

SOME LEGAL ASPECTS OF ENERGY SECURITY IN THE RELATIONS BETWEEN EU AND RUSSIA

Ovidiu-Horia Maican*

Abstract. *The need for a sustainable, secure and competitive energy supply has long been recognized within the Community, and has been addressed on numerous occasions, notably in the Green Papers elaborated by the Commission in 2000 and 2006. Recent supply crises and rapidly escalating fuel prices have focused the minds of leaders across the European Union, as well as those of businesses and individual energy consumers. Energy policy transcends a range of different policy areas, including competition, transport, environment and energy itself. Decisions relating to energy policy in Europe are primarily within the remit of individual Member State governments, with the European Commission's powers limited to two specific areas (creation of the European single market and matters relating to nuclear safety and security under the EURATOM Treaty). The extent of the transfer of powers towards Europe is clearly a critical decision point and in practice a sensitive balance is likely to be required between those matters for which the Commission should have responsibility and those where Member State governments retain sole authority. European officials are putting into evidence their belief that Europe's energy predicament is acute and mention energy security as a priority issue for the Common Foreign and Security Policy. Policy commitments say that energy strategy must move beyond the internal sphere and become systematically a part of EU external relations. The Commission's 2006 Energy Green Paper promised "a better integration of energy objectives into broader relations with third countries".*

Keywords: *energy, energy security, gas, Russia, solidarity, Energy Charter, competition*

JEL classification: *K1, K19*

I. Introduction

There are two basic terms in English having the same meaning: "energy security" and "security of energy supply".

The first one is widely used by many organizations and government advisors, and the second is accepted by the EU and is included in the text of Lisbon Treaty, many already having implemented the

legal and political documents of the Union.

In accordance with the Green Paper 2000, "the European Union's long-term strategy for energy supply security must be geared to ensuring, for the well-being of its citizens and the proper functioning of the economy, the uninterrupted physical availability of energy products on the market, at a price

* **Ovidiu-Horia Maican** is an Assistant Professor, Ph. D, Law Department, Bucharest Academy of Economic Studies. His research interests include community law, constitutional law, international relations, international law and geopolitics. E-mail: ovidiuszm@yahoo.com

which is affordable for all consumers (private and industrial), while respecting environmental concerns and looking towards sustainable development..." The security of energy supply in the European understanding has two essential components – technical and commercial. The technical component consists of the physical accessibility to the resources and non-interruption of energy flows. The commercial component presupposes the affordability of the energy prices. After the entry into force of the Amsterdam Treaty in 1997 the security of energy supply policy was built into the concept of sustainable development.

The expression "*energy security*" also makes part of the EU vocabulary, being narrowed, mostly as the technical security of the energy installations and infrastructure.

The Russian definition of energy security is found in the Energy Strategy of Russian Federation adopted by the Government Decision in 2003. It is defined as the "state of protection of the country, its citizens, society, state, economy from the treats to the secure fuel and energy supply". There is also another definition contained in the document: "the full and secure provision of energy resources to the population and the economy on affordable prices that at the same time stimulate energy saving, the minimization of risks and the elimination of threats to the energy supplies of the country". In the Strategy there are mentioned the basic elements of energy security in Russia:

- The ability of the energy sector to meet internal and external demand with affordable energy resources of the necessary quality;

- The ability of consumers to use the energy resources efficiently, preventing

unnecessary expenditure by society on energy supply creating a deficit in the energy balance;

- The stability of the energy sector in the face of internal and external economic, technical and natural threats and its ability to minimize the damage caused by different destabilizing factors.

The comparison of the ways the security of supplies is defined both in Russia and in the EU and of the elements accepted by political and legal doctrines on both sides leads to the essential conclusion – the general understanding of the security of energy supplies is largely the same for Russia and for the EU. The main difference is that the Russian Federation is the energy exporter and the EU is the energy importer.

II. Situation in the European Union

The political documents of the EU contain numerous measures aimed at securing stable and affordable energy supplies to the Union. The most significant are:

- measures and agreements aimed at creation of the single European energy space;

- interaction and cooperation with the largest consumer states, inter alia within the framework of the development policy;

- improvement of the access of the European companies to global energy resources;

- improvement of the investment conditions in the international projects;

- use of the financial instruments to increase the security of supplies;

- elaboration and promotion of an energy efficiency agreement.

In our days, the legal basis for cooperation in the energy sector

comprises the following international instruments: Agreement on Partnership and Cooperation (PCA), Energy Charter Treaty (ECT) and political agreements within the framework of EU-Russia Energy Dialogue. Each of the mentioned documents has its own strong and weak points.

The *Partnership and Cooperation Agreement* (PCA) with Russia was the first one entered into by the European Community, followed by other PCAs with the former Soviet Republics. The objectives of this Agreement and of the Partnership established thereby are to provide an overall framework for political dialogue between the parties, for the gradual integration of Russia and wider Europe and create the necessary conditions for the future establishment of a free trade area between the European Community and Russia.

The trade regime provided for by the PCA is based on GATT provisions. The Parties to the PCA grant to one another most favoured-nation treatment. The Agreement prohibits quantitative restrictions and excessive (discriminatory) taxation of imported goods.

The principle of the freedom of transit is one of the conditions essential for the achievement of the purposes of the Agreement. Each Party is expected to provide for freedom of transit through its territory of goods originating in the customs territory or destined for the customs territory of the other party.

It is necessary to bear in mind the exceptions from that principle contained in the article 19 of the PCA. These exceptions provide that the Agreement shall not preclude prohibitions or restrictions on imports, exports or goods in transit justified on grounds of public morality, public policy or public security

and also on grounds of protection of natural resources.

The European Union officials have repeatedly expressed concern over the obstacles for the natural gas transit from Central Asia through the Russian Unified System of Gas Supply to the European market. These concerns have never been taken to formal dispute resolution under the rules of international law. It would suggest that the exception for the purposes of protection of natural resources may serve as a valid legal basis for the limitation of the freedom of transit.

It is clear that the rules of the PCA cannot guarantee the security of energy supply to European Union by means of diversification of supply and transportation from Central Asian countries that do not have common frontier with the EU. Article 65 of the PCA, specifically dedicated to energy, refers to cooperation in such areas as formulation of energy policy, improvement in management and regulation of the energy sector, introduction of institutional, legal and fiscal conditions necessary to encourage increased energy trade and investment, promotion of energy saving and modernization of energy infrastructure including interconnection of gas supply and electricity networks. Cooperation in the area of improvement of the quality and security of energy supply in an economic and environmentally sound manner is stated as the main priority. It must be noted that article 65 of the PCA with Russia does not make reference to the diversification of supplies which is a common feature of the Agreements on Partnership and Cooperation with other ex-Soviet republics. The provisions of the article 65 implicitly confirm the role of Russian Federation as the key energy supplier for the European Union.

A suspensive condition is mentioned in Article 105 of the PCA which relates to the application of the Energy Charter Treaty and Protocols thereto in matters covered by the PCA. In case of Russia it is especially important to note that the provisions of the ECT substitute the respective norms of the PCA only upon entry into force of the ECT on the territory of Russian Federation, upon its ratification by Russian Federation.

A political declaration on international energy cooperation, the *European Energy Charter*, was adopted in December 1991, followed by the legally binding Energy Charter Treaty (ECT), which was signed in December 1994 and entered into force in April 1998.

The ECT has two distinctive features.

Firstly, it is the only body of legally binding international rules that is tailored specifically to the energy sector.

Unlike other international economic treaties, it therefore takes into account the wider range of risks faced by energy companies (for example, geological risks) and the extraordinary high capital needs of the energy industry. The ECT covers such areas as energy investment, trade and transit, and energy efficiency. It offers dispute settlement for disagreements between states, and between states and investors.

Secondly, the ECT membership includes a broad and diverse range of countries across Eurasia. A total of 51 European and Asian countries have signed or acceded to the ECT, and all but five have ratified it. The five that have not are Australia, Belarus, Iceland, Norway and the Russian Federation. Belarus and Russia have accepted provisional application of the ECT in so far as it is compatible with their own constitution, laws and regulations. Another 20 states

and ten international organizations have observer status in the Energy Charter, among them the US, Pakistan, China, Korea, Iran and ASEAN. Although the ECT initiative was initially focused on east-west co-operation in Europe, its scope is now considerably broader. The Energy Charter is therefore the natural basis for the evolving Eurasian energy market, which also includes (not geographically, but from an energy-economic perspective) North Africa.

The ECT and its related legally binding documents constitute one dimension of the Energy Charter. The other is the inter-governmental Energy Charter process. The Energy Charter offers a depoliticized, energy-specific international forum which is unique in that it brings together producing, consuming and transit countries. It allows its member-states not only to discuss new challenges in international energy markets, but to incorporate common concerns and understandings into new legally binding instruments.

The ECT aims to help the development of open and competitive energy markets. Its rules are meant as a minimum standard, which leaves each member-state free to follow its own path and speed towards market opening.

Those countries that push ahead cannot demand that other ECT members follow their particular market model, nor are they permitted to discriminate against companies from such countries in any way.

Russia signed the ECT in 1994. But although Moscow applies ECT rules on a provisional basis and has been actively participating in the Energy Charter process, it has not ratified the treaty.

When the Russian State Duma (Parliament) discussed the ECT, it

concluded that it would not revisit the question of ratification unless a number of conditions were fulfilled. These included two clarifications regarding the ECT's provisions on transit (in article 7) and the finalization of a special protocol on transit. In fact, an agreement on the Transit Protocol would offer the most practical way to resolve the outstanding disagreements on article 7.

But the protocol cannot be adopted before the ECT is in force because only countries that have ratified the ECT can ratify protocols attached to it.

At present the *relations between Russia and the EU in the energy sector*, and in the sphere of energy security, apart from the Partnership and Cooperation Agreement rules, are formally governed by the provisions of the Energy Charter Treaty. Russian Federation has signed the ECT, but has not ratified it. The rules of the ECT are applied provisionally on the territory of Russian Federation to the extent that such provisional application is not inconsistent with Russia's Constitution, laws or regulations. Such possibility of provisional application is provided for by the article 45 of the ECT.

The scheme of the ECT may be qualified as "investments for the producers (mostly from the Eastern countries) in exchange for the security of the energy supplies. The ratification of this Treaty by the Russian Federation is the key element of the scheme, and without this element the system does not function properly.

The change in energy consumption structure of the European Union puts into evidence an increase in the share of natural gas. Russian natural gas reserves therefore increase the importance of Russia as the key energy exporter to the European market. The Central Asian states

– Kazakhstan, Kyrgyzstan, Turkmenistan and Uzbekistan – also possessing significant energy reserves require large and stable transit routes in order to be able to supply energy to Europe. Considering the geographic location of those countries, energy transit through the territory of Russian Federation seems the most suitable.

The legal regulation of international energy transit in Russia exerts significant influence on the amount of energy supplied from the Middle Asia countries to the European market and hence - on the security of the EU energy supply.

The international transit regime provided by the ECT if applied on the territory of Russian Federation would serve as a solid legal basis for free and uninterrupted energy transit from Central Asia to Europe. For Russia the relationship with the transit countries and with the countries that use the territory of Russian Federation for the transit of their gas have revealed important priorities in this area, which are not fully recognized by the text of the ECT. The international recognition of the principle of noninterruption of transit and inviolability of the resources transported, and the establishment of an obligatory international dispute resolution mechanism that could validly apply those principles must correspond to the interests of Russian Federation. The principle of the freedom of transit cannot be included in this list. Moreover, it is not clear at present whether the ECT provisions governing transit would be applicable on the territory of the European Union on the basis of international law or as a consequence of the European Union legal system.

In the first case Russia and other non-EU parties to the ECT shall have clear remedies for the breach of the ECT transit

regime by the EU and its member states, whereas in the second case European Union will be able to change the rules by means of its secondary legislation. The 2006 and 2009 gas disruptions occurred due to the controversies between Russian Gazprom and Ukrainian Naftogaz also show that ECT mechanism can not prevent such situations, although Ukraine has ratified the ECT. Bearing in mind that the economic and political environment in Russia has changed over the recent years, it is necessary to take into consideration new challenges and requirements.

It is evident that a large amount of investment is necessary for the EU energy sector, which is *inter alia* underlined in the Green Paper adopted by the European Commission in 2006.

The possibility of expansion of the Russian energy companies to the European market becomes real. The Energy Charter Treaty in its present form can hardly serve as an adequate legal framework for the new economic and political realities. The abovementioned scheme "investments in exchange for the security of energy supplies" had been changed significantly since the adoption of the ECT, which objectively has created the necessity to review the legal basis for the EU-Russia cooperation.

A decision was adopted during the EU-Russia summit in 2000 to establish a strategic partnership in the energy sector which was later called the *Energy Dialogue*. The reason for that was basically the refusal of the Russian Federation to ratify the Energy Charter Treaty.

The new *Energy Dialogue* could serve as a basis for bilateral cooperation. The underlying reasons were to ensure stable energy markets, reliable and growing

imports and exports, to address the need to modernize the Russian energy sector and to improve energy efficiency.

By setting-up the Energy Dialogue, the parties put forward five major topics of common interest. Those topics included ensuring the security of energy supplies of the European continent, the development of the potential of the Russian economy, in particular Russia's energy resources, the opportunities of the pan-European market, the challenge of climate change and the conditions framing the use of nuclear energy.

It is thus evident, that the major part of the ECT elements was embodied in the programme of the Energy Dialogue. It gives an additional argument in favour of the opinion that the Energy Dialogue represented a specific substitute for the ECT.

Security of energy supply in Europe was obviously the key element of the Energy Dialogue. A number of political and legal measures were initially proposed in that area. As a starting point, the parties highlighted the necessity to share adequately the risks between the energy producers (investors) and the energy consumers.

Such risk-sharing is essential in order to create the conditions for long-term investment decisions in large-scale projects, on the one hand, and guaranty the security of energy supply, on the other. In our days certain results in the sphere of energy security are evident under the framework of the Energy Dialogue. The European Union acknowledged the importance of the long-term contracts for the supply of natural gas.

On the one hand, it proves the impossibility for Europe to diversify the import of oil and still more the import of natural gas. On the other hand, it shows

the necessity to develop a strategic cooperation with Russia as the major energy exporter, which means that Russian energy supplies should be stable and uninterrupted no matter how the international situation evolves.

From the legal standpoint, the Energy Dialogue represents a permanent consultative mechanism aimed at the development of international relations in the energy sector. At present it does not provide for the guarantees of EU energy security within the meaning of the international law. Potentially, however, it may serve that purpose.

In general the level of legal formalization of the security of supplies from Russia to the EU does not adequately correspond to the scale of international relations and the amount of supplies. The enormous volumes of energy involved in the Russia-EU trade require a solid legal basis. Of importance in this respect may be the policy, currently being elaborated by the EU institutions. The policy is aimed at creating a single European energy market that should embrace all European countries including Russia. It is proposed to extend the basic principles of the EU law, particularly the rules of competition, free movement of goods and services, freedom of access to the energy infrastructure, to the markets of the energy exporting countries. Such measures aimed at energy prices reducing and establishing common requirements common for producing and consuming countries to reduce the amount of the natural rent received by producers. This can hardly coincide with the economy guidelines and the energy security of the Russian Federation.

In order to adopt and implement an agreement which would be legally binding and effective, the strategic

interests of the Russian Federation should be taken into consideration.

First, Russian energy companies are keen to gain access to downstream assets in EU member states. They want to sell their goods and provide services to the final consumers.

Second, of importance to Russia are the principles of non-interruption of transit and inviolability of resources transported. However, the freedom of transit is definitely contrary to the interests of Gazprom.

Third, the emerging market players in Russian electricity sector, which has undergone the liberalization processes, may be looking forward to sell electricity in the EU-countries and hence require the interconnection of the network systems.

It should also be noted that even if there is success in the first three points, Russia would hardly accept EU competition rules. Such acceptance would lead to significant interference in the corporate structure of the energy companies in Russia. It is, of course, impossible to follow completely the demands of Russia, but vice versa it is illogical for Russia to accept all the requirements of the EU.

The 2000 European Commission Green Paper on the security of supply notes that "energy supply security must be geared to ensuring...the proper functioning of the economy, the uninterrupted physical availability... at a price which is affordable...while respecting environmental concerns... Security of supply does not seek to maximize energy self-sufficiency or to minimize dependence, but aims to reduce the risks linked to such dependence".

The 2006 Energy Green Paper continues this line of thinking by describing the proposed energy strategy

for Europe as an attempt “to balance security of supply, competitiveness and environmental protection”.

The European Parliament states that “being dependent on imports is neither necessarily a bad thing nor economically inefficient provided the sources are diverse, no one supplier is dominant and we can produce sufficient goods and services to pay for them”.

Taking into consideration the European Commission’s 2000 Green Paper on the security of energy supply, the following types of risks can be identified:

- technical risks (including systems failure owing to weather, lack of capital investment or generally poor conditions of the energy system);

- economic risks (imbalances between demand and supply, stemming from a lack of investment or insufficient contracting);

- political risks (potential government decisions to suspend deliveries because of deliberate policies, war or civil strife, or as a result of failed regulation, which is defined as regulatory risk);

- environmental risks (the potential damage from accidents such as oil spills or nuclear accidents, which includes pollution, the effects of which are less tangible or predictable);

The secure delivery of energy is a complicated matter for at least four reasons:

- at all stages, the access (rights) to resources, upstream operations and the transit or transport of energy have their specific risks, possible reasons for delays, etc;

- the existing delivery infrastructure inside and outside the EU was built for different historical, commercial and other reasons, and sometimes for a different

purpose (especially that in the former USSR area);

- demand forecasting, investment planning and the actual construction of infrastructure and the development of big fields take years and are very risky for investors;

- there is the subjectivity of risk perception, the difference in the languages of comfort and assurance between nations and political cultures, the different readings of real events and the political and mass media interference in economic considerations.

Now in principle the Single Market rules applied to the gas market, but very little happened in the gas sector. In 1994 a European Energy Council meeting took the decision to prioritize the opening up of the electricity market.

The gas market only saw its first sector-specific liberalizing instrument in 1998 (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), with the first gas directive. Under the second directive (Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC), commercial gas customers were supposed to be free to choose suppliers by July 2004 and residential customers are to have the ability to do so by July 2007.

Another problem is the application of the competition rules to the gas market. Liberalization has been comprehensively frustrated by the member states and domestic incumbents. DG (Directorate-General) Competition has launched a major sectoral review into the state of competition in the gas and electricity

markets. The preliminary report of this review suggests that many member states and their domestic incumbents have effectively side-stepped the liberalization directives and the gas regulation.

Even if there are many laws on the statute books, effective circumvention practices are in place:

- legacy contracts (dominant incumbents are tying up both upstream and wholesale markets with 20-year contracts with renewal clauses, effectively foreclosing markets for the foreseeable future);
- confidentiality clauses (specific clauses are used to deny information on capacity and storage to potential new market entrants);
- possible market-sharing agreements among incumbents.

Real competition means ensuring that Gazprom does not operate with an unfair advantage based on its monopolistic structure. For this reason, the EU must adopt a clear and consistent position in favor of competition, above all by insisting that Gazprom's operations in the EU are unbundled. However, as long as Brussels seeks to impose this by the special Gazprom clause rather than as part of a comprehensive package of energy market reform applying equally to EU utilities; it will have little leverage in Moscow. The European Commission therefore needs to overcome the opposition from French, German, and other energy monopolies and impose across-the-board unbundling, rather than focusing on the Gazprom clause as a compromise position.

The EU's Third Gas Directive (September 2007) initially called for complete ownership unbundling. In the face of opposition from France, Germany, and a handful of smaller states,

the European Commission was forced to fall back on the creation of independent system operators (ISOs), which allow the big European energy firms to maintain ownership of transmission infrastructure but leave management decisions to the ISOs. At the national level, the ISO option is suboptimal from the point of view of encouraging competition, but more important, it does nothing to address the security challenges posed by Russian participation in the European market.

The EU Commission and Council should push for full implementation of the Parliament's September 26, 2007 resolution that called for a "*common European foreign policy on energy*". Carrying out the Parliament's recommendations would help "level the playing field" for Western investors, reduce opportunities to engage in non-transparent or corrupt business practices in the East-West energy business and decrease the large profit that stems from monopoly control of piped natural gas exports from the Caspian Sea countries and Russia to Europe.

- Western companies should petition the EU, DG COMP and national governments to enforce more vigorously existing anti-trust and competition policy, particularly in regards to Russian state companies.

Greater import competition would lower prices for consumers and for Western power and refinery operators. Opening existing Russian pipelines to competitors would also increase the supply of oil and gas coming from Russia and Caspian countries and bring more predictability in supply.

- The Council and Parliament should consider establishing an independent regulatory agency with the authority to monitor (but not approve or disapprove)

all major energy agreements between EU and non-EU companies. It would report to the Commission regarding the likely effect of the proposed agreement on the broader EU energy market. The agency could enforce a minimum level of revenue transparency in international energy contracts, extending to all companies (domestic or foreign) that do business within EU member states.

- Require all member governments to notify the Commission at the start of negotiations with foreign entities regarding the construction of new energy pipelines, the offering of tenders for energy contracts and when conducting talks for the sale of existing facilities within their border.

This might counteract the “divide and conquer” activities of Russian state-owned energy firms, thereby leading to greater cooperation by EU states.

- Western energy companies would benefit from a uniform reporting requirement that applied to domestic and foreign firms doing business within the EU; one that mandates revenue transparency reporting for their operations at home and abroad. This would weaken the present advantage held by firms from countries with high levels of business corruption and an unwillingness or inability to enforce existing contracts.

- Firms should be barred from including confidentiality clauses that hide revenue transparency in contracts with foreign energy companies.

- The EU Commission should be more active in defending member states against politically-motivated disruptions in energy flows from Russia, such as occurred in Lithuania and Latvia. An unwillingness to defend EU members from this kind of disruption only disadvantages the energy firms and the

state interests targeted by Moscow. It also further encourages those elements in Russia who oppose domestic reform and enforcement of the rule of law.

In order to enhance external coherence, it is necessary to combine the EU’s traditional normative policy based on the promotion of values and its model of governance with strategic thinking focused on Community interests.

The EU should be more assertive in presenting its interests clearly to all major producers, and should identify conflicting and overlapping interests with actors such as China, Russia and the US. Considering that external energy policy should be an integral part of the Common Foreign and Security Policy (CFSP) much will depend on how the modifications introduced by the Reform Treaty will be exploited by the new High Representative for EU Foreign Policy. Security of supply can no longer be considered only a national issue.

First, any action taken by any member state in the energy sector should not violate the security interests of any other member state, let alone contravene the Community objectives. And if this were the case, then the Community should have the power to take adequate measures. The main problem is to construct an accepted methodology that will identify risks and threats, their likelihood and scale (European, regional, national), and to arrange responses, along with the designation of the responsible actor and the political mandate to react. Such a mechanism should be prepared carefully so as not to let any member abuse it in order to block important undertakings.

Second, it is essential to make solidarity work. The need for action in the spirit of solidarity is unquestionable. With no infrastructure in place, this principle will

remain on paper, which can widen the credibility gap. An obligatory solidarity mechanism may send the wrong signals to some countries which in turn may abandon expensive modernization of their own energy systems and count on “free-riding” when a crisis occurs.

However, the EU member states, in particular those most vulnerable to disruption, may expect effective common protection mechanisms in the face of external risks in return for conferring upon the Community additional control over domestic energy affairs. Otherwise, they may revert to purely national measures resulting in energy de-integration. It would surely make the EU more vulnerable to external actors, who would benefit directly from intra-European disunity. It is necessary to focus on the creation of common ground in terms of regulations and standards, functional market-based mechanisms, and sufficient physical and technical links. True unity in the field of external energy policy can be possible only after achieving real integrity within the EU.

The scale of the would-be European common energy market combined with the collective character of a would-be common energy policy could transform the EU into a real energy power. It could use market access and the principle of reciprocity as a policy tool. It could speak with one voice in bilateral or multilateral talks through one agent (most probably through the High Representative).

The fragmentation of the European energy market dates back to the 1970s, when EU member-states responded in an individual fashion to the oil crisis.

Some countries, like France, diversified their energy panorama, while others proceeded to rapidly explore their own reserves, as the Great Britain did in

the North Sea. Germany built up strategic reserves of gas and invested heavily in infrastructure.

In recent years it was adopted Council Directive 2004/67/EC of 26 April 2004 concerning measures to safeguard security of natural gas supply. In the directive two important terms are defined, “long-term gas supply contract” (a gas supply contract with a duration of more than 10 years) and “major supply disruption” (a situation where the Community would risk to lose more than 20 % of its gas supply from third countries and the situation at Community level is not likely to be adequately managed with national measures). According to the directive, the Commission shall monitor the degree of new long-term gas supply import contracts from third countries, the existence of adequate liquidity of gas supplies, the level of working gas and of the withdrawal capacity of gas storage, the level of interconnection of the national gas systems of member States and the foreseeable gas supply situation in function of demand, supply autonomy and available supply sources at community level concerning specific geographic areas in the Community.

A Gas Coordination Group is set-up (composed of the representatives of Member States and representative bodies of the industry concerned and of relevant consumers, under the chairmanship of the Commission) in order to facilitate the coordination of security of supply measure.

After the gas supply disruptions in January 2009, it was formulated a Proposal for a Regulation of the European Parliament and of the Council concerning measures to safeguard security of gas supply and repealing Directive 2004/67/EC. In the proposal, the security of

gas supply is a task of the natural gas undertakings, competent authorities of the member states, the industrial gas customers, and the Commission within their respective areas of responsibility. Each member state shall designate a competent authority responsible for the implementation of the security of gas supply measures.

The Commission shall coordinate the competent authorities at the Community level through the Gas Coordination Group in particular in the case of a Community emergency. The measures to ensure the security of supply must be clearly defined, transparent, proportionate, non discriminatory, verifiable, and shall not unduly distort competition and the effective functioning of the internal market. A Preventive Action Plan containing the measures needed to mitigate the risks identified and an Emergency Plan containing the measures to be taken to mitigate the impact of a gas supply disruption.

The Preventive Action Plan must include the measures to fulfill the infrastructure and supply standards, the risk assessment, the preventive measures to address the risks identified and the information on the relevant public service obligations. The Preventive Action Plan shall be updated every two years.

The Gas Coordination Group shall assist the Commission in particular on issues related to security of gas supply, at any time and more especially in times of emergency, all information relevant for security of gas supply at national, regional and community levels, best practices and possible guidelines to all the parties concerned, the level of security of supply, benchmarks and assessment methodologies, national, regional and Community scenarios and testing the

levels of preparedness, coordination of measures to deal with emergency within the Community, Energy Community Treaty countries and with third countries and implementation of the plans.

III. Situation in Russia

In the situation of Russia, there are often apparent misunderstandings between the oil and gas sectors.

Unlike the gas sector, the oil markets have evolved globally and are not dependent on EU-Russia relations. The Russian oil sector has seen the emergence of new international majors that place western oil companies in an uncomfortable position. In the aftermath of the USSR's break-up, the Russian oil sector comprised a weak and highly fragmented patchwork of companies. Production and supply were unbundled from the transport sector, most of which was privatized.

A number of new private companies emerged at the national (Lukoil, Yukos, Sibneft) and regional levels (Tatneft, Bashneft, Surgutneftegaz, TNK). Rosneft remained a state-owned company.

Unlike production and supply, the oil pipeline sector, which has the world's largest network, is mainly regulated by the state-owned company Transneft.

If the oil sector is a global market, the gas trade links Russia directly to the EU. Europe has been Russia's main client since the 1960s and Gazprom wants to maintain its positive image in Europe.

The complete halt of gas deliveries violates Article 7 (on transit) of the Energy Charter Treaty (ECT). Ukraine ratified this treaty, while Russia signed and has applied it, though has not ratified it. Transit issues lie at the heart of a long-term solution for European

energy concerns. The EU wants to push negotiations on the Transit Protocol in the EU-Russia energy dialogue and the EU-Russian negotiations on the Partnership and Cooperation Agreement.

The full application of this multilateral international regime would install dispute settlement mechanisms. It would be a first step to acknowledge the necessity of a multilateral regime if both sides invoked the conciliation procedure according to Article 7 (7) that the ECT provides.

Gazprom wants to own pipelines outside of Russia, but refuses to let foreign companies or governments own pipelines inside Russia. The EU and Russia are currently negotiating a new Partnership and Framework Agreement. The EU-Russia energy dialogue also provides another bilateral mechanism to negotiate energy issues. These channels have to be used now to address structural issues, such as the early warning mechanisms, which provide the possibility of engaging transit countries as well. The EU has to put a stronger emphasis on energy infrastructure, but also pressure for more legal certainty in Ukraine.

The development and signing into law of *production sharing agreements* (PSAs) in Russia became extremely important for the foreign investors. Even if there are inadequate, PSAs have become a popular model for the Russian government and foreign oil company to share petroleum output in pre-determined amounts. They also offer the investor the possibility of reducing exposure to long-term contractual risk by accelerating the recovery of invested capital. And finally, under this construct, the investor's tax liability to Russia can be offset by increasing the government's percentage take of profit oil.

It should also be pointed out that the

foreign oil company faces numerous competing authorities in Russia, all claiming control over portions of the petroleum industry. At the federal level, "the President, the Parliament, and the various ministries and commissions compete for authority over aspects of oil production and export. Administrative bodies at the regional and local levels have increasingly asserted jurisdiction over petroleum assets located within their respective territories." Sometimes the federal government promulgates legislation that is inconsistent with that of the regional government, and vice-versa. The result for foreign investors is the "proliferation of overlapping and contradictory laws, regulations, and licensing requirements, all with the potential for arbitrary and capricious enforcement."

It is no surprise that disputes might arise in the execution of the contract.

In the case of Russia, where the political risk is considered to be high and where there are significant power asymmetries, investors may insist upon a neutral forum outside of the host country to arbitrate potential commercial disputes. There is a difference in perception on such issues as "force majeure" and "hardship," both central themes for the investor and usually standard features in petroleum contracts. Without them, there would likely be no agreement, as they are designed to address the possibility that unanticipated events may fundamentally change the economics of the negotiated agreement.

Foreign oil and gas companies lobbied for a Production Sharing Agreement law. The President Yeltsin signed the PSA Law in December, 1995, a year after the ECT was concluded. Although the PSA is available to Russian as well as foreign

citizens, and the first PSA approved involved a Russian-owned company, the PSA Law remains one of the most controversial pieces of legislation in Russia.

The legislation is a three-party agreement among the Investor, the State, and the regional political subdivision of the Russian Federation where the investment will take place. It grants the investor an exclusive right for exploration, development and production of mineral raw materials on the subsoil area provided for in the agreement and for conducting operations thereto on a chargeable basis and for a certain period of time (Article 2). Foreign investors are limited to 30 percent of Russia's hydrocarbon resources.

Under Article 7 in Terms and Conditions for Conducting Operations, Russian legal entities are granted the priority right to take part in the conduct of the Agreement and no less than 80 percent of all employed personnel in operations should be Russian. In exchange for relief from most types of taxes (except profit and social taxes), the Investor agrees to give the State a share of the oil that it produces. The Investor may pay the State in product or in the form of proceeds from actual sales. The State's share of the oil consists of a royalty, which is based on a percentage gross production, and a portion of "profit oil". Profit oil is defined as the oil produced in excess of the amount given to the State as a royalty and the amount necessary to reimburse the Investor for the costs of its investment ("cost oil"). Article 8 states that after a PSA is signed, the government and the regional authority are supposed to agree separately as to how to divide their respective portions of the State's share.

The PSA Law expressly provides that the Investor is to be reimbursed for the costs of its investment out of an agreed portion of the oil that the Investor produces, before any profit oil is taken by the parties to the agreement. The PSA itself, however, determines which costs can be compensated, and some of these costs are disallowed. In addition, the PSA seeks to guarantee the rights of the Investor to fair treatment and to stabilize the regulatory regime by offering such assurances as the right of the investor to export its share of profit oil freely, nondiscriminatory access to pipelines and storage facilities, and a special legislative "stabilization clause providing compensation if the commercial terms of the PSA become less favourable as a result of subsequent Russian legislation (Article 9). Article 22 of the PSA grants permission to refer disputes to international arbitration.

The 1995 PSA Law considerably advanced Russian petroleum law. Even containing many uncertainties, it must be seen as framework legislation, where many, if not most, significant issues "remain to be resolved through negotiation of individual production sharing agreements between foreign oil companies and the Russian Federation".

Although the PSA legislation contains a stability clause, it provides at the same time that a change of the PSA is allowed in the event of a substantial change of circumstances as defined under the Russian Civil Code.

On the other hand, a worsening of the investor's situation caused by subsequent legislation entitles the investor to a change in the PSA to maintain the commercial result had there been no such legislation.

The Law authorizes international arbitration and waives Russia's sovereign

immunity to such extent, leaving it to the parties to determine whether to agree on the same. It also affirms the contract-based character of the PSA as a fully recognized ground for the issuing of a license for the use of the subsoil. The Duma rewarded demands of domestic manufacturers' and workers' demands for a mandatory local content requirement (70% of equipment used by PSA operators is required to be of Russian origin and 80% of the workforce employed at a PSA project must be Russian). The percentage of existing national oil and gas reserves that may be designated for development under a PSA is limited to 30%. Despite the hopes of the supporters of the PSA Law, the Russian Federation has not received the substantial foreign investment that was supposed to come in wake of the new legislation. PSA amendments passed in 2001 introduced the concept of an optional scheme of direct sharing under which there is only one stage of division of production shares between the producer and the state (instead of a first-stage "cost" share followed by a second-stage "profit" share between the parties.) The 2001 amendments also enabled an existing holder of a license to transfer it to a PSA operator without requiring the PSA holder to get a new license e-issued.

Given that under the PSA Law, no less than two separate actions of the State Duma are required (approving the particular field to be listed to which the PSA Law applies and approving the PSA after it is negotiated), and no less than three separate negotiations with local authorities or other private companies are necessary (negotiations with a license holder for the field in question; negotiations with federal and local authorities to allow the field to be developed under a PSA, and finally –

after initial Duma action – negotiation with federal and local governments of a PSA), it is not surprising that only 3 PSA projects in Russia have been implemented.

The government is supported by numerous Russian oil and gas companies, which want to do away with the production sharing agreements altogether, contending they are no longer needed and give unfair advantages to foreign rivals. Indeed, this view is becoming ever more mainstream, prompting visions of gloom from industry observers.

Another legal instrument in the Russian legal panorama is the joint venture contract. The joint venture form of contract is seen to be in Russia's interest, the foreign investor committing significant capital upfront to the Russian state. In contrast to a production sharing agreement, however, the investor is not able to recoup capital investment in the course of cost recovery. Thus the joint venture arrangement offers less economic incentive.

The Department of Natural Resources (NR) prepared a draft law on the subsoil in the summer of 2002, re-issuing it in March 2003 with slight changes. NR supports the continuation of the license procedure under the existing Subsoil Law as the primary mechanism for granting rights of exploration and exploitation of the subsurface.

Revocation of a license is conceived as an administrative act that a license holder can challenge in court. The multiplicity and complication of taxes are among the complaints common to foreign as well as domestic investors. Holders of subsoil licenses are subject to numerous taxes and other charges in connection with the franchise: royalties

for the use of subsoil resources, excise taxes, charges for mineral replacement, export duty, value added tax, property tax, profit tax, land tax, withholding tax, and local taxes and duties.

Foreign investors are complaining of having to deal in Russia with multiple agencies, overlapping and inconsistent laws and other legal instruments, a weak judicial system making contractual enforcement in the courts a chance proposition at best, and corruption. These complaints are shared by Russian companies but on the other hand such situation seems to disadvantage foreign investors more directly in the short run than local companies and in fact, it may act as a sort of protection against foreign competition.

Another example of legal uncertainty in legislation is the Russian Arbitrage Procedural Code. This Code gives the Arbitrage (state commercial courts) exclusive jurisdiction in disputes relating to Russian real estate where foreign investors are involved in the dispute. Real estate is defined in the Code to include the subsoil and thus would appear to prohibit foreign investors from selecting foreign arbitration in contracts dealing with the subsoil.

IV. Conclusions

Energy policy is subject to majority voting at the EU level. With the new reform proposed under the now revised (constitutional) Treaty of Lisbon, some sort of EU foreign policy mandate is possible. There are four factors in the international economic context that contribute to reinforcing the energy relations between the EU and Russia.

The first factor is the regionalization of international oil geopolitics. The

rise of Islamic extremism in the Middle East, US intervention in Iraq and the subsequent destabilization of the Gulf region pushed many economic actors to focus on regional energy transactions. The regional axis of oil geopolitics was outlined by the European Commission in its Communication on the energy policy of the enlarged EU in 2004.

The second factor is the rapid growth of natural gas in the EU's energy consumption. The EU's liberalization of the gas sector was an attempt to create an integrated gas market whose success is highly linked to the availability of supply. Russia is a valuable source of supply as it has 36% of the world's gas reserves. For Russian gas exporters the EU market is still the most stable and profitable source of revenues.

The third factor is the introduction of competition in the electricity markets of both the EU and Russia. Electricity markets have traditionally been exempt from cross-border trade. The introduction of the competitive model of power supply has created new opportunities for energy investment and trade. European electricity companies invest in less mature markets in order to reinforce their position in a context of increased competition. The liberalized electricity market has given rise to new opportunities for cross-border trade. In the liberalized markets it might be more costly to maintain marginal reserve capacity than to build new infrastructure to import electricity. This is why, following reforms in the power sector, Russia now has a significant potential for investments in the electricity sector.

The fourth factor is the emerging environmental market, brought about by the entry into force of the Kyoto Protocol. The EU's objective is to reduce CO₂

emissions by 8% by 2012, compared to the 1990 level, in order to meet its commitment on climate changing.

The most effective way for the EU to counter Russian attempts to divide Member States is to restructure its internal gas market, making it much more difficult for Russia to advance its political interests.

In the past three years, the debate has evolved around three equally unsatisfactory proposals for EU responses to the Russian gas challenge:

- regain energy independence from Russia by developing alternatives to natural gas, especially nuclear power and renewables. (This is not a credible option. Even if nuclear and renewables are competitors to natural gas, they cannot marginalize it in the medium term. Pushing for alternatives to Russian gas will not keep it from dividing Member States);

- further diversify Europe's gas supply through aggressive pursuit of sources of non-Russian gas (the Europe's gas supply has considerably diversified in recent years, and Russia's share of EU imports has declined continuously since 1980. During that period Russian gas has become *more* divisive politically, not less. It is unclear how further diversification would help resolve the issue);

- bind Russia's hands by having it accept treaty-backed policy and behavioural disciplines (Such an attitude depends entirely on Russian goodwill, which has lately been in short supply. The EU is powerless to force a sovereign state like Russia to obey the treaty-backed disciplines, considered by Moscow as detrimental to its national interest. The solution to the Russian gas challenge lies not in foreign energy policy but in reform of the European gas market itself).

Russia is interested in market segmentation.

Permitting to Gazprom to acquire European transmission or storage assets attracts the risk of reinforcing barriers to market integration. The authorities in charge of the European market should screen all proposed takeover projects.

Due to this reason, an integrated and competitive European gas market would:

- create the maximum possible degree of solidarity between European gas consumers;

- improve collective supply security by allowing the price mechanism to re-allocate physical supply across the entire market in times of supply or demand shocks;

- make Member States' bilateral relations with Russia largely irrelevant to the conditions of access to Russian gas for consumers. An integrated market would europeanize bilateral commercial relationships with Gazprom, without the need for political involvement from the EU.

The Commission must to develop a business case which clearly articulates where it believes that a more centralized approach is required, on an item by item basis.

Both the EU and Russia must set-up a political commitment to reach a free trade agreement.

Only with a political accord will they be able to go towards multilateral mechanisms for crisis prevention and the settlement of disputes for short-term transit crises as well as for an improved investment climate. A clear legal framework based on the Energy Charter will allow the estimation of necessary energy investments.

Without a political commitment the Energy Charter will remain marginalized.

In contrast, once the commitment to a framework exists, a multilateral legal regime for energy can be established.

Another important issue in this context is to help Member States, especially those in Central and Eastern Europe who are highly dependent on Russia, to develop and implement national action plans for improving their gas security.

The Directorate General for Competition (DG Competition) should continue to investigate abuses of dominant position in the gas industry and, where appropriate, demand that companies sell their transmission networks.

Another necessity is to enforce the Energy Charter Treaty. According to Article 45 of the Treaty it went into effect when a state signed it (not ratified it), unless there was a specific declaration that it would "opt out" such as Norway. Russia already has a binding treaty obligation with the EU member states; even it announced recently the refusal to enforce and to ratify the Charter.

Another problem is to enforce the Rome Treaty's competition and anti-trust rules in cross-border deals between Transneft, Gazprom and individual European states. It must calculate the true cost to the European consumer of Russia's pipeline monopoly of Central Asian supplies and of the very expensive Nord Stream pipeline.

Other important aspect is to prevent member states from reaching individual deals with Russia that undercut the viability of EU plans to bring alternative supplies of energy to Europe, in the same time with providing more leadership in

working with Central Asia to supply gas and oil directly to the EU, without the use of intermediaries.

The multiplicity of players has been a principal reason behind the West's failure to develop a coherent, strategic approach to the reality of Europe's growing dependence on Russia for its energy. By leaving the energy policy to national governments, the European Union has struggled to cope with the fact that the interests of its members can be different one from another, and from those of Brussels. The most fundamental challenge facing the EU is thus to ensure greater solidarity between eastern and western Europe, and between countries dependent and independent of Russian gas.

Unification of European gas markets, which would be the single most effective way of decreasing the geopolitical risk of dependence on Russia, can be real only if the diverging interests of countries in positions as different as Germany, Poland, Hungary, and Spain can somehow be reconciled. Reaching such solidarity will be even more difficult in the aftermath of a global financial crisis that has forced countries to put their own interests first.

A common position on energy security remains critical to the viability of the EU as a political force. Europe can resolve the problem of its dependence on Russia only in close partnership with the United States. Due to the fact that it does not depend on Russia itself, the United States is well positioned to play the role of a disinterested consensus-builder among the Europeans.

BIBLIOGRAPHY

- Baev Pavel, Bartuska Vaclav, Cleutinx Christian, Gaddy Clifford, Götz Roland, Gros Daniel, Ickes Barry, Konoplyanik Andrey, Kosachev Konstantin, Mitrova Tatiana, Piebalgs Andris, Piper Jeffrey, Swieboda Pawel, Trenin Dmitri, Yastrzhembsky Sergey – *Pipelines, politics and power. The future of EU-Russia energy relations*, Centre for European Reform, London, October 2008
- Belyi Andrei V. - *Why a Political Accord is Needed to Make EU-Russia Energy Relations Work*, Elcano Royal Institute, Working Paper 19/2009, Madrid, 2009
- European Commission (2000), *Energy Infrastructure and Security of Supply*, Communication from the Commission to the European Parliament and the Council, COM (2003), Brussels.
- European Commission (2005), *Doing More With Less*, Green Paper on Energy Efficiency, Brussels.
- European Commission (2006), *A European Strategy for Sustainable, Competitive and Secure Energy*, Green Paper, COM (2006), Brussels.
- European Commission (2006), *Annex to the Green Paper "A European Strategy for Sustainable, Competitive and Secure Energy – What is at stake?"*, Background Document, Commission Staff Working Document, COM(92206), Brussels
- European Commission (2007), *An Energy Policy for Europe*, COM (2007), Brussels.
- Egenhofer Christian, Grigoriev Leonid, Socor Vladimir, Riley Alan - *European Energy Security. What should it mean? What to do?* European Security Forum Working Paper no. 23, Brussels October 2006
- Mankoff Jeffrey - *Eurasian Energy Security*, Council on Foreign Relations, Council Special Report No. 43, February 2009
- Noël Pierre – *Beyond dependence: How to deal with Russian gas*, European Council on Foreign Relations, Brussels, November 2008
- Sergey Seliverstov - *Energy Security of Russia and the EU: Current Legal Problems*, Note de l'Ifri, Paris, April 2009
- Smith Keith – *Russian Energy Policy and its Challenge to Western Policy Makers*. Center for Strategic and International Studies Commentary, Washington, March 2008
- Smith Keith – *Corruption, not dependency is the risk to Western Europe from Russian energy trade*. Center for Strategic and International Studies Commentary, Washington 2008
- Smith Keith – *Russia and European Energy Security. Divide and dominate*. Center for Strategic and International Studies, Washington, October 2008
- Wyciszkievicz Ernest - *EU External Energy Policy – Between Market and Strategic Interests*, Polish Institute of International Affairs, PISM Strategic Files, Warsaw, January 2008