

EU-Russia Relations in the Energy Field: The Continuing Role of International Law

By Sophie Nappert*

“[A]ll European countries are interested in good relations with the Russian Federation, [and] the Russian Federation is interested in good partnership relations with the European Union and specific countries in Europe. These relations are not opportunistic and should not depend on any political events. And we definitely should not look at the signing of the partnership agreement with the European Union as some kind of prize that Russia gets for its good behaviour (...).”¹

Introduction

The energy policies of the Russian Federation (‘Russia’), as well as the role they are made to play in its international relations, are the subject of worldwide publicity, comment and speculation. Russia’s gas pricing disputes with the Ukraine, and legislation on foreign investment in strategic industries,² provide recent examples.

Up until mid-2009, Russia had embarked upon an increasingly vigorous expression of its readiness to cast aside the Energy Charter Treaty (‘ECT’) as a frame of reference for EU-Russia energy relations. Prime Minister Putin, in his speech at the 2009 World Economic Forum in Davos, stated: “Unfortunately, the existing Energy Charter has failed to become a working instrument able to regulate emerging problems. I propose we start laying down a new international legal framework for energy security.”³

President Medvedev took up the same theme in his March 2009 interview with the Spanish press: “I have come up with an idea, which I first voiced at the Moscow summit during this gas conflict [with Ukraine] – let’s draw up a new Energy Charter or a new version of the Energy Charter. But what should it be like? It should not benefit just the consumers. Yes, a consumer is a vulnerable party. But sometimes we need to think about the producers as well, and the transit countries. Otherwise we cannot come to an agreement.”⁴

Indeed, on 20 April 2009, President Medvedev tabled a ‘Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles)’, seeking to revisit the principles enshrined in the Energy Charter Treaty.⁵

Next came Russia’s formal notification, on 20 August 2009, that it ‘did not intend to become a Contracting Party’ to the ECT. In accordance with Article 45(3)(a) ECT, this notification resulted in Russia’s termination of its provisional application of the ECT after a period of sixty days from the receipt of the notification, in this case 18 October 2009.⁶

Most recently, the arbitral tribunal in the legal proceedings brought against the Russian Federation by the Yukos majority shareholders⁷ pursuant to the ECT, decided that provisional application of the ECT amounted to its fully-fledged application by Russia. The tribunal did not have to opine, and did not opine, on whether Russia’s notification amounted to withdrawal.

This article looks at the current EU-Russia relations in the energy field through the prism of international law. It considers whether international law, and more specifically the ECT, can continue to offer avenues towards facilitating these relations. It questions whether, in a field of such importance to its economy and sovereignty, Russia’s stepping away from a recent international agreement with significant currency, which it has been held provisionally to apply⁸ (at least until its August 2009 notification) and which promotes international law and international arbitration, really serves Russia’s purpose: to be considered as an equal counterpart in its energy relations with the EU.

Energy and Sovereignty

Reports on recent events have encouraged a perception in Europe that Russia can behave as an unreliable, unruly Behemoth, prone to knee-jerk reactions and willing on a whim to abuse its position of power as the holder of the world’s largest deposits of natural gas. From Russia’s standpoint, the EU appears to front its fragmented position on energy with the unilateral imposition of its own terms and conditions, without regard to Russia’s interests.

A summary look at recent history sheds some light on how Russia frames its energy interests, and how they relate to what is a sensitive, and politicised, area of activity on both sides, and a central one to EU-Russia relations generally.

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For at least a decade, Russia has consistently placed natural resources at the core of its sovereignty and national security. Vladimir Putin's scholarly dissertation as Candidate of Sciences ('kandidat') at the St Petersburg Mining Institute dates back to 1997, two years before his appointment as Prime Minister. Entitled 'Strategic Planning of the production of mineral-natural bases in the region under the development of market economy conditions', its message was essentially two-fold:

- Natural resources must remain under State control: it is too important a sector to be left entirely to market forces.
- Energy policy and energy security are essential to Russia's security policy.⁹

In the 2003 Energy Strategy of the Russian Federation to 2020,¹⁰ a similar message emerges:

- Energy policy is intimately linked with national security.
- Energy policy will be used to preserve Russian independence.
- Russia should remain a reliable trading partner.

The most recent Energy Strategy paper, mapping out Russia's energy strategy to 2030, is based on the same priorities, adding a notable message of modernisation.¹¹

Russia's underlying philosophy is that, when it comes to energy questions, the State acts in the best interests of society. There is here an undercurrent of public order, and assertion of sovereignty. The starting point about interfacing with Russia on energy matters, therefore, is that any transaction involving oil and gas is intimately linked to the very core of Russia's sovereignty.

The concept of sovereignty is central to a State's idea of itself and sense of future direction. The Permanent Court of International Justice established, in one of its early cases, that international law as a system frames the contours of a State's sovereignty, and delimits it. Thus a strongly sovereign State recognises that, whilst international obligations restrain the exercise of sovereign prerogatives, the right to assume international obligations is itself an attribute of State sovereignty.¹² In such a context, it is difficult to reconcile Russia's departure from the ECT with public interest.

Mixed messages abound, and tend to weaken Russia's position. Russia claims that it deserves an equal place at the table with its EU counterpart in the energy dialogue. Recognising the role and importance of international law in its energy policy would be a significant step towards asserting confident sovereignty and laying the foundations for the credibility which Russia claims it deserves. On the other hand, stepping away from international law would sideline Russia in the dialogue and entail a significant loss of credibility, no matter how large its natural gas reserves, or how dependent on them the European market might be. The 'new' Energy Charter proposal is too incompletely formulated at this stage to be a credible alternative to the ECT.

The sovereignty conundrum will also be familiar to EU Member States,¹³ livened up as it is by the current state of uncertainty surrounding the respective spheres of competence of the European Communities alongside the Member States in matters of foreign investment, notably under the ECT. Both sides of the EU-Russia dialogue are thus grappling with similar issues, albeit from different standpoints.

The EU's House-keeping Matters

The EU has its own internal tensions to address. Its unease in the delimitation of its sphere of competence in 'mixed agreements' alongside that of its Member States is tangible and leaves several important questions currently unresolved, particularly with respect to the ECT and foreign investment more generally.¹⁴ There are unique challenges presented to the EU as a party to international treaties alongside some of its Member States, and in its dealings with other state parties. These challenges give rise to avenues which newly-acceded EU Member States defending investor-to-State claims are starting to invoke: a BIT (Bilateral Investment Treaties) dispute settlement mechanism violates the principle of 'mutual trust' between Member States;¹⁵ the 'diversion' away from the European Court of Justice (ECJ) of the determination of questions of EC law in investor-State cases; the inconsistency between BIT protection and EU law;¹⁶ in the ECT context, claims by EU nationals against other Member States.¹⁷

A coherent message on EU competence and policy in energy matters would assist in allowing international law standards to remain the natural choice as a framework for future EU-Russia relations.

The ECJ may just have afforded an opportunity to put the EU house in order. In its decision of 3 March 2009 in the cases brought by the European Commission against Austria and Sweden respectively,¹⁸ and against Finland on 19 November 2009,¹⁹ the ECJ examined certain bilateral investment treaties ('BITs') pre-dating the accession of these countries to the EU, which contained wording conferring unrestricted freedom of transfer of capital and profits for investments covered by the BITs. Whilst free movement of capital is a fundamental principle of EU law, Articles 57, 59 and 60 EC give the Council

powers to impose exchange controls for certain limited or temporary purposes. The Council has never exercised these powers. However, if it were to do so, the unrestricted freedom of transfer clauses in the relevant BITs would make it difficult or impossible for Austria, Sweden or Finland to comply with their obligation to cooperate with the Council, and the Commission takes the view that there is a “hypothetical conflict” between the BITs and the EC Treaty.

The ECJ agreed and ordered Austria, Sweden and Finland to renegotiate the relevant BITs or to denounce them. Although these cases arose in the context of bilateral treaties, a similar freedom of transfer provision is found at Article 14 of the ECT. The prospect of the ECT’s quinquennial review (Article 34(7) ECT) might afford the right forum to discuss the possible impact of the ECJ’s decision.

Avenues in International Law

Contractual Provisions

International contracts may contain several types of provisions to protect a foreign party wishing to do business in Russia. However, recent amendments to existing Russian legislation appear to cast doubt on how viable these protections can be in Russian territory.

One of the most widely-recognised, and universally sought-after, protections is that provided by an arbitration clause, whereby all disputes arising in an agreement are submitted to a private arbitral tribunal, often seated in a third country for purposes of neutrality, rather than to a State’s judicial courts. This is especially valuable where investors are dealing directly with a State or State entity (as is the case in the natural resources sector) and do not want to submit to that State’s courts, whilst the State would not submit to the courts of another State. Moreover, arbitration awards can be enforced in a number of foreign countries via an international instrument called the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. The New York Convention works by setting out a list of restricted, mandatory grounds on which a State court may refuse to recognise and enforce an award rendered in another country. Russia has ratified the New York Convention, as have 143 other States: international arbitration therefore carries important buy-in, can be a powerful tool, and is undisputedly the premier system of dispute resolution in international business.

The 2008 Amendment to the 2005 Russian Law “On Concession Agreements” (widely used in the natural resources sector) blurs the picture. Whereas the original wording of the 2005 law allowed disputes between a grantor (the State) and a concessionaire to be resolved via international arbitration, wherever located, the amended wording appears to subject it to a Russian seat. Article 17 provides that these disputes may be heard “in accordance with the legislation of the Russian Federation in courts, arbitrazh courts, arbitral tribunals of the Russian Federation.”²⁰ If that interpretation is right, awards would from now on be liable to review by the Russian courts, and be removed from the ‘restricted review’ protection of the New York Convention, as they would no longer be foreign awards. This appears to be the interpretation placed on the new wording of Article 17, which requires that disputes may not be heard by way of institutional or ad hoc arbitration outside the boundaries of the Russian Federation.

Placing such a condition on an essential prerequisite to foreign investment portrays an image hardly consistent with that of a host country welcoming foreign investment, as championed in Mr Medvedev’s statements in the Spanish press. It does not accord with international business practice, breeds unpredictability, and achieves the opposite effect of that which Russia wishes to portray: that it has the hallmarks of a sophisticated, international partner instilling confidence in international business and in other States.

Treaties and Public International Law

Given the uncertain treatment of contractual recourse to international arbitration in Russia, investors may wish to look to public international law for protection. As a matter of international law, investors, notwithstanding any contractual rights they may have, may benefit from a direct recourse against States pursuant to any bilateral or multilateral investment treaties to which both the home State of the investor and the host State where the investment is located are parties. These treaties provide internationally-recognised standards for the protection of investments, and a direct right of action is granted to investors to enforce these protections by taking States directly before an arbitral tribunal.

This recourse is also found in the investment chapter of some multilateral treaties. Of particular interest here is the Energy Charter Treaty (ECT), the first multilateral instrument aimed at promoting and protecting investment, security of supply and transit in the energy sector. Fifty-two States, including the EU and its Member States, have signed the ECT and twenty-two more are observers.²¹ Until its August 2009 notification, Russia had signed the ECT, but not ratified it, placing it in the position of provisionally applying the ECT.

Russia's Provisional Application

Whilst 'provisional application' is not a novel concept in international law, the continued non-ratification of the ECT by one of its key signatories in geopolitical terms placed Russia in a unique position. This position was tested in the arbitration proceedings started against Russia by Yukos' majority shareholders for the alleged expropriation of their investment in Yukos.²² In a decision on its jurisdiction and the admissibility of the claims made against Russia, the tribunal found that, for investments pre-dating 18 October 2009, Russia was bound by the ECT. Although the findings of investor-to-State arbitral tribunals have no official precedential value, the authority and stature of the Yukos tribunal is such that this decision is very likely to influence future investor-to-State cases brought against Russia concerning investments for the relevant period.

The Way Forward

What, however, of investments made after 18 November 2009? Russia has made it clear that it is no longer provisionally applying the ECT, but has not formally withdrawn from it in terms (as provided in Article 47 ECT). This places Russia in a grey area such that it is unclear whether Article 47(3) ECT, whereby the protection of the investment chapter survive withdrawal by a period of 20 years, finds application. By not formally withdrawing from the ECT, Russia could conceivably have left the door open to re-entry.

It remains to be seen what proposals Russia will put forward for a 'new generation' ECT and how practicable they might be.²³ It is recognised that there is scope for a fresh perspective on the ECT given the important changes that have taken place, and continue to take place, in the energy geo-political map since its inception. Article 34(7) of the ECT provides for its quinquennial review. The Energy Charter's Secretary-General has raised the possibility that 'new tasks and new directions' be explored, and has singled out transit, which has troubled Russia from the outset, as an area for discussion.²⁴ The ECJ rulings in the cases against Austria, Sweden and Finland provide another timely reason to open these discussions.

However, particular care ought to be taken not to dilute the fundamental treaty protections that have proved useful in creating a stable investment environment, including dispute resolution provisions. The viability and longevity of these core aspects also depend in part on the EU putting forward a clearer and more consistent message and on addressing its internal competence struggles alongside Member States in the energy arena.

Conclusion

International law and the ECT offer standards of substance and flexibility of procedure to provide assistance in the EU-Russia dialogue. It is not a straightforward exercise on either side, but Russia's willingness to step away from an instrument with barely-tested potential appears premature.

International law does have a way of getting back at States who make light of it. The European Court of Human Rights has agreed to hear a \$98 billion case against Russia alleging the unlawful expropriation of Yukos's assets, and a number of freezing orders have been granted in European and U.S. courts with a view to enforcing a ruling against Rosneft, Russia's State oil company which swallowed Yukos's assets.²⁵ Yukos is finding that international law can provide ways to haunt Russia from beyond the grave.

Footnotes

¹ President Dmitry Medvedev, in an interview with the Spanish press, reported in *Russiatoday*: "Europe needs new Energy Charter – Medvedev", www.russiatoday.com, 1 March 2009.

² Two enactments came into force on 7 May 2008: (1) Law No. 57-FZ "On the Procedure for Contributing Foreign Investments in Legal Entities which are of Strategic Importance for the Defence of the Country and Security of the State" ('Law on Foreign Investments in Strategic Companies'); and (2) Law No. 58-FZ "On Amendments to Certain Legislative Acts of the Russian Federation and the Abolition of Certain Provisions of Legislative Acts of the Russian Federation in Connection with the Adoption of the Federal Law [No. 57-FZ]" ('Law on Amendments').

The Law on Foreign Investments lists 42 sectors of strategic importance 'for the defence of the country and the security of the state', where foreign investment is made subject to stricter requirements. These sectors include nuclear energy, natural monopolies, the survey, exploration and production of large deposits of oil, gas, gold, copper and other 'deposits of federal importance', aviation, space and other defence-sensitive industries. For a review of the Law on Foreign Investment from the standpoint of the OECD criteria for legislation aimed at encouraging the growth of foreign investment, see Jesse R Heath, "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", September 2008, <http://ssrn.com/abstract=1264041>.

³ Wall Street Journal Online, 28 February 2009.

⁴ *Russiatoday*, 1 March 2009, *supra*, footnote 2.

⁵ Available at <http://kremlin.ru>. See S Nappert, ‘Russia proposes “new” Energy Charter Treaty’ (2009) *Global Arbitration Review* Vol.4 Issue 3, p 31.

⁶ It is beyond the scope of this paper to consider the complex issues raised, as a matter of treaty law, by Russia’s notification, and Russia’s current status with the other Energy Charter Treaty Contracting Parties. Whether the notification amounts to Russia’s ‘withdrawal’ from the ECT, as is often read in the press, is uncertain. Formal withdrawal, according to Article 47(3) ECT, entails the continued application of the ECT’s Investment Chapter for a period of twenty years from the date of withdrawal. It also appears incorrect, as a matter of law, to say that Russia’s notification simply frees it from the obligation provisionally to apply the ECT, and returns it to the status of mere signatory: see, contra, Dr A Konoplyanik, letter to the *Financial Times*, 26 August 2009, <<http://www.ft.com>>.

⁷ Yukos Universal Ltd, Hulley Enterprises Ltd, Veteran Petroleum Trust v Russian Federation, Interim Award on Jurisdiction and Admissibility, 30 November 2009, available at <<http://www.encharter.org>>.

⁸ See below. Article 45 provides that the ECT is provisionally applied by its signatories provided (i) its provisions are not inconsistent with the Contracting Party’s domestic law; (ii) the Contracting Party has not opted out of provisional application.

⁹ Scepticism has been widely expressed on whether these views, or the dissertation itself, were Mr Putin’s own. Whatever the position, it does not alter the fact that Mr Putin, once in power, did follow a course of energy policy consistent with the views defended in the dissertation to which he put his name.

¹⁰ Adopted by the Russian government on 28 August 2003: http://ec.europa.eu/energy/Russia/events/doc/2003_strategy_2020_en.pdf.

¹¹ Energy Strategy of the Russian Federation to 2030, at <http://www.energiystrategy.ru>.

¹² As held by the Permanent Court of International Justice in the seminal case of *The SS Wimbledon* (1923), cited in this context in J Paulsson, “El Poder de los Estados para Hacer Promesas Significativas a los Extranjeros” (2009) *TDM Issue 1*, www.transnational-dispute-management.com. See also his recent post, *Repudiation of International Arbitration Agreements and the Public Interest*, 16 February 2009, <http://kluwerarbitrationblog.com>. For an historical and witty account of *The SS Wimbledon*, see J Klabbers, “Clinching the Concept of Sovereignty: *Wimbledon Redux*” (1998) 3 *Austrian Review of International and European Law* 345.

¹³ *The Treaty of Lisbon (Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community 2007/C 306/01, in force 1 December 2009)* and the potential loss of Member States’ competence in matters of foreign investment, prompt a new look at sovereignty, which some argue is in need of ‘democratic recalibration’: see A Kemmerer, “The Crack in Everything: Sovereignty in a European Union of States, Peoples and Citizens”, forthcoming in Helge Høibraaten/Jochen Hille (eds.), *Northern Europe and the Future of the EU*, Berliner Wissenschafts-Verlag, Berlin, available on www.ssrn.com. The official position of the European Union is that Member States “remain independent sovereign nations, but they pool their sovereignty in order to gain a strength and world influence none of them could have on their own”: http://europa.eu/institutions/index_en.htm.

¹⁴ S Nappert, ‘Le droit dérivé et les investissements’, in C Kessedjian and C Leben, *Le droit européen et l’investissement*, Ed. Panthéon Assas 2009; M Burgstaller, “European Law and Investment Treaties”, (2009) *Journal Int’l Arb.*, forthcoming; H Wehland, “Intra-EU Investment Agreements and Arbitration: Is European Community Law an Obstacle?” (2009) *ICLQ* forthcoming; C Tietje, “The Applicability of the Energy Charter Treaty in ICSID Arbitration of EU Nationals vs. EU Member States”, draft in *TDM*, September 2008.

¹⁵ Notably in *Eastern Sugar BV v The Czech Republic*, Partial Award, 27 March 2007: <http://ita.lawuvic.ca/documents/EasternSugar.pdf>.

¹⁶ *Micula and others v Romania*, ICSID Case No. ARB/05/20, Decision on Jurisdiction and Admissibility, 24 September 2008: <http://ita.law.uvic.ca/documents/Micula.v.RomaniaJurisdiction.pdf>.

¹⁷ *Mercuria Energy Group Limited v Republic of Poland*, Stockholm Chamber of Commerce, claim registered on 24 July 2008, *IAReporter*, Vol.1, No.8, 26 August 2008: <http://www.iareporter.com>; *Electrabel S.A. v Republic of Hungary*, ICSID Case No. ARB/07/19: <http://www.worldbank.org/icsid>; *AES Summit Generation Limited and AES-Tisza Erömu Kft. v Republic of Hungary*, ICSID Case No. ARB/07/22: <http://www.worldbank.org/icsid>. In the cases against Hungary, the European Commission has applied for *amicus curiae* participation, arguing that the long-term power purchase agreements at issue, which guarantee a return on investment, violate EU competition law.

¹⁸ *Case C-205/06 Commission v Republic of Austria*; *Case C-249-06 Commission v Kingdom of Sweden*, Decisions of the Court, 3 March 2009: <http://eur-lex.europa.eu>.

¹⁹ *Case C-118/07 Commission v Republic of Finland*: <http://eur-lex.europa.eu>.

²⁰ Federal Law N108-FZ amending the law “On Concession Agreements” N115-FZ (2 July 2008). See J M Hertzfeld and M K Ivanov, “Disputes Regarding Immoveable Property (Real Estate) in the Russian Federation: The Competence of Arbitral Tribunals” *SCC Newsletter* 2/2008.

²¹ www.encharter.org.

²² *Supra* note 7.

²³ The overall legal framework of the new Russian proposal remains unclear. An agreement strictly between Russia and the EU along the proposed terms does not appear politically feasible: see S Nappert, ‘Russia proposes “new” Energy Charter Treaty’ (2009) *Global Arbitration Review*, footnote 5 above.

²⁴ www.encharter.org: “A word from the Secretary General on the Energy Crisis of Early 2009”, 13 February 2009.

²⁵ ‘A spectre of litigation’, *The Economist*, 27 March-2 April 2010, page 69.