THE EUROPEAN GEOPOLITICAL FORUM

The EU-Russia Energy Partnership: Overcoming the Challenges

Summary of Panel I:
The Future of the Energy Charter and the Debate over the Third Package

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Introduction

The energy trade between Russia and the countries of the European Union (EU) is of fundamental significance for the energy security of each party. Despite the close proximity of the EU-Russia energy relationship, however, the legal and political basis underpinning this relationship, particularly with regards to the gas trade, has proven itself inadequate in guaranteeing the energy security of both parties. Russia's recent announcement of its intention "of not becoming a member" of the Energy Charter Treaty, and new proposal for global energy security has created further uncertainty. While it is hoped that a new government in Kiev will lead to an improvement of Russian relations with Ukraine, Ukraine's national gas transportation operator remains in a difficult financial position and another gas crisis embroiling Ukraine, Russia and the EU, whilst hardly imminent, cannot be entirely ruled out.

Major challenges continue to underpin the energy partnership between the EU and Russia, therefore, raising a number of concerns at both policy and industry levels, including:

- **The future of the Energy Charter Treaty, which remains highly uncertain**
- **How Russia will develop its newly proposed framework for energy security**
- **How the development of the EU internal energy market will impact on the EU-Russia energy relationship**
- **How the two sides will collectively address gas transit through Ukraine**
- **How the Russian upstream energy sector has been responding to the global financial crisis**
- **How the impact of new gas exploration technologies will impact on the Russian gas supply to Europe**

Leading Russian and international energy professionals have shared their views on these policy challenges in an online session, extending over 5 days and comprising two panels. In the first panel, which focused on the future of the Energy Charter and the debate over the EU's Third Energy Package, the discussion brought out the following messages for European policy makers:

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Key points for policy makers:

- The relevance of the Energy Charter Treaty (ECT), a key investor protection instrument and framework agreement for Eurasian energy security, has declined drastically since the Russia-Ukraine gas crises of 2006-09

- Russia's lack of confidence in the ECT has led to Moscow trying to seize the initiative away from Brussels with its own contra-Charter: the Conceptual Approach to Energy Security announced by Russian president Medvedev in Helsinki in April 2009

- The Conceptual Approach should not be viewed as an alternative to the ECT: the initiative should instead be viewed as evidence of a political decision taken in Moscow to terminate Russian involvement with the Energy Charter and to call for new post-Charter instruments of European energy security

- It could be in Russia's interest to keep the ECT and the struggling Charter process alive since the ECT could provide a dispute settlement mechanism which can be used against the EU to protect Russian downstream investments in the EU market, particularly after Brussels' Third Energy Package comes into effect

Extended commentary:

A new framework for European energy security – the Energy Charter and the contra-Charter

The inaugural Russia-Ukraine gas crisis which took place in January 2006 has become the "9/11" of the EU-Russia energy relationship. It resulted in a largely cosmetic agreement between Gazprom and Naftogas and presaged a much larger crisis in January of 2009. The relevance of the Energy Charter Treaty (ECT), a key investor protection instrument and framework agreement for Eurasian energy security, has declined drastically since that time. Russia could have ensured the relevance of the ECT, as well as enhanced its own image as a reliable partner to European energy consumers, had it pursued arbitration mechanisms (such as those available under the ECT or other legal instruments) as a means of resolving its gas disputes with Ukraine. Moscow chose to employ (gas) flow reduction instead of arbitration, however, which lead to an escalation of the crisis and an opportunity to improve the country's image in the international arena was lost. That being said, law-based methods of resolving energy disputes between Russia and Ukraine may not have been a realistic option for either party to pursue due to a number of factors, including the tense relationship between the two countries which existed at the time.

In theory, the ECT's provisions on transit should offer protection for Russian gas transiting via Ukraine to the EU, whilst on the other hand obliging Russia to act as a transit state for West-bound Central Asian gas. In reality, none of this has happened. Russia's gas disputes with Ukraine, together with the collapse of negotiations on an additional ECT protocol on transit, appears to have convinced Moscow that the ECT is (in practice) unable to protect Russian gas in transit to Europe via Ukraine. Whilst Article 7 of the ECT requires Ukraine to ensure "freedom of transit" for Russian gas bound for the EU throughout the period of a gas price dispute with Russia, the view from Moscow is that Ukraine was siphoning of Russian gas for its own purposes rather than assuring its freedom of transit.

An initial reduction, and eventually a cessation of gas flows was the only option available for Moscow, therefore, as Ukraine violated its "freedom of transit" obligations under the ECT, according to the Russian view. Russia's lack of confidence in the ECT, which has been simmering for some time but has been rekindled by the lack of visibility of both the ECT and the Charter Process during times of crisis, has led to Moscow trying to seize the leadership away from Brussels with its own contra-Treaty (the Conceptual Approach to Energy Security announced by Russian president Medvedev in Helsinki in April 2009).

Medvedev's Conceptual Approach, has been little more than acknowledged by the EU thus far, which continues to stand by the ECT. It is highly unlikely that the Conceptual Approach, assuming the document's current form, can be viewed as an alternative to the ECT. The initiative should instead be viewed as evidence of a political decision taken in Moscow to terminate Russian involvement with the Charter and, given the absence of Russian participation in ongoing dialogue aiming to modernise the Charter process, to promulgate the necessity for new post-Charter instruments of European energy security. Remaining a member of a reforming Charter process does not seem to be an option for Moscow at present. Neither does OPEC membership, while engagement in other institutions of global energy governance, such as the Gas Producers' Forum or the International Energy Forum serve different purposes altogether.

Maintaining the ECT likely to be in Russia's long term interest

The ECT could be of greater value to Russia than is currently appreciated in Moscow, however. This is likely to become more the case as Brussels comes closer to implementing its Third Energy Package, which aims to harmonise the rules of the game in the EU internal gas and electricity markets. Russia craves downstream energy investments inside the EU. Implementation of the Third Package could create a number of complications for Russian energy companies to operate in the EU, due to its requirements for non-EU energy companies to follow the same EU internal market rules as those for EU companies, even if such companies (and their investments) originate from outside of the EU. Just like the ECT can be used to protect EU (energy companies') upstream investments in Russia, so to can it be used to protect Russian downstream energy investments inside the EU.

Therefore Russia has an interest in keeping the ECT and the struggling Charter process alive since it could provide a dispute settlement mechanism which can be used against the EU to protect Russian downstream investments in the EU market. As a way of modernising and reforming the Energy Charter, therefore, it may be in the Russian long term interest to invoke certain aspects of the ECT, such as investor protection, in contrast to the present day necessity to strengthen the ECT's transit provisions, which is in the interest of both the EU and Russia.

The Third Package – the myth of an anti-Russian measure

The EU's Third Package aims to create new rules for setting up a competitive, transparent and liberised internal EU market for gas and electricity. Implementation of the package has been slow inside the 27-member EU bloc, however, given that member states are yet to reach consensus over its adoption. Russian energy professionals feel that the package needs to be clarified via additional explanatory notes and regulations, which the European Commission is capable of issuing. The new rules could be too demanding for energy companies from third countries seeking business in the EU, it is felt. Once implemented, it is felt that the Third Package may prevent the possibility of Russia taking part in gas transportation investment projects inside the EU since implementation will require full independence of transportation activity from production (or full unbundling of companies engaged in such investment projects).

This hardly presents a tolerable scenario for Russia and puts into question Gazprom's aspiration of active involvement in (the acquisition and management of) transportation assets in the EU gas market, which goes well beyond its present role of external supplier. However, it is not sensed in Moscow that the Third Package is aimed primarily at harming the EU bound business aspirations of energy companies from third countries. The primary aim is to create a uniformed set of rules and level playing field for all players, whilst the unbundling measures are primarily aimed at EU energy monopolies, not the energy monopolies from third countries. The adoption of the Third Package is a process which is likely to undergo several stages of implementation, while pursuing an optimal balance between market forces and imposed regulation. It will also require the combination of national and EU-wide approaches. A return to purely national (energy) markets (within the EU) is unlikely to happen. Furthermore, it will be essential to establish a clear set of rules on compatibility of the ECT and the Third Package, as well as accepted rules on protection of the EU energy market from future Russia-Ukraine gas disputes.

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Full Commentary