

Gas Transit in Eurasia: Transit Issues between Russia and the European Union and the Role of the Energy Charter[†]

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This paper deals with the structure of the legal relationship relating to gas supplies and, specifically, to gas transit issues between Russia and the EU. The first section examines the evolution of the contractual structure of Soviet/Russian gas supplies to Europe, based on the Groningen (Dutch) concept of long-term gas export contract (LTGEC). The second section analyses new transit risks, both within and outside the EU, in the gas value chain of Russian gas supplies to Europe (within the area of responsibility of Russian exporters); these transit risks appeared after dissolution of the COMECON and the USSR. The paper then provides a more specific analysis in the third section of the new transit risks outside the EU which reflects the result of steady move from political to market-based pricing within CIS and, in section four, new transit risks within the EU which reflect the liberalisation processes within, and enlargement of, the EU energy market. Solutions for transit risks and where they are best provided - within WTO or ECT and its draft Transit Protocol – are examined in section five and section six examines, one by one, the key debated transit issues and draft solutions within Energy Charter framework, including the new Russian initiative (of 21 April 2009) on the new international energy order. The conclusions contain a road map to finalise the draft Transit Protocol to allow Russia to ratify the ECT.

About 40 per cent of the world's oil production, 20 per cent of gas and three per cent of electricity are exported, ie sold across at least one border. Only a limited portion of external trade in oil requires transit (ie crossing at least two borders) since most occurs by sea in oil tankers. The role of transit in the electricity trade is even less significant although crucial for some individual states (eg, for the Central Asian states of the Former Soviet Union in the Fergana Valley region – the result of the grid laid out during Soviet times).

But the transit component for gas exports is of critical importance. Transit accounts for up to 40 per cent of the international gas trade or about seven per cent of global gas production.

For Russia, transit of its energy exports (mostly destined for the European market) is more important than for any other energy-exporting country, including those competing with Russia in Europe, especially in gas. Direct supplies account for only about 40 per cent for Russia's gas exports compared with 66 per cent for Norway and 75 per cent for the Netherlands. Direct supplies for Algerian gas exports are similar to Russia's at about 45 per cent but Russian gas has a significantly higher portion of transit through the territories of two or more countries.¹ The major market for Russian gas has been the European Union, which will become increasingly dependent on external gas supplies (especially from Russia) through the forthcoming decades.

The article proceeds as follows. The first section examines the evolution of the contractual structure of Soviet/Russian gas supplies to Europe, based on the Groningen (Dutch) concept of the long-term gas export contract (LTGEC). The second section analyses new transit risks, both within and outside the European Union, in the gas value chain of Russian gas supplies to Europe (within the area of responsibility of Russian exporters); these transit risks appeared after the dissolution of the COMECON² and the USSR. The third section of the article then provides a more specific analysis of the new transit risks outside the European Union, which reflects the result of a steady move from political to market-based pricing within the Commonwealth of Independent States (CIS) and, in the fourth section, new transit risks

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1 A Konoplyanik. 'Russian Gas to Europe: From Long-Term Contracts, On-Border Trade, Destination Clauses and Major Role of Transit to ...?' (2005) 23 *JERL* 282–307.

2 COMECON = CMEA = Council for Mutual Economic Cooperation (рус: СЭВ = Совет Экономической Взаимопомощи).

within the European Union which reflect the liberalisation processes within, and enlargement of, the EU energy market. Solutions for transit risks and identifying where they are best provided – within the World Trade Organization (WTO) or Energy Charter Treaty (ECT) and its draft Transit Protocol – are examined in the fifth section and the next section examines, one by one, the key debated transit issues and draft solutions within the Energy Charter framework, including the new Russian initiative (of 21 April 2009) on the new international energy order. In his conclusions the author presents his vision of the road map to finalise the draft Transit Protocol to allow Russia to ratify the ECT. This section also discusses key elements of the new Russia initiative.

Soviet/Russian gas supplies to Europe: contractual structure and its evolution

Soviet/Russian gas export contracts to EU countries (historically), to the former COMECON member states (following the collapse of the USSR) and to the CIS (recently) have been based on (or are evolving towards) a modernised Dutch (the so-called Groningen) concept of the LTGEC.

Groningen model of the LTGEC

The Groningen model was developed in the Netherlands in the early 1960s following discovery of the Groningen field in 1958. The concept was driven by the Dutch Government's desire to maximise resource rent – or rather a specific part of the rent, the so-called 'Hotelling rent' – from the development of that uniquely sized field. The key elements of this model were formulated in a statement made by the then Dutch Minister of Economy, Mr de Pous, in 1962 to the national parliament, establishing the main principles of a new government energy policy. The statement became known as the '*Nota de Pous*'. The intent of the new policy (which was fully reflected in the Dutch LTGEC concept) was to generate maximum revenue for the gas-producing country in the long term.³

The Groningen LTGEC is characterised by the following key elements (see Figure 1)⁴:

- (1) It is based on a long-term contract to provide a secure, lasting and stable demand for production from the field and thereby facilitating the necessary investment for field development. Contract duration is

3 For more information see 'Putting a Price on Energy: International Pricing Mechanisms for Oil and Gas' (Energy Charter Secretariat, 2007); A Correlje, C van der Linde and T Westerwoudt, *Natural Gas in the Netherlands: From Cooperation to Competition?* (Oranje-Nassau Groep, 2003).

4 For more details see 'Putting a Price on Energy'

- a function of the need to: (a) secure lasting, predictable and stable cash flows from gas exports necessary to pay back the investment in the upstream project (field development, including related transport infrastructure); and (b) match the duration of guaranteed gas sales from the upstream project with the project lifetime.
- (2) Both domestic and export gas prices are pegged to gas replacement value (the price of gas substitutes for the end-user, ie, 'on the burner'). This allows the exporter to derive the maximum resource rent from its gas sales while keeping the gas competitive with alternative energies in its specific market(s). This pricing formula is an integral part of any LTGEC.
 - (3) The contract provides for regular price review (both within the given contract pricing formula as well as review of the formula itself). This review is needed to reflect and adapt to price fluctuations of gas substitutes to keep gas prices competitive.
 - (4) Minimum pay obligations (known as 'take and/or pay' obligations), which guarantee that the producer will receive minimum guaranteed revenues from gas sales. On the other hand, the buyer will have the flexibility to decide whether to offtake all contracted volumes or only a part of them within the range allowed under the contract. The producer takes the 'resource' risk associated with the upstream activities (risk of producing energy resources, geological risks and of the transport of gas produced up to the delivery point), while the consumer assumes the 'market' risk associated with the downstream activities from the delivery point to the end-user (risk of energy marketing and sale).
 - (5) Net-back to the delivery point (from end-user, eg gas replacement value for the end-user less transport costs from the delivery point to this end-user). This clause (the pricing principle) secures the competitiveness of gas exports delivered to various markets via different routes. It also means that if gas is supplied from a single source (producer) to various export markets via one delivery point, the export price for such gas at such delivery point may vary significantly under the terms of different contracts owing to the differing end-use prices (gas replacement values) of such export markets and differing transport distances to such markets from this delivery point. In the case of intra-West-European LTGEC the distances between the producer (Groningen) and the (Western European) markets were not as long – so differences in end-use prices were more important, especially at the earlier stages of the development of the West European markets, compared to the factor of transport distances. With the diminishing difference between end-user gas prices within the emerging common

internal EU gas market, the difference in contractual prices at the same delivery point has been diminishing as well (which is not the case for the Soviet/Russian LTGEC – see below).

- (6) Destination clauses are required because gas may be further re-exported to different export markets with differing contract prices at the given delivery point. A destination clause (also known as a territorial sale restriction) precludes the re-exportation of cheaper gas (purchased by the importer under one contract for a more remote market) at a higher price (specified in another contract for a closer market) thereby securing maximum resource rents for the exporter.

The Groningen model of the LTGEC provided the contractual framework for the creation and further development of the European gas supply and transport system. Over 250 BCM of gas is annually imported into Continental Europe under the terms of contractual arrangements based on the Groningen concept of the LTGEC.

Figure 1. Soviet/Russian & Groningen (Dutch) LTGEC Models: Differences & Similarities

	Groningen LTGEC model (since 1962)	Russian (Soviet) LTGEC model (since 1968)	Why Russian LTGEC model differs from Groningen LTGEC model
Contract duration	Long-term	Longer-term	Larger West Siberian fields & unit CAPEX, longer transportation distances & pay-back periods
Delivery point	Upstream to end-user	Upstream to end-user - on EU-15 border; one delivery point served few final consumers	Historically: on the political border between East & West
Pricing	Replacement value + net-back to delivery point + regular price review + minimum pay obligation (take-and/or-pay)		West: both for export & domestic sales; East: only for export sales
Protection from price arbitrage	Destination clauses		More important since fewer delivery points and one delivery point but differing export prices for different markets.
Role of transit	None (minimal)	Significant – especially after dissolution of COMECON & USSR & after EU expansion	New sovereign states appeared upstream of historical delivery points & new EU rules discriminating against transit

Russian model of the LTGEC

Soviet gas supplies to Western Europe commenced in 1968 with shipments to Austria under a contract with OMV. The Groningen model, developed for gas deliveries with short transport distances within a politically homogeneous Europe, was adapted to the specific conditions of Soviet gas supplies to Western consumers on the other side of 'the iron curtain' thousands of miles away from production in Western Siberia. One key form of adjustment was to fix the delivery point as close to the market as possible in order for the producer to manage supply risks. This meant that the delivery points would be at the Western border of COMECON (ie, at Baumgarten on the Austrian/Slovak border or at Waidhaus at the Czech/Germany border).

This contractual structure of Soviet/Russian gas supplies has proved to be viable and reliable for 40 years both during times of confrontation between the two political systems in Europe (the Cold War era) but also through the post-Soviet transformations of the political map of Europe.

What are the specific features of the Soviet/Russian model of the LTGEC? And how does it differ from the Groningen model (see Figure 1)⁵:

- *Contract duration.* The Soviet model of long-term 'take-and/or-pay' contracts was distinguished by an even longer duration (20-30 years and more) because they served as the basis for the financing of large-scale gas production (worldwide, the largest gas fields developed) and long-haul transport projects (the longest transport distances). Long-term contracts have been requested by the financial community rather than producers since the LTGEC has always been the basis for funding capital-intensive, long-distance and fixed infrastructure projects⁶ because the majority of upstream projects are funded with debt (project) financing. This type of financing provides up to 80–90 per cent of the investment and requires long-term and stable cash flows from gas sales to service and repay debt.
- *Delivery points locations.* The delivery points for Soviet/Russian gas (where ownership also transfers) have been historically placed on the outer eastern border of the 'former' European Union (EU-15). The Soviet Union could assure uninterrupted supply within the area of its political influence, eg through USSR/COMECON to the eastern border of the European Union

5 For more information see А Конопляник, '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?)'. *Нефть, газ и право*, 2005, No 3, с 33–44; No 4, с 3–12.

6 For more details on long-term contracts as financial instruments for upstream development in oil and gas see, for instance, А Конопляник, 'Развитие рынков газа, долгосрочные контракты и Договор к Энергетической Хартии'. *Нефтегаз*, 2002, No 4, с 25–33.

(Western Europe), while West European buyers could do so downstream of such points to their end-users. Thus, one delivery point for Soviet gas could serve several EU buyers/end-users. This was not usually the case for gas exports originating in European gas fields. Compared to the Groningen practice, delivery points in the Soviet/Russian LTGEC were also much further away from both the producer and the end-user market.

- *Pricing.* Soviet/Russian gas pricing at given delivery points is defined as the replacement value at the end-use market in a particular EU country minus the cost of transport from the delivery point to the market(s). This explains why there are different contract prices for Russian gas destined for different markets from one and the same delivery point (eg, Baumgarten serves as a delivery point for Soviet/Russian gas exports for Austria, Italy and France; similarly Waidhaus on the German–Czech border serves as a delivery point for supplies to Germany, France, etc).⁷
- *Regular price review and minimum pay obligations.* Regular price review and minimum pay obligations in the Soviet/Russian LTGEC were similar to the Groningen model.
- *Destination clauses.* Given the different markets served, destination clauses were essential in order to protect against price arbitrage by the buyers of Soviet/Russian gas.⁸ Such clauses also help to monitor price risks and enhance the reliability of debt repayment because price behaviour is more predictable. Given the greater distances involved from delivery points, destination clauses for the Soviet/Russian LTGEC were much more important than for their Western European analogues.
- *Role of transit.* The location of the delivery points also foreshadowed the importance of transit although during the Soviet era transit risks did not exist since all COMECON states were politically and economically dependent on the USSR. And there was no transit at all within the Soviet Union for so long as gas flows were crossing the inter-Soviet boundaries between republics of the USSR. Furthermore, Soviet state institutions such as the Soyuzgasexport (foreign trade was a state monopoly in the USSR) had full operational control over Soviet gas transit flows within the COMECON area. With the dissolution of COMECON and the USSR (1989 and 1991 respectively) the number of transit states has increased

7 For more details see, for instance, M Frisch, 'The forced removal of destination clauses: European gas security of supplies implications', presentation at the conference 'Eurasian Natural gas: Opportunities and Risks', organised by the Energy Charter Secretariat, 12–13 November 2003, Brussels; M Frisch, 'Can Price Review and Destination Clauses undermine gas security of supply in Europe?' presentation at the conference 'NGas Summit', organised by Informa IBC Energy, 1–3 July 2003, Paris.

8 *Ibid.*

and thus transit rights are much more significant for Russian gas than for Russia's main competitors.

Prior to the late 1980s and early 1990s transit problems both in the Eastern and Western segments of the Soviet gas export value chain were solved through vertical integration and political control. In the West, the wholesale buyer of Soviet gas was typically a vertically integrated company that owned or leased the transit pipeline. In the East, the exporter (Soyuzgasexport) had operational control through the COMECON over the transit flows usually (subject to some exceptions) without owning and/or leasing the pipeline.

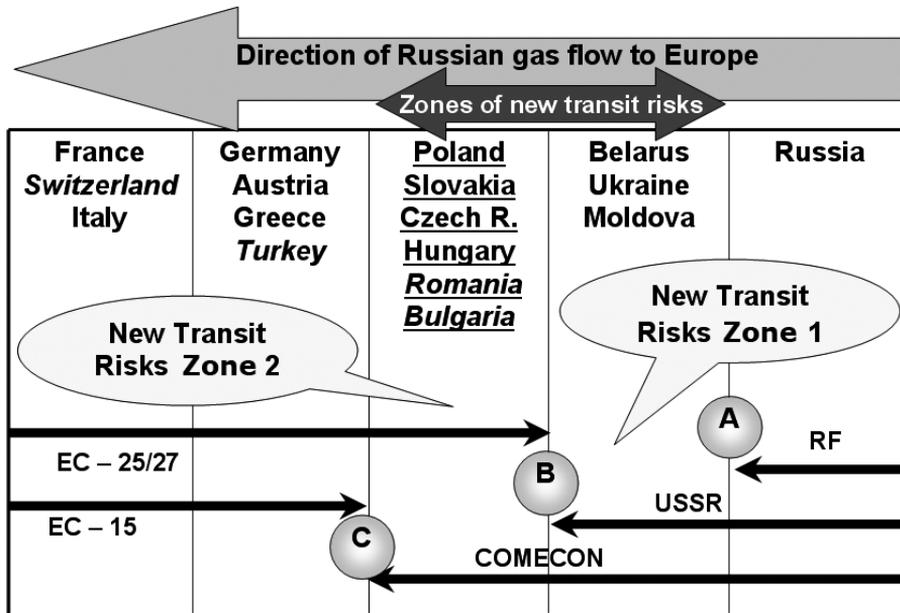
There have been significant changes since the early 1990s. In the East, we have seen the emergence of new sovereign transit states many of which (since 2004/2007) have become Member States of the European Union. The Russian institutions and companies – successors to the Soviet Gas Ministry and Soyuzgasexport – are no longer solely responsible for reliable gas supplies through the gas value chain to delivery points at the EU-15 border. In the EU area there have also been significant developments including EU expansion (with its *acquis communautaire*) and the evolution of internal market liberalisation resulting, inter alia, in unbundling and implementation of mandatory third party access (TPA). The Russian gas delivery points, which were formerly on the outer border of the 'former' EU-15 (and not subject to the European Union's *acquis*), are now located inside the 'new' EU-25/27 and subject to internal EU legislation. Moreover, considerable Russian gas volumes are now transited across the European Union as a whole (through the Balkans route with delivery to Turkey and to the former Yugoslav states, and, in the case of deliveries to Kaliningrad Oblast of Russia, through the Baltic States). This creates new transit risks for Russian gas within the European Union.

Zones of new transit risks – within and outside the European Union – in the gas value chain of Russian gas supplies to Europe

Where and when did the new transit risks start to arise? It is possible to distinguish two zones and three phases in the development of these risks (with a fourth phase probably emerging).

The two main new transit risk zones along the value chain of Russian gas supplies to Europe include both the countries outside (see 'Transit Risks Zones 1' at Figure 2) and inside the European Union (see 'Transit Risks Zones 2' at Figure 2). The genesis of the new risks in each of the two zones differs considerably.

Figure 2. Russian Gas Supplies to Europe: Zones of New Risks for Existing Supplies Within Russia's Area of Responsibility



Italic – non-EU countries;
 New EU accession states: underlined – since 01.05.2004, underlined + italic – since 1.01.2007;
 A, B, C – represent points of change of ownership for Russian gas and/or pipeline on its way to Europe

First phase

The first phase of transit risk (relating to Russian gas transit to Europe) began in the late 1980s and the early 1990s following the reunification of Germany and the collapse, first, of the COMECON, and later of the Soviet Union, along with the emergence of new sovereign countries and new legislation and regulations. This creates new political, legal and, consequently, economic risks for the supplier undertaking transit by the very fact (even if not by the nature) of the new rules. In addition, the former COMECON member states and Russian suppliers began to convert their contractual relationships along the lines of a modified Groningen model. These first-phase risks continue with respect to the former republics of the Soviet Union, which are now sovereign CIS states.

Second phase

The second phase dates back to 2002–2003 when the European Commission, Gazprom and several West European customers agreed to waive destination clauses in the relevant Russian LTGECs (first with ENI of Italy and OMV of

Austria and then with Eon-Ruhrgas of Germany, etc). Made under pressure from the Commission, this was hardly to Gazprom's advantage.⁹ For instance with ENI, part of the quid pro quo was to be expanded access for Gazprom to the market in the end-use country (Italy). To this end, the signed documents envisaged a capacity expansion of the transit pipeline, Trans Austria Gasleitung (TAG) through which all Russian gas was shipped to Italy.¹⁰

However, the bidding procedure for access to the TAG expanded capacity allocations to all bidding companies (149 in total) without requiring bidders to provide assurances of available gas volumes. As a result, Gazprom did not get an adequate share of the expanded capacity. Its allocation neither corresponds to its declared willingness to provide secure gas for 100 per cent of the TAG's additional capacity (the entire expansion) nor does it compensate Gazprom for losses caused by waiving the destination clauses. Moreover, immediately after the auction (December 2005), Gazprom started to receive offers from other companies to purchase Gazprom gas to allow them to fill their allocated capacity or proposing that Gazprom buy their access quota (at a totally different price).¹¹

Third phase

The third phase covers the two-step EU enlargement between 2004 and 2007. These risks superseded the first-phase risks within the former COMECON member states, which now became EU Member States. These are upstream of the delivery points for Russian gas and the transit areas now fall within the developing EU rules on gas market liberalisation (which rules do not provide adequate security for long-term transit flows inside the European Union, as it would be shown below).

Fourth phase

The fourth phase refers to the possible emergence of new risks associated with the Third EU Liberalisation Package announced on 19 September 2007, which has recently been approved by the European Parliament at second

9 A Konoplyanik, 'Russian Gas to Europe: From Long-Term Contracts, On-Border Trade, Destination Clauses and Major Role of Transit to ...?' (2005) 23 *JERL* 282–307.

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

11 В И Фейгин and Е А Медведева, "Дьявол в деталях" европейской либерализации: вокруг аукциона по TAG'. Институт энергетики и финансов, 'Экономическое обозрение', ноябрь 2006, No 5, с 37–39.

reading (22 April 2009). This package has drawn much criticism both outside and inside the European Union and some new risks to Russian gas transit within Europe seem unavoidable.

The expansion of the European Union extends the importance of the Union's *acquis communautaire* in ascertaining the relevant transit rules. Other transit rules include the GATT/WTO rules and the ECT and its draft Transit Protocol. The WTO has broader geographical coverage although some major gas producers within Eurasia are not yet WTO members (eg, Russia, Turkmenistan and Iran). On the other hand, the ECT, which incorporates GATT/WTO rules in its trade section, has a more limited geographical coverage but it is energy specific and includes all major gas producers in Eurasia, although some are observers rather than full members.

New transit risks outside the European Union: from political to market-based pricing within the CIS

A key part of transit risk for Russian gas supplies to Europe is reflected in the challenge of managing the transition from political pricing and supply obligations that prevailed within the unified political system of the USSR and COMECON to market-based pricing and supply obligations between sovereign states and their commercial entities based on the modified Groningen concept. Prior to the dissolution of the USSR and COMECON, Soviet gas supplies to COMECON states were characterised by two features. First, export prices to COMECON states were defined on the basis of political (friendship) pricing and not on the 'cost-plus' or 'replacement value' principles used in international gas contracts.¹² Secondly, transit tariffs were also defined on the same basis and were not 'cost based'.¹³ The same was true for Russian gas supplies to CIS states after dissolution of the USSR and until recent years.

Under these arrangements the flow of gas into COMECON states consisted of two flows to cover its internal gas demand (defined on the basis of the physical gas balance within the centrally planned COMECON system): (1) an inflow of gas that reflected payment 'in kind' for the flow of Soviet gas transited through the COMECON state to the West; and (2) an inflow of exported Soviet gas into the COMECON state. Usually the same gas price was

12 For more details on international gas pricing mechanisms see 'Putting a Price on Energy': n3 above. See also a further development of this study, especially in regard to the former COMECON and CIS area, in a series of Energy Charter Secretariat presentations at the Workshops on International Pricing Mechanisms in Oil and Gas, organised with the author's participation in 2007–2008 in some ECT member states and the author's presentations and writings on this issue (available from www.konoplyanik.ru).

13 For more details on transit tariff methodologies see 'Gas Transit Tariffs in Selected ECT Countries', Energy Charter Secretariat, January 2006.

used for both gas flows and it did not reflect economic values. Both export prices and transit tariffs calculated by this means were underpriced and reflected subsidised export prices and transit tariffs. Subsidised gas export price means that a portion of resource rent was left with the importing state but in return transit tariffs were also subsidised. This was possible because of the broader elements of the COMECON economic/political system including barter and quasi-barter deals and counter-supplies of the goods and services that were usually overpriced to neutralise the trade balance between USSR and COMECON states. Export and transit supplies were not contractually separated within the COMECON system.

Dissolution therefore required a long and painful transition to contractual separation of transit and export supplies governed by separate legislation, and a transformation to market-based pricing for both transit tariff methodologies and the export energy price. The transition was particularly painful because it was implemented for Ukraine and Belarus (major transit states for Russian gas to Europe), after long delays, after 2004 when oil prices began to rise dramatically followed by gas prices as a result of gas-to-oil indexation formulas in the LTGEC.¹⁴ But any further delays were problematic as the gap between 'political' and 'economic' gas export prices became broader and broader.¹⁵ The transition was also exacerbated by changing political attitudes towards Russia in some transit CIS states, beginning with Ukraine after the 'orange revolution'. This created a much more negative environment for any radical changes in gas prices based on the move to market-based pricing principles. The international media further politicised the issues during, for example,

14 For more details see 'Putting a Price on Energy': n3 above. See also A Konoplyanik, 'Gas Pricing: Indexation Versus Gas to Gas Competition (Chairman's opening remarks to the Round-Table 2 Discussion)', presentation at the European Gas Conference 2008, 23–25 January 2008, Vienna; А Конопляник, Эволюция ценообразования на газ в континентальной Европе. Часть 1: Гронингенская модель долгосрочного экспортного газового контракта как основа формирования европейской системы газоснабжения. *Газовый бизнес*, январь-февраль 2009, № 1, с 62–69; Часть 2: Контрактная структура поставок и цены. *Газовый бизнес*, март-апрель 2009, № 2, с 78–80; Часть 3: Формулы привязки в рамках долгосрочных контрактов и (или?) конкуренция 'газ-газ' на рынке разовых сделок? *Газовый бизнес*, май-июнь 2009, № 3, с 76–82.

15 For more details on the Russian–Ukrainian gas dispute and on the debate on 'political' and 'economic' pricing and prices in Russia–Ukraine gas relations see, for instance, А Конопляник, Российско-украинский газовый спор: размышления по итогам Соглашения от 4 января 2006 г (в свете формирования цен и тарифов, экономической теории и ДЭХ). *Нефть, газ и право*, 2006, № 3, с 43–49; № 4, с 37–47; Он же, Третейский газовый суд. *Эксперт. Украинский деловой журнал*, № 8 (106), 26 февраля 2007 г, с 28–34, etc.

the Italian gas supply problems in the winter of 2005/06.¹⁶

While former COMECON states were under some pressure (through, eg, accession to the European Union) to shift contractual relations to a Groningen model, there was no similar pressure on countries such as Ukraine or Belarus, and the price gap between market and political price, which was already significant, began to grow with increased oil prices. For example, while the price gap for the Czech and Slovak Republics in 1998 (when they converted their political pricing for Russian gas to the market-based Groningen formula) was less than US\$10/mcm, for Ukraine in winter 2005/06 the price gap between the 'market' and 'political' price was already about US\$160/mcm, and for Belarus (winter 2006/07), the price gap was even bigger (US\$170/mcm). This clearly explains the political sensitivity of any transition from 'political' to market-based pricing and prices within CIS states.

The compromise solutions finally agreed presented a soft and prolonged transition to market-based pricing and prices. In the case of the Russia–Belarus agreement of 31 December 2006, gas exports priced at the Russia–Belarus border will reach their net-back European value in 2011. The position is more complex in the case of Ukraine since the export flow of gas

16 Analysis of the real causes of undersupplies of gas to Italy during winter 2005/06 showed the following. This winter was the coldest in the previous 60 years, thereby increasing the demand for electricity in the neighbouring countries to Italy where prices increased. That, in turn, increased the margins in cross-border electricity trade and stimulated excessive depletion of Italian underground gas storages for export-oriented electricity production. When the temperatures dropped to abnormally low levels, there was just not enough gas in the underground storage to cover the abnormally high peak demand for gas. However, the timing of the Russian–Ukrainian gas dispute allowed some to try to shift attention from the real internal cause (utilisation by Italian companies of short-term trade benefits to the detriment of longer-term security of supplies of Italian end-users) to external events that did not have a direct effect on the problem of undersupply of Italian gas consumers. (See, for instance, Marco Alverà, 'Securing Reliable Natural Gas Supply in the UNECE Region', UNECE Working Party on Gas – seventeenth session (UNECE: Geneva, 23 January 2007). By contrast, in Germany and France, major gas companies were criticised for non-market behaviour since they did not sell gas from underground storages to the UK where the prices also increased and were the highest compared to those in Continental Europe. The companies were criticised for not using the short-term economic benefits of price arbitrage. In response, the companies argued that their behaviour reflected not their potential short-term economic interests, but their existing longer-term contractual obligations. They did not have the legal right to utilise price arbitrage since they had contractual obligations to hold corresponding volumes of gas in storage to cover seasonal fluctuations in demand. Furthermore, since this gas was contracted to cover the specified needs of particular end-users, the companies were not entitled to use it for their own short-term trade benefit. So in this case Continental Europe supply security and contractual obligations in favour of end-users dominated the short-term economic benefits of the traders.

to Ukraine includes both Russian gas (priced at the Russia–Ukraine border since January 2006 on the net-back replacement value principle based on end-user prices of European importers of Russian gas) and Central Asian gas (priced between January 2006 and January 2009 at the corresponding Central Asian state border on a cost-plus principle, plus the cost of transport to the Russia–Ukraine border). According to the Russia–Ukraine Agreement of 4 January 2006, the adjustment time was to be flexible. In addition, the use of intermediaries (Russia–Ukraine joint venture RosUkrEnergo (RUE) as a sole exporter to Ukraine of gas from both Russia and Central Asia and UkrGasEnergo as a sole supplier exclusively to the domestic Ukrainian market of gas purchased from RUE) allowed the parties to implement a ‘soft’ increase of export prices for Ukraine, and to avoid the re-export to Europe of Russian gas destined for the domestic Ukrainian market.¹⁷

The parties also agreed to adapt transit tariffs for gas and their methodologies (based, *inter alia*, on the above-mentioned Energy Charter Secretariat study on transit tariffs¹⁸). Transit tariffs for Russian gas through Ukraine were increased from 1.09 in 2005 to 1.6 in 2006 and then to US\$1.7/mcm/100km in 2007. Negotiations on further adaptation of transit tariffs continue between Gazprom and Naftogas.

In practice, transit tariffs for Russian gas through Ukraine (all Central Asian gas is consumed within Ukraine) and the transport tariffs of Central Asian gas through Russia (in legal terms there is no transit – see below) are equal and established on a reciprocal basis (ie any increase in transit tariffs through Ukraine automatically leads to corresponding increases in tariffs for Central Asian gas through Russia). This is likely to continue in the absence of a new agreement which recognises the need for cost-based transit tariffs and that a ‘one-size-fits-all’ approach is not sustainable.¹⁹ Various technical, economic, financial, geographical, legal and regulatory factors may lead to different tariffs.

Direct comparison of transit tariffs in different countries with different transit systems (the argument of some CIS transit states, which compare their lower transit tariffs with the higher transit tariffs inside the European Union and seek to increase their tariffs to the ‘European’ level) needs to be

17 For more details see A Konoplyanik, ‘Russia-Ukraine Gas Trade: From Political to Market-Based Pricing And Prices’, presentation at the conference ‘Reassessing Post-Soviet Energy Politics: Ukraine, Russia, and the Battle for Gas from Central Asia to the European Union’, co-sponsored by the Harvard Ukrainian Research Institute and the Davis Center for Russian and Eurasian Studies, 7–8 March 2008, Center for Government and International Studies, Cambridge, MA, USA. See also other author’s presentations and publications on related issues available at www.konoplyanik.ru.

18 ‘Gas Transit Tariffs in Selected ECT Countries’, Energy Charter Secretariat, January 2006.

19 ‘Gas Transit Tariffs in Selected ECT Countries’, Energy Charter Secretariat, January 2006, and Energy Charter Secretariat presentations at the pricing workshops in ECT member states (www.konoplyanik.ru).

done cautiously since there are at least four different types of transit tariff methodology corresponding to four different types of transit system:

- (1) *postage stamp*: a single, fixed fee used for low-pressure distribution systems;
- (2) *point-to-point*: quoted for every entry–exit pair within the system;
- (3) *distance-based*: commonly used for gas transit in one direction with few offtake points – this is usually the case for transit through the CIS and former COMECON (which are nowadays ‘new’ EU) states; and
- (4) *entry–exit*: suitable for highly meshed systems with many injection and delivery points – typically the case for the ‘old’ EU states and the goal of the European authorities for the common internal EU gas market.²⁰

The chosen tariff methodology must ensure financial sustainability and avoid excessive profits. Contractual separation of transit and gas supply arrangements enables more transparent and cost-reflective tariffs.

In March 2008, three Central Asian gas exporters (Turkmenistan, Uzbekistan and Kazakhstan) signed an agreement with Gazprom to provide that, effective from 1 January 2009, on-border export prices for each state will be increased to European levels less transport costs (eg, netted back from European levels to the Central Asian state border). It was agreed that contractual relations will be based on long-term contracts. These agreements came into effect in January 2009 and since then Russia has bought Central Asian gas at netted-back ‘European’ price levels.

On 19 January 2009, after the Russia–Ukraine gas crisis, the two parties signed a ten-year-long LTGEC based on the Groningen concept and pricing formula along with a corresponding ten-year-long transit agreement. The Russian export price for Ukraine for 2009 will have a 20 per cent discount from the net-back to the Russia–Ukraine border of gas replacement value in the European market. There will be no more discounts as of 2010. The parties will further negotiate transit tariffs methodology and tariff levels based on generally accepted principles. By signing this agreement Russia finalised the 20-year-long process of moving gas export prices to CIS countries from

20 ‘Gas Transit Tariffs in Selected ECT Countries’, Energy Charter Secretariat, January 2006.

political to market-based pricing and prices.²¹

With the continuous move of gas export pricing and prices to internationally used formulas and economically justified levels, and with further adaptation to these new rules, the specific transit risks within the CIS related to the transition from political to market-based pricing and prices, tariffication and tariffs have been diminishing.

New transit risks within the European Union: liberalisation and enlargement of EU energy market

The development of an integrated EU market and its further liberalisation and enlargement create new transit risks for Russian gas inside the European Union (see 'New Transit Zone 2' at Figure 2).

The key elements of EU energy market liberalisation are unbundling and mandatory third-party access (MTPA) to energy infrastructure, including energy transport. Unbundling and MTPA inevitably create new transit risks because of the possibility of the non-renewal of existing transit contracts in a situation where the import delivery contract (usually LTGEC) is longer in duration than the corresponding transit arrangements (the so-called 'contractual mismatch' problem).

In the past, vertically integrated companies (VICs) in Europe developed and used the energy infrastructure (the 'own and operate' principle) for their own gas (produced or purchased by them), and thus had full control over flow and capacity. Under such conditions there was no need to ensure that the LTGEC (supply contract) was matched by the corresponding transport (transit) contract since the VIC undertook both operations simultaneously. This was an internal managerial task and the VIC could reserve some capacity for its own gas.

Driven by the move to a more competitive market, EU legislators have been continuously implementing unbundling within the organisational structure of the EU energy market. The unbundling requirements have

21 See A Konoplyanik, 'Russian and Central Asian gas in the FSU and continental Europe: evolution of contractual structures and pricing mechanisms', presentation at the Harriman Institute and Center for Energy, Marine Transportation and Public Policy (CEMTPP), School of International and Public Affairs (SIPA), Columbia University, 3 March 2009, New York, NY, USA; А Конопляник, 'Российский газ в континентальной Европе и СНГ: эволюция контрактных структур и механизмов ценообразования'. Выступление на 99-м заседании открытого (Некрасовского) семинара 'Экономические проблемы энергетического комплекса', Институт Народнохозяйственного Прогнозирования РАН, Москва, 25 марта 2009 г (available at www.konoplyanik.ru).

become tougher over time: from operational (in the first Electricity²² and Gas²³ Directives of 1996 and 1998) to financial (in the Second Directives – of 2003²⁴) and to legal unbundling (in the third liberalisation package proposals of 2007²⁵). After unbundling, any supply contract (LTGEC) requires a corresponding transport contract. This is no longer an internal managerial task of a VIC but the result of negotiations between the owner of the gas (supplier/shipper – former VIC) and the owner/operator of the transport infrastructure.

Since the Second Gas Directive of 2003 (which repealed the Directive on Transit of 1991²⁶) there have been no separate rules for transit. According to the Treaty of Rome (1958), domestic transport is subject to the free flow of goods (ie competitive) inside the European Union. Competition is enforced through TPA, negotiated TPA in the First EU Gas Directive and MTPA in the Second Gas Directive. TPA diminishes the right of pipeline owners to make decisions based on the ownership of the gas in the pipe and treat short-term and long-term shippers on a more equal footing. This creates the problem of contractual mismatch (see above), one of the major risks for long-term transit supplies through linear transit systems.

In order to develop a more liberalised and competitive EU energy market, EU authorities have been trying to increase its liquidity by stimulating the short-term trade in gas. The Commission has also opposed long-term contracts, despite the fact that LTGECs are still the backbone of the existing European gas supplies²⁷ and despite the fact that the alternative (spot markets with gas hubs, ie liquid marketplaces) are still

22 European Parliament and Council Directive 96/92/EC concerning common rules for the internal electricity market.

23 Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas.

24 Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC; Directive 2003/55/EC of the European Parliament and of the Council (26 June 2003) concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC.

25 Energising Europe: A real market with secure supply. Commission Press Releases. MEMO/07/361, Brussels, 19 September 2007, www.europa.eu.

26 Council of the European Communities. Council Directive of 31 May 1991 on the transit of natural gas through grids (91/296/EEC) (no longer in force).

27 LTGECs supply more than 90 per cent of Continental European countries' gas imports and will continue to be an important integral part of the EU gas market contractual structure in the foreseeable future.

in their infancy.²⁸ In this debate between the interests of the producers/suppliers of gas into the EU market (to protect secure transit flows) and the resellers of this gas within the EU market (to create a liquid and competitive internal market) it is the second group that is gaining ground. Thus, paragraph 25 of the 2003 Second EU Gas Directive states: ‘Long-term contracts will continue to be an important part of the gas supply of Member States and should be maintained as an option for gas supply undertakings in so far as they do not undermine the objectives of this Directive and are compatible with the Treaty [of Rome, 1958, establishing the EU], including competition rules.’²⁹

This suggests that the competition rules will prevail over the interests of long-term security of supplies. This inevitably creates new transit risks within the European Union exacerbated by its geographical expansion, which means that the area covered by EU regulation (*acquis communautaire*) with the incurred risks for transit flows has been expanding upstream from the delivery points of Russian gas to the European Union. What is most important, these risks occur within parts of the gas value chain which are within Russia’s area of contractual responsibility (according to its LTGEC) for stable and secure gas supplies to Europe.

Since transit involves at least three states, any solutions to the problems of transit risk need to involve all the parties.

Solutions for transit risks: WTO vs ECT and draft Transit Protocol

Option to address transit risks

There are, in *operational* terms, four types of organisation of pipeline transit system:

- (1) A pipeline crossing sovereign territory and carrying transit gas without any connection to the gas supply system of the transit country (examples include the Moldova and Algeria/Morocco lines).
- (2) A transit pipeline owned by a separate entity, predominantly used for gas transit, but also used to supply gas of the same origin to the transit country (examples include most Russian transit pipelines, and TAG, WAG, MEGAL and TENP).

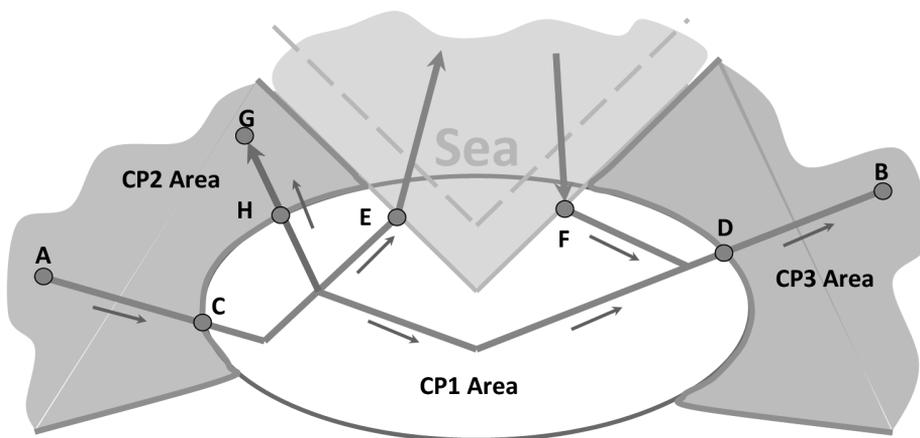
28 For more details on this see А Конопляник, Ценообразование на газ в континентальной Европе: формулы привязки в рамках долгосрочных контрактов и (или?) конкуренция ‘газ-газ’ на рынке разовых сделок? Нефть и газ, No 10, декабрь 2008, с 58–60, 62–64, 66, 68, 70–72, 74, 76 (Украина).

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

- (3) A transit pipeline system integrated into the domestic supply system and owned and operated by the main national transmission operator, where the transit gas flow can still be traced (examples include Ukraine and Belgium).
- (4) Systems where transit volumes commingle within a highly meshed national grid (examples include the United Kingdom, Germany and France).³⁰

Article 7 'Transit' of the ECT³¹ suggests that there are three different options for carrying supplies of energy materials and products (EMP) from the territory of one contracting party (say, from point A located within the CP2 Area) to the territory of another contracting party (say, to point B located within the CP3 Area) if there is at least one more contracting party (CP1 Area) between them (see Figure 3).

Figure 3. Transit is not the only option ...



Three possibilities to supply gas from A to B:

- (1) No transit (eg on-border sale at C; examples Turkmenistan/Uzbekistan/Kazakhstan-RF-UA, Algeria-Italy, Algeria-Spain);
- (2) Transit through the pipe in CP1 owned/leased by shipper (eg France in Germany, Norway in France, Italy in Austria; RF (partly) in EE);
- (3) Through the pipe in CP1 not owned by shipper (eg Ukraine, Belarus (until 2007), EU)

³⁰ 'Gas Transit Tariffs in Selected ECT Countries', Energy Charter Secretariat, January 2006.

³¹ For the text of the ECT see www.encharter.org.

Option 1 – no transit

In this case the goods will be sold at the border at delivery points C and D (see Figure 3), at which point title to the gas passes and ownership of the pipeline also changes. There is thus a chain of on-border sales. Such an arrangement may avoid transit risks for the producer state but will preclude the producer from receiving the higher price that it might have obtained at the end of the transit chain. There is thus a trade-off between lower risk and higher returns. In its long-term gas purchasing agreements with Turkmenistan, Uzbekistan and Kazakhstan, Russia buys the gas produced in these states on their border. In this case it is the Russian buyer³² (except for the period 2006–2008) who transits Turkmen gas through Uzbek and Kazakh territory, and Uzbek gas through Kazakh territory. Transport of this gas through Russia is not itself transit.³³ Similarly, Turkmenistan sells its gas destined to China on its border and thus it is the Chinese buyer that transits Turkmen gas through Uzbek and Kazakh territory. On-border sales are also an integral part of the Algerian supply schemes to Italy (transit through Tunisia by the Italian buyer) and Spain (transit through Morocco by the Spanish buyer).

It may also be possible to escape transit by developing new pipelines through international waters. Examples include the ‘Blue Stream’ pipeline connecting Russia with Turkey through the Black Sea (an alternative to supply via Ukraine, Moldova, Romania and Bulgaria). The Northern European gas pipeline project ‘Nord Stream’ will connect Russia with Western Europe (using Germany’s Baltic coast as an entry point) through the Baltic Sea.

32 In 2006–2008 it was Russia–Ukraine joint venture ‘RosUkrEnergo’, a Swiss-registered company, which delivered and sold, at least in legal terms, Central Asian gas to Ukraine. This was the period when two different pricing principles applied for deliveries to Ukraine of gas originated from Russia (net-back EU replacement value) and from Central Asia (cost-plus-plus): 2006–2008 was a transition period of moving Russian export gas prices to Ukraine from political to market-based pricing (see the author’s presentations at www.konoplyanik.ru).

33 On sale to a Russian company (Gazprom) at the Turkmen–Uzbek border, this gas is no longer ‘Turkmen’ but only ‘originated in Turkmenistan’ since title passes to the Russian company at the border. It is now ‘Russian’ gas (ie, belonging to the Russian company Gazprom). This gas is further transited through Uzbek and Kazakh territory – now as ‘Russian’ (Gazprom’s) gas (in 2006–2008 it was further re-sold at this point to Gasprom subsidising JV RosUkrEnergo and then transmitted through Uzbek and Kazakh territories as gas owned by RUE). It is then transported to the Russia–Ukraine border where title passes once again. Since the delivery points in the chain of physical supplies of Turkmen gas to Ukraine are located on consecutive state borders, this gas chain (from Turkmenistan to Ukraine) contains a ‘transit’ segment between the Turkmen–Uzbek and Russia–Kazakh borders. Transport of this gas from the Russia–Kazakh to the Russia–Ukraine border is not a transit in legal terms. Similar considerations apply to supplies of the gas of other Central Asian states through Russian territory to Ukraine and/or other CIS states.

Option 2 – transit through pipe that is owned/leased by the shipper of gas

An example of such a scheme is gas originating in Russia and destined for France. Gas de France ships gas from the delivery point at Waidhaus through Germany to the French border through the pipeline partly owned by GdF. Similarly, ENI ships gas destined for Italy from the delivery point at Baumgarten through Austria through the TAG pipeline partly owned by ENI. Gazprom implemented the same approach throughout the 1990s in the former Soviet Union and Central Europe. Gazprom has tried to purchase stocks in pipeline companies in countries that historically have acted as transit states for Russian gas supplies to Europe. It failed in Ukraine where a special law prohibited privatisation of the state gas transport system³⁴ but succeeded in Poland, where the new pipeline is partly owned by Gazprom, and in Belarus where Gazprom bought a 50 per cent interest in the country's existing pipeline system.³⁵

Option 3 – transit through pipe not owned by the shipper of gas

This option is currently dominant within the European Union as a consequence of liberalisation, unbundling and MTPA. In some non-EU countries where there is no mandatory unbundling this option might apply where the transport system is state owned (as in Ukraine) or where the shipper is unable to obtain title to the transit pipe (as in Belarus prior to the end of 2006).

Option 2 is certainly more costly but considered by shippers to be safer (at least within as yet unbundled systems) than option 3 and international law may be used to minimise transit risks under the less secure (as compared to direct ownership of the pipe) option 3 in as yet unbundled systems. But international law might offer least-cost protection against transit risks within all types of transit system. Multilateral instruments dealing with transit include Article V of GATT/WTO 'Freedom of Transit', Article 7 'Transit' of the ECT and the draft Energy Charter Protocol on Transit.

34 After a long debate, the Verkhovnaya Rada (Parliament) of Ukraine (by 430 votes from the registered 439 deputies) passed (6 February 2007) a law that prohibited alienation of the property of national joint-stock company 'Naftogas of Ukraine' and of the gas transport system of Ukraine, including reorganisation, merger, acquisition, transformation of the state enterprises of gas-main pipeline transport and their privatisation. ('Бектор ТЭК', 6–13 February 2007).

35 In a package deal of 30 December 2006, when the portion of the Russian gas export price formula increase for the 2007–2011 period was partly paid by shares in Beltransgas (the Belarus state company – the owner of this state gas transport system).

GATT Article V 'Freedom of Transit'

The principle of freedom of transit aims to enable goods to cross transit countries (trade) without undue restrictions. The concept originated in the Barcelona Convention and Statute on Freedom of Transit of 1921 and is embodied in Article V of GATT (1947). It provides for transit via the most convenient routes without distinction on the basis of place of origin, departure, entry, exit or destination, or relating to the ownership of goods or means of transport. One of the most important elements of freedom of transit is the exemption from customs duties or other charges, except charges for transport or those charges commensurate with administrative expenses or with the cost of services rendered. Furthermore, all charges and regulations with respect to transit are required to be reasonable. Finally, transit cannot be subject to any unnecessary delays or restrictions.

Article V of GATT emphasises the characteristics of transit compared with other means of transporting goods to their final destinations rather than the regulation of transit per se within or through the transit state. These provisions were negotiated in the 1940s when most goods were transported by 'mobile' carriers such as vessels, trucks, trains, etc, rather than through fixed ('immobile') infrastructure such as pipelines and electricity grids. Most goods would trade in discrete packages or containers (eg, for oil: barrels, tanker lorries, tank wagons, oil tankers, etc) adequate for the selected carrier (eg, for oil tankers: Aframax, Panamax, Suezmax, VLCC, ULCC, etc). GATT Article V does not therefore address some of the issues associated with transit especially through fixed (immobile) infrastructure, ie through oil and gas pipelines and electricity grids.

ECT Article 7 'Transit' (transit through fixed infrastructure)

Transit through a fixed infrastructure (pipelines, electricity grids) has special characteristics which have to be addressed in addition to the generic rules of GATT Article V:

- (a) Energy infrastructure requires large upfront investments. The costs of energy infrastructure are dominated by the capital costs of the investment and its financing. Operational costs of throughput are minor. Thus, economic viability requires predictable long-term high-level utilisation of transit/transport capacity. Costs may be especially high where the goal is to link new oil and/or gas deposits in undeveloped areas with existing or new markets.
- (b) A fixed infrastructure requires corresponding rights of way. In theory, the alignment of rights of way can be negotiated with all land owners; in

practice, however, the power of ‘eminent domain’³⁶ is needed to avoid holdout problems.

- (c) Pipelines have clear capacity constraints. These constraints can only be overcome by further investment and construction, which may take several years, frequently ten or more years. Short-term solutions to congestion are therefore limited.
- (d) There is a range of possible physical and commercial interactions between the transit product and the country’s fixed infrastructure. One arrangement is a pool-like system (which can also serve as a marketplace, typically for electricity, but also for highly meshed gas systems); another arrangement is a dedicated linear system (typically for oil, but also most large gas export systems).³⁷ In pool-like systems, energy flows may change on short notice depending on optimisation of production and consumption decisions within the system (and usually the internal flows of the system). In these systems, production levels of individual domestic producers (and thus individual traded flows) are usually much less than (and non-comparable with) the combined consumption level of the whole system. Linear systems are typically used for the transfer of resources from a single (usually – rather big, external and sovereign) source to a specific market area over a long time and thus usually by the LTGEC. Optimisation of this system deals with externalities, including sovereignty issues. Individual energy flows in this system are usually relatively high and comparable with the combined consumption level of the whole system, and cannot be changed at short notice.

36 ‘Eminent domain’, also called ‘condemnation’, is the power possessed by the state to appropriate private property for ‘public use’ (may also be named ‘public interest’ or ‘public convenience and necessity’). In some jurisdictions, the state delegates its eminent domain power to certain public and/or private companies, typically utilities, so that they can bring eminent domain actions to run telephone, power, water or oil and gas lines. With respect to energy transport infrastructure, when the state (and/or regional processes) finds that a proposed project is in the public convenience and necessity or is needed to address transport bottlenecks of national (or sometimes cross-border) interest, the designated entity has the right to acquire the property for that project by eminent domain even if the owner does not wish to sell the property or where the landowner and the pipeline investor cannot agree on the compensation to be paid for the land.

37 See ‘Gas Transit Tariffs in Selected ECT Countries’, Energy Charter Secretariat, January 2006, Chapter 3.4.

The ECT 1994³⁸ incorporates GATT 1947 (and WTO 1985 by the Trade Amendment 1998³⁹) to EMP, which include by definition those EMP that are being traded/transported/transited only through fixed infrastructure, like electricity,⁴⁰ or through both mobile and fixed infrastructure, like oil (tankers/trains/trucks and/or pipelines), gas (LNG/compressed gas carriers and/or pipelines) or coal (trains/trucks/ships and/or coal slurry pipelines).

ECT Article 7 'Transit' explicitly addresses energy transit by fixed infrastructure. It requires parties to facilitate transit of EMP (eg, parties must place 'no obstacles in the way of new capacity being established, except as may be otherwise provided in applicable legislation'⁴¹) based on the duty not to discriminate. The article also deals with the definition of a transit area (both the territory of individual ECT member states and the Regional Economic Integration Organisations (REIOs)), securing established transit flows, the non-interruption of transit flows in case of disputes and a special dispute resolution mechanism (conciliatory procedure).

Strengthening ECT Article 7 through the draft Energy Charter Protocol on Transit

Most decisions on the transit of EMP that require access to fixed infrastructure are long term, since they are usually linked to LTGECs. Surplus capacity in fixed infrastructure is expensive and, therefore, usually only temporary. Surplus capacity may be allocated through non-discriminatory congestion management mechanisms. Congestion can in principle be overcome by investment in additional capacity, but this must take account of the time necessary for planning, authorisation and construction.

38 For more details on the ECT see, for instance, Centre for Petroleum & Mineral Law & Policy, University of Dundee, T Wälde (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), p 700; *Договор к Энергетической Хартии – путь к инвестициям и торговле для Востока и Запада (под ред Т Вальде – англ.изд. и А Конопляника – рус.изд.)*. М: Международные отношения, 2002, 632 стр; or a more condensed version: A Konoplyanik and T Wälde, 'Energy Charter Treaty and its Role in International Energy' (2006) 24 *JERL* 523–558.

39 Amendment to the Trade Related Provisions of the Energy Charter Treaty, April 1998.

40 Thus considering electricity to be a 'good' rather than a 'service'.

41 ECT, Art 7.4. This does not mean that any request to build a new transit capacity is to be implemented by the potential transit state. There are at least five levels of decision-taking where a potential transit state may provide reasoned objections and refrain from building new transit capacity (А Конопляник, 'Есть только один путь к ратификации ДЭХ. Чтобы договориться, надо понять возражения противной стороны', *Нефть и капитал*, 2001, No 3, с 8–10; А Конопляник, 'We must ratify Energy Charter Treaty – but not yet', *Oil & Capital. Russia & CIS Energy Magazine*, April 2001, pp 6–8).

Article 7 does not address these issues in detail and hence the ECT member states expanded on these matters in the Transit Protocol. The draft Protocol on Transit deals with the following major issues:

- the obligation to observe transit agreements;
- the prohibition of unauthorised taking of EMP in transit;
- the definition of available capacity in energy transport facilities used for transit;
- negotiated TPA to available capacity (MTPA is excluded except for the areas where it is legally required by domestic legislation⁴²);
- the duty to facilitate construction, expansion or operation of energy transport facilities used for transit;
- the requirement for transit tariffs to be non-discriminatory, objective, reasonable and transparent, not affected by market distortions, and cost based (including a reasonable rate of return);
- the requirement for technical and accounting standards to be harmonised by the use of internationally accepted standards;
- the requirement for energy metering and measuring to be strengthened at international borders;
- coordination in the event of accidental interruption, reduction or stoppage of transit;
- the requirement for international energy swap agreements to be protected;
- implementation and compliance; and
- dispute settlement.

Negotiations on the draft Energy Charter Protocol on Transit (TP) started in 2000 and have so far resulted in considerable progress. For example, the draft provides a definition of available capacity and establishes the principles of transit tariffication.⁴³ It is expected that successful finalisation of the TP and its implementation will diminish risks related to transit, improve the financing terms of projects with a transit component, increase the competitiveness of transit supplies and improve energy security within its trilateral integrity of security of supplies, demand and infrastructure.

42 The Energy Charter Treaty and related legally binding documents provide a minimum standard for application of their norms and provisions within the ECT member states, which means that each ECT contracting party has a right to implement more liberal rules, in its own domestic legislation but is not authorised to demand the same, more liberal rules from other ECT member states.

43 For a detailed description of the development of TP negotiations and consultations see the author's publications and presentations at www.konoplyanik.ru.

At the Energy Charter Conference in December 2002,⁴⁴ all 51 member states agreed on a text of the draft TP.⁴⁵ However, there remain three unresolved issues between the European Union and the Russian Federation. Two of these issues relate to transit per se and one is broader and is related to the idea of the European Union as an REIO. The points of substance are as follows:

- (1) The non-discriminatory use of available capacity and the rules to handle congestion and the relevance of the cost-based ideas of tariffs versus auctions.
- (2) Issues stemming from the longevity of transit decisions. Should the issue be dealt with through a right of first refusal (one solution broadly used outside the European Union) or through avoidance of contractual mismatch by requiring correlation in terms of timing/duration and volumes/throughput capacities between transit contracts providing access to transport capacities, and underlying supply contracts (usually LTGEC)?
- (3) The application of the draft TP inside the European Union. The issue here is whether the definition of 'transit' should apply *only* to a crossing of the entire EU territory as a single REIO (as proposed by the European Union in the draft TP (Article 20)), and thereby narrowing the definition of 'transit' in the ECT, or should 'transit' *also* include the crossing of each single EU member country *and* of the European Union as a whole (as REIO) as defined in the ECT. This issue stems, inter alia, from the fact that each EU Member State has signed/ratified the ECT in a dual capacity: as both individual ECT contracting party and as an EU Member State (as an REIO), which, in turn, is itself a separate contracting party of the ECT.

In addition to these three issues, the Russian Federation has raised concerns regarding the interpretation of some key transit-related provisions of the ECT:

- (1) the implementation of MTPA within the ECT area;
- (2) the correlation between tariffs for transit, export, import and domestic transport (ECT, Article 7.3);

44 The Energy Charter Conference is the supreme authority of the member states of the organisation comprising 51 states in Europe and Asia plus the European Union and EURATOM as two institutional parties to the Treaty (as the so-called Regional Economic Integration Organisations (REIOs)). Prior to 2005, the Conference held its meetings twice a year (usually in June and December); since 2005, they are held once a year, at its end.

45 The draft Energy Charter Protocol on Transit in its version as of December 2002 (at the end of the first multinational phase of negotiations) is available from the Energy Charter website (www.encharter.org/fileadmin/user_upload/document/CC251.pdf).

- (3) the conciliation procedure of transit-related dispute settlements (ECT, Article 7.7);
- (4) the role of long-term contracts, which are fundamental for long-term transit solutions.

These issues were not included by the Energy Charter Conference along with the three open issues between Russia and the European Union since they related to the ECT and not to the draft TP; however, it is anticipated that these issues will be discussed and resolved within the whole ECT multilateral community based on the principle that ‘nothing is agreed until everything is agreed’.⁴⁶

Regulating the transit of energy: GATT/WTO or ECT?

The energy transit-related group of issues have also been dealt with as part of the Russia–EU bilateral negotiations on Russia’s accession to the WTO as part of six items introduced by the European Union in the so-called ‘Lamy package’⁴⁷ (see Figure 4). At that time (2003), this package led to a very sharp public response from the then Russian President Putin during his meeting with the then German Chancellor Schröder in Yekaterinburg (a major Russian industrial city in the Urals area). These two negotiations (the TP and the Russia–EU negotiations on Russia’s WTO accession) overlapped both in timing and in substance.

In December 2002, the multilateral phase of the ECT TP negotiations was provisionally finalised by the ECT member states. Three unsettled issues were to be referred to bilateral consultations between Russia and the European Union. The two parties’ negotiators compromised on the text of the TP in June 2003,⁴⁸ immediately prior to the 12th regular meeting of the Energy Charter Conference. But before Moscow and Brussels could approve these achievements it appeared to the Russian team that the European Union was taking a different position on

46 А Конопляник, Договор к Энергетической Хартии: ‘Ратифицировать надо, но не сегодня ...’. *Промышленный мир*, 2001, No 2, с 44–48; А Konoplyanik, ‘We must ratify Energy Charter Treaty – but not yet’, *Oil & Capital. Russia & CIS Energy Magazine*, April 2001, pp 6–8. See also A Konoplyanik, ‘A Common Russia–EU Energy Space: the New EU–Russia Partnership Agreement, Acquis Communautaire and the Energy Charter’ (2009) 27 *JERL* 258–291.

47 Named by Pascal Lamy – then the Head of the Commission’s Directorate on Trade and a key EU negotiator within the Russia–EU bilaterals on Russia’s accession to the WTO; he is currently Director-General of the WTO.

48 For more details see, for instance, A Konoplyanik, ‘Russian Gas to EU Markets – 1: Thorny issues impede progress toward final Transit Protocol’, *Oil & Gas Journal*, 20 October 2003, vol 101, N 40, pp 60–64; ‘Russian Gas to EU Markets – 2: Compromise is best course for Russia, EU in Protocol negotiations’, *Oil & Gas Journal*, 27 October 2003, vol 101, N 41, pp 68–75.

Figure 4. 'Lamy Package' (October 2003 The EU Commission's six energy agenda demands of Russia in the EU-Russia WTO accession negotiations)

- Raise internal prices for natural gas
- End Gazprom's monopoly on gas exports
- Lift restrictions on gas transit ('free transit')
- Allow foreign investors to build pipelines in Russia
- Introduce equal prices for transit of gas for domestic users and for exports
- Cancel gas export tariffs

Source: www.russiajournal.com, 02.03.04

the meaning and particularities of transit within the WTO debate, by presenting the Lamy principles (see Figure 4), than it had within the Energy Charter process.

In particular, it appeared that in some cases, EU demands within the 'Lamy package' were based not only on the European Union's interpretation of WTO rules, but also on the EU *acquis communautaire* and EU practice. This reflected the general EU policy of attempting to export the *acquis* through the international treaties to which the European Union is a party.⁴⁹ This was the case, for example, with item 5 of the 'Lamy package', which requested Russia to introduce transit tariffs for gas, equal to transport tariffs for domestic users and to export tariffs. Further work by the Energy Charter Secretariat on transit tariffs has proved that (both within and outside the European Union) they typically exceeded domestic tariffs⁵⁰ despite the obligation within the European Union's *acquis* that these tariffs need to be equal within the European Union. This suggested that there was no basis on which to argue that WTO rules, EU *acquis* and EU practice all required equal tariffs. Thus it seems possible that the demand for equal transport tariffs owes more to the notion of 'free movement of goods' (though not yet fully implemented within the European Union) as required by the original Treaty of Rome (1958) than it does to the WTO rules.

In response, the Russian Government stated that it would not complete the bilateral Russia-EU consultations on the Energy Charter Protocol on Transit as long as the European Union continued to take contradictory positions in

49 For more details see, for instance, A Konoplyanik, 'A Common Russia-EU Energy Space: the New EU-Russia Partnership Agreement, Acquis Communautaire and the Energy Charter' (2009) 27 *JERL* 258-291.

50 'Gas Transit Tariffs in Selected ECT Countries', Energy Charter Secretariat, January 2006, table 6.2 (p 67).

the two fora.⁵¹ A key issue in the Russia–EU debate relates to the role of GATT Article V on freedom of transit. Does the article apply to network infrastructure facilities (pipelines, electricity grids, etc) and, if so, is GATT Article V the dominant rule for ‘freedom of transit’ or is it ECT Article 7⁵²? Furthermore, there is considerable uncertainty about the meaning of ‘freedom of transit’. There cannot be unlimited ‘freedom of transit’⁵³ and thus the term requires legal definition and in a manner that takes account of the realities of energy transport infrastructure (grids) and the interests of shippers, owners of the transport facilities, investors, and the producer-, consumer- and transit-states. The ECT rules do a better job of this than GATT Article V, and, furthermore, ECT rules should prevail since they are recognised by members and non-members of the WTO. In the case of Russia, the ECT takes account of the reality that Gazprom is both a gas producer and a gas transport capacity owner (which is also the case for some other states within the ECT area) and that it is up to the ECT member state to define the organisational structure of its energy sector: whether to unbundle vertically integrated companies (as in the European Union) or not (as in the Russian gas sector). While the ECT and its draft TP do not provide for MTPA, they do introduce a definition of ‘available capacities for transit’, define access to available capacities and deal with the formation of transit tariffs. Without this sort of legal clarification the term ‘freedom of transit’ will be hollow and will create transit-related risks and not manage them. This lack of clarity with respect to the freedom of transit rules between Russia and the European Union serves neither; preference should be accorded to the ECT-based rules in this sector.

Key debated transit issues and draft solutions within the Energy Charter framework

The quest for balanced solutions to satisfy both competition and investment considerations continues. After the multilateral phase of negotiations was temporarily suspended, bilateral negotiations between Russia and the European Union achieved progress on many points.

51 This concern reflected the comparative importance of the two processes and the two international organisations (WTO and Energy Charter) for the Russian leadership: from that perspective the WTO was clearly more important than the Energy Charter.

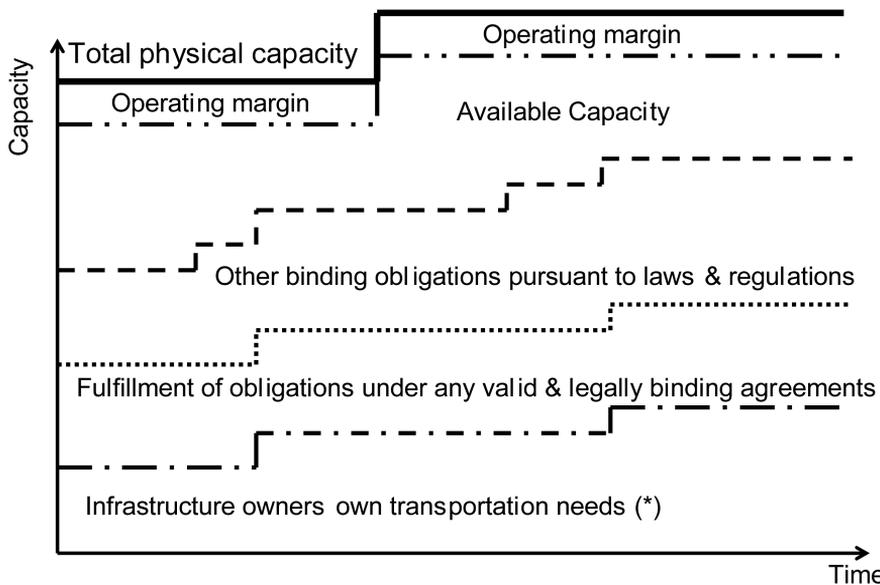
52 For more on this debate see A Konoplyanik, ‘Russia-EU Summit: WTO, the Energy Charter Treaty and the Issue of Energy Transit’ [2005] 2 *International Energy Law and Taxation Review* 30–35.

53 This was also a concern for the Russian President which he expressed in Yekaterinburg in late 2003 in regard to the Russia–EU WTO debate and which has been repeated since then by a number of high-ranking Russian officials with respect to the debate on ECT ratification by Russia; the ECT does not authorise ‘unlimited free transit’.

Definition of available capacity (draft TP, Article 1.2)

The Energy Charter documents do not deal with ‘free access to the transport infrastructure’. The draft provision on the definition of ‘available capacity’ (Article 1.2 of the draft TP – CC251)⁵⁴ excludes, inter alia, capacity reserved for the implementation of existing long-term contracts (including LTGECs) and for future supplies of hydrocarbons from fields where the licensee is the owner of the transport system (see Figure 5). This latter exception was vigorously debated. The clause is designed to accommodate the situation in gas-producing ECT states where the gas-producing company also owns the gas transport system (eg Gazprom in Russia, Naftogas in Ukraine and Kazmunaigas in Kazakhstan) where the unbundling of vertically integrated gas companies is not required by domestic law. Thus, if there is no free capacity (‘available capacity’) on these pipelines because they are booked (reserved) forward by the existing supply contracts (LTGECs) and/or for future production, they cannot be forced to provide access.

Figure 5. Definition of Available Capacity
(draft Transit Protocol Art. 1.2 – CC251)



(*) “Subject to requirements for access to energy transportation facilities applicable within a Contracting Party” (EU’s additional proposal to draft TP Art. 1.2)

54 See www.encharter.org/fileadmin/user_upload/document/CC251.pdf.

Domestic, import/export and transit tariffs (ECT, Article 7.3)

The Russian Federation has also concluded that ECT, Article 7.3 on transit tariffs and ECT, Article 7.7 on the conciliatory procedure are seriously problematic. Russia is concerned that ECT, Article 7.3 may be interpreted so as to require that transit tariffs have to be the same as to export, import and domestic tariffs,⁵⁵ and that ECT, Article 7.7 may be interpreted so that provisional transit tariffs established by the conciliator would not be recalculated to the final agreed tariffs.⁵⁶ These matters need to be clarified or resolved taking into consideration Russian concerns before the TP can be concluded and the treaty ratified.⁵⁷

In Autumn 2006, the then Russian presidential aide responsible for Russia–EU bilateral relations Mr S Yastrzhembsky stated: ‘We cannot bear with the fact, that tariffs for transit of energy resources for external and internal consumers need to be equal.’⁵⁸ It is important to examine why this is so contentious. Why is this clause so sensitive for Russia?

Article 21 (3) of the Russian Law ‘On gas supply in the Russian Federation’⁵⁹ provides: ‘With a view to implement accounts between organisations being part of the gas supply system, the organisation-owner of this system [ie Gazprom] determines internal expected prices for gas and internal expected tariffs for services on gas transportation.’ This allows Gazprom to consolidate the net profits of its affiliates by establishing subsidised tariffs for domestic transport of its affiliates. Article 21 does not apply to shippers that are not subsidiaries of Gazprom, but Gazprom is concerned that EU interpretation of ECT, Article 7.3 might oblige Gazprom to provide access to its transport system⁶⁰ for competing cheaper (to produce) gas from Central Asia at the same subsidised transit tariffs that Gazprom established for its

55 The European Union has been requesting this of Russia despite the fact that some EU Member States do not provide for equal tariffs – see ‘Gas Transit Tariffs in Selected ECT Countries’, Energy Charter Secretariat, January 2006.

56 For more details see, in particular, А Конопляник, Договор к Энергетической Хартии: ‘Ратифицировать надо, но не сегодня ...’. *Промышленный мир*, 2001, No 2, с 44–48; А Конопляник, ‘We must ratify Energy Charter Treaty – but not yet’, *Oil & Capital. Russia & CIS Energy Magazine*, April 2001, pp 6–8.

57 For further explanation as to why Russia should only ratify the ECT simultaneously with ratification of the TP see А Конопляник, ‘A Common Russia–EU Energy Space: the New EU–Russia Partnership Agreement, Acquis Communautaire and the Energy Charter’ (2009) 27 *JERL* 258–291.

58 А Мернье and А Конопляник, ‘Энергетическая Хартия: проигравших не будет’. *Нефтегазовая Вертикаль*, 2007, No 3, с 26–29.

59 Law N 69-FZ of 31 March 1999.

60 This is also not required by the ECT, as was explained above in relation to the definition of ‘available capacity’ and also to the implementation of МТРА.

subsidiaries.⁶¹ In any event, and following the Energy Charter Secretariat's study of transit tariffs in ECT member states,⁶² the draft Understanding to the Transit Protocol (similar to the Understanding to the ECT with regard to implementation of МТРА) was in principle accepted at the informal expert level by both the EU and Russian delegations, pending agreement on all other open issues. The substance of this draft Understanding is that transit tariffs need not necessarily equal the tariffs for domestic transport.

Conciliatory procedure (ECT, Article 7.7)

ECT, Article 7.7 describes a conciliatory settlement mechanism available to ECT member states and/or their companies involved in transit disputes.⁶³ If conciliation does not lead to agreement, the conciliator (appointed by Energy Charter Secretariat General Secretary) may make an interim decision which will bind the parties for 12 months if the dispute is not settled earlier. Russia has proposed a clarification to these procedures to provide that where the conciliator fixes interim transit tariffs, and where there is a subsequent agreement on tariffs, those agreed tariffs will also be taken to apply in the interim period and recalculated accordingly, with interest.

The conciliation procedure has yet to be used by ECT member states. It was first proposed to the disputed parties during the Russia–Ukraine (winter 2005/06) and the Russia–Belarus (winter 2006/07) gas disputes in case they were not able to reach bilateral agreements but the relevant provisions were never triggered since the parties reached such agreements.⁶⁴ These disputes

61 For more detailed analysis related to the debate on the issue of correlation between transit and domestic tariffs and other concerns of Russia regarding ECT ratification, see А Конопляник, 'Ратификация ДЭХ Россией: прежде всего необходимо развезть добросовестные заблуждения оппонентов'. гл 22 (с 545–614) в кн 'Договор к Энергетической Хартии – путь к инвестициям и торговле для Востока и Запада' (под ред Т.Вальде – англ.изд. и А.Конопляника – рус.изд). М: Международные отношения, 2002, 632 стр.

62 'Gas Transit Tariffs in Selected ECT Countries', Energy Charter Secretariat, January 2006.

63 For more detail see В Сорокин, Энергетическая Хартия: развитие многостороннего режима транзита энергоносителей. гл 21 (с 526–544) в кн, *Договор к Энергетической Хартии – путь к инвестициям и торговле для Востока и Запада* (под ред Т.Вальде – англ.изд. и А.Конопляника – рус.изд). М: Международные отношения, 2002, 632 стр.

64 On the prospective use of a conciliatory procedure in the Russia–Ukraine and Russia–Belarus gas disputes see Андрей Конопляник, 'Единственным вариантом обеспечения предсказуемости и прозрачности ценообразования между "Газпромом" и "Нефтегазом" может быть только формульный подход'. *Экономические Известия*, 24 ноября 2008 г, No 212 (975), с 1, 3, (Украина); Андрей Конопляник, 'Газотранспортная система Украины и России всегда была единой'. *Экономические Известия*, 24 декабря 2008 г, No 234 (997), с 1, 3 (Украина); Andrey Konoplyanik, 'A formula approach may be the only option for guaranteeing pricing predictability and transparency between Gazprom and Naftogaz of Ukraine', *Oil, Gas and Energy Law (OGEL), Special Issue on EU–Russia relations*, vol 7, issue 2, May 2009; Andrey Konoplyanik, 'The gas transportation system of Ukraine and Russia has always been unified', *Oil, Gas and Energy Law (OGEL), Special Issue on EU–Russia relations*, vol 7, issue 2, May 2009.

have been examined in detail elsewhere as has the more recent dispute between Russia and Ukraine of January 2009⁶⁵ and it is not proposed to go over that ground again here.

Congestion management (draft TP, Articles 10 and 10bis)

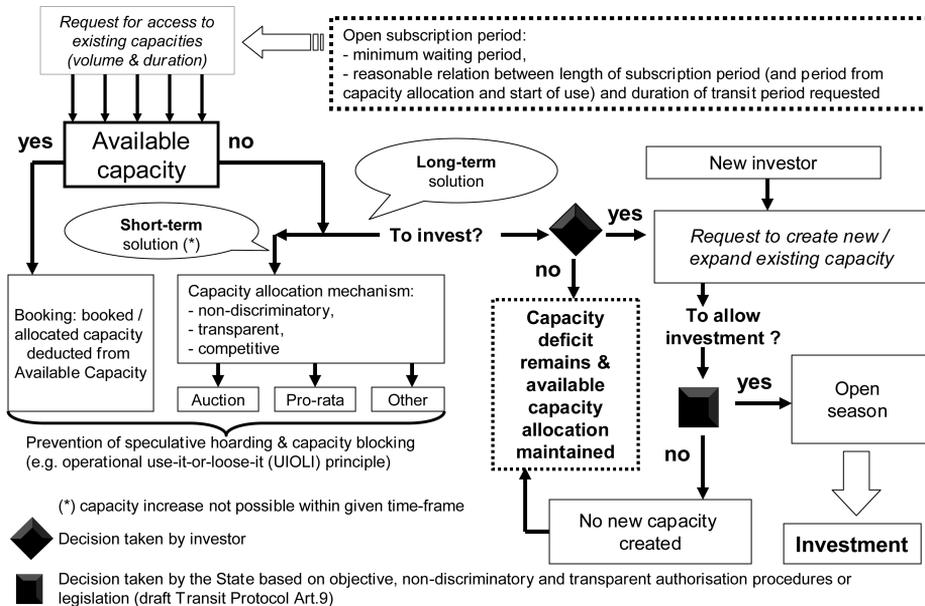
One of the three outstanding issues that remain in the draft TP (Document CC 251)⁶⁶ concerns auction-based access to transport capacity for transit (Article 10). Article 10.3 of the draft TP incorporates the principle of cost-reflectiveness and suggests that ‘transit tariffs shall be based on operational and investment costs, including a reasonable rate of return’. However, Understanding 11 of CC 251 declares that congestion management mechanisms may include auctions which means that transit tariffs determined by auctions should be cost-reflective. There is an inconsistency here since auctions may not result in cost-reflective rates and may generate revenues that exceed costs. Russian and EU experts proposed a solution both to this peripheral issue but also to a more general problem. The experts proposed a non-discriminatory competitive procedure to allocate available capacity on energy transporting infrastructures (see Figure 6).

In a world of increasing energy demand it is important to allow for the expansion of existing infrastructure including for the purposes of transit. Depending on duration, congestion issues can be overcome by investment or other measures if shippers are willing to cover the extra costs incurred. The period within which auctions may be used to manage congestion and access to the network should be restricted to the period necessary to implement measures to relieve this congestion. To avoid an incentive to perpetuate congestion, revenues collected beyond cost recovery should be used to relieve congestion or to reduce tariffs.

65 See, for instance, J Stern, *The Russian-Ukrainian gas crisis of January 2006*, Oxford Institute for Energy Studies 16 January 2006; A Konoplyanik, ‘Russian – Ukrainian Gas Dispute: Prices, Pricing and ECT’, *Russian/CIS Energy & Mining Law Journal*, 2006, N1 (Volume IV), pp 15–19; A Конопляник, *Российско-украинский газовый спор: размышления по итогам Соглашения от 4 января 2006 г (в свете формирования цен и тарифов, экономической теории и ДЭХ)*. *Нефть, газ и право*, 2006, No 3, с 43–49; No 4, с 37–47; K Yafimava and J Stern, *The 2007 Russia-Belarus Gas Agreement*. Oxford Energy Comment, January 2007; S Pirani, J Stern and K Yafimava, *The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment*. Oxford Institute for Energy Studies, February 2009, NG 27; Andrey Konoplyanik, ‘Modernization and expansion of the gas transportation system will create positive macroeconomic effects for Ukraine’, *Oil, Gas and Energy Law (OGEL), Special Issue on EU–Russia relations*, vol 7, issue 2, May 2009.

66 See www.encharter.org/fileadmin/user_upload/document/CC251.pdf.

Figure 6. Available Capacity Allocation & Creation
(non-discriminatory competitive procedure – a joint proposal of Russian & EU experts informally agreed at multilateral level of Energy Charter community)



Detailed principles agreed between the EU and Russian experts to provide for transparent and non-discriminatory congestion management were confirmed by the ECT community in 2007, subject to an overall agreement. The text addresses the time span within which congestion mechanisms should apply before capacity increases can be implemented and principles of non-discriminatory capacity allocation in case of congestion, based on the idea of open seasons. In the event that capacity requests exceed the available capacity in terms of volume and/or duration (capacity congestion), there are two options:

- (1) continue allocating the existing capacity in a non-discriminatory and transparent manner by one or more capacity allocation mechanisms (pro-rata, auction, other) – a short-term solution;
- (2) decide to invest in new capacity – a long-term solution (Figure 6).

Article 9 of the draft TP addresses the creation of new capacity. The question of who is entitled or obliged to invest in developing transit infrastructure depends on the regulatory model chosen by the respective country (regulated access with transit system operators (TSOs) vs negotiated access). In the case of a single system operator and regulated access, an obligation to create

transit capacity by the TSOs is necessary to avoid obstacles to transit. This should not be an undue burden given cost-reflective tariffs.

In the case of negotiated access (when everybody, including those seeking transit, is allowed to invest in new transport), the necessary rights of way have to be secured by the company investing in new transport. Without the right of eminent domain, transit projects will be difficult to realise when the transit route crosses many private pieces of land. The draft TP addresses various problems associated with the creation of new transport capacity through expansion of existing lines or construction of new lines:

- a new Article 10bis requires a party to take all reasonable measures to mitigate congestion (see Figure 6);
- Article 9 stipulates objective, transparent and non-discriminatory (as to origin, destination and ownership of energy) authorisation procedures and legislation on the creation of new capacity in energy transport facilities (ETFs), and also requires that authorisation procedures and legislation do not discriminate between ETFs used for transit and those used for internal transport.

Prior to any decision to allocate existing capacity or new investment for additional capacity, an ‘open season/open subscription’ process may be initiated. This will help determine market demand with respect to additional capacity. Under the draft TP such procedures must be based on objective, transparent and non-discriminatory principles.

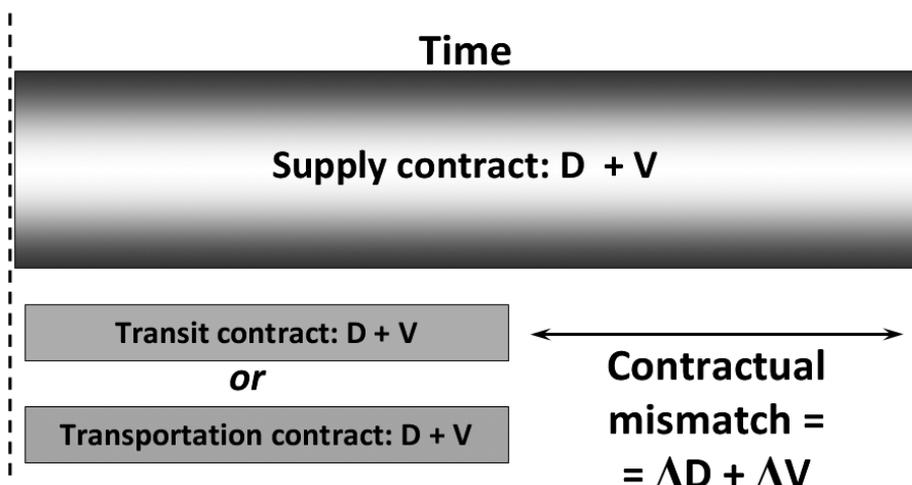
Finally, and as noted above, EU and Russian experts have agreed that surplus revenues from auctioning available capacity should be used to debottleneck available capacity or reduce ‘excessive’ tariffs paid by shippers through auction-based access arrangement.

Contractual mismatch problem (draft TP, Article 8)

The contractual mismatch problem has been described above. The key object is to guarantee the producer’s/supplier’s access to relevant transport capacity for the entire term of the existing LTGEC and all the contracted volumes thereunder (see Figure 7).

It should be recalled that the typical size of most long-distance gas and oil export projects to justify a new pipeline is in the order of at least ten billion cubic metres per year for gas and ten million tonnes per year for oil and that the project duration is usually not less than ten years, with 20–25 years being most common. Banks will require proof of sufficient reserves, market outlet and corresponding transport arrangements linking production and

Figure 7. The Contractual Mismatch Problem



Mismatch: between duration/ volumes (D/V) of long term supply (delivery) contract and transit/transportation contract integral to fulfillment of the delivery contract => risk of non-renewal of transit / transportation contract => risk for supply contract.

Core issue: guarantee of access to / creation of adequate transportation capacity for the duration of long term contracts.

market, to finance such projects. Competition for transit is predominantly competition between such large projects.

Unless it is possible to base long-term export decisions on highly liquid markets (as for oil in general and for gas in North America and, to some extent, the United Kingdom), the export decision will be based on long-term (gas) contracts.⁶⁷ In any case, a long-term commitment to export resources through fixed infrastructure to a specific market needs secure access to that infrastructure for the duration of the delivery commitment.

There is a contractual mismatch problem within the CIS countries (mostly between Russia and Ukraine, and Belarus) since transit arrangements with CIS transit states (to implement Russian LTGEC supply contracts with EU buyers) were usually signed on an annual basis. In CIS countries and other non-EU states the problem of contractual mismatch has been resolved

⁶⁷ See 'Putting a Price on Energy: International Pricing Mechanisms for Oil and Gas', Energy Charter Secretariat, 2007, chapter 4.1.

through a ‘right of first refusal’ (RFR).⁶⁸

Article 8.4 of the draft TP (as in CC 251) adopted the RFR approach thereby allowing any long-term firm transport customer to continue to receive that firm service by agreeing to pay up to the maximum rate and matching the length of contract term offered by another customer who wants and values the service. Thus, if a competing bidder offers to pay the maximum transport rate for a term of 20 years, the existing customer cannot retain capacity by agreeing to pay the maximum rate for a shorter term but does have the right to match those terms and take the contract. However, in considering the applicability of RFR it is important to bear in mind the structural differences between the US and European gas markets and transport infrastructures. Most European oil and gas transits (except those within a common market) take place through pipeline systems driven by specific upstream projects from a single supplier and are usually constructed and owned by this supplier/project company. Therefore, there is often only one contractual arrangement, which allows the use of the entire/most transit capacity by one supplier/project company. In the United States, however, there are typically multi-transport agreements within one pipe and many different suppliers and shippers.

The European Union takes the view that RFR arrangements confer preferential access rights on incumbents and discriminate against new prospective shippers who must resort to a more capital-intensive solution such as the construction of a new transit infrastructure. This makes new entrants uncompetitive in the end-use market and perpetuates existing monopolies and/or high market concentration in the industry.

The expert discussion between the European Union and Russia suggested that draft Article 8.4 was designed to *avoid* the mismatch and that the RFR was *only one* of the possible instruments to address the problem. Another possibility is a call for an open season to give everybody interested a time-limited opportunity to join on a non-discriminatory basis. And in principle, there should be no restriction as to the duration of a bona fide request for capacity booking backed by a credible long-term payment commitment.⁶⁹

There were concerns that some countries may wish to limit the duration of transit arrangements to less than the duration needed for the

68 A right of first refusal (RFR) gives the holder of the right an option to take the terms offered by a third party before the owner enters into a transaction with that third party. RFR is a common concept in the United States where it was introduced by FERC Order 636 in 1992.

69 See at: http://ec.europa.eu/energy/gas/legislation/doc/interpretative_note/sec_2007_822_en.pdf.

corresponding long-term export contracts. Reasons for such restrictions could be of a technical nature (which could be overcome) but also a wish to give a free option to newcomers. Inside the European Union, there is a desire to foster competition by limiting the duration of EU internal transport contracts, but these are of a different nature than transit-linked import contracts.

The burden of contractual mismatch falls on the seller/supplier since the supplier is responsible for making transport arrangements up to the delivery points. However, it is the owner (operator) of transit capacity who has the best information about existing contracts/agreements and future demands for transit capacity. This should allow the owner (operator) to identify in advance potential shortages of available transit capacities. In such a case, EU experts stated that the necessary development of capacity should be put in place so as to ensure that 'contractual mismatch' problems do not arise within the EU area.

Other non-EU ECT member states may elect the RFR model and provide the incumbent the first right to accept the new transit conditions after the existing transit contracts ends with the clarification that the RFR can only be exercised within the duration of a valid LTGEC.

TP implementation inside the European Union ('REIO clause' – draft TP, Article 20)

EU Member States have signed the ECT in two capacities: as individual EU Member States and as the European Union as a whole (as an REIO). Thus, the ECT has 51 member states but 53 contracting parties.⁷⁰ This creates a potential issue as to the definition of the 'area' – in the current case, the 'area of transit'. Does this refer to the area of the individual EU Member States or to the European Union as a whole? Article 7 of the ECT clearly defines transit through both the EU as REIO and single EU Member States as transit, but Article 20 of the draft TP is more restrictive than the ECT and treats only the European Union as a single area as the area of transit. This would reduce the application of the draft TP within the EU area to a few insignificant cases (eg gas transit to Switzerland or Russian supplies inshore to Kaliningrad Oblast or onshore supplies to Turkey).

When examining this issue, it is important to distinguish between electricity and hydrocarbons. The electricity transmission system is a pool-

70 The second REIO is Euratom.

type system (see discussion above) consistent with the physics of electricity. Net imports of electricity into the European Union are minor (two per cent during the last 20 years) and electricity transit is not traced for single Member States inside the European Union because of the pool system. By contrast, the gas system is not a pool system; imports are large (now close to 50 per cent and projected to rise to more than 70 per cent by 2030); a major part of imported gas is delivered at borders inside the European Union (Baumgarten, Waidhaus, Frankfurt/Oder) and transit through single EU Member States can be and is (for taxation purposes) registered separately from national transport or imports or exports of gas. Thus, while it would be difficult to have a separate transit regime for electricity, these difficulties do not apply to oil and gas.

In response to the EU's concern that long-term supply contracts and related long-term transport contracts within the EU gas market represent an obstacle to competition within the European Union, Russian experts suggested that it would be possible to implement the TP up to the delivery points of the LTGEC, ie from the outer EU border until the first point at which title to the gas changes. However, EU experts did not support this idea. The experts also discussed the idea of using the draft TP as a benchmark but there was no consensus on this approach either. Now, when all other open issues in regard to transit provisions of the Treaty and draft TP are resolved at the multilateral expert level (pending overall political agreement), it seems that it might be possible to withdraw the European Union proposed Article 20 of draft TP and bring the TP to finalisation and provisional application with immediate effect (ratification by member states will take more time). This needs to be linked with Russia's obligation simultaneously to ratify the ECT and TP (within the commonly defined time frame) since under this option all of Russia's valid concerns in regard to the ECT are solved as prescribed by the Russian State Duma in 2001.

Transit emergencies and new Russian initiative

On 21 April 2009, a document entitled 'Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles)' was posted on the Kremlin's official website.⁷¹ This document stemmed from Russia's dissatisfaction with the role of the Energy Charter during and prior to the

71 'Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles)' (www.kremlin.ru/text/docs/2009/04/215305.shtml).

January 2009 Russia–Ukraine gas crisis.⁷² The document has three segments:⁷³

- (1) Main Principles of the New Legal Framework for Global Energy Cooperation: these principles could be considered as a road map to adapt the multifaceted Energy Charter process to the new challenges and risks facing international energy markets;
- (2) Annex 1: Elements of the Transit Agreement; and
- (3) Annex 2: List of Energy Materials and Products.

A presidential aide, Arkady Dvorkovitch (who probably oversaw the document's preparation), suggested that it could replace the ECT.⁷⁴ But it would be more practical to work on improving the multifaceted Energy Charter process and its instruments. It is true that the ECT lacks effective mechanisms to prevent crises and to resolve conflicts quickly – as reflected by the inaction of the political leadership of the Energy Charter Secretariat (ECS) prior to and during January's Russia–Ukraine gas crisis and the unwillingness of the parties involved to approach the ECS to initiate a conciliatory procedure for transit dispute settlement. Modernising these areas of the Energy Charter process by adding new legally binding instruments to the existing treaty and other documents – such as, for example, a protocol on preventing emergencies in gas transit – would be preferable to attempting to define a completely new international agreement to replace the ECT.

It should be noted that Gazprom's experts prepared the draft agreement on the prevention of transit crises explicitly as a document to supplement the ECT and the draft TP, and not to replace them. There is only one innovative element in this text, but it is an important one – a system of international commissions authorised to resolve emergencies connected with transit, if the threat thereof arises.

72 For the author's views on the history of this document and the arguments in favour and against its further development via different avenues, see А Конопляник, 'Энергетическая хартия и российская инициатива. Что делать с правовой базой международного сотрудничества'. *Время новостей*, 28 апреля 2009 г; А Конопляник, '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 relations*, vol 7, issue 2, May 2009; *ibid.* 'A common Russia–EU energy space (The new EU–Russia Partnership Agreement, *acquis communautaire*, the Energy Charter and the new Russian initiative)', *Oil, Gas and Energy Law (OGEL), Special Issue on EU–Russia relations*, vol 7, issue 2, May 2009; *ibid.* 'Russia: don't oppose the Energy Charter, help to adapt it. Russia should improve the Energy Charter process, not abandon it, says Andrey A Konoplyanik', *Petroleum Economist*, July 2009, pp 2–3.

73 For more details, see publications under previous footnote.

74 Presidential Aide Arkady Dvorkovich's Responses to Questions from Reporters (www.kremlin.ru/eg/text/docs/2009/04/215762.shtml).

Conclusions

Transit is a multilateral challenge that requires multilateral solutions. Current energy transit issues are most important in gas, where transit occurs principally through a fixed infrastructure and via an increasing number of sovereign jurisdictions. Energy transit faces an increasingly cross-border character and the best solutions lie in international law. Transit has become an important problem for Eurasia, especially the continental part, and the importance of transit has increased with more cross-border trade in gas and the dissolution of the COMECON and the USSR. Transit is especially important for Russia–EU relations, since both are increasingly and mutually dependent on Russian gas supplies to Europe.

Transit issues are addressed in such multilateral law instruments as WTO rules and the ECT. But the WTO, while it covers a broader community of member states, is not an energy-specific organisation and does not deal with transit through fixed infrastructure. It is the ECT and its related documents, such as the draft TP, that most effectively addresses energy-specific transit issues. Multilateral consultations on the draft TP show that the parties have reached technical consensus (on a multilateral technical level) on all valid open issues except one (the implementation of the TP within an REIO) – which is an internal EU issue. Further to recent Russian proposals on international cooperation in the energy sector, it should be possible for the Energy Charter community to proceed with the following actions aimed at obtaining a new instrument of international law further to develop commonly accepted transit rules:

- Russia presents to the Energy Charter community its ‘Main Principles of the New Legal Framework for Global Energy Cooperation’ as a road map for adaptation and actualisation of the multifaceted Energy Charter process to new challenges and risks to the international energy markets;
- Russia presents to the Energy Charter community its draft agreement on emergencies in transit as a new draft Energy Charter Protocol;
- the European Union withdraws its proposal for TP, Article 20, which should allow the parties to finalise the TP;
- the TP and the new Protocol on Emergencies in Transit are finalised (it is hoped, at the December 2009 Energy Charter Conference) and provide for immediate provisional application;
- Russia simultaneously undertakes (for instance, as part of a Conference decision) to begin the ECT ratification procedure as soon as provisional application of both Protocols commences;
- the Conference decides that ECT member states are bound by provisional

application of both Protocols until Russia ratifies the ECT but only for a mutually agreed period to allow for Russian ratification (a 'sun-set clause'); failing which the provisional application of both Protocols should be automatically withdrawn;

- Russia is to present to State Duma simultaneously for ratification both the ECT and two Protocols (on transit and on emergencies in transit).

It is hoped that this will lead to ratification of the ECT by Russia with all its valid transit-related concerns having been addressed and to the finalisation and enforcement of the TP and newly proposed Energy Charter Protocol on Emergencies in Transit. This will further improve stability and reliability of transit flows in Eurasia on the basis of international law and its energy-specific ECT and related instruments.