in the Middle East and North Africa. Energy trade is related to enormous financial transfer but also to power shifts, and the strong demand between 2002 and 2008 had favored producing countries in that respect. However, the economic crisis and the gas glut (due to decreased demand, a shale gas revolution in the United States, and the freed liquid natural gas volumes available) have turned the gas markets around, especially in Europe. Climate change has become a pressing issue and the energy sector is at the heart of the problem. Energy savings, energy efficiency, and a rising share of renewable energy are more important than ever.

The Energy Charter Conference adopted the Road Map for Modernisation of the Energy Charter Process on November 24, 2010, thereby acknowledging the new developments. This was the first visible output by the Strategy Group established at the previous conference in Rome, which had paved the way for the modernization of the Process with the Rome Declaration. The Road Map for the Modernisation of the Energy Charter Treaty, which makes reference to seven crucial areas (among them promotion of the Energy Charter and the Energy Charter Treaty; transit and cross-

border trade; investment promotion and protection; energy efficiency, etc.), reflects the new environment pretty well.

The key issues in EU energy supply still relate to natural gas and the imports from countries of the Former Soviet Union. However, electricity supply may soon follow when the share of renewable energy in the electricity mix increases, as will be necessary by 2020 and thereafter. Cross-border electricity lines, off-shore wind-farms, and concentrated solar power plants outside the EU will become pillars of the electricity supply to the continent. The promotion of energy efficiency and renewable energy technology is a prerequisite for addressing climate change and transitioning from a conventional energy system into a low-carbon energy system in the future. All this requires multinational fora to discuss the relevant and related issues.

Nonetheless, the Energy Charter Process is currently at a difficult stage. The Russian attitude toward the Treaty has contributed to that, but the EU has also favored its own instruments and mechanisms to deal with energy in the region, for example the Energy Community or the European Neighborhood Policy, Partnership and Cooperation agreements, etc. Moreover, in a number of EU countries the ECT is seen as “sacrosanct” and not subject to modernization, which is denounced as renegotiation with Russia—a position that could perpetuate the deadlock. Moreover, the gas glut and the North Stream pipeline diminish the pressure in respect to the transit issues at first glance. However, policymakers should not be led astray by these developments.

The Energy Charter Treaty: Stranded costs or added value?

To be very blunt, the ECT is in danger of becoming insignificant on the political scene and the conference process in danger of being downgraded. However, this would amount to high stranded institutional, financial, and political costs. What is

needed is a new impetus. The ECT and the related Process are quite unique in the tool set of the EU and in international governance. The Energy Charter Treaty can contribute an added value.

Complement to the EU architecture. Each instrument has its own target. The ECT aims to establish a level playing field for energy trade, transit, and investment on the international level. It introduces WTO principles. The Energy Community, the Neighborhood Policy, and other instruments build upon convergence and coherence with the EU internal market and foresee an expansion of the energy-related *acquis communautaire* within the respective countries. This is a very ambitious goal—without a clear perspective on enlargement, the EU is stripped of its strongest tool regarding its repertoire of positive and negative sanctions. Expanding the EU internal market has its limits and Russia is certainly out of reach for the foreseeable future. Thus, these instruments are complementary, not supplementary, to the Energy Charter Process and the related Treaty.

Outreach and scope. Gas is still the major focus of regional energy governance in Europe. If gas supplies are to become more diversified and gas markets are to become more global, then the reach of a treaty has to go beyond neighboring regions, and new transnational pipelines have to be built. This is equally relevant and all the more true for a developing green electricity market on the wider continent, with SEATEC or DESERTEC as important pillars. The envisaged regional cooperation may serve as a model for other regions in the world. Thinking through the new “bottom-up approach” in the UN climate process and diplomacy to the end, we will soon witness more integrated energy and climate partnerships and North-South cooperation to achieve envisaged greenhouse gas emission reductions. The ECT provides the essential tools. Common rules favor and facilitate investments and efficient markets. The modernization process opens

the possibility to adapt to new challenges presented by renewable energy and technology promotion.

Liquid markets. Moreover, the EU's supply security—with its energy market based on the structural principles of competition and solidarity with unbundled companies—depends on transparent and liquid energy markets. Liquidity is necessary both regarding finance and volumes—a level playing field is fundamental and hardly achievable with an exclusively bilateral approach but rather demands a multilateral design. Although the safeguarding provisions for investments will still apply under provisional application to investments made beforehand for another 20 years, the lack of an international, legally binding framework for investments will become a matter of paramount concern.

Politics. First and foremost, it is a political issue to preserve and revitalize the Energy Charter Process. It is the only standing forum that deals multilaterally with the mentioned issues and brings producing, transit, and consuming countries to the table. The political message to the Russian side should be clear: The proposal will be discussed in the Energy Charter Process. The argumentation is that forum-hopping bears the risk of problem-shifting. Besides, Russian participation in the modernization process can help to restore its reputation: It may contribute to confidence-building if the Russian side comes back to the table. Regaining confidence can be seen as a prerequisite for Russia to maintain its position as a major supplier to the EU. The Russian attitude toward the Energy Charter Treaty should be contrasted with new initiatives for cooperation and partnership, as envisioned by Premier Putin in Berlin in November 2010, when he proposed an “economic community from Lisbon to Vladivostok,” with energy relations being one of the pillars. How can such an initiative be taken seriously as long as Russia abides by its decision not to ratify the ECT and sidesteps the modernization of the Energy Charter Process?

To sum up, now more than ever, the Russian proposal should be used as a catalyst to flesh out the details of a global energy treaty that goes beyond existing documents such as the 2006 G8 Declaration on Global Energy Security. The right forum is the Energy Charter Process.

Russia's initiative illustrates an important point, though: The key countries need to come to the table. The timing is auspicious since public sentiment seems to have shifted in favor of more intense regulation in the energy sector and greater cooperation in the field of technology and know-how transfer as well as on the question of price volatility and the aim of increased compliance with the climate regime. In order to win over important producer and consumer countries, intensive diplomatic efforts are necessary and could be undertaken, for example, in the framework of the G8 and G20. Now is the time to make renewed efforts with Norway consolidating (“inreach”) and engaging North Africa (“outreach”) in the Energy Charter Process. The developments on the gas markets may present a window of opportunity: Gas supply security is under heavy scrutiny by consumers as is gas demand by producers. Reputation and confidence need to be restored.

The result should be an international, legally binding framework, an “Energy Charter Plus” that takes the interests of the energy producers and transit countries more strongly into account in a number of areas and includes modifications of several points that are already under discussion.

However, this implies a commitment to the ECT as well as the will to modernize and revise the Treaty. This ball is now in the court of the EU and its member countries.

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