Executive Summary

In December of last year, Russia and the EU agreed on moves towards visa-free travel and funds for indebted eurozone countries. An important step – certainly - yet no breakthroughs were reached on perhaps the most important topic of all, energy. Fraught with incidents in recent years, in particular the 2006 and 2009 gas crises with Ukraine end the frequent interruptions of oil supplies through Belarus, mutual energy relations are in need of a positive stimulus.

Key problems over the years have been the differing views on reciprocity in energy market access following the adoption of instrumental legislation both in the EU and Russia, the difficulties to reach agreement on a successor to the 1997 Partnership and Cooperation Agreement (PCA), and Russia’s role in the Energy Charter Treaty (ECT) after its continued refusal to ratify the Treaty. Finally, many commentators and analysts have repeatedly pointed to the seeming inability for the Union to form a coherent whole in its energy relations towards Russia as the source of many of today’s difficulties.

This Policy Brief argues that the solution to many of these problems can actually be found through making changes within the Union or through creative engagement within the Energy Charter Treaty (ECT), rather than focusing squarely on Russia itself.

*The views expressed in this policy brief are the authors' and in no way reflect the views of the European Commission.
Equal Market Participation

Reciprocity in energy market access is a topic which throughout the years has featured consistently at the top of the EU-Russia agenda. Over time, the issue has come to mean different things on either side of the partnership however. For the EU, reciprocity pertains to openness of the internal energy market in exchange for access to foreign markets. Similarly, reciprocity allows for the protection of the internal market against those states that have not liberalised their energy sectors in equal measure. Russia however, sees reciprocity in relation to the status of the long-term supply regime that exists in international gas trade. It deals more with quantitative exchanges, such as ‘volumes-by-volumes’, or asset swaps. At the same time, investment reciprocity stems from any political accord between the actors involved.1

In essence, the matter is best illustrated through, on the one hand, the rules on third country operators within the EU internal energy market within the ‘third legislative Market Package’, and the amendment of existing and adoption of new Russian legislation on the participation of foreign companies within its energy sector. In 2007, the European Commission tabled a package of proposals to reform the internal energy market. The package included strong rules on the separation of networks from activities of production and supply ( unbundling) and a reciprocity clause – popularly dubbed the ‘Gazprom clause’ – which raised eyebrows not only in Moscow2, but also within the EU.3

After vehement opposition to full ownership unbundling in several EU Member States – France and Germany in particular – an agreement was reached where companies will be required to choose one of three options of unbundling – full separation of transmission and production, handing over the management of the grid to an independent operator or keeping the transmission business but under strict supervision by a mixed body which includes third party shareholders.4 Moscow however continued to view unbundling as a threat to the ability of its investors to acquire a reasonable income and might possibly therefore look to the Chinese market. Moreover, the Kremlin claimed that limiting Russian investment in the Union could prevent asset swaps that could give European energy companies access to Russia’s vast reserves, in for example Western Siberia.5

Conversely, what caused most consternation in Brussels were the adoption of the Russian ‘Law on Foreign Investments in Strategic Sectors’ in April 2008 and the subsequent amendment of its ‘Law on the Subsurface’. The former obliges foreign energy companies to notify the government if they hold at least 5% of shares in strategic oil and gas companies and obtain preliminary consent if they wish to acquire more than 50%.6 The latter’s amendment meant that subsoil parcels of federal significance on the continental shelf may only be grated to Russian legal entities that have at least 5 years experience of the Russian continental shelf exploration/production and are at least 50% controlled by Russia – granting a de facto monopoly to Gazprom and Rosneft.7 With Europe interested in the Western Siberian gas fields and Gazprom
keen on expanding in the EU, this mutual exclusion is certainly not to anyone's benefit.

**PCA/ECT?**

Negotiations on a new PCA have been ongoing since November 2007 and the end is not in sight yet. Similar ongoing difficulties are seen with the ECT and its Draft Transit Protocol (DTP) which Russia never ratified. Instead, Moscow opted to apply it provisionally \(^8\), until it announced it would cease provisional application on 20 August 2009. \(^9\) Both issues share many similarities, as in the eyes of the EU a new PCA should be firmly based on the principles of the Charter, as well as reciprocity, transparency and non-discrimination. \(^10\) Russia however sees full ECT implementation, among other things, as a free entry to its energy production and transport infrastructure and is not sure it gets something of equal value in return, both in terms of assets as well as regulatory protection. \(^11\)

Whereas, the EU seems to favour a PCA that contains precise wordings on energy, and energy security in particular, based on exporting the Union’s *acquis communautaire*, Russian President Medvedev rather supports a document that is ‘short, without too many details’ and would leave provisions for cooperation in different sectors to special protocols or agreements. \(^12\) However, for Moscow to reach an agreement that is incompatible with EU law is just as unlikely as for the Union to convince Russia to include ECT principles within a new PCA, particularly as it viewed the Treaty as unable to play an active role in preventing and solving the crises with Ukraine. \(^13\)

However, the most fundamental issues relate to the problem of ‘contractual mismatch’ and the *nature* of transit within the Union. Contractual mismatch refers to the fact that the duration of long-term export supply contracts often does not match the duration and/or volume of the transit contract provided to the shipper by the owner/operator of the transport system within an unbundled market. \(^14\) The crises with Ukraine were often a result of this mismatch and the inability of parties to reach agreement before the contract expired. To solve this issue, Gazprom suggested granting a priority right for an existing supplier with a long term contract for rebooking transport capacity in cases where the long term contract was still in place. \(^15\) However, the EU saw this as violating its competition rules and quickly rebuffed the idea. \(^16\)

The other issue is that under Art. 7 ECT transit refers to the crossing of the territory of both the EU as a whole and of its individual Member States. However, pursuant to Art. 20 DTP – as proposed by the EU – transit constitutes merely crossing the territory of the Union as a whole and not of individual Member States as such. \(^17\) The application of the DTP within the EU has been an issue since 2002, ever since Brussels first proposed Art. 20 DTP. The stricter nature of this article compared to Art. 7 ECT would limit the application of the DTP to cases where energy originates from a third country and passes through EU territory destined for another third country. \(^18\)

However, the problem here is that a few years back, a new wording was introduced in Article 20 DTP. The new article states that ‘the rules of a Regional Economic
Integration Organisation (REIO) provide an overall standard at least equivalent to that resulting from the provisions of this Protocol'. For Russia, this overall standard is not enough as it would have to be at least a similar standard. Russia feels it is thus left relying on the ‘goodwill’ of the EU. Moscow has since never given up that the EU might be ready to surrender this provision, but for Brussels this remains a sine qua non.  

Coherence in External Energy Relations

One of the most important questions for the EU is how to rationalise its energy policy, enabling the Union to be the central actor, as opposed to a set of disparate Member States. The former is preferred by the European Commission and various Member States, whereas some of the larger Member States tend to prefer the latter. Pursuing individual barter deals, however, inadvertently creates possibilities for elites in supplier countries to pursue their own ‘reciprocity rules’, i.e. not limiting demands to capital, arguing more substantial trade-offs are necessary in order to get things done, such as asset swaps. The monopolistic and quasi-statist character of such energy markets thus remains unchanged. Moreover, the myriad of individual Member State actions often blur the view of third countries on what the EU really wants to pursue in its external energy policy.  

Intra-EU divergences have led to several Member States forging deals with Russia for the creation of gas pipeline projects, in spite of the fact that the Union’s overall goal is diversification. In fact, the signing of bilateral energy contracts with suppliers such as Gazprom is repeatedly mentioned as the single biggest undermining factor of a coherent external energy policy. Much cited examples were the decisions on the construction of the Nord Stream gas pipeline and the fact that Gazprom has managed to secure the support of several EU Member States for its South Stream pipeline in spite of the Union’s diversification agenda.  

Asked about whether the European Commission could play a larger role in terms of coordination, some Member States are swift to point to the lack of competences over energy at EU level, claiming energy policy is a Member State responsibility. Others merely refer to the split in competences between the Commission and Member State level and the extent to which Member States are (un)willing to confer theirs – leaving the Commission sometimes unable to deliver on its promises.  

The fact that EU Member States sign individual cooperation agreements with Gazprom undermines the Union’s diversification efforts. In an attempt to harmonise Member State efforts, the European Commission recently proposed to set up an information exchange mechanism on international agreements between Member States and third countries – including those which are still under negotiation. Furthermore, it suggests that such agreements can also be negotiated at EU level if they have a large bearing on the Union’s energy policy objectives, and where there is a clear
common EU added-value. Some progress in this area has already been achieved in the form of a Council mandate to negotiate a legally-binding agreement with Azerbaijan and Turkmenistan on the construction of a TransCaspian pipeline. Turkmenistan subsequently announced it would start work on the contractual and legal basis for supplying gas to Nabucco. Russia however was quick to remind the EU that such a pipeline would violate the interests of Caspian states and could damage the environment.

Currently, some of the bigger EU Member States are still not convinced that a truly common energy policy is in their interests. Different energy exposures are largely seen as preventing a strengthened commitment to energy’s external dimension. Whereas some of the EU’s Central and Eastern Member States are positive towards a larger role for the European Commission, countries such as France, Germany, the UK, Italy and the Netherlands – are not too eager on having their sovereignty limited as they view their market size and power as a sufficient defence against any threat posed by external dependency. It seems therefore that the Central and Eastern European Member States feel they need the support of the European Commission to keep up on par with the ‘bigger’ Member States when it comes to energy.

Recommendations

In the energy relations between the EU and Russia, reciprocal market access remains one of the thorniest issues. However, the fact that Europe is concerned about a lack of upstream access to Russian hydrocarbons and in exchange limits Moscow’s participation within its internal market insofar as such participation is not in line with ownership unbundling rights, should not necessarily result in stalemate where each party is afraid to make the first move. It is fair to assume that hitherto Brussels has had little leverage in Moscow to ‘persuade’ Russia to change its position on the matter. Moreover, any such attempts were undermined by the dividedness between ‘old’ and ‘new’ Europe and the former’s preference for doing business bilaterally, rather than in a concerted effort. Therefore, rather than trying to influence the Russian position and be hampered by internal dividedness, it is more worthwhile for the Union to look into its own market structure instead.

Looking back, it becomes clear the European Commission was already well aware of this when it tabled its Third Legislative Market Package in 2007. Resistance from Germany and France in particular prevented the EU from moving towards a system of full ownership unbundling however. This has led to a situation where currently exceptions to full ownership unbundling are allowed of which Europe’s larger energy corporations such as French GDF/Suez and German E.ON Ruhrgas and RWE are seen as profiting. Not surprisingly, when at the same time strong restrictions are in place against potential ‘vertically integrated’ third country entrants, Moscow perceives this policy as unfair and constituting a double standard. As
long as this situation persists, Russia is unlikely to move on reciprocity. However, by granting access to competing firms, full ownership unbundling would all but rule out market abuse by big, vertically integrated companies; both EU ones, as well as Gazprom. Therefore, in the longer term it seems more advantageous for the Union to instigate a new attempt at across-the-board’ unbundling, rather than granting continued existence to current compromise measures.

A more immediate problem however is the need to work towards an encompassing new bilateral EU-Russia agreement and find a solution to the future role of the Energy Charter Treaty (ECT). Next to key substantive issues such as a the legal nature of a new Partnership and Cooperation Agreement (PCA) and the EU’s status as a Regional Economic Integration Organisation (REIO) in the ECT, it seems that part of Russia’s disquiet stems from that it perceives its concerns are not taken seriously enough by the EU. However, there seems little chance for Russia that the Union will change its position on the legal nature of such an agreement, or that it will abandon the rules of the ECT altogether. Taking this into account, a first step in rapprochement will have to be found in less controversial, but therefore no less important issues.

As a start, one such matter could be an attempt at solving the broader issue of contractual mismatch between long term supply contracts, and (often) shorter term transit contracts. Current discussions within the Energy Charter on an alternative transit allocation system may prove useful in this regard. What is discussed is that when transit capacity is requested and cannot be granted due to a supply contract, the applicant party would be placed on a waiting list. In order to enter up on this waiting list, one has to undergo a non-discriminatory selection practice. If transit capacity could ultimately – for some reason – not be granted, it should be created. Such a system has the potential to avoid costly ‘transit conflicts’ such as the ones in January 2006 and 2009. This would be a great improvement in European energy security, as well as a boost for Russia’s tainted image as an energy supplier. Such a system could possibly assure the EU that its rules on competition are respected, and convince Russia that its concerns are heard, incumbents are treated equally, and construction of new transit capacity is not ruled out a priori.

Finally, it should be reminded that the Union’s collective efforts risk being undermined if there is a lack of coherence between the actions of EU capitals on the one hand and those of Brussels on the other. A recent proposal as put forward by former Commission President Jacques Delors for Member States willing to cooperate more strongly on energy to engage in ‘enhanced cooperation’ has a certain value in this regard. As indicated by interviewees there seems a split between some of the Union’s ‘old’ and ‘new’ Member States on how to engage third country suppliers like Russia. For that matter, it is unlikely to expect a change from the status quo – of dealing largely bilaterally with third country suppliers – to come from countries such
as Germany, France, Italy, the Netherlands or the UK.

Drafting a new energy treaty altogether is unlikely to receive the necessary support of the above mentioned Member States. Therefore, in the medium to long term, it would be more worthwhile for those Member States who have the most to benefit from more concerted action at EU level – including Poland, Latvia, Lithuania, Estonia, Hungary, Slovakia, Slovenia, Czech Republic, Bulgaria and Romania – to engage in pragmatic and voluntary cooperation along the lines of a ‘Schengen for energy’. If, over time, this could develop into a more institutionalised practice, it could potentially attract other countries along the way and strengthen its presence within the EU system.

In the end, if coherence in external energy relations is not to be reduced to an ‘empty phrase’ which is continuously repeated, yet not acted upon, it is of great importance that the Lisbon Treaty will be utilised to its full potential. It is imperative in this regard that energy becomes a central element in the work of both the HR/VP, as well as the EEAS. For, ultimately it is only good cooperation between the HR/VP, EEAS and the Commissioner for Energy on the one hand, coupled with coherent Member State action on the other that can improve the current situation.

2 The original proposal reads that companies from third countries [who] wish to acquire a significant interest or even control over an EU network, will have to demonstrably and unequivocally comply with the same unbundling requirements as EU companies, allowing the Commission to intervene where a purchaser cannot demonstrate both its direct and indirect independence from supply and generation activities.

3 France, Germany, Austria, Bulgaria, Cyprus, Greece, Latvia, Luxembourg and Slovakia opposed full ownership unbundling, with France and Germany leading the charge and initially only won support from the UK, Spain, Sweden, and the Netherlands. Interviews with officials from EU Member State Permanent Representations on 19 and 23 April, 12 and 13 May, and 10 June 2010.


7 S. Seliverstov, (2009), *supra* note 6, p. 17; K. Hóber, (2009), *supra* note 6, pp. 438-439. Subsoil parcels of federal significance include all subsoil parcels in the internal waters, territorial sea and continental shelf and other parcels that contain extractable reserves over a certain threshold. Any field with – or with more than – 50 billion cubic metres of gas or 70 million tons of oil.

8 Provisional application is provided for by Art. 45 ECT. Russia linked ratification of the ECT to reaching an agreement on its Transit Protocol.


Interview with official from Energy Charter Secretariat, 13 October 2010. Others admitted that the negotiation process on this matter has been long, but without much result. Interviews with officials from EU Member State Permanent Representations, 23 April, 12 May and 7 June 2010.


See K. Hóber, (2009), supra note 6, p. 423; and R. Youngs, (2009), supra note 5, pp. 82-84, 86-87, 91 and 96; Interviews with officials from EU Member State Permanent Representations, 19 April and 23 April 2010; and interview with official from cabinet of Jacek Saryusz-Wolski, MEP, 26 April 2010.


Interviews with officials from EU Member State Permanent Representations, 12 May, 5 May, 13 May, 19 April, 23 April, 20 May, and 19 April 2010; interview with official from cabinet of Jacek Saryusz-Wolski, MEP, 26 April 2010; interview with several officials from European Parliament Directorate-General External Policies, 5 March 2010.

Nord Stream is a natural gas pipeline linking Russia and Germany via the Baltic Sea.

South Stream is a proposed gas pipeline to transport Russian natural gas to the Black Sea to Bulgaria and further to Italy and Austria. It is seen as the rival to the EU-backed Nabucco pipeline.

Interviews with officials from EU Member State Permanent Representations, 10 and 24 June 2010.

Interviews with officials from EU Member State Permanent Representations, 23 and 19 April 2010; interview with official from European Commission DG Energy, 26 March 2010.

COM(2011) 539 final of 7 September 2011, pp. 4-5.


34 Interview with official from EU Member State Permanent Representation, 10 June 2010.


