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EU-Russia gas relations: hints for a trustful common future

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Outline of the presentation

I. The EU, Russia and the Energy Charter Treaty (ECT)

II. Transit through Ukraine and the permanent state of crisis

III. New pipeline projects between Russia and the EU

A few introductory remarks: a new, positive context for improvement of relations

- NATO enlargement to Ukraine and Georgia has been stalled, inclusive, Eurasian security regime will need to be developed, especially for Ukraine (for ex. “Helsinki Plus” proposals)
- Anti-missile defense shield in PL/CZ has been abandoned, USA-Russia « reset », Russia increasingly supportive in Afghanistan (shared interests)
- USA likely to less interfere in EU’s policy making while the EU is likely to progressively strengthen its own foreign policy and common interest assessment, and less rely on the USA
- EU-Russia negotiations over a new partnership and cooperation agreement are a good opportunity to give a new impetus to cooperation
- End of outdated G8 → G20 highlights the need for Russia and the EU to better identify their common interests and cooperate to defend them (when facing the USA and China, for example)
- Economic competitiveness, innovation and energy efficiency, will now be more than ever decisive factors of full recovery and sustained development. The cost of lacking economic modernization will become always more expensive in social, economic and strategic terms, especially with regards to China/Brasil/India

I. The EU, Russia and the Energy Charter Treaty

Why has Russia refused to ratify and commit to the ECT? (1)

- The clause of regional economic integration: threat for destination clauses and for transit regime, such as prices and regulations (Europogas-Yamal)
- Transit facilitation (Art.7): perception of risk for existing discriminatory pipeline access and for the Russian gas balance between offer, including Central Asia, and demand, internal and external
- The transit protocol: direct threat to existing discriminatory pipeline access and monopolization of Central Asian gas as mandatory pipeline access
- Failure of ECT to prevent and overcome conflict situations (although Russia official not party to the treaty)
- Yukos case: Permanent Court of Arbitration in The Hague could rule the state's action towards Yukos/Khoroshkovsky (expropriation of shareholders) illegal

I. The EU, Russia and the Energy Charter Treaty

Why has Russia refused to ratify and commit to the ECT? (2)

- Russia could have ratified the ECT but EU bears partial responsibility in believing it can realize its legal extension towards Russia and bring Russia to abandon its (legitimate) interests. Russia is a critical gas supplier, virtual gas transit country, massive gas consumer and gas producer, which determine decisive economic, social and strategic interests it won't abandon.
- EU Commission should have been less sticking to reciprocity and a strong instrumentalization of EU law and have a better political understanding that Russia holds the strongest position and can't be brought to abandon its strategic assets, positions, revenues and opportunities (destination clauses, pipeline access, market access, production access)
- Russia holds partial responsibility for its possibly inappropriate legal actions and not prioritizing a normalization of relations through legal security and primacy of fair laws
- The ECT's own drawbacks, weaknesses and deficits also play a role, as it is a clear importer-consumer, EU lead regime which doesn't correspond to today's realities and producers' interests

I. The EU, Russia and the Energy Charter Treaty

Do we need the ECT or a new international regime? Assessment of positions

- Russia has officially withdrawn from the ECT

But: ambiguous position towards the ECT as it may be committed to provisory application:

Art.45 (1) + international public law+ no declaration when signing stating that it is not able to accept provisional application (Art.45 (2))+ has always participated and shown interest in the Charter's work+ has repeatedly referred to the Charter during January 2009 gas crisis + recent termination of provisional application creates ambiguity as implicit recognition that it was until then, bound by the ECT

- Russia considers the ECT to be outdated and too problematic and wishes to replace it → President Medvedev's proposals on new energy security treaty outlined in Helsinki on 20/04/2009
- EU considers ECT to be necessary and irreplaceable, though improvable, and has included its ratification as an objective of current EU-Russia negotiations over a new cooperation agreement

I. The EU, Russia and the Energy Charter Treaty

Assessing Medvedev's proposals related to gas and comparing them to the Charter

	Medvedev's April 20, 2009 proposals	Energy Charter Treaty	Comments
Treaty	Yes	Yes	Russia also recognizes the need for a legally binding, multilateral international treaty to regulate energy relations and improve energy security
Principle	Calls responsibility of producing, consuming and transit states for energy security	Energy security based on market, free and fair competition	Medvedev's proposals provide a welcomed rebalancing of interests in favor of producers. There's a need for an obvious adjustment of importance related to free and fair, competitive market rules and there's a clear dichotomy between EU model and the Russian model
Transit	Strong transit protection to ensure uninterrupted energy flows, but only for parties already realizing transit according to contracts and agreements; calls for market rules and predictability for transit regimes	Freedom of transit principle; Compulsory transit facilitation (Art.7), but no mandatory third party access; obligation to ensure uninterrupted energy flows and transit, even in case of conflict; market rules and predictability for transit regimes	Russia faces legal uncertainties over transit regimes in its neighborhood because of its own refusal to ratify the ECT and due to expansion of EU's <i>acquis communautaire</i> (itself upgraded) through the Energy community treaty. In Medvedev's proposal, parties to the treaty are not obliged to allow free transit through their territory (not mentioned). At least, contracting parties should be able to demand reciprocity of treatment and conditions among them

I. The EU, Russia and the Energy Charter Treaty

Assessing Medvedev's proposals related to gas and comparing them to the Charter

	Medvedev's April 20, 2009 proposals	Energy Charter Treaty	Comments
Dispute settlement	Yes, based on diplomacy and UN	Yes, for transit (Art.7) and investment disputes between contracting parties (Section V). Settlement is based on contracts and arbitration, involving conciliator and interim decisions, especially state vs. private entities	Questionable role of diplomacy when conflicts are about legal provisions= President Medvedev proposes weaker provisions→ real paradox compared to recognized failure of "existing ...arrangements ..and norms..to prevent conflicts". ECT has a much more developed mechanism, although largely perfectible as it can't act in urgency
Market access	" non discriminatory access to international energy markets, their opening, and increased competition"; unconditional state sovereignty over national energy resources	Free and fair, total non discriminatory; reciprocity of rules; state sovereignty over natural resources (Art.18)	Both recognize sovereignty; ECT puts less emphasis on limitation of foreign companies but more on sovereignty on issues of taxes, policies. Questionable notion of "increased competition"; There's a need to find a better legal equilibrium guaranteeing states' discriminative policies and rules but that would demand strong respect of market rules, when not specifically excluded or limited
Investment	Asset and capital swaps and exchanges; non discriminatory investment promotion and protection	Section III: principle of extension of national treatment, or external most favored nation treatment	Obvious difference of political interests: asset swaps vs. free actors' activities. Investment provisions protection need to be strong to ensure small and medium enterprises can develop

I. The EU, Russia and the Energy Charter Treaty

Assessing Medvedev's proposals related to gas and comparing them to the Charter

	Medvedev's April 20, 2009 proposals	Energy Charter Treaty	Comments
Prices	Shared between actors; objective of price stabilization and of revenues	Principle of fair revenues, based on predictable, market based formulas	Obvious debate about S curve pricing, long term production when low pricing, but this stands in contrast to producers' great satisfaction with summer 2008 all times' high prices, and calls for greater increases
Transparency	Clear emphasis on upstream, midstream and downstream transparency	Art.20: focus on transparency of rules, laws, regulations and policies	Welcomed emphasis on transparency in Medvedev's proposals. ECT excludes all aspects of transparency but regulation, Medvedev's proposal focus on market conditions. There's a need for greater emphasis on transparency and information exchanges in both regimes to target conflicts and corruption
Exchange of information, dialogue	No information over institutionalization	Yes, institutionalization through secretariat, and numerous works and forums	The Charter is a unique platform for dialogue between producers, transit and supplying countries not only of the Eurasian continent
Energy efficiency/ environmental protection	?	Energy efficiency protocol (PEEREA); Art.18, strong emphasis	The ECT intends to encourage energy efficiency and be a platform for exchange of best practices, experience, legislation, and investment promotion and security
Various	Coordination of investment in pipeline systems and consultations and coordination of energy policies Notion of predictable marketing		Clear political provision on coordination of pipeline system; coordination and consultations of energy policies and projects already exists in bilateral dialogues; notion of predictable marketing is a paradox in a competitive market, though questions EU's failure to provide reliable and clear market development forecasts

I. The EU, Russia and the Energy Charter Treaty

Conclusion: towards a reformed ECT involving Russia (1)

- President Medvedev's proposals are similar to the ECT, though weaker in some extend. They contain no fundamental contradiction.
- Replacing the ECT would open a very long (a least 5 years) process, with uncertain results
- Claim that ETC is not satisfying is legitimate, but at least, it exists. ECT can be modified (Section VII, Art.33) and there's a consensus that it needs adjustments
- President Medvedev's proposals provide a constructive base for improvement of the ECT but it looks illusionary to replace the ECT as we need to quickly gather Russia, Ukraine and EU member states in a legally binding and effective energy regulation agreement
- Russia should reintegrate the ECT process in obtaining legal exemptions and facilitations to mitigate its immediate concerns: for example, the signature of an additional protocol by all parties to the ECT stating that Russia is only bound once reforms to the ECT have been agreed; and leave aside the transit protocol
- Norway should also be convinced to take part, and other key producers/ transit states

I. The EU, Russia and the Energy Charter Treaty

Conclusion: towards a reformed ECT involving Russia (2)

→ Need to modernize the ECT and focus on:

- ✓ transparency of energy flows at all stage of the chain, starting with gas metering
- ✓ efficient, preventive, legally binding, legal dispute and conflict settlement for transit and investments
- ✓ Strong investment protection provisions: Russia's modernization and development is dependent on the increase of volume of foreign direct investments in energy efficiency and production and the change of number and nature of investors. Big companies from important Russian partner states can do without these provisions but not so much small and medium companies, who can play a critical role!
- ✓ Adapt market access to today's reality: we have to live with limitations to competition and market access both in upstream and downstream sectors: in the EU, limits are based on risks to distorted competition, in Russia, they are justified by sovereignty and rent capture
- ✓ Need to strengthen focus on energy efficiency: "gas partnership through energy efficiency", where investment in gas efficiency would be encouraged in providing temporary access to spared gas volumes

II. Transit through Ukraine and the permanent state of crisis

Overall remarks

- Russia/Gazprom bear a huge responsibility for supplying, in 2008, 30% of EU's total gas demand, 50% of EU's total imports, while 67% of its gas exports to the EU transit through Ukraine
- Ukraine's transit position is irremovable on the short to mid term, can be reduced on the long term (almost halved), but not fully suppressed
- Uncertainties with transit countries (especially Ukraine) have become constant and when conflicts develop, there's a need for credible, effective, preventive legal solutions, as well as settlement mechanisms
- These crisis always deal with, at some point, disputes over volumes and flows (typical accusations of gas theft, transit impediment, etc)
- Permanent state of crisis calls reliability not only of transit country, but also of supplier into question, especially when full transparency is not provided. They put the whole gas industry at risk: the use of gas becomes subject to strong criticism and growing pressure to favor alternatives

II. Transit through Ukraine and the permanent state of crisis

- Need to avoid gas supply interruptions to the EU at all cost
- Why not developing a full fledged legal treaty that would provide for a quick, fair and legal settlement of conflicts and disputes, to which parties would commit, and that would complete existing contracts? Why not accelerating an enhanced early warning mechanism? (within the EU-Russia gas agreement, extended to Ukraine, Belarus, Georgia, Moldova, and others; could be incorporated into the ECT, later on)
- Why not exerting strong pressure on transparency of gas flows under international monitoring which would neutralize any suspicion in case of conflicts, both in dispatching centers and gas metering points, in Moscow, Kiev and downstream in the EU?
- Why, on the Russian side, not providing greater clarity on contractual obligations and their interpretation, on consequences of possible contractual violations, and on settling long in advance conflicting issues, such as reduction of take or pay obligations (contradictory signals from Putin and Miller)?
- Why not, on the Ukrainian side, providing for greater transparency on possible problems of payments, gas off take volumes and take or pay clauses, interpretation of legal obligations and consequences in case of failure?

III. New pipeline projects between Russia and the EU: stakes and challenges

Overall remarks

- New pipeline projects linking former Soviet Union gas resources to the EU are being developed:
 - Russia lead with EU partners (Nord Stream, South Stream) + Blue Stream 2 with possible implications for the EU
 - EU lead (Nabucco, ITGI), though also targeting Irak gas
- Pipelines seek diversification of transport routes and additional supplies, Russian and non Russian, to strengthen security of supply and ensure additional gas volumes are available which fit with EU's increase of external gas demand, downstream liberalization attempts and competition requirements
- The economic crisis adds a new central question mark to those pipeline projects, which is sufficient demand. It adds to already existing questions of gas availability, costs, opportunity vs. alternatives, etc
- Important media talk and perception of pipeline wars, which needs to be addressed through greater transparency, frankness, information exchanges and dialogue

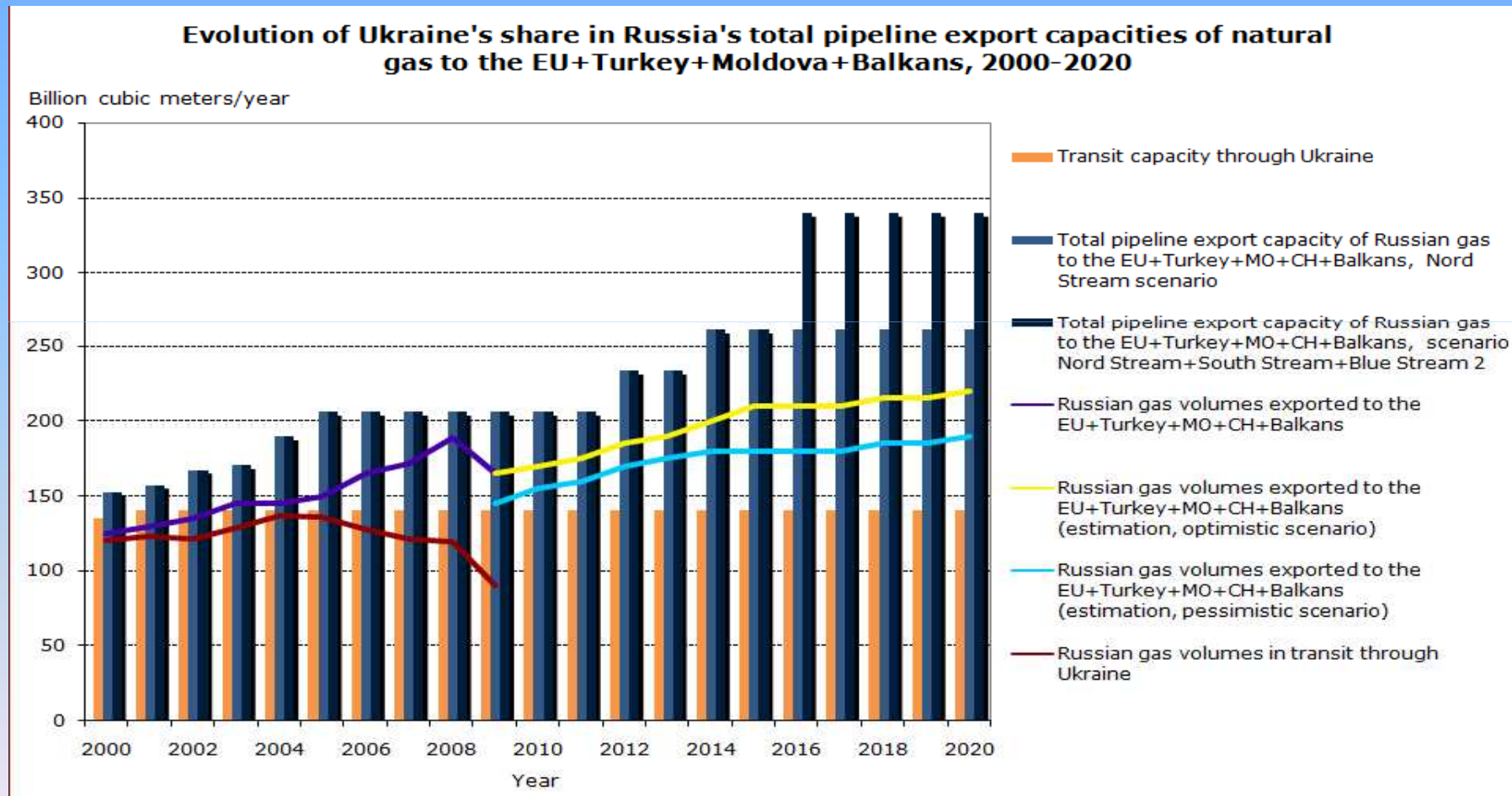
III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which the EU needs to answer about its supported pipeline projects:

- Why is the EU so much sticking to Nabucco while not pushing for the ITGI and a “Nabucchino”, admitting that a 30 bcma Nabucco is unrealistic?
- Why can't the EU revise its project support policy, especially regarding (currently absent) hierarchy of priorities (ITGI-Nabucco-South Stream)?
- Why can't the EU provide a clear assessment of future gas demand forecasts?
- Why can't the EU develop an objective, fair and clear energy infrastructure project assessment mechanism based on EU's interest in having stable and secure, long term additional gas supplies, with reasonable prices and low political costs, and upon which projects would, or not, obtain financial support as well as special conditions (South Stream project would need to be as fairly assessed as Nabucco, for example, in an upgraded TEN listing system)?
- Why has the EU Commission accepted listing the increase of Ukraine's GTS transport capacity among its objectives when supporting the modernization of Ukraine's GTS (neither Russia, nor EU member states/companies, wish so, and while the EU wishes to import Turkmen gas avoiding Russian and Ukrainian territory?)

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU → Very likely future over dimensioned supply capacities of Russian gas to Europe



Sources: Naftogaz, Gazprom, Eurostat, Eurogas, author's estimations

Marc-Antoine Eyl-Mazzega – Baden-Baden Group, Moscow meeting, 16-17/11/2009

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU:

→ Will Nord Stream be underloaded ?

Nord Stream string 1 looks well loaded with additional gas while string 2 raises questions as to where the gas will come from, and where it will go (questionable sufficient demand level, even if demand recovers; alternative gas sources may be more attractive). Gas could be diverted from Ukraine but this raises questions of additional transmission costs, network congestion in Russia, and agreement with downstream customers.

→ Will South Stream be underloaded ?

South Stream project with a capacity of 63 bcma looks amazing on the paper, but issue of cost, gas source availability (new Russian fields? Azerbaijan? Turkmenistan? Where else?), competition with Blue Stream 2's additional supplies, and downstream demand is questionable (so far, only EDF looks capable of buying additional volumes out of the pipeline, but not more than 1/6 of the capacity and all possible partners in the project are heavy competitors on often the same markets). If objective of diverting gas away from Ukraine, then two more questions loom: transmission bottlenecks in Russia, additional costs, and better alternatives for investments

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU

- The question of financing: Nord Stream financing has proven to be quite difficult, how could South Stream not be even more difficult, given its planned construction costs, at least two times higher?
- Obvious over capacities vs. increased gas transit security due to additional routes: is Russia/Gazprom ready to share economic opportunities provided by these over capacities and the flexibility they provide/opportunities of optimization of flows? In making gas selling points more flexible? In moving gas selling points to the entrance of pipelines? Is Russia/Gazprom ready to share downstream markets, such as the Balkans?
- Would a 30 bcma South Stream gas pipeline not be more realistic as a starting point for discussion?
- What is the real price of gas supply security (likely to be too high)? Who will pay for this supposed increase in gas supply security?

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU: the future of the Ukrainian transit corridor

- The Ukrainian transit corridor will remain necessary and probably at least transit equal gas volumes to those transiting through South Stream, if the latter is build and fully loaded. What ever new gas pipeline projects, the Ukrainian gas transit corridor will remain key.
- Ukraine's gas transit system has so far proven to be totally reliable from a technical point of view, provides a unique infrastructure and capacity (3 main strings, multiple secondary, low diameter pipes) and unique storage at EU's boarder.
- Ukrainian storage will become safer and more attractive to foreign companies due to Energy Community membership

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU: the future of the Ukrainian transit corridor

- According to EU-UA December 2005 Memorandum on cooperation in the field of energy, Ukraine has committed itself to Europeanize its gas market + develop projects for investments into the GTS's modernization and obtain international financial support
- Ukraine has fulfilled formal accession conditions to the Energy community in October 2009 (should be implemented by 2011): Gas Law has been prepared and agreed by Commission and transferred to Parliament; Naftogaz has realized tender to advice on its reorganisation;
- Ministry of Fuel and Energy prepared concept for investments in UA's GTS for the period 2009-2015: investments totaling 2,57 billion \$, excluding so far the contested Novopskov-Bohorodzany-Uzghorod gas pipeline project, and open in principle to all investors and companies
- The modernization and investment process takes place, which is all parties interest
- Need for real and expected implementation of reforms, increase of internal gas prices, improved transparency and viability of Ukrtransgas

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU: the future of the Ukrainian transit corridor

- Russia should provide more clarifications and public discussion about its repeated calls for the development of an international consortium to take over Ukraine's transit and storage infrastructure:
- Is such a consortium a priority, is there a real interest, and how should it be realized?
 - Which infrastructure would be taken under control? Under what legal regime? What kind of company would be set up? Who would be the shareholders? How would shares be divided, control be organized? Should Ukraine retain a controlling stake?
 - What would be the price? What would be the transit tariff? The investments in modernization? The return on investment rate?
 - Does Russia expect Ukraine to give up full control? To accept making the project without a political EU counterpart, or multiple EU companies?
 - Who on EU's side would step in ? EU companies (don't seem interested, are happy not to bear responsibility for gas transit) The European Commission, through a special fund ? (how, with what money, on what legal basis?) → if no EU counterpart, likely refusal of Ukraine

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU: the future of the Ukrainian transit corridor

- What would be the long term objective? Would a consortium mean that South Stream is abandoned? Is the objective to downgrade Ukrainian transit route to minimum amounts? To export Turkmen gas via Ukraine to the EU?
- Would Russia/Gazprom accept to provide for flexibility in gas selling points to allow access of EU companies to Ukrainian storage?

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU: the future of the Ukrainian transit corridor

- Ukraine should also provide greater clarity over its own realistic assessment of its future gas transit corridor and possible interest in a multilateralisation and conditions
- Why is there no discussion over an assessment of South Stream (63bcm/a) vis-à-vis an enhanced existing Ukrainian alternative:
 - Studying political and institutional measures which could efficiently strengthen transit security (set up a complete, transparent information mechanism on all flows, which requires cooperation from Russia and from Moldova!) + conflict settlement mechanism + international legal binding transit regime such as an adjusted ECT
- There's a need to assess what implication a major reduction in transit volumes through Ukraine could have on its capacity to operate its transit system, given that Ukraine will still need to transit gas, and this transit must be operated smoothly, which is all parties interest

III. New pipeline projects between Russia and the EU: stakes and challenges

Questions which Russia needs to answer, in cooperation with the EU: the future of the Ukrainian transit corridor

- So far, no objective, immediate and urgent need for an international consortium
- The ball lies in Ukraine's hand and Ukraine bears a critical, long term responsibility vis-à-vis Russia and the EU
- The modernization of Ukraine's GTS must be an opportunity for EU-Russia-Ukraine cooperation and not confrontation, with transparency as well as fair and competitive participation of respective companies
- There must be a discussion on the need of an additional, objective, transparent inquiry into the gas pipeline network (INOGATE study was realized in 2004-2005, and since then, system might have further deteriorated while Naftogaz has reduced maintenance expenses)
- The consortium project can only be viewed as a ultimate solution and option, should there be credible, obvious and immitigable threats identified to the viability of the Ukrainian gas transit corridor and security of gas transit
- There's a need for a trilateral dialogue, EU-Russia-Ukraine, on gas supply security

Conclusion

- EU-Russia gas relations are exceptional but need to become again the flagship for EU-Russian cooperation.
- The relations will never be like USA-Canada gas relations. This is no problem, but there's still a deficit of a sustainable, stable, efficient equilibrium to guarantee energy security
- At first, we need less suspicion, more dialogue, more informations, better understanding, better transparency
- Then, we need a modernized ECT
- EU needs to understand that Russia holds the power on the short to mid term and that it can't impose its conditions in the game. But Russia needs to understand that it depends on the EU on the long term to overcome its internal and external critical challenges to stability and modernization. There's an asymmetry in favor of Russia in the short to mid term, and an other in favor of the EU on the long term. Gas relations need to be rethought according to this assessment of asymmetry and interdependence.
- Russia and the EU would be winners if Russia would share more its gas rent, and if the EU would share more the benefit one can make on energy efficiency
- Russia has the gas which the EU needs, while the EU has the money to pay, the experience and technology of energy efficiency and tools for competitiveness improvement, which Russia needs

Thank you !

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