

## **Why a Political Accord is Needed to Make EU-Russia Energy Relations Work (WP)**

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### Introduction

*A secret of politics? Make a good treaty with Russia.*  
Otto von Bismarck, 1863

EU-Russia relations have entered into a spiral of misunderstandings and of an unprecedented 'securitisation' of energy-related affairs. The concept of energy security has gained a much broader meaning than that of simple energy dependency and supply shortages. The concept of energy security stems from general perceptions of threats coming from 'outside' and, in the case of the EU, Russia represents a 'natural' threat to energy security.

Russia's reaction to the European securitisation of energy supplies has, by and large, been to reject European regulatory norms and practices. Due to the growing political divide and values conflicts, the currently existing frameworks for cooperation between Russia and the EU have demonstrated their shortcomings. For instance, the EU-Russia Energy Dialogue, designed in 2000 to increase mutual understanding, appeared to be next-to-useless during the recent gas crisis.

In addition, Russia continues to delay the ratification of the multilateral Energy Charter Treaty (ECT) and explicitly rejects its dispute-settlement mechanisms. The Energy Charter was signed in the political context of 'seminar diplomacy' during the so-called 'democratic romantic period', characterised by a cooperative semantic in international relations. Likewise, during the same period, the Organisation for Security and Cooperation in Europe was created out of the Conference for Security and Cooperation in Europe, accompanied by a number of declarations, such as the Paris Charter of Human Rights and the Bonn Charter on economic cooperation. The principles of market economy emerged as the dominant factor in inter-state relations. In this context, the aim of the Energy Charter was to find mutual interests between producing and consuming states of the post-Cold War area. Once the 'romantic period' of East-West relations was over, the Energy Charter's political dimension was marginalised. Moreover, the Energy Charter itself was progressively marginalised within the EU's general energy strategy.<sup>1</sup> Instead,

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<sup>1</sup> For instance, the Energy Charter is not mentioned in major EU documents on energy policy and energy security (*White Book of 1996* and *Green Book of 2000*). However, it is mentioned in the *Green Book of 2007* but

the EU simply began to export its own legal regime, through the Energy Community Treaty, to non-Member countries.

Given the exportation of EU norms, the Energy Charter is wrongly viewed as an instrument of pressure from Brussels with respect to Moscow. Consequently, some Russian officials and analysts suggest removing the country's signature from the Treaty. Nevertheless, President Medvedev has proposed either to revise the Treaty substantially or to conclude a totally new agreement with the EU.<sup>2</sup> For Europeans, however, this is taken as another signal that Moscow is not a trustworthy partner, a claim which Russia, in turn, repeatedly and consistently denies.

In this context, the EU's own policy perspectives are also unclear. Expanding the Energy Community Treaty through the *acquis communautaires* to the EU's largest energy supplier has already proved to be impossible due to the significant discrepancies in regulatory approaches in the EU and Russian gas sectors. Indeed, Russia remains sceptical as regards the EU's liberalisation model (still incomplete and under construction), which is seen by many in Europe as a *panacea* for Russia as well. Moreover, the EU Member States themselves are still divided on the extent to which energy security should be considered, or moved to, a supranational domain.

Despite the political turmoil, however, the energy ties between the East and West of the continent have been reinforced in recent years. It is no surprise that since the EU's enlargement, Russia has become its largest oil and gas supplier and that the lion's share of Russia's government revenues now comes, at least indirectly, from the EU. Furthermore, the January 2009 crisis between Russia and Ukraine clearly showed how Russia and the EU stick together as a result of their mutual dependence (ie, Russian energy revenues from Europe and EU export sales to Russia).

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 regionalisation of international oil geopolitics. The rise of Islamic extremism in the Middle East, US intervention in Iraq and the subsequent destabilisation 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 back in 2004. Russia is a valuable alternative to the Middle East, being the second-largest producer of oil in the world after Saudi Arabia and holding almost 13% of the world's proved oil reserves. Moreover, Russia remains the only non-OPEC country where the production to reserve ratio remains positive.

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only regarding EU-Russia relations.

<sup>2</sup> *Union Newsletter*, nr 06 (127), 6/II/2008.

The second factor is the rapid growth of natural gas in the EU's energy consumption mix. The EU's liberalisation of the gas sector was an attempt to create an integrated gas market whose success is highly linked to the availability of supply. In this respect, 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 financial 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. Thus, 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. Moreover, the liberalised electricity market has given rise to new opportunities for cross-border trade. In the liberalised 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 CO<sub>2</sub> emissions by 8% by 2012, compared to the 1990 level, in order to meet its commitment on climate change. However, the three largest EU economies, Germany, France and the UK, have exhausted their own potential for emission abatement, which makes the targets more difficult to achieve. By contrast, the Russian economic depression of the 1990s caused a decline in emissions and led to an increased energy consumption per capita despite the decrease in gross energy demand.<sup>3</sup> Hence, there is a growing potential for an environmental market.

An analysis of Russian energy policy provides a set of analytical puzzles about where norms and practices might be closer to European ones and where Russia will maintain its own national specificity. As will be observed, the energy relations between Russia and Europe are much better than their political relations. The idea put forward in this paper is that a strong political accord, which would strengthen the relations between the EU and Russia in general, and hence improve relations in all energy sectors, should be pursued by both parties. Energy interdependence does not reduce the risk of political conflict: the UK and Germany had very close economic relations immediately before WWI.

This paper will mainly address Russian policy issues. The four areas mentioned above represent very different fields of the energy sector. The oil sector comprises a strongly business-oriented group of companies which are not highly politicised, in contrast to how they are often presented in the European mass media. The gas sector, by contrast, continues to be a major political tool of Russian foreign policy. The electricity sector is in

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<sup>3</sup> International Energy Agency, *Russia Energy Survey*, Paris, 2002.

the process of rapid liberalisation. Finally, the environmental dimension of energy policy is starting to make its presence felt in Russia's strategy.

### **The Russian Oil Sector: The Emergence of New Business-oriented International Majors**

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.<sup>4</sup> 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 shadily privatised. 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, accounting for only 15% of the national oil production output. In the meantime, between 1991 and 1998, Russia's GDP was down by around 40%. After having lost its natural domestic petroleum market, oil production also decreased significantly: in 1998 it was at around 59% of its 1990 level. Only since 1999 has an increase of oil exploration and production been observed.

From the start of the new century, Russia has moved progressively from chaotic liberalisation and shady privatisation towards the transformation of major oil companies into international majors. The biggest merger was concluded between TNK and British Petroleum. The deal's main outcome was an unprecedented build-up in the capitalisation of both TNK and BP in Russia. Other private oil companies, such as Lukoil and Surgutneftegaz, started to build a larger international profile as well.

Since 2003 we have observed a move by the state towards establishing a more active control over the state's positions in the oil sector through a process of consolidation. A daughter company of Yukos, Yugoneftegansk, was taken over by Rosneft in 2004, with a positive effect on its production rate as it increased from 900,000 bpd in 2003 to 1,400,000 bpd in 2007.<sup>5</sup> Only since this consolidation has Rosneft become the leading Russian oil producing company and one of the world leaders in oil reserves. In spite of its state-owned structure, Rosneft has proved its efficiency and willingness to become a truly international player by purchasing assets abroad. Russian political involvement in the oil sector remains, however, rather weak if we compare Moscow's passive strategy to the US's active support of its foreign oil companies in the past.<sup>6</sup>

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<sup>4</sup> The best example is the conflict between the TNK's and BP's shareholders on the foreign acquisition strategy of their 50/50 owned company TNK-BP.

<sup>5</sup> TEK Statistics, Moscow, 2008. See also J. Lee, 'Oil Sector in Russia', Conference at the Centre for Global Energy Studies, London, 26/VI/2008.

<sup>6</sup> S. Randall, *US Foreign Oil Policy since World War I*, McQueen University Press, 2005.

In the West, the influence and power of Rosneft is often viewed as a sign of the state's political reinforcement over the oil sector. However, the influence of Russian private oil companies –Lukoil, Surgutneftegaz and TNK-BP– was demonstrated when the new gas export law was adopted in 2006, which imposed a state monopoly on the export of natural gas and LNG. The oil companies managed to exempt gas condensate located in mixed fields, which belonged to them, from the new law.<sup>7</sup> Currently, both private and public companies are lobbying for the de-monopolisation of Gazprom's gas exports. The oil companies would like to commercialise their huge reserves of natural gas at an international level. The state-owned Rosneft is in full agreement with the private oil companies' position on the issue, proving the existence of an 'oil lobby' in Russian politics which does not depend on the ownership structure of the players involved.

Unlike production and supply, the oil pipeline sector, which has the world's largest network, is mainly regulated by the state-owned company Transneft.<sup>8</sup> Again, Transneft is often considered a tool of Russian foreign policy. In the Western-mass media<sup>9</sup> the closure of some branches of the export oil pipeline network to the Baltic States (and Belarus in the mid-term) has often been held up as an example of political pressure by the Russian state.<sup>10</sup> However, Transneft's 'political strategy' in the pipeline closure has arguably been exaggerated. Historically, the Druzhba oil export pipeline was initially designed to supply the Eastern European markets and it therefore has a telescopic structure, ie, the further West it goes the smaller the pipeline's diameter, implying an increasingly limited capacity the closer it gets to Central Europe. Nowadays, oil companies are attempting to increase their exports to Western Europe and prefer to use national sea terminals as the Druzhba pipeline allows them only a limited export capability. Therefore, rail oil delivery to the oil terminals has also increased recently. It is for these reasons that Russian investment strategy is oriented towards a higher utilisation of oil terminals and to reducing exports via the economically outdated Druzhba pipeline. Consequently, the partial or –perhaps in the future– total closure of Druzhba is a business –and not political– decision.

Another contributing factor in the securitisation of the Russian oil sector is European –in essence mainly British– investment in the Russian upstream market. According to Walde,<sup>11</sup> tensions between an oil producing State and foreign investors always emerge during a sustained period of high oil prices. The Russian state, during such a period, attempted to increase its share of oil export profits that had largely benefited the

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<sup>7</sup> See CERA report, 'Is it Gas?', Moscow, 2006.

<sup>8</sup> Russian legislation allows private pipelines. The largest private pipeline runs between the Caspian and Black seas (the Caspian Pipeline Consortium). Smaller pipelines are operated under production and sharing agreements.

<sup>9</sup> BBC News, 6/1/2007.

<sup>10</sup> K. Smith, *Security Implications of Russian Energy Policies*, Centre for European Policy Studies, Brussels, 2006.

<sup>11</sup> T. Walde, 'Renegotiating Acquired Rights in the Oil and Gas Industries: Industry and Political Cycles Meet Rule of Law', *Journal for World Energy Law and Business*, vol. 1, num. 1, Oxford University Press, May 2008, p. 55-98.

corporate sector. Its attempt showed the stronger state control over the taxation of oil production fields and *de facto* substituted Production and Sharing Agreements by a licensing system. More recent Russian legislation has adopted a new strategy for the control over resources and taxation. The new legislation does not prevent foreign companies from participating in the upstream market but in some 'political' cases it does force the renegotiation of agreements. Such was the case with the agreements between international investors –Shell in Sakhalin and BP in Kovykhta– and the Russian state-owned company Gazprom. Again, these projects related to the gas sector, which remains very different from oil.

Russian oil companies, whether national or private, are not interested in closing the door to foreign investors domestically because their own overseas investment strategies bring in considerable profits.<sup>12</sup>

### **Natural Gas: Impossible Market Relations without Political Involvement**

If the oil sector is a global market *per se*, 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.

Difficulties in the regional gas trade are related, primarily, to intra-Former Soviet Union (FSU) trade rather than to Russia-EU relations. In the USSR, under the command economy, the energy sector was entirely submitted to governmental control. The availability of energy has long been considered *a right* rather than a good or service and access to cheap energy allowed the development of non-energy industries as well as contributing to overall GDP growth. Since its transition to a more market-oriented economy, Russia has maintained a monopoly in the gas sector. More recently, in order to protect its sovereign rights over these strategic sectors and to avoid future 'wild' privatisations, such as those that occurred in the 1990s, Russia named them 'natural monopolies'. It is necessary to emphasise that the underlying essence of a 'natural monopoly' in Russia is different to what is understood by the term in the West. Unlike the oil sector, in the gas sector commercial considerations are of secondary importance to considerations of national political stability.

The concept of the 'right' of gas supply has remained valid across the FSU despite its transition to a more market-oriented economy. Gas prices have been set by bilateral political accords at the intergovernmental level and subsequently covered by confidential inter-company agreements that specify the conditions for gas supply and transit. Dispute settlement mechanisms are usually restricted to a short sentence in the agreements, stating that 'disagreements are to be settled amicably between the parties to the dispute'.

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<sup>12</sup> The issue of investment reciprocity is analysed separately. See A. Belyi, 'Reciprocity as a Factor of the Energy Investment Regimes in EU-Russia Energy Relations', *Journal for World Energy Law and Business*, Oxford University Press, forthcoming April 2009.

Since 2002 the Russian gas monopoly has attempted to reshape these tariff-trade agreements to make them more profitable. For instance, at the European level, the gas price is set in accordance with the ‘replacement value’, which means that it is indexed to the oil product price.<sup>13</sup> International practice demonstrates that the economic rent gained from the gas trade is calculated not only on a cost-basis but also in accordance to what the consumer is ready to pay for it. Therefore, the gas tariff is linked to the oil product price, making the calculation of the gas rent margin easier. Even after the introduction of gas-to-gas competition, as in the UK, the gas price still follows the oil price dynamic.<sup>14</sup>

Instead of applying the net-back model, Russia has allowed its direct neighbours, Belarus, Moldova and the Ukraine, to enjoy lower tariffs through direct bilateral political agreements. In turn, barter agreements have allowed Russia to avoid additional payments for gas transit. For instance, up to 30 bcm were supplied to the Ukraine as a transit fee. From the Ukrainian side, the tariff method included barter payments in natural gas and further cash payments. Parts of the payment have been offset against Ukrainian debts outstanding to Russia for gas supplies in the 1990s.<sup>15</sup> All long-term contracts between Russia and the Ukraine included a clause, called the destination clause, which placed restrictions on the resale of gas. In exchange, the Ukraine was allowed to re-export up to 6 bcm of gas to Europe at a higher price than that at which it bought the gas from Gazprom.<sup>16</sup>

Since the early 2000s Gazprom has been suggesting a transition into a market-based mechanism for intra-FSU trade.<sup>17</sup> However, Gazprom faces two major difficulties, the first being that it wants market-based relations to be founded upon a monopolistic access to pipelines and exports. The second is that any transition towards a new trade and tariff system in the gas sector needs to take place within a positive political context.

The first difficulty is purely inherent to Russia. The second one depends to a significant degree on its relations with the Ukraine, the largest transit country in the FSU –and these relations worsened after the ‘Orange’ revolution in Kiev–. It is sometimes argued that the new Ukrainian authorities deliberately deteriorated their relations with Moscow in order to appear the victims of their big eastern neighbour and therefore come closer to the EU by seeking its protection. On these grounds, the Ukraine did not hesitate to use its strategic transit position to exert pressure on negotiations with both Moscow and Brussels.

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<sup>13</sup> A. Konoplyanik, *Russian-European Energy Relations and the Role of the Energy Charter*, State University-Higher School of Economics, November 2007.

<sup>14</sup> International Energy Agency, *Natural Gas Market Review*, 2006, p. 80.

<sup>15</sup> For details of gas transit methods in the Ukraine, see Energy Charter Secretariat, *Transit Tariffs*, 2006, p. 60.

<sup>16</sup> Official Gazprom statistics, [www.gazprom.ru](http://www.gazprom.ru).

<sup>17</sup> See also J. Stern, *Future of Russian Gas and Gazprom*, Oxford Institute for Energy Studies, 2004.



The first important gas crisis between the two countries occurred in January 2006. It prompted a wide-ranging reaction in Europe even though the impact of the crisis was not very significant in supply terms. For instance, gas shortages due to the weather were no less important than the transit dispute.<sup>18</sup> However, the January 2006 crisis provoked a higher degree of politicisation of energy security concerns regarding Russian gas supplies. Indeed, since January 2006 energy security became formalised as an issue in the EU's Common Foreign and Security Policy, which shows energy being considered beyond its simply economic dimension.

There is, in addition, a discrepancy between European and Russian attitudes towards how the crisis was brought about. For most of the European countries, the gas dispute is mainly a political issue, whereas for Russia it is the result of the Ukraine's inability to pay free-market prices for its gas.

The extreme politicisation of energy trade and transit issues only started at the beginning of the 2000s. During the Cold War era the systemic conflict between the two antagonistic blocks did not hinder energy cooperation, particularly in economic terms. On the contrary, security of energy supplies from the USSR was not at the top of the agenda of the Western European states. During the oil shocks provoked in part by the actions of the OPEC, the Arab world was considered the prime component of the energy security issue. Then, during the 1990s, energy trade and transit issues were not the object of wide political debate although transit theft and non-payment were already occurring. However, it was the rising share of natural gas in Europe's energy portfolio and in electricity generation following liberalisation, along with environmental policies, that extended the scope of the economic dimension of energy security.

The crisis of 2006 was resolved by a somewhat cosmetic agreement which led to the establishment of a new joint venture, RosUkrEnergo, which is jointly owned by Gazprom and Naftogaz. The aim of the new joint venture was to supply the Ukraine with gas, while all transit to Europe remained Gazprom's responsibility. Despite this apparent change in the relationship, Russia and the Ukraine otherwise maintained a similar general framework whereby tariffs were adjusted politically without oil product indexation, dispute settlement mechanisms remained unclear, and all issues related to volumes and supplies were still agreed by annual Protocols. The agreement concluded in 2006 maintained a very important feature inherited from the past: gas trade and transit relations remained mainly based on political accords between Moscow and Kiev. Both trade and transit continued to be opaque.

By the end of 2008, the Ukraine was still unable, and unwilling, to adapt to the net-back tariff policy and continued to reject proposals regarding Gazprom's control of the networks. A deep political divide emerged as a result of the lack of an agreed legal

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<sup>18</sup> For details on the crisis see J. Stern, *The Russian-Ukrainian Gas Crisis of January 2006*, Oxford Institute for Energy Studies, January 2006.

framework for energy trade, tariffs and transit. In addition, the Ukrainian political classes were unable to reach an agreement on energy, further complicating the situation.<sup>19</sup>

Moreover, it should not be forgotten that the crisis in 2009 occurred only a few months after the Georgia-Ossetia conflict, in which Russia intervened deep inside Georgian territory. The fact that Russia is the main political peacekeeper in the region is not new, as it has continued to exert its power and influence since 1994. However, the military operation of August 2008 was the first large action by Moscow within another sovereign State since the collapse of the USSR. This shocked the political elites and wider society in most EU member states. Nevertheless, most of them refused to isolate Russia politically mainly due to the energy supply issue.

The Ukrainian political position during the Caucasian conflict was opposite to that assumed by the Russians. The Ukrainian President backed Georgia's actions and attempted to foster a wider and stronger political coalition against Russia. The political divide between these two countries has further deepened since Ukraine's request to join NATO and since it started to object to the Russian naval presence on the Ukrainian Black Sea coast. As expected, part of the Ukrainian political elite decided to purposefully worsen relations with Russia in order to feel closer to the West.

These factors constituted grounds for Russia to adopt an even stricter negotiating position with the Ukraine. Indeed, after the Ukrainian refusal to sign an agreement with Russia, Gazprom had no legal or political grounds to continue supplying the Ukraine with gas. The issue of the Ukraine's debt to Gazprom –around US\$2 billion– has also been the subject of a political accord: Russia emphasised its importance by refusing the usual debt restructuring. By contrast, in many other situations –as in the case of Belarus and of buyers of weapons in the Middle East– Russia usually supports debt restructuring.

Nevertheless, both parties tried in vain to find a solution till the very end of 2008. Gas supplies to the Ukraine were reduced, but not those to Europe. However, the legal complexity of gas trade and transit, including barter agreements, rendered some additional complexity to the exercise. For instance, the Ukraine usually takes around 15% of the natural gas for its supply facilities, prompting Russia to accuse it of unlawful appropriation.

It is important to consider the opacity of the negotiations as well as the lack of transparency regarding transit flows. Russia accused the Ukraine of taking more than the transit flow required. The Ukraine, in turn, accused Russia of under-supplying gas. Consequently, the situation was similar to the crisis of January 2006. The difference, however, is that neither party made any further effort to reach an agreement.

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<sup>19</sup> The main conflict was between President Yushenko, who took a hard-line position, and Prime Minister Timoshenko, who preferred a compromise with Russia.

As far as gas transit to Europe is concerned, an appropriate agreement is still in force until 2010. Nevertheless, the Ukraine claimed the right to increase transit fees for Russian gas in response to the gas supply increase. On 5 January a Kiev court banned the transit of Russian natural gas via the Ukraine by Naftogaz at the tariff previously agreed with Russia (US\$1.6/1,000 cubic metres/100km in 2009). On 6 January Gazprom's European partners noticed a significant under-supply in the south-westerly direction (towards Austria and Italy). Under pressure from the threat of further transit gas theft, Gazprom decided to halt all transit flows via the Ukraine. In turn, Gazprom requested that the Ukraine compensate supplies with its own reserves because of the previous thefts. The Ukraine rejected the deal and real gas shortages were consequently felt in some European countries. The crisis lasted for almost two weeks. Unlike the 2006 crisis, however, the perception of threat regarding FSU gas supplies were closer to the actual supply situation and therefore accelerated the securitisation of energy in Europe.

The crisis of January 2009 also gave a boost to the EU's policy in the FSU region. In January 2006 the EU (both the Commission and the member states) failed to provide mediation for the crisis. Furthermore, due to a high level of securitisation, EU policy focused more on Russia as a security issue than on the need for an agreed political and legal framework between Russia and the Ukraine. Between 2006 and 2009 the EU placed energy security, particularly as regards Russia, at the top of its agenda. However, the EU failed to give rise to any agreement on a framework during that time.

By contrast, the EU Presidency was far more influential in crisis mediation in January 2009. Although the Czech EU Presidency called an extraordinary meeting only on 5 January, when the crisis had already entered into its second phase and transit to Europe was cut, it was quite successful in imposing a solution with international gas transit observers. Consequently, the EU gained some 'soft power' through influencing both Russia and the Ukraine to come to an agreement where others had failed.

The consequent softening of Russia's geopolitical position towards the gas trade could also be linked to the ensuing period of low oil prices. Indeed, discussions on the 'shared responsibility' of transit through the Ukraine is a new semantic in Russian energy diplomacy. Nevertheless, Russia and the Ukraine continue to be unable to find a long-term solution to transit conflicts or to establish a satisfactory dispute settlement mechanism<sup>20</sup>. The EU has frequently requested Russia to respect the Energy Charter. As the crisis demonstrated, there is a need for political accord to implement a multilateral legal framework. On these grounds, we can hypothesise that the crisis of January 2009 might well become the basis for a new dispute settlement regime for gas transit.

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<sup>20</sup> In this respect, the Energy Charter provisions of art 7(7) are the most relevant framework. Nevertheless, on both occasions Gazprom rejected using the Treaty due to the fear of a boomerang effect of gas transit disputes with Central Asian States. See A. Belyi & U. Klaus, 'Dispute Resolution Mechanisms in Energy Transit – Missed Opportunities for Gazprom or False Hopes in Europe?', *Journal of Energy and Natural Resources Law*, vol. 25, nr 3, 2007, p. 7-26.

The main puzzle in the gas sector continues to be its highly political dimension. In order to achieve gas supply security in Europe, a political accord with Russia is needed first, before any economic (trade and tariff) or legal (Energy Charter Transit Protocol) agreements.

### **Electricity: An Imperfect Market Similar to the EU's**

The primary political discrepancy between Russia and the EU over the liberalisation of the power sector is that the former is keen to liberalise its electricity sector but foresees economic dangers in gas liberalisation while for the latter both processes are interrelated.

At the start of Russia's reform of its power sector the EU attempted to position itself as a model to follow even though the EU's electricity market had itself only recently been liberalised. The EU consequently took a strong stance on issues such as anti-dumping and investments. For instance, Council Regulation nr 2229/2003, of 22 December 2003, concerns the imposition and collection of a definitive anti-dumping duty on imports of silicon originating in Russia and states that: 'electricity prices in Russia are regulated and that the price charged by this electricity supplier was very low, even when compared to other suppliers of electricity generated by hydro-electric power stations in the analogue country Norway and also in Canada, it was decided to reject this claim and to confirm the provisional decision to use the electricity price charged by another electricity supplier in Russia. This price was found to be in line with the lowest price of representative electricity producers found in the Community'.

Similar claims continued until at least 2008 but continue to be based on outdated facts, especially as Russia's wholesale market structure has gradually evolved towards a competitive cost-effective market. In turn, the electricity company RAO UES has been restructured and a complex legislative framework has been put in place to ensure gradual liberalisation. The EU often continues to express concern about three main issues. The first, as noted above, is based on the perception that Russia has taken insufficient steps so far in its electricity reforms, the second is about Russian electricity tariff levels and the third is based on the opinion of European energy companies who would like to see more opportunities to invest in Russian electricity generation and to participate in the wholesale market.

Regarding Russia's progress in electricity market liberalisation, it should be noted that the transition from vertical integration to the competition model is shaping up in both Russia and the EU. Ideally, the transition must incorporate as much of the critical market design features as possible along with an internally consistent method of moving from the old to the new mode of market governance.<sup>21</sup> It is also dependent on the effectiveness of policy in achieving its targets.

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<sup>21</sup> W. Hogan, *Market Power and Electricity Competition*, 50th Annual Antitrust Law Spring Meeting American Bar Association, Washington DC, 25/IV/2002, p. 8.

Thus far, the effectiveness of market liberalisation in the EU cannot be defined as optimal. First, the European Commission recognises that there are problems in implementing the energy directives. Often, even after legislation is adopted no market enforcement mechanisms are put in place. Taking that into account in April 2006 the Commission sent out 28 letters of formal notice to 17 member states. Accordingly, on 12 December 2006 the Commission approached 16 member states with no less than 26 reasoned opinions for the non-implementation of energy legislation (both Gas and Electricity Directives). Moreover, the European Commission has won two cases concerning the non-implementation of the Electricity Directive: (1) C-353/05, *Commission v. Luxembourg*, judgement 28 November 2006; and (2) C-259/01, *Commission v. France* [2002] E.C.R. I-11093. The implementation of the Electricity Directive also remains problematic in the new EU member states.<sup>22</sup>

In Russia, since 2003 the liberalisation timetable has been defined by a '5 + 5' approach, with first and second five-year implementation plans, with full market opening initially foreseen for 2012. The timetable initially defined in 2003 has not been fully respected, particularly since the governmental reorganisation in 2004 slowed down the restructuring process. Moreover, the Russian regulatory system has often been criticised for being insufficient. For instance, the legislation on supplier-of-last-resort and on participation in the wholesale market was delayed until 2006. Therefore, the effectiveness in implementing electricity market liberalisation cannot be considered to be better in the EU than in Russia, or vice-versa.

The wholesale market for industrial users was opened up in 2003. Since then between 5% and 15% of market users employ spot trading. Market expansion was held up for a long time by the players themselves, mainly because of regulatory and legislative uncertainties. Since 2006, legislation has significantly improved and the unregulated share is rapidly increasing in the industrial sector. Figures are similar to those in Eastern Europe, but market opening is lagging behind the UK, Germany and the NORDEL countries.

The second issue regards tariff discrepancy. The EU electricity markets are characterised by very large differences in tariffs between regions and countries. Price convergence is high within each region, while price differences are substantial between them. For instance, the NORDEL markets have much lower tariffs for industrial users than the southern countries, such as Italy. At the same time, the NORDEL and UK markets have experienced high price volatility due to their wholesale market structures.

The average EU electricity price for industrial users decreased during the early stages of the liberalisation process. After 2004, however, prices climbed back up and even exceeded the previous level. The main reasons were rising gas prices, the lack of interconnection

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<sup>22</sup> See also K. Talus, *Role of the European Court of Justice in the Opening of Energy Markets*, ERA FORUM, nr 3, 2007.

between electricity regions, the decrease in available capacity, the decrease in network investments and the fluctuations in demand markets.

Before the electricity sector's restructuring, Russian electricity tariffs had been below the level of costs through a country-wide cross-subsidy of the energy demand. In 2000, the electricity tariff for industrial users was around €15/MWh, which was significantly below the tariffs in the UCTE, NORDEL and CENTREL areas.<sup>23</sup> With the reform, the wholesale markets moved to a cost-based tariff methodology. In 2006, the average wholesale price for industry was around €26-27/MWh,<sup>24</sup> which is higher than in the Baltic region and above the average of the Central European market but similar to the OTC tariff in Germany. It remains significantly below Western European and NORDEL tariffs mainly due to their market structure.

Due to the availability of primary sources, the cost of new generation capacity in Russia is 1-1.5 cents/kWh below the EU average.

The third, and final, issue regarding the EU is related to the investment climate for companies seeking to invest in the Russian power sector. Russia still faces several structural investment problems mainly due to the embryonic stage of its regulatory policies, especially as regards domestic dispute settlement mechanisms. Also, the Russian system is characterised by high price volatility in its wholesale market and by a lack of mechanisms for reinvesting profits.

This overview of the legislative, market and tariff structures in the EU and Russia shows that there is no single approach to achieving a competitive market design. Multi-level legislation in the EU has amended the initial target of implementing an EU-wide electricity market through the development of several regional markets, but even then the supranational authority still faces the problem of massive non-implementation of the Directives by member states.

The Russian regulatory approach to introducing competition into the power sector is not exempt from inefficiencies either. Hence, there are similar trends in the EU and Russia regarding their transition to competitive power markets. There are grounds for believing that the Russian power sector, which has a severe lack of generation capacity, might yet attract European investors in the near future.

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<sup>23</sup> Energy Charter Secretariat, *Regional Electricity Markets*, October 2003, Brussels, p. 46.

<sup>24</sup> The average price from December 2005 to December 2006 was around 91 kopek per kWh (conversion rate: €1 = RUR34).

## **The Environmental Dimension of Energy Policy: A Huge Potential in an Incomplete Legal Context**

The environmental markets are still at a very embryonic stage in EU-Russian relations. The resource-hungry EU<sup>25</sup> has been interested in promoting a non-fossil fuel economy since the 1970s. The issue of diversification emerged in the 1970s at a time when energy supply concerns were principally focused on the eventual extinction of fossil fuels (especially oil) by the end of the 20th century. In turn, in the 1990s energy concerns focused on the anticipated dangers stemming from climate change caused by growing energy use.

Until now these energy concerns have not affected the resource-rich Russia. By contrast with the European states, the environmental dimension of energy policy remained of secondary importance in Russia until 2008. Surprisingly, the EU's influence plays an important role regarding the issue. In January 2008 the EU Commission proposed a draft directive, which lays down a binding minimum 10% target for the market share of biofuels in 2020 in its member states. This has led to a positive reaction in Russia, as its vast expanse of arable land provides ideal conditions for a high level of biomass production for both biofuels and heat generation, which can be exported to the EU. Russia has over 20 million hectares of available unused farmland and could produce huge amounts of feedstock for biofuels and other biomass technologies.<sup>26</sup>

Russian biomass producers hope to take advantage of the opportunities arising from the increased interest in biomass technologies in the EU. They also aim to get Emission Reduction Units from Joint Implementation projects.

Small- and medium-sized Russian businesses are becoming more involved in investing in environmental projects. Apart from biomass, interest is focusing on the significant potential for various renewable energies in the remoter regions of Russia. There are still areas in the Russian Arctic, Kola Peninsula, Sakha Republic, Magadan Region, Kamchatka and Sakhalin which have no electricity networks and could provide important new markets. At present these off-grid territories are mainly dependent on diesel and petrol generators and often experience supply shortages. The unmet demand could be satisfied by the construction of decentralised environmentally-friendly power plants. In particular, decentralised heat and power generation of 1.5-2 kW installed capacity could benefit small consumers in these regions.

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<sup>25</sup> The EU's specificity in its approach to the non-fossil economy also differs from resource-rich nations, such as the US. See S. Boehmer-Christiansen, 'Investing Against Climate Change: Why Failure Remains Possible', *Environmental Policies*, nr 11, vol. 3, 2002, p. 1-31.

<sup>26</sup> A. Belyi, 'Renewable Energy Potential and Regulation in Russia', UNDP newsletter, July 2008.

Around a dozen companies are already active in the promotion of wind turbines and eight companies are producing photovoltaic cells. In some cases, regional authorities are active in renewable energy investments. The most recent example is the Kalmyk government's agreement with the Czech company Falkon, which plans to build Russia's first wind park. The Mutnovka geothermal power plant in Kamchatka, with 50MW installed capacity, is one of Russia's biggest success stories.

Apart from renewable energy, Russian environmental investments are also due to the economic interests of the fossil fuel industry. For instance, the level of gas flaring in Russia is equivalent to a third of Russian gas exports.<sup>27</sup> Likewise, pipeline transport losses amount to 5% of commercial energy. Renewable energy policies can only be complementary to much greater environmental investments.

Environmental projects in Russia are also of interest to the EU, which aims to remain a leading voice in the debate on international climate change. In order to better attract investors and improve legislation, a favourable position must be gained in the post-Kyoto regime. The EU and Russia are natural allies in terms of the investments necessary for Joint Implementation projects.

## **Conclusions**

This overview of Russian energy policies shows that national energy sectors differ and that each requires a specific approach. In order to improve the general situation a political agreement is needed to make clear what the EU wants from Russia.

At the same time, history shows that the EU's policy of extending its market model beyond its borders can lead to a dead-end. Nevertheless, both the EU and Russia need to make a political commitment to reach a free trade agreement. Only on the basis of a political accord will they be able to move 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 necessary energy investments to be estimated. However, without a political commitment the Energy Charter will remain marginalised. In contrast, once the commitment to a framework exists, a multilateral legal regime for energy can be established.

A sector-specific approach must be considered. The oil sector does not need political intervention: it evolved in Europe before European integration and the EU therefore has no influence over the sector domestically. Nevertheless, there is a need to avoid political misconceptions about Russia's oil majors. Paradoxically, getting rid of the Druzhba pipeline, which is criticised in Eastern Europe, will only forge more market-based relations. As history has demonstrated, the attitude towards international investment

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<sup>27</sup> See IEA, *Optimizing Russian Natural Gas*, Paris, 2006.



protection depends to a large degree on world oil price volatility. Again, the Russian case shows that depoliticising oil sector relations will help international investors in Russia.

The gas sector will remain a question of political relations for both EU and Russia for a long time. The reason is the huge discrepancy in regulatory approaches. The second gas crisis highlighted the political and legal vulnerabilities of the current mediation and dispute settlement mechanisms. It can be asked to what extent Gazprom is committed to liberalisation, the export monopoly and the Energy Charter process. Obviously, a state-owned company cannot easily adapt to the new economic reality of the changing gas markets. However, any transition towards an economic-minded approach in Russia can be hindered by the securisation and politicisation of energy supplies in the EU. Therefore, Brussels and Moscow need a political accord in order to improve their relations in the highly politicised energy sector.

The electricity and environmental sectors remain attractive to European investors. Although Russia has significantly improved its legislation in these sectors, good political relations with the EU will help to increase the range of possibilities for international investors. Russia should enhance its multilateral investment mechanisms in order to improve its own investment climate. These are two areas in which Russia and the EU can attempt new economic experiments.

The difficulties in energy relations stem from the transition processes in both Russia and the EU. The issue is how to make both transitions *politically* compatible.