

COMMENT:

EU should use international law to tackle Russian energy relations

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How will the EU and Russia shape their energy relationships in the future? The EU is still under the shock of the week-long Russian-Ukrainian gas crisis in early 2009, which left scores of Eastern European households in the cold. It is currently discussing in many Brussels conferences various practical solutions to avoid a new standoff of this scale, from setting up international pipeline consortia in Ukraine to increasing the number of LNG terminals.

Russian President Dmitry Medvedev joined discussions by offering, during a recent visit to Spain, to renegotiate the Energy Charter Treaty (ECT) in order to make it more favourable to "producers". In the meantime, the EU has agreed to restart Partnership talks with Russia.

The EU should back any moves to increase energy security and to negotiate with Russia with steps to strengthen the legal institutions that underpin its energy and related commercial relations to Russia. The EU should make a more systematic use of Bilateral Investment Treaties (BITs) and in particular the Energy Charter Treaty (ECT) as it is now. This must be complemented by speeding up reforms to create a single EU energy market.

Strategic rethink

The EU's recent strategy to deal with its gas relationship with Russia has failed to achieve predictability and stability in the security of supplies. The situation has even deteriorated: the January disruptions are unprecedented in scale. Renewed threats in early March from the Kremlin to cut supplies have highlighted how fragile the situation remains. It is to the EU to take steps to tilt energy relationships towards a minimum of rule of law. Granted, the EU has already attempted to do so. But its strategy has failed. So far, it has attempted to tie Russia to a legal-based international economic order by supporting its entry into the World Trade Organization followed by tying Russia to a comprehensive Free Trade Agreement or Common Economic Space.

The latter is part of the current Strategic Partnership talks. The EU wants a stronger agreement than the current Partnership and Cooperation Agreement (PCA), which has expired but is still renewed annually. The PCA is an inadequate attempt by the EU to export its model. At the same time it is very weak legally. When disputes arise, there is no effective mechanism in place to address them. Result? Russia is still outside the WTO and there is no partnership agreement in sight. The strategy continues to be applied nonetheless. It follows a systematic pattern: each time there is a serious crisis, such as the prolonged ban on Polish meat or the Georgian war, or the last gas row, talks are suspended. A few weeks later, after bitter rows between Russia-wary and Russia-supporting EU member states, a Brussels delegation is sent over to Moscow to mend ties and start talks again: without result, except a further dent in the EU's already weakened credibility.

The proposed Common Economic Space can only be a proposition for the long term. In the meantime, however, the aim is to avoid that the tight-knit system mixing hydrocarbons and state power that emerged in Russia does any more damage to the EU. Under the cover of resource nationalism, the former president and now prime minister, Vladimir Putin, has

tightened the state's grip on the country's natural resource companies. In 2006, Gazprom was given the monopoly over the oil and gas pipeline system in Russia, giving it complete control over Russia's hydrocarbon exports. This coincided with the ousting of political or economic rivals in the oil and gas sector such as Yukos or Russneft. At the same time, foreign investors in the hydrocarbons sector were stripped of their assets in favour of state behemoths. Gazprom's focus on rent-extraction leads it to neglect much-needed pipeline infrastructure development and improvement of the company's production capacity. This threatens the EU's energy security further. The EU already imports one-third of its gas from Russia, and this share is set to rise.

The EU itself cannot do much about this situation. But it can surely make some moves that would lead the Kremlin to think twice before it yet again cuts gas supplies or harasses a foreign investor. What the EU should start doing immediately is getting serious about applying to itself some of the market-based laws for European energy markets already in place or on the table.

BIT of a solution

The potential for using BITs is not sufficiently explored. Russian BIT partners in Europe include France, Germany, Italy, the UK, the Netherlands, Belgium, Luxembourg, Austria, Finland, Greece, Sweden, Norway and Switzerland. Russian BITs cover about 40% of Russia's inward and roughly 15% of its outward foreign direct investment stock. BITs are designed to guarantee foreign investors treatment in accordance with the established standard in international law. A core element of BITs is to allow investors to enforce their rights under a respective BIT vis-a-vis the host state through international arbitration. A few arbitration cases involving Russia are known. However, they do not match by far the number of cases of violations of investors' rights in Russia.

A further and very important institution is the ECT. The EU itself is party to the ECT, along with its member states. The ECT has strong dispute-settlement provisions for foreign investment in the energy sector. Both states and businesses can launch disputes. It also provides a conciliation mechanism on transit matters. As noted earlier, Russia has not ratified the Treaty. But it has a clause that obliges states that have not yet ratified it to apply it provisionally. The Treaty allows parties to explicitly opt out of provisional application. However, Russia has not done so. Recently, Yukos shareholders have launched a case against Russia that will help determine the real scope of Russia's legal commitments in the ECT. The ECT's powerful members have so far been reluctant to use it. When it comes to Russia, general wariness in the EU to litigate in and outside the ECT also arises from fear of investors and government to attract political or business retaliation. But not making a government accountable for its commitments won't save any investments in the future nor put a halt on the temptation to yet again shut the gas taps.

The choice of going down the legal path with Russia must be backed by the strengthening of the EU's own energy market institutions. The EU has failed to create a single energy market. National markets dominate the scene, with big national champions, mostly government-owned or -backed, pursuing their own agendas. Small and strongly gas-dependent member states in Central and Eastern Europe have not much choice but to deal with the powerful Gazprom alone, whereas some big powerful Western European member states, chief among them Germany, France, Italy and to a certain extent Spain, consider a direct relationship with the Russian behemoth more suitable to their interests.

Brussels has tabled proposals to liberalize and unify the EU's energy market. But most of the same member states that prefer special relationships with Gazprom, are also the ones attempting to water down the proposed legislation's provisions on competition. The benefits however are clear: a common market would increase incentives for firms to develop EU-wide grids, and improve the interconnection of energy routes between member states. That would facilitate the re-routing of gas supplies to needy areas in case of emergency, such as gas supply disruptions. It would also tilt interests in favour of a common position towards Russia.

The economic downturn should not induce the EU to be complacent about acting. One needs to bear in mind that the longest-ever supply disruptions, those that occurred this January, did so at the height of Russia's economic downturn. It was among others an attempt by Gazprom to secure better prices for itself. The crisis is a danger rather than a respite from energy problems. If the EU wants its way with Russia, member states in the EU will need to finally clean up their own act and bring in more competition in favour of EU consumers. They must now agree to fully apply to themselves the principles, competitive markets and economic integration they happily preach to others, not least to Russia. Europeans and Russians should not let themselves be misled by President Medvedev saying the ECT is tilted too much in favour of consumers. Adam Smith himself warned against "the interested sophistry of merchants and manufacturers." The latter's "interest is... directly opposite to that of the great body of the people." Who wants the terms of Europe's energy markets to be determined by a few competition-shy national champions keen on doing cosy deals east and west of the border between the EU and Russia?

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