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Europe's energy dependency and Russia's commercial assertiveness

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INTRODUCTION[1]

Europe is dependent on Russia for its energy supply and finds itself at odds with designing a policy that addresses its rising number of concerns over Russia (military, political, commercial) while not putting its energy imports at risk. Russia's new assertiveness, in energy and as well as in other external relations, has repeatedly led it to bully its trading partners, including the EU. Foreign investors increasingly find Russia an unstable destination for investments, where commercial rule of law still widely remains an alien concept. Trade and investment policies are unclear and subject to unannounced and arbitrary amendments. With power being increasingly concentrated in the Kremlin and around the former President, Vladimir Putin, Russian politics has slithered towards authoritarianism. There has been a growing convergence of interests between the Kremlin and Russia's energy oligarchs.

Kremlin's commercial assertiveness is visible across the entire economy but is especially pronounced in the

SUMMARY

Russia's commercial assertiveness is not a self-correcting, temporary phenomenon. The notion of state capitalism has come to the fore of Russian politics and is here to stay. This affects Europe's energy supply as well as the conditions for European investors to act in Russia. The two also hang together – to be a reliable partner for future energy delivery Russia must accept a considerable role for European companies and investors in its energy sector.

Negotiation over a new PCA will soon start, and hopefully it will present an avenue to address core commercial problems Europe has in its dealings with Russia. However, it remains unlikely that a new PCA will address the core energy-policy and investment-policy problems, and the EU needs to consider why it should seek a new agreement with Russia if it does not anticipate comprehensive improvements for the core part of the current commercial relations – for its energy imports as well as the European investors who have been mistreated in Russia's drive for re-nationalization.

There are two pieces missing in Europe's approach to Russia. Firstly, the EU needs a much more integrated energy policy, including a single market for gas, which could provide for unity and greater economic efficiency. The current approach allows Russia to play games with Europe as a whole by engaging individual member countries on a preferential basis, clearly to their advantage.

Secondly, the EU needs an in-built legal structure in its policy towards Russia needs that could establish structured procedures for addressing disputes and give investors better certainty. For investments in Russia's energy sector, such a legal structure is provided in some BITs between Russia and individual EU member states. Furthermore, a pending case related to the Energy Charter Treaty is to bring greater clarity to the extent Russia is actually bound by this treaty. Regardless the outcome, greater legal clarity in Europe's investment relations to Russia is central to reap the potential benefits of closer commercial integration. If Russia is not interested in subjecting an agreement with the EU to stronger legal protection for European investors, then the EU should seriously consider if an agreement at all should be advanced.

energy sector. The Yukos affair in 2004, stripping the owners of Russia's biggest hydrocarbons company of their assets, came as a true shock to the Russian as well as the international business community. It was to be followed by other actions where the government, or trusted partners of the government, grabbed others' assets. In 2007, for example, a smaller oil company operating independently of the Kremlin, Russneft, was forced to merge into a holding headed by a major Kremlin-connected tycoon, and its CEO left the country. Efforts by Kremlin to re-nationalize the country's hydrocarbons assets have hit foreign investors. In several instances assets were confiscated. In other cases, foreign investors conceded their shares not quite as voluntarily as portrayed by authorities. The transferred ownership of the Sakhalin-II oil field and the Kovytka site in Siberia epitomize Russia's determination to re-gain control over its energy resources.

Europe finds itself in a difficult position. Commercial law, let alone principles, is repeatedly disregarded in Russia. But European investors fear to take legal action as the political consequences can be even more financially damaging. Russia is not a member of the World Trade Organization (WTO), and complaints cannot be taken to the WTO for dispute resolution. As long as Russia remains outside the WTO, a Free Trade Agreement is not an option for Europe to establish greater certainty. The commercial component of the current Partnership and Cooperation Agreement (PCA) is weak, and has not proved to be an adequate tool to constrain Russia's commercial policy and behavior. Inits negotiations over a bilateral accession protocol to Russia's WTO accession, which appeared likely to happen before long during Putin's first term, Europe had some leverage, but it was spent on getting Russia's signature on the Kyoto protocol.

Europe's commercial problems are compounded by its dependence on Russian energy. Russia is the most important supplier of energy to Europe. Russia currently delivers around 30% and 40% of the EU's oil and gas imports respectively.[2] The Russian energy sector also attracts many European investors, and Europe thus has commercial interests to pay attention to. Although investors have long discounted losses due to 'Russian unpredictability', European direct investment in Russia more than doubled between 2002 and 2004 alone. For 2007, it was estimated at 17.1 billion.[3]

Europe's political problem in its commercial dealings with Russia lies in its conflicting internal interests and a weak bilateral institutional structure. Europe is trapped in its political economy of energy and external relations to Russia. On the one hand, an excessively tough stance towards Russia might provoke hostile reactions, jeopardize European investments, its access to Russian markets as well as its energy security. On the other hand, current policies and practices put Europe in a vexing position which displays political weakness and drastically reduces the value of European investments, especially in the energy sector. Current trends also lead to problems for Europe's energy security. The Russian energy sector is in a bad shape, it is gradually rotting away under state control, but European positions to build greater stability and certainty in its medium-to-long term energy markets run the risk of provoking a tête-à-tête with Kremlin, involving ceded deliveries of energy in the short term. European investors and politicians, thus, badly need a strategy for Russia addressing Europe's energy security, its investments, and Russia's commercial and political assertiveness.

This paper will analyze Europe's energy relations to Russia in light of recent and future developments in Russia's energy sector. It will discuss Europe's policy response to an increasingly complex energy structure in Russia and the Kremlin's use of energy to leverage its foreign policy. Furthermore, the paper will present policy recommendations for EU's own energy policy and its relations to Russia.

EUROPE'S ENERGY DEPENDENCE ON RUSSIA

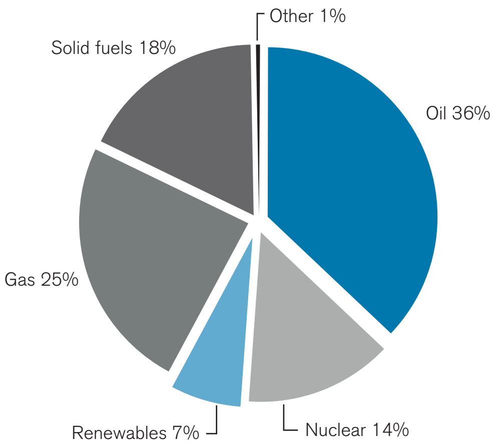
European governments are well aware of the fact that Europe's increasing demand for Russian energy puts the Kremlin in a comfortable position to neglect calls for more reliable and lawful governance. EU-Russian energy relations are likely to become increasingly asymmetric in the future. Current economic weather conditions might positively affect Russia's interest in adhering to rules of commerce – especially its position to WTO accession. Yet its political economy of energy will remain a source of dismay, also to Europe. Europe's rising demand for energy in general, in conjunction with its inability to press ahead with its technological and geopolitical energy diversification, will aggravate the problems posed by high dependence on Russian imports.

According to the European Commission, Europe's overall dependence on energy imports will rise from 50% in 2000 to 70% in 2030.[4] In the case of oil products, its dependency is projected to reach 90%.[5] Notably, some major European economies are already ahead of the general trend. While Germany needs to import almost two thirds of its energy, Spain and Italy's dependency rates have risen to 81.4% and 86.8% respectively.[6] This is chiefly the result of two concurrent developments: European energy consumption is constantly growing and it is making little progress in gaining access to energy sources in other regions.

In 2030, the EU is expected to consume 15% more energy than it consumed in 2000.[7] Although this growth rate is lower than projected economic growth – suggesting improving energy efficiency – its full significance can be appreciated only in juxtaposition with the sharp decline in European energy production. Between 2000 and 2030, EU25 production of oil, gas, and solid fuels is expected to decline by 73%, 59%, and 41% respectively. Between 2004 and 2005 alone, production of oil, gas and coal fell by 9.0%, 5.8% and 5.7% respectively.[8]

The impact of this general decline is barely dampened by the fact that the production of renewables is expected to double over the same period. This is due to the EU's unfavourable energy mix.[9] As the graph below shows, about 80% of the energy consumed in the EU is generated by fossil-fuel combustion, with renewables accounting for not even a fifteenth.

Figure 1. EU's energy mix



Source: European Commission, "Energy and Transport in Figures", Statistical Pocket Book 2007.

This distribution is unlikely to see change in the near future. Even if the EU achieves its target of sourcing 20% of its energy needs from renewables by 2020, fossil fuels will remain the most important source of energy, especially as there is widespread unwillingness to switch to nuclear. In fact, Europe's leaders have chosen to rely on gas as the main source of energy in the future – at a time when Europe-wide production is decreasing sharply. The black gold, by contrast, no longer glitters. The prevailing perception that the political precariousness of the Middle East, which to date has provided the majority of Europe's oil imports, will not be solved in the near future has not only caused the price of crude oil to increase (and fluctuate substantially), but has also altered the EU's energy security scenarios. Moreover, current energy policies in Europe encourage EU providers to build easier-to-finance gas-fired plants.[10]

The focus on fossil fuels in general and natural gas in particular increase Europe's dependence on imports of energy. The EU27 imported 53.8% of the natural gas it consumed in 2006.[11] By 2030, the EU will have to import up to 80% of its consumption.[12] As Table 1 shows, some major European economies, such as Germany and France, already exhibit dependency rates of this magnitude. Twelve EU member states, including Portugal and Sweden, are even wholly dependent on foreign imports of gas. These figures need not be discounted much if intra-European trade is taken into account. In 2004, the only two net exporters, Denmark and the Netherlands, exported just about the amount of gas that Spain imported. Statistically speaking, the rest of Europe therefore depends on gas imports from outside the EU.[13]

Table 1. Dependence on imported gas for selected EU countries

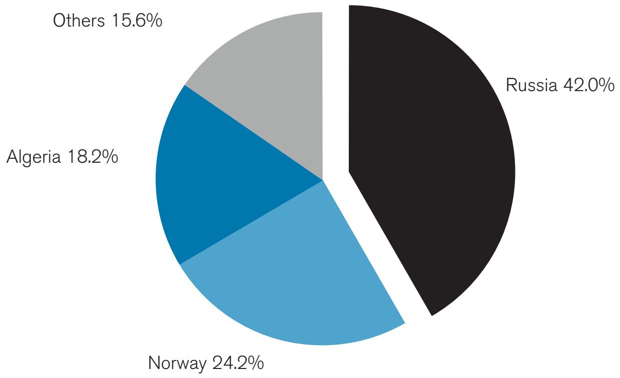
COUNTRY	DEPENDENCE ON IMPORTED GAS, 2006
Germany	83.6%
Spain	101.3%
Italy	91.2%
France	80.0%
Denmark	-101.3%
Netherlands	-61.6%
Portugal	100%
Sweden	100%
UK	11.8%

Source: DG Tren, Pocketbook 2007

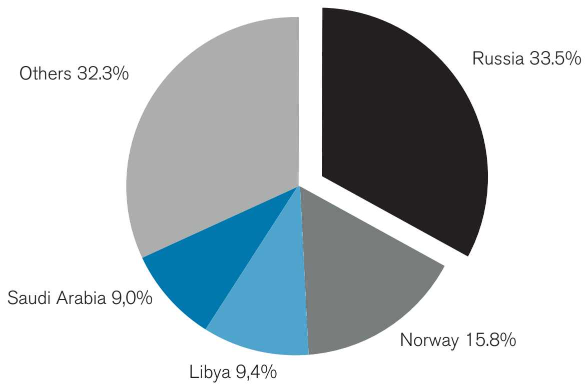
Besides its failure to diversify its energy mix, Europe has made little progress in gaining access to new energy sources in other regions. Russian delivery is the chief part of Europe's gas and oil import, as Figure 2 shows. Central Asia has recently become the special focus of the European Union's strategy to diversify its energy sources. Although Central Asia harbours only 4% of the world's known energy resources, a vast proportion of these reserves have not yet been exploited. It is expected, for instance, that the oil fields of Central Asia are potentially capable of yielding four million barrels per day by 2015, which is comparable to the daily output level of Iraq and Kuwait combined.[14]

Figure 2. EU's gas and oil imports

EU-27 Gas Imports - 2006



EU-27 Crude Oil Imports - 2006



Source: DG Tren, Pocketbook 2007

The Baku-Tbilisi-Ceyhan (BTC) oil pipeline was inaugurated in May 2005, stretching from Baku in Azerbaijan to the Mediterranean coast of Turkey. Though the pipeline initially transported exclusively Azeri oil, the construction of the BTC provides the European energy market with long-term access to other central Asian energy resources.[15] Two European companies currently involved in exploring Kazakhstan's vast offshore 'Kashagan' field are members of the BTC consortium and enjoy preferential tariffs for exporting their oil through the new pipeline.[16] After months of delays and setbacks, Nabucco, the European Union's ambitious natural gas pipeline project, received its first supply order in June 2008.[17]

European attempts to gain access to Central Asian energy supplies have been undermined, however, by hostile Russian diplomacy and Europe's dislike for *Realpolitik*. While Russia, spearheaded by former President Putin, has been astonishingly successful in torpedoing the EU's diplomatic efforts by offering seductive deals to Central Asian autocrats, the EU has had painfully to appreciate that it is currently in no position to attach political conditions to its offers to invest in the region's energy sector. After all, Russia and China offer "less emphatically democratic and more pragmatic relationships", as one analyst puts it.[18]

Rising energy demand and difficulties in accessing other sources of energy suggest

Europe will probably not be able to reduce its energy dependence on Russia. In fact, the European Commission itself estimates that its gas imports from Russia will climb from today's 40% to 60% (of total import) in 2030. One could challenge such assumptions, primarily on the basis of the poor performance of the Russian gas sector and the problems for Gazprom in particular to bring new fields on stream. Yet with Russia's investment in new import capacity, and the declining role for gas production in Europe (the Netherlands, the United Kingdom and Norway), Russia's share of European import will remain high. It will probably also increase in the medium term.

Europe's import dependence appears even more worrying in light of the increasing competition for Russian energy from the Far East. The current gap between China's stagnant energy production and fast-growing consumption is projected to widen even further in the next two decades. Notwithstanding political and commercial suspicions and frictions between the two countries, Russia is eager to meet China's insatiable demand for energy. The new Taishet-Daqing pipeline is expected to supply 20-30% of China's oil imports by 2010.[19] Gazprom plans to spend 11 billion USD to construct four pipelines to supply China with as much as 80 bcm of natural gas annually,[20] which covers about 150% of Chinese gas consumption in 2005.[21]

RUSSIA'S NEW STATE CAPITALISM

Dependence on energy imports is not in itself a problem. The problem facing many parts of the world, however, is dependence on supply from authoritarian countries with unstable political conditions and institutions. The additional political problem for Europe is that its chief foreign supplier is politically moving in the wrong direction – in general and in its energy policy – and that its energy sources and supply infrastructure increasingly have been re-nationalized, often by dubious means damaging European investors.

Re-nationalization of Russian energy has been extremely strong in the 2000s. Kremlin's desire to wield the significant political leverage that is associated with the world's largest natural gas reserves (and the second-largest solid fuel reserves) is one reason behind Russian re-nationalization. The Russian government has also feared political opposition from the country's energy oligarchs. The re-emergence of Russia's particular brand of nationalism has added a strong ideological layer to its energy policies, and provided an official rationale in the re-nationalization of energy sources and assets. The re-nationalization itself was also seen as a popular way to punish oligarchs who acquired ownership of energy firms in a way that would not have been possible today.

Yet there is also an economic 'logic' behind the wave of re-nationalizations. In today's Russia, occupying the commanding heights of the economy consists mainly in controlling the energy sector. As with all other resource-rich countries, economic growth and development in Russia is inextricably linked to the ownership of energy sources and the distribution of the windfall gains. The revenues generated in the energy sector are so vast, and represent such considerable parts of economic output and government income, that most governments in resource-rich and resource-driven economies find it impossible not to claim ownership over the resources.

Russia's recent decade-long economic boom has largely been driven by its energy exports. There has been a real export bonanza. Domestic demand and consumption have pushed economic growth, too. Yet the growth in export revenues from energy, especially in later years amid surging commodity prices, and energy-related investments have been the leading sources of economic growth.[22] The total export share of energy has increased not only because of skyrocketing world-market prices, but also due to steadily growing export volumes. Since the collapse of the Russian economy in the mid-1990s, output of crude oil has three-folded. According to the IEA, it will rise to 10,5 mb/d in 2011, which represents a 12% increase between 2006 and 2011. Growth in gas output, albeit slower, has averaged 2% per year between 2002 and 2006. Due to these advances, oil and gas represent more than two thirds of Russia's total exports in 2007.[23]

However, the real-exchange rate effect of the energy boom has driven prices of Russian industrial goods to such high levels as to erode their international competitiveness. Rather suggestive in this respect is the fact that in 2005, for the first time in a decade, a majority of Russia's arms production went to the government for its own needs, rather than to the export market.[24]

The Kremlin has used the economy's vulnerability to Dutch disease to justify its move toward state capitalism. The other part of the justification pertains to the oligopolistic structure of the energy sector, which called for regulatory intervention. Yet lacking the will – or perhaps the institutional means – to regulate a privatized energy sector, the Kremlin has bluntly decided to re-nationalize it. It takes the simplistic view that ownership of energy resources is the chief, if not the sole, determinant of the distribution of the windfall gains flowing from their exports. Russia's energy sources are thus concentrating in the hands of the government or of firms controlled by the government. Gazprom, until recently headed by now-President Medvedev, has been on a buying spree for the past five years and today accounts for 84% of Russian gas output.[25] The government holds more than half of Gazprom's shares since 2005. Also the oil sector has seen growing concentration and re-nationalization. In 2007, more than 52% of crude oil output was produced by state-controlled companies, up from 19% in 2004.[26] Altogether, the state controls about 47% of the Russian energy sector.[27]

The energy boom has filled the government's coffers to the brim. Russia earned 500 million USD a day from crude oil exports in 2005.[28] In 2007, the Russian authorities collected 85 USD billion from duties alone, receiving around 47 and 20 USD per barrel from export and extraction taxes respectively. The export revenues of Gazprom exceeded 37 billion USD in 2006.[29] The government's Stabilization Fund, set up in 2004, hit 158 billion USD at the end of 2007. Yet far from re-investing these windfall profits into the energy sector or those industries allegedly suffering from the symptoms of Dutch disease, the government has channeled 80% of the Stabilization Fund into foreign assets, which has been necessary for its sterilization, whilst pumping the remaining fifth into a National Welfare Fund. So far, this fund has mainly served to bail out undercapitalized banks and prop up the financial market.

The nationalization of energy sources has been disastrous for Russia's oil and gas sector. This is demonstrated by a comparison between these sectors and the flourishing coal sector. The fact that between 2002 and 2004 private oil majors grew ten times faster than state-controlled companies did not discourage the government to extend drastically its ownership in the industry between 2003 and 2005, mainly through the confiscation of Yukos and Gazprom's purchase of Sibneft. As a result, industry-wide output growth plummeted from 9% in 2004 to a mere 2% in 2006. Yukos' output even declined by 40%.[30] Gazprom itself has been badly managed and has problems of extracting more gas, especially from secondary fields. It behaves like a typical monopolist, with clear effects on productivity and commercial strategies.

The coal sector, on the other hand, stayed private; its growth rate rose from 1% to 6% between 2004 and 2006.[31] The abrupt stagnation of the oil sector seems to be clearly related to the changes in its ownership. Also indicative in this respect is that, against a background of spiking energy prices, the private owners of Russia's coalmines boosted investment by an impressive 67.5% in 2004, whereas the oil industry reduced its investments by 20%. The energy sector generates about half of public revenues, but only 7% of total investment flows back into it.[32]

Moreover, nationalized, state-owned energy majors in Russia belong to the least productive energy firms in the world. This inefficiency is clearly attributable to state control. The return on total asset (ROTA) of Gazprom, for instance, was only 25% of the ROTA of Yukos prior to its confiscation. There is a link between Gazprom's inefficiency and its frantic acquisition of energy firms and international expansion. One the one hand, it has sought to polish up its own production figures by purchasing more efficient private firms. On the other hand, its own inefficiency is also due to the fact that its managers seemingly prefer to spend the company's revenue on anything but improving the performance of the company. Spending only $12.5 billion per year on developing new fields, Gazprom has never brought a major gas field on-stream.[33] State control undermines efficiency mainly in two ways. First, when faced with competitive problems, it is easier for Kremlin-connected firms to solicit the government to implement regulation detrimental to more efficient competitors than to tackle their own efficiency problems. Second, given the lack of transparency in state-controlled firms, managers are highly prone to corruption.[34]

THE VICIOUS CYCLE OF RE-NATIONALIZATION

The appalling record of government-controlled firms is unlikely to lead the Kremlin to abandon its strategy. In fact, the opposite is more likely: the Kremlin and the government controlled energy firms are likely to strengthen their hold of energy sources and the supply infrastructure. The logic of state capitalism has already set in. There are some structural features in this logic that reinforce the logic and which are difficult to change. These are the following:

Firstly, the Russian government has an insatiable demand for capital, and so far they have not managed to establish any other sustainable system for extracting revenues from the energy sector (especially the windfall gains) without damaging the productivity of these firms. The corporate tax system has not worked. Since many of the owners have their capital abroad, it is not possible to raise much revenue via capital taxes. Hence the drive for re-nationalization: it is a secure way to boost revenues in the short run.

Secondly, the Russian government will have an increasing demand for capital as energy prices have dropped, which immediately affects government revenues. Furthermore, the coddled sectors in the economy have a constant demand for financial support.

Thirdly, government-controlled energy firms have invested too little in new energy sources, and as old fields are running empty they need to get access to already existing extraction. Private or foreign firms have invested relatively more than government-controlled firms and are also part of the development of new fields. The government-controlled firms, especially Gazprom, have profiled their investments downstream and in establishing new supply routes for gas. There is a limit to the rents firms could extract from supplying the infrastructure – delivering gas through the pipelines – and those rents are not viewed as an alternative to extracting the revenues that come by owning the sources.

Thus, a vicious cycle kicks in: with output growth stagnating as a result of inefficiency and insufficient levels of investment, the government will need to extend further its ownership for its windfall gains to be maintained or keep growing. Knowing that the sector's capacity will stagnate in the long-term, and the general short-sightedness in Russia's energy policy and extraction, the Kremlin will keep trying to squeeze it out as much as possible.

Fourthly, the institutional structure of energy governance invites to re-nationalizations. The institutional structure is overall weak and is controlled jointly by the Kremlin and some of the big firms, Gazprom in particular. Temptation for re-nationalization is heightened by the fact that it is so easy to do. Unlike industrial products, commodities can be extracted and exported without any need for a wider integration with other countries or firms. As the energy sector requires no inputs, the Kremlin need not worry about adverse effects in the overall supply chain. No sound policy-making is required for the Kremlin to reap the fruits of abundant natural resources.

It is hardly surprising that European firms find it increasingly difficult to invest in Russia. Foreign investors' access to the energy sector has become more and more restricted. The Kremlin recently passed a law to the effect that foreign companies seeking to acquire more than 50% of a Russian company must obtain prior approval by a special government commission. This threshold is reduced to only 10% if the target company is part of a strategic industry; the energy industry, of course, as well as arms, is of the highest strategic importance. The exact criteria of assessment which such approval hinges on have not been explicated. Though the law clarifies in which industries foreign investment is formally possible, it hardly changes the fact that it is ultimately contingent on the Kremlin's arbitrary discretion.

The special emphasis of these restrictions on foreign investment in the energy sector is manifest. In fact, other sectors of the Russian economy have been opened to foreign investors, as a result of such reforms as the commercial code implemented under President Putin. Hence, while total FDI in Russia increased by an impressive 380% between 2004 and 2006, hitting €23 billion in 2006, foreign investment in the energy sector saw only about half this growth rate.[35] Though there are no reliable figures, this estimation seems to be plausible. Consider, for instance, the fact that the Sakhalin oil and gas field – which some European companies were driven out of – in 2002 attracted one fourth of all FDI in Russia.[36] The difficulties faced by foreign investors in gaining access to Russian energy resources is reflected in the fact that they own less than a tenth of Russia's energy sector.

Aside from the quantitative restrictions on investment and ownership, Russia's energy sector, is a source of growing risks for European investors. As ownership is increasingly centralized, Russia becomes an evermore unpredictable and risky destination for European investors. Fragmented, private ownership generally makes for greater stability than concentrated state-control. Foreign investors face evermore obstacles when doing business in Russia. Profitable and sustainable commercial activity in Russia is largely contingent on political relations and subject to the whims of political leaders.

Another problem is that property rights are built on shaky foundations at best. The Sakhalin II project, again, serves as a case in point. Gazprom purchased Shell's shares in the field for far less than their real value. True, Shell decided not to complain about this partial expropriation. But this rather reflects a strategy to avoid worse treatment. Typically, a country allowing such moves would be punished by market-based mechanisms, and in the long run that tends to happen everywhere. In the short-to-medium term, however, the market-based mechanism for sanctioning bad behavior is not sufficient to establish good investment conditions.

EU-RUSSIA RELATIONS

What could and should be Europe's response to this development? In light of the Kremlin's tightening control of the Russian energy sector, it is utopian to believe that market-driven forces alone will do the job of inducing legal compliance and good corporate citizenship, let alone internal political change. Neither the political leadership nor the institutional framework is likely to see change any time soon. While Russia's neo-patriarch Putin, even more so than his personally anointed successor Medvedev, is highly popular with an increasingly stable and prosperous Russian society, the move toward state capitalism has found more widespread support than many liberal critics are prepared to admit. Yet Europe's energy dependence on Russia considerably limits the room for bold political maneuvers, such as tightening Russian access to European markets. The EU needs to find a much more subtle solution to this problem.

The solution, it is often suggested, lies in new and better agreements with Russia that 'regulates' its behavior. The EU's core objective in pushing ahead the negotiations over a new Partnership and Cooperation Agreement (PCA) with Russia is to open up the Russian energy sector and bring greater certainty to Europe's energy supply. Negotiated by political means, a new agreement, it is hoped, will de-politicize energy relations between the EU and Russia. In exchange, the EU is willing to offer deeper economic integration. Yet, although the EU-Russia Summit in late June was held in a generally friendly, optimistic and constructive atmosphere, it seems unlikely that Russia will make any substantial concessions regarding foreign access to what it regards as the nucleus of its economy.

From the Russian point of view, there are two arguments against embedding such commitments in a new PCA. Firstly, the FTA offered by the EU remains an illusion as long as Russia is outside the WTO. With its highly mercantilistic outlook, Russia also has hesitations about the benefits of joining the WTO or opening up its uncompetitive industrial and service sectors to European competition. Yet Moscow claims that it still seeks accession as soon as possible. However, the increasingly unilateral and protectionist nature of its trade policy, contradicts its diplomatic rhetoric. Second, energy products, as all commodities, are scarcely subject to the trade barriers that exist between the two parties.[37] As Russia's exports mainly consist of commodities, it is not to gain so much from an FTA as to be persuaded to stop clamping down on foreign access to its energy sector.

There are no other carrots that the EU could offer to Russia, at least none that could possibly tempt the Kremlin to sacrifice, even marginally, its energy supremacy and its short-term view on its energy sector. Access to European markets for Russian investors is almost entirely free. Nor is there much point in turning to the stick method by, say, restricting access to European energy markets. True, Gazprom has in recent years been eager to invest in European infrastructure, and introducing obstacles to its commercial expansion to the West would be a serious blow to Russia.

However, with the liberalization of the European energy market, there are no effective means to stop EU companies from selling assets to Russian buyers. In the absence of formal economic sanctions on Russia, moral appeals will be unheard. Generally speaking, any 'tough' measure on Russia is bound to boomerang. While Europe may be justified in playing 'tit', the second Russian 'tat' might be crushing. European leaders cannot ignore a scenario where Russia halts energy transports to Europe, more than it has done hitherto, because it is irritated by political moves in Europe. The crisis of January 2006, when European leaders and energy providers panicked after a drop in gas supplies amidst Russian-Ukrainian tensions, should provide sufficient warning.

Certainly, Russia is also dependent on the EU. After all, two thirds of Russian exports, two thirds of which comprise energy products in turn, go to the EU. In comparison, exports to China are negligible, amounting to only 6%, at least for the time being. Nonetheless, while Russia could easily shut down its pipelines to Europe for a few days, especially with a view to the immense reserves it has amassed in recent years, Europe cannot do without Russian energy even in the very short-run.

Another obstacle is Europe's internal disunity. For instance, while Greece and Cyprus have generally defended Russian interests and have threatened to veto a tough EU common policy toward the Kremlin, other countries have opposed negotiations between the EU and Russia against the background of an asymmetric interdependence favouring the latter. Even within and among the EU institutions there are considerable divisions as to the most appropriate approach to take. Some major European actors, furthermore, seem hardly interested in a common EU policy. Germany and France, inter alia, have preferred to deal with Russia directly, rallying to secure the sweetest deals for their national energy champions. The most prominent example here is the Nord Stream pipeline project initiated by the former German Chancellor Schröder and Putin.[38] Although this new pipeline between Russia and Germany would not directly redress the problem at issue here, the project exemplifies a widespread willingness to bulldoze the ideal of common European energy policy as and when this seems advantageous.

Such bilateral approaches, however, merely serve to shift around the burden of the problem among EU member states. Given that Russia is determined to limit European access to its markets, some investors' gains must be to some others' detriment. One reason why European leaders were suspicious of Schröder's friendship with Mr. Putin were concerns about the latter's human rights record. Another reason, albeit often downplayed by politicians and the media alike, were fears of being left out. No individual member state possesses the political, let alone economic, weight to redress the increasingly asymmetric relations with Russia in a one-man show.

EUROPE'S RESPONSE SHOULD START AT HOME

Inevitably, Europe will soon re-start its PCA negotiations with Russia. The PCA from the mid 1990s has expired and, according to the official motivation for a new PCA, there are many benefits to be made for both parties by stronger economic and political integration. Russia is Europe's third largest trading partner and current commercial exchange, as well as current efforts to create a Common Economic Space, needs a stronger policy framework. Energy policies, it is acknowledged, will be difficult to address, but there are other issues of concern which can only be addressed by proper negotiations. Moreover, the EU needs to take a long-term look at Russia and provide for its integration into the world economy and world politics. This integration will continue to present disappointments and problems, but there is not any other way to establish a peaceful and sustainable cooperation between Russia and the rest of the world.

One can raise serious concerns about the PCA negotiations. Re-launching them so soon after Russia's invasion of Georgia is not only problematic in itself, but also demonstrates (and painfully so) the power balance between the EU and Russia. Another set of concerns regard the integrity and status of a new PCA agreement. The current PCA expired in 2007. It has been prolonged for one year and could continue to be prolonged on an annual basis. The PCA is weak and does not establish a functioning institutional framework neither for commercial nor for political relations. The PCA has several commercial provisions, but Russia has apparently not hesitated to violate them. Clearly, there are areas where a PCA, or a bilateral commercial agreement, ideally could solve problems, but it remains highly uncertain if PCA negotiations can do that. In some areas, such as energy, it is highly improbable that a PCA could provide for the policies needed to create a better commercial atmosphere. Furthermore, negotiations might be able to solve some of the less demanding issues, but there is a danger that such an agreement, with clear exclusions of the sensitive and really important areas, will actually give legitimacy to dubious commercial policies and practices. The treatment of European investors in Russia, especially in the energy sector, is one such area. The fact that pertaining issues will not be (properly) addressed in an agreement, and that the EU signs it anyway, indicates it does not find these issues sufficiently important.

There are two pieces missing in the EU's approach to Russia and its increasing assertiveness. Both of them concern structural factors and developments outside the direct external-policy relation between the EU and Russia. The first piece is greater energy cooperation in Europe and in particular a single market for gas. The current policy fragmentation in Europe creates internal divisions and inefficient energy markets. Furthermore, this fragmentation allows Russia to increase internal divisions by favouring some countries over others. As long as Europe maintains fragmented energy markets, its bargaining power against Russia will be weak, and bilateral relations will continue to sour and be subject to endless internal rivalries. However, a single market for gas, and a new comprehensive strategy for energy-policy cooperation, appears distant. The opinions among EU member states are too divergent.

The second piece missing in Europe's approach to Russia is a stronger reliance on existing legal frameworks to address disputes. The legal aspect of a commercial relation, which is necessary for a stable investment environment, is all the more important in this bilateral relation as Russia is not a member of the WTO. The EU itself can only play a limited role in this context as many of the pertaining issues remain outside its remit. Yet the EU must start to plan for the event that European investors are using other legal means to address it commercial problems in Russia. Two legal 'tracks' to address problems concerning European investments in energy are particularly interesting.

Firstly, several EU countries have entered Bilateral Investment Treaties (BIT) with Russia. These treaties have already been used in commercial disputes, although the full extent by which these agreements have been used in commercial arbitration remains unknown. A BIT is signed to give good protection to investors and many EU countries have entered such an agreement with Russia. A key part of a BIT concerns expropriation.

It is well recognized in international law that it falls within the sovereign powers of states to expropriate foreign investors' property. It is equally well established in customary international law and BIT practice that this sovereign right is subject to four conditions, namely that the exercise of this right must be non-discriminatory; the measure is taken to serve a public purpose; it is taken in accordance with applicable laws and due process; and full compensation is paid in a prompt, adequate, and effective manner. BITs typically further stipulate that compensation must be paid without undue delay in a freely convertible currency, and stipulate a standard of valuation of the respective property. Moreover, a standard feature of BITs is to protect investments from both direct and indirect expropriation. The concept of indirect expropriation relates to two factual circumstances. First, expropriation is deemed existent where a series of measures is used to deprive investments of their economic falue , but where no individual measure in itself would have the effect of expropriation ('creeping expropriation'). Secondly, indirect expropriation is found where a measure is taken for regulatory purposes but has an impact on the economic value of the asset owned by the investor that amounts to de facto expropriation ('regulatory expropriation').

Russia's bilateral investment treaty program conforms to these international standards. Only individual treaties deviate from international BIT practice. For instance, the UK-Russia and Ukraine-Russia BITs do not refer to public interest or a due process requirement. However, against the background that most of the listed standards have reached the status of customary international law, the deficiencies of these particular agreements should not have any effect on a host state's actual obligations with regard to the expropriation of foreign property. Thus, Russia's bilateral legal regime governing the expropriation of foreign property arguably provides for a sound standard of foreign investment protection.

Secondly, the Energy Charter Treaty (ECT) is now also the centre for a dispute involving the Russian government and three European investors. So far Brussels has adopted a sceptic view of the ECT in relation with Russia. This, however, might soon have to change. Russia has signed but not ratified the ECT, but an arbitrational tribunal decision will soon be issued on the applicability of the ECT to settle a dispute between former shareholders in Yukos and the Russian government.[39]

RUSSIA AND THE ENERGY CHARTER TREATY

The Russian Federation is a signatory to the ECT. However, it has not ratified the agreement and has no intention of doing so. But can Russia be bound by the ECT despite the fact that the Russian legislature has not ratified it? Arguably, it can.[40] The basis for this view is that Russia has, by means of signing the ECT, consented to the *provisional and full application of the ECT for an indefinite period of time*. Furthermore, it has not made use of the provisions in the ECT that enables a signing party to exempt itself from provisional coverage until the agreement has been ratified.

The ECT is the first comprehensive international agreement that is aimed at the promotion and protection of investment, security of supply and transit in the energy sector. The treaty provides for contracting parties' obligations regarding transparency and non-discrimination in the treatment of foreign investment, freedom of transit and a long term commitment towards a liberalization of trade in the energy sector. Moreover, and typical for international investment treaties, the ECT contains strong dispute settlement provisions which give contracting parties and its private investors the unconditional right to submit disputes with other contracting parties to international arbitration.

In December 1994, fifty-two states (including the EU as a unit, Russia and Ukraine) signed the ECT. In accordance with Article 44, the treaty entered into force in April 1998, 90 days after the date of the deposit of the thirtieth instrument of ratification. Apart from Russia, four other states have not yet ratified the treaty. As a consequence, the ECT has not entered into force for these signatories.

What is important, however, is that Article 45(1) of the ECT provides for the provisional application of the ETC. It states that "[e]ach signatory agrees to apply [the ECT] provisionally *pending its entry into force for such a signatory* (…), *to the extent that such provisional application is not inconsistent with its constitution, laws or regulations*"[emphasis added].

Article 45(1) ECT raises three critical questions: First, is there a time limit regarding the provisional application of a treaty where ratification is not anticipated? Second, what is the legal scope and substance of the concept of provisional application in terms of signatories' obligations under the ECT, e.g. does the concept confer the legal obligation upon a signatory to apply the treaty as a whole and in its entirety? And thirdly, after these general issues have been addressed, is the provisional application inconsistent with a particular signatory's constitution, laws or regulations, which would then, entirely or partially, exempt this signatory from its obligation under Article 45(1)?

Provisional application of treaties is a common concept in international law and international legal practice. Article 25(1) of the 1969 Vienna Convention on the Law of Treaties (VCLT) stipulates that a "treaty or a part of a treaty is applied provisionally pending its entry into force if: (a) the treaty itself so provides; or (b) the negotiating States have in some other manner so agreed." The VCLT, however, neither provides for a definition of what provisional application entails nor does it place a limit on its duration. In contrast, the obligation conferred by Article 18(2) VCLT, where treaty signatories shall not defeat the object and purpose of a treaty, continues to apply only as long as the entry into force of the treaty "is not unduly delayed". This standard for a "reasonable period of time" has not been written into Article 25 VCLT. It is left to the respective treaty provisions to define or limit the scope of provisional application.

Reviewing the provisions of the ECT, Article 45 (2) holds that any signatory may, when signing, declare that it is <u>not</u> able to accept provisional application and thereby exempt itself from the obligation conferred by paragraph one of the same article. Several signatories have made use of this opt-out clause. The Russian Federation, however, is <u>not</u> among them.

Furthermore, Article 45(3)(a) allows a signatory to terminate the provisional application of the ECT by written notification of its intention not to become a contracting party to the treaty. The Russian Federation has <u>not</u> yet issued such an express notification, despite the fact that Russian senior officials have repeatedly dismissed the agreement.

Subparagraph (b) of Article 45(3) gives an important indication for the possible scope of the provisional application of the ECT in terms of the substance of the obligations conferred by it and its duration. In the event a signatory uses the right to terminate the provisional application of the ECT, the provision states that this signatory is further obliged to apply Part III (Promotion and Protection of Investment) and Part V (Dispute Settlement) of the ECT for another twenty years with respect to investments made in its area prior to the termination.

The provision seems to confirm that these critical parts of the treaty, and not only the more lofty ECT rules contained in other parts, do fully apply during the period of provisional application and confer binding obligations. Article 45(3) contains the ECT's only reference to a time limit applicable to provisional application, notably by allowing for an opt-out through express termination. Allowing for express termination, by inference, seems to preclude an implied time limit. Thus, the ordinary meaning of the terms of Article 45 supports the argument that the treaty *as a whole applies provisionally for an indefinite period of time* if not terminated by a signatory through notification.

Having deduced the general scope of provisional application of the ECT from the ordinary meaning of the terms of the treaty, the subsequent step is to determine the scope of the limits set by the 'domestic exception' clause contained in Article 45(1), which provides that the ECT applies provisionally "to the extent that such provisional application is not inconsistent with its constitution, laws or regulations." Given the unusual extensive scope of provisional application of the ECT in terms of duration, this phrase is aimed at striking the important balance between negotiating parties' intent to apply the treaty as soon as possible, on the one hand, and the imperative that international treaties must only be applied and enforced in coherence with the domestic legal system of its respective signatories, on the other hand.

The terms of the 'domestic exception' clause are ambiguous. The language can mean that: (a) provisional application as a concept must not be inconsistent with the state's domestic laws and regulations and/or (b) the individual substantive provisions of the ECT must not be inconsistent with the state's domestic laws and regulations.

On interpretation (a), there is no express provision to be found in the Russian Constitution which refers to provisional application of international treaties. However, Article 23 of the 1995 Federal Law on International Treaties recognizes the provisional application of international treaties by Russia if the respective agreement, to which Russia is a party, stipulates as such. Interpretation (b) is far more difficult to analyze and is beyond the scope of this brief, but will surely be tested in the ongoing arbitration proceedings against Russia. It is clear, however, that the 'domestic exception' clause would, if authoritatively interpreted as in (b), allow for extensive possibilities of abuse by signatory states which could seek to evade specific substantive obligations by invoking internal laws on a case-by-case basis.

Judging from the information that is available in the public domain, the history of investor-state arbitration under the ECT entails one authoritative interpretation of Article 45. Despite the fact that the findings of the ICSID tribunal in *Ioannis Kardassopoulos vs. Georgia* do not establish a binding precedent for the applicability of the ECT for Russia, or the pending case between Yukos shareholders and the Russian government, the interpretations advanced in the *Kardassopoulos* case give us an idea.[41]

The *Kardassopoulos* Tribunal made the following findings with regard to its jurisdiction:

- Provisional application of the Energy Charter Treaty is not aspirational in character. It is a matter of legal obligation.

- It is the treaty as a whole and in its entirety which is to be applied "pending its entry into force".

- The language in Article 45(3)(b) confirms that ECT parts III and V apply during the period of provisional application, and that the operation of these parts gives rise to an obligation.

- The language of Article 45(1) means that each signatory state is obliged, even before the entry into force of the treaty for the respective state, to apply the entire treaty as if it had already done so.

- The burden of proof, to show that provisional application was inconsistent with the constitution, laws or regulations of the state where the investor is based or of the state the investment was made in, is on the defendant. In this specific case, the tribunal held that provisions, which do not deal with provisional application but establish circumstances in which treaties become an integral part of domestic law and require prior ratification for those purposes, are not inconsistent with provisional application.

The *Kardassopoulos* case, however, refers to the specific factual circumstances where a Greek private investor claimed Georgia's interference with a joint-venture in Georgia in violation of the ECT *pending* the ECT's entry into force in April 1998. The ruling left the question of indefinite provisional application after that date untouched. Nevertheless, the language of the treaty does not support an advanced interpretation in favor of any kind of implied self-termination of provisional application. To the contrary, even in case of express and notified termination, Russia would remain bound by parts III and V with regard to investments made during the period of provisional application for twenty years hence.

Therefore, the ECT could provide contracting parties, signatories, and investors with a forceful legal tool by means of which they may file claims and win awards with regard to energy sector investments made in the territory of the Russian Federation. If this is confirmed by the tribunal in the current case between shareholders in Yukos and the Russian government, it will have implications for Europe's overall approach to Russia. Many more cases are likely to be subject to arbitration proceedings and, in effect, Russia will have to change its policy.

CONCLUSION

Russia's commercial assertiveness is not a self-correcting, temporary phenomenon. The notion of state capitalism has come to the fore of Russian politics and is here to stay. Europe therefore must react if its investors are to re-gain access to the Russian energy sector. In doing so, however, Europe should be calm, rational and, above all, united. It should seek ways to de-politicize its commercial relations to Russia.

Negotiation over a new PCA is an approach, and hopefully one that could address core commercial problems in the energy sector and for European investors. However, it remains unlikely that a new PCA will address these problems and the EU needs to consider why they should seek a new agreement with Russia if it does not anticipate comprehensive improvements for the core part of the current commercial relations – for its energy imports as well as the European investors who have been mistreated in Russia's drive for re-nationalization.

There are two pieces missing in Europe's approach to Russia. Firstly, the EU needs a much more integrated energy policy, including a single market for gas, which could provide for unity and greater economic efficiency. The current approach allows Russia to play games with Europe as a whole by engaging individual member countries on a preferential basis, clearly to their advantage.

Secondly, the commercial relation between the EU and Russia needs, more than anything else, a legal framework which could establish structured procedures for addressing disputes and give investors better certainty. For investments in Russia's energy sector, such a legal structure is provided in some BITs between Russia and individual EU member states. Furthermore, a pending case related to the Energy Charter Treaty is to bring greater clarity to the extent Russia is actually bound by this treaty. Regardless the outcome, greater legal clarity in Europe's investment relations to Russia is central to reap the potential benefits of closer commercial integration. If Russia is not interested in subjecting an agreement with the EU to stronger legal protection for European investors, then the EU should seriously consider if an agreement at all should be advanced.

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