Perspectives in Energy, 2006, volume 10, pages 1–24

Evolution of contractual structure of Russian gas supplies to Europe*

Andrei A Konoplyanik
Energy Charter Secretariat
Brussels, Belgium

Abstract. As is well known, Europe will remain strongly dependent on external energy and, in particular, gas supplies, for at least another few decades. Among the external suppliers Russia has been and will remain the major one. What will be the contractual terms of the new Russian supplies to Europe? Will they be the same as existing ones? Most probably, the answer is negative. Contractual changes are inevitable. But they need to be adequate to the changes in market structures and to reflect the balance of interests of both producers (exporters) and consumers (importers). If such changes generate incremental risks within one or another segment of the gas value chain, the relevant risks need to be adequately addressed, controlled and redistributed among all the players involved, without creating ungrounded competitive advantages to this or that player in the chain. Three groups of issues related to supplies of Russian gas to Europe are considered: 1) How the latter have been organised and why so; 2) Whether and how they are being reorganised and why so; 3) Whether current changes reflect the balance of interests for the exporters and importers (producers and consumers). Review is made of major contractual characteristics and elements of Russian gas export supplies to Europe united in one package: a) long-term "take and/or pay" contracts, b) on-border sales (on the external border of the 15 "old" EU member states), c) "destination clauses" (territorial sales restrictions), d) key role of transit (both in physical and contractual terms). It is proved that only complex changes to the whole package will result in the establishing of a new balance of interests of the parties involved.

As is well known, Europe will remain strongly dependent on external energy and, in particular, gas supplies for at least another few decades. According to official EU Commission estimates, the proportion of imports in energy and gas supplies to the Union will reach around 70 per cent in the period 2020–2030. The most recent EU document in relation to this issue is the new Directive on Gas Supply Security of April 2004 (CD 2004). This only gives reference to the Green Paper of 2000 on security of energy supply, which is the most relevant EU document in this regard** (other more recent EU documents also only give reference to it), which says:

---

* This article is based on the following presentations given by the author:

a) "The nature of future Russian gas exports to Europe", Adam Smith Institute International Energy Symposium, 15 March 2004, London, UK;

b) "Russian gas to Europe: from long-term contracts, on-border trade and destination clauses to ...?", 3rd EU Energy Law & Regulation Workshop "New Challenges for Regulation: Investment, Environment & Co-ordination", September 23–24, 2004, Florence, Italy;

c) "Transit provisions of the Energy Charter Treaty and draft Transit Protocol" Energy Charter Secretariat's Conference 'Energy Transit in Eurasia: Challenges and Perspectives', 19–20 October 2004, Brussels, Belgium;

d) "Gas import to European Union from Russia and other countries: reliability of supplies, possible risks and risk prevention mechanisms", International Conference MIEC-CGEMP 2005 "Energy relation between the European Union and Russia in the global context", Paris, France, 18–19 April, 2005.

** Currently, EU Commission is preparing a new revision of this document, which is to be published on March 8, 2006.

"As long-term growth begins to revive, the overall energy dependence of the EU is likely to rise once again, reaching 70 per cent within 20 to 30 years. ... dependence could reach ... for gas 70 per cent ... Enlargement will only serve to reinforce this trend. Natural gas imports to the applicant countries may rise from 60 to 90 per cent of demand. ... At present, the EU is moderately dependent on imported natural gas, which supplies 40 per cent of consumption. To try and offset the likely increase in this dependence (to 70 per cent) over the next 20 to 30 years, the Union has several options ..." (GP 2000).

A later Communication from the Commission to the European Parliament and the Council of 2002 provides the same figures – 70 per cent for the Union's external energy dependence in gas by 2020 (Communication 2002). The International Energy Agency (IEA) in its most recent forecast (World Energy Investment Outlook 2003) presented similar figures to the EU official estimates (Outlook 2003).

Among the major external suppliers Russia has been and will remain the major one. "In geopolitical terms, [as stated in the Green Paper] 40 per cent of natural gas [imports come] from Russia. The European Union does not yet have all the means to change the international market" (GP 2000). According to recent Centre for European Policy Studies (CEPS) estimates, Russia will provide around 250 bln m^3, which will be equal to about half of Europe's demand for imported gas (525 bln m^3) in 2020. Of that 525 bln m^3 required for import to Europe in 2020, 400 bln m^3 are not yet contracted, including a bulk of prospective Russian supplies (Cayrade 2004). The new contractual terms for this as yet uncontracted supply are crucial both for exporters and importers.

Russia/USSR has been a reliable trade partner throughout the historical period of Russia/USSR-EU trade relations. As stated in the EU Green Paper of 2000, "It should be noted, moreover, that despite various difficulties the USSR and subsequently Russia always fulfilled its supply obligations under its long-term contracts with the European Union" (GP 2000). But, according to general development trends in the world/international energy markets and owing to further liberalisation trends within the internal EU energy markets, the contractual structures of the energy and gas markets are not fixed once and for all – they have been evolving as well, moreover, it evolves in the context of two superimposing trends, i.e. general regularities in the development of contractual structure of the oil and gas (hydrocarbons) markets and specific regularities dictated by individual features in the development of internal energy markets in Europe and Russia and influenced by this specificities "deviations" from general trends in development (evolution) of contractual structures in gas trade between Europe (EU) and USSR/Russia in a long-standing historical context.

What will be the contractual conditions of the new Russian supplies to Europe? Will they be the same as existing ones? The answer is: most probably not. The reason is that the current contractual structure of Russian gas supplies to Europe reflects the realities of the political picture and dominant market development trends of the recent past, when this contractual structure was established. Taking into consideration the objective development trends in energy markets, including gas markets (in particular, an increasing typology of contracts and diminishing duration of contracts within the time frame) (Konoplyanik 2002a; 2004a; 2004b)*, and political changes in the countries where these supplies have originated from and are destined to go (i.e. within the post-USSR and European spaces), it can be concluded that corresponding contractual changes are inevitable. But they need to

* Number of other writings on this and related issues are available at www.enippf.ru (publications in the period up to 2002) and www.encharter.org/Secretariat/Deputy Secretary General (in the period since 2002 up to the moment).

be adequate to the changes in market structures and to reflect the balance of interests of both producers (exporters) and consumers (importers) as well as transit states. If such changes generate incremental risks within one or another segment in the gas value chain, those risks need to be adequately addressed and redistributed between all the players involved.

One of the strongly debated current issues relating to the contractual structure of Russian gas supplies to Europe is the problem of the so-called "destination clauses" (territorial sales restrictions). These provisions are an integral part of the existing Russian export gas supply contracts to Europe and face strong opposition from the EU Commission as being in contradiction to its competition laws. For some time, the Commission has been aimed at a forced removal of "destination clauses" from all existing gas import contracts with Russia, Algeria and Norway.

The Commission (Directorate-General on Competition – DG COMP) opened the files on the "destination clauses" issue in 2001 in relation to Russian gas supplies to Italy, Austria and Germany. After some strong and lengthy debates on this issue, corresponding changes have been incorporated into Russian/Gazprom's contracts relating to gas supplies to Italy (with ENI, 2003) and Austria (with OMV, 2004). Similar negotiations are still under way with Germany (with EON/Ruhrgas). Whether the problem of "destination clauses" is considered to be solved and the "model" precedent established?

This author's answer is: "not yet". The problem is deeper than it seemed to be at first glance and does not relate only to the problem of "destination clauses" as such since the latter, owing to objective reasons, reflect only an integral part of the broader package of contractual characteristics dictated by more than 30-year history of Soviet (Russian) gas supplies to Europe, as well as economic and contractual structure of the supplies providing high security and uninterrupted gas supply to Europe.

This article will examine the problem of "destination clauses" in more detail, looking at three groups of issues relating to Russian gas supplies to Europe:

1) How they have been organised and why so.
2) Whether and how they are being reorganised and why so.
3) Whether current changes reflect the balance of interests for the exporter and importer (producer and consumer).

That will provide the opportunity to understand clearly the economic background of the current contractual structures of Russian gas supplies to Europe in order to:

— find a balanced solution in their updating adequate to and in correlation with objective changes in the (broader European) gas market developments; and thus
— provide secure and effective gas supplies to Europe as it enlarges within as yet uncontracted import demand quantities.

1 Major elements of Russian gas exports to Europe

The organisation of Russian gas exports to Europe can be described by the presence of four key features united in one package:

— long-term "take and/or pay" contracts (LTCs TOP);
— on-border (on the external border of the EU 15) sales;
— "destination clauses" (territorial sales restrictions);
— key role of transit (both in physical and contractual terms).

This system reflects the historical balance of interests in the organisation of gas trading between exporters (USSR/Russia) and importers (Europe/EU).

"Destination clauses" are only one integral element in this package and thus are subject to the so-called 'matrix effect' known from elementary mathematics: when one element in

the matrix is changed, that leads to corresponding changes of the sums in the respective rows and columns, and of the sum total of the whole matrix, which in turn results in establishing a new balance within the new matrix. So the change of only one element leads to a change in the whole picture. And that is why only complex changes to the whole package will result in the establishing of a new balance of interests.

2 Long-term contracts

2.1 *Russian LTCs to Europe*

The current organisation of Russia's gas supplies to Europe is the result of investment decisions taken some decades ago. The export-oriented infrastructure for Russia's gas supplies to Europe was created mostly during the USSR period. The famous "gas to pipes" deal of the 1970s – a set of investment projects according to which supplies of pipes and compressor stations (including computer facilities) from the European contractors, mostly from Germany, Italy and France (the then US Presidents Carter and Reagan established an embargo on corresponding US supplies to the USSR), for the newly built export pipeline to Western Europe – was to be compensated by supplies of Soviet gas to those countries. The contractual structure of those deals was based on long-term "take and/or pay" contracts, which were needed to guarantee the long-term flow of revenues to pay back the cost of credits and supplies received for the development of the project.

As is well known, the long-term "take and/or pay" contract is a financial tool required by the financial community (banks and other financial institutions). They serve a buyer's geographical market area on an exclusive (monopoly) basis. Seller(s) assume reservoir and delivery risk, while buyers assume market risk. Since the 1970s, owing to objective reasons reflecting natural developments in both international energy and financial markets, there has been a clear shift from "equity financing" to "debt financing" as a dominant means of raising finance for the development of new oil and gas projects. Since that time, more and more oil and gas investment projects have been developed under "project financing" instruments, especially in upstream markets (Razavi 1996; Konoplyanik-Lebedev 2000; Konoplyanik 2003a). The volume and value (cost) of financing is dependent on future revenues and risks relating to those revenue flows. Revenue flow is a function (product) of the volume of supplies multiplied by the price of the commodity and thus is dependent on "volume" and "price" risks. On the one hand, the LTC TOP is an effective mechanism of supply risk ("volume risk") reduction since it guarantees the volume of commodity to be supplied during the contractual period. LTC TOP reduces the delivery risks for both parties of the contracts, i.e. consumer/buyer and producer/seller (via the "take and/or pay" formula). On the other hand, the LTC TOP along with adequate pricing mechanisms incorporated into such contracts present an effective mechanism of "price risk" reduction (Konoplyanik 2002b).

In the first half of the 20th century (up to the 1950s–60s), i.e. at the early stages of development of energy markets, the LTCs TOP were an integral trade part of the concessions and production-sharing agreements (PSA) that were the dominant financial/investment instrument for the development of upstream projects in oil and gas. That was the period of the absolute dominance of long-term contracts. Prices in these contracts at that time were usually fixed for the whole duration of the contract, since that was a period (especially in its end) of relatively stable oil prices and fixed exchange rates (i.e. prior to the establishing of the floating US dollar exchange rate).

Since the late 1970s/early 1980s (and prior to the "exchange (spot/futures) pricing", which has not yet reached most countries, except the United States and the United

Kingdom) prices in the gas LTCs TOP were no longer established directly. In contemporary long-term contracts, the gas price is a 'formula price' and is based on the so-called "escalation" formulas, which tie down the gas price to the prices of other primary energy resources competing with gas on a given market in a given end-use sector (the so-called "replacement values" or "substitution prices"). For example, if Russian gas is supplied to German power plants, then its price may be tied down to the prices for coal and residual fuel oil (RFO) competing with gas in the balance of fuel supplies to power plants on the German market, which are its "substitution prices" (replacement values) in the given sector of trading. Most frequently, gas prices are tied down to exchange (spot/futures) quotations for RFO and crude oil, which hinge on global expectations of the world oil market players (where the stage of "exchange pricing" came in the second half of 1980s). At the stage of "exchange pricing" of the energy markets development, the pricing mechanism of LTCs TOP will be decoupled from "escalation formulas" and will be based on a combination of spot/futures/options with hedging instruments. At this stage, which can result from sufficient and/or excess gas supply, the competition along the "gas – substituting energy resources" line (which is the base for pricing mechanisms formation relying on "escalation formulas") will be supplemented (replaced?) with competition along the "gas–gas" line. But the long-term contracts as such would continue their existence – until the risks related to being a party to them do not exceed the risks related to being a party to a shorter-term contract. Hence, the market niche for the LTCs will be retained within the objectively expanding range of contractual tools in the energy markets.

The combination in one tool of the mechanisms of reduction of both "volume" and "price" risks makes the LTCs TOP an effective financial instrument for new upstream (production and transport) projects developments. It is a popular method of risk reduction for project financing in long-term capital-intensive greenfield upstream projects, especially in new regions with no (or a lack of) production and transport infrastructure. This mechanism was used to finance the "Southern" (through Ukraine, in the 1970s) and the "Northern" (through Belarus, in the 1980s–1990s) major routes of Soviet/Russian gas supplies to Europe. Recently, a major part of Russian LTCs TOP to Europe was prolonged owing to its upcoming expiry, and new LTCs TOP were signed.

2.2 *LTCs within the EU market*

Long-term contracts are not only a major characteristic of Russian gas (and any other imported gas) supplies to Europe. The European gas market itself has been developing based on long-term take-and/or-pay gas supply contracts and nowadays the LTCs TOP is the core element of domestic European gas supplies as well. LTCs supply more than 90 per cent of Continental European countries' gas imports and will continue to be an integral part of the EU gas market contractual structure in the foreseeable future (see table 1).

Table 1. Role of long-term contracts in gas supplies to EU Member States*.

	Italy	France	Germany	Spain	Belgium	Greece
Total supplies in 2002, bln m^3	72.5	44.2	94	23	17.5	2.1
Share of imports in total supply, %	80	96	82	99.5	100	100
Share of LTC in total supply, %	–	94	–	44	91	100
Average residual duration of contracts, years	14	15	11	–	–	13

* *Source: ECS calculations*

The European Commission has argued strongly and for a long time against long-term contracts as preventing competition, and has even established in its first Gas Directive restrictions on suppliers with LTCs TOP by allowing refusal of access to the network for them.

"Competition introduced into gas sector will entail loss of the market share belonging to today's suppliers*. Very often the companies purchase great volumes of gas from its producers in the framework of LTCs TOP, according to the contract terms buyers are obliged either to take the gas/pay for it, or anyway to pay for most part of the contracted volume, even if they cannot (will not be able) to sell the purchased gas. As competition increases with the progressive development of the internal market for gas, prices are expected to fall. This could give rise to serious financial difficulties for gas companies having entered into take-or-pay obligations at higher prices. The gas directive does, however, provide specific safeguard mechanisms if such a situation should arise. In case of serious economic difficulties related to take-or-pay obligations, access to network may, as a last resort, temporarily be refused thereby protecting the market of a supplier" (EC 2000).

Fortunately, the Commission has finally agreed that the LTCs TOP plays an important role in gas supplies – though with not yet fully defined observations permitting various interpretations of the extent to which the use of LTCs TOP corresponds to the EU legislation (CD 2003).

3 On-border trade

Two major routes of export pipelines from Western Siberia to Europe are the Southern, through Ukraine and further through Slovakia and the Czech Republic, and the Northern, through Belarus and further through Poland. Russian gas is exported to the European Union under long-term contracts that provide for delivery points at a few locations on the EU 15 external border (on the Eastern borders of the European Union prior to its enlargement on 1 May 2004), e.g. in Baumgarten on the Slovak-Austrian border or in Waidhaus on the Czech-German border, etc. (points labelled "C" at fig. 1).

Such a contractual structure has a clear economic explanation under given historical circumstances. The USSR signed its long-term contracts with European companies during the Cold War, when two political systems had been separating Europe into the NATO zone in the West, and the COMECON zone in the East. Under these circumstances, the USSR could have guaranteed security of its supplies to Europe (in order adequately to face delivery risk) only within the territories under its direct and/or indirect control, i.e. throughout the journey of gas from Western Siberia to the external border of Western Europe. And the European companies could have provided control over Soviet gas supplies within the territories of the Western European states only. That is why when Soviet gas was supplied to France, delivery points (where title of ownership on gas supplied was changed from a Soviet to a foreign entity and until which point the delivery risk is taken by supplier) were established at the Czech-German border, to Italy at the Slovak-Austrian border, and so on. So the USSR/Russia (in the face of its economic agent, which, during the USSR period was the Ministry of Gas Industry of the USSR and the Foreign Trade Association "Soyuzgasexport", and, since the USSR collapsed, has been the Russian quasi-state company Gazprom and its external trade arm "Gazexport") has taken and take responsibility for gas supplies within the route from Western Siberia and up to the delivery points at the EU 15 border, and Western companies have taken responsibility from those delivery points up to the consumers of that gas.

* One need to remember, that according to the terminology of the authors of the EC document being cited, "supplier" – is a wholesale buyer (impoter) of gas from its producer.

In the 1990s, the political situation in Europe changed – both the USSR and COMECON collapsed and new independent states appeared on the political map of Europe. But the delivery points of the now Russian gas to Europe have been the same since they were an integral part of the LTCs TOP that were signed earlier, before the collapse of Soviet Union. They are still in place and will stay in place until their new expiry dates in the years to come. That means that after EU enlargement took place on 1 May 2004, the main delivery points of Russian gas to Europe have automatically 'moved' inside the EU area. A new dimension of Russian gas supplies to Europe has appeared that was not in place before this date: there were no Russian gas supplies (in *legal* terms) within the EU 15, but within the EU 25 there are – crossing the territories of some new EU accession states*. At the points labeled "B" in fig. 1, only the title of ownership of the pipelines has changed (transferred from the companies of the corresponding CIS states to the companies of the corresponding new EU Member States), but the title of ownership for the Russian gas being shipped through these pipes still remains with Gazprom**, while at the points "C" (delivery points of Russian gas as per LTC TOP) both the title of ownership for the pipelines and for gas inside these pipelines has been transferred to European companies.

EU enlargement has established a new reality in the Russian gas trade with Europe – since 1 May 2004, Russian gas (in legal terms) has been trading within the EU territory. It is the most important feature of the changes in the Russian gas trading in Europe that shall be emphasized, since EU enlargement has affected not geographic but legal structure of contractual relations between Russia and EU. Enlargement of EU implies that though gas is traded now in the EU territory, the relevant proprietary rights belong to Russian suppliers. That has led to a new issue between Russia and the European Union, which needs to be clarified: has this new reality generated new risks within existing gas supplies for any contracting parties? Which particular type of risks (if any) has it created? What is their origin? For whom precisely have they appeared? How is it possible to secure, prevent or spread these risks among the participants?

The article will address this issue in more detail in its final part.

4 Destination clauses

"Destination clauses" (or territorial sales restrictions) are an economically motivated integral part of existing Russian export schemes to Europe. "Destination clauses" allowed a gas supplier to sell gas to different buyers at different prices and conditions at one and the same delivery point. "Destination clauses" restrict onward sales and limit use of gas sales only to contractually specified geographical market areas and thus prevented gas-to-gas competition including, first of all, for gas supplies originating from the same source.

An illustrative economic background of "destination clauses" is shown in fig. 2. "Destination clauses" have been an instrument used to reduce market risk under supplies based on LTC TOP with fixed delivery points on the external border of the area while the physical supplies are shipped further within this area. "Effective" – as formulated by Mr. Frisch (Frisch 2003a; 2003b) – export prices at delivery point "A"*** for supplies to markets B, C, D and E (refer to fig. 3) are calculated at a net-back formula (price at the

* The new and old BU boundaries (of EU 25 and EU 15 correspondingly) are indicated at fig. 1 by dark lines passing through points B and C respectively.

** At the way from points A to points B at fig. 1 rights of ownership on gas in the export pipes belong to Russian supplier-companies (Gazprom/Gazexport/etc.), and the rights of the ownership on the pipelines – to corresponding companies of CIS countries.

*** So-called "fob" price.

consumer market* less cost of transport from delivery point "A" to the particular market – so-called "net-backing" principal of pricing). Generally, the longer the distance from the delivery point to the particular market, the lower the "effective" price of gas (or FOB price) at this point for the supplies to this specific market. "Destination clauses" prohibit reselling by the importer of the gas at a cheaper effective price, i.e. destined for a market which is more distant from the delivery point, at the closest to the delivery point market for which the supplies' effective price is the highest at this delivery point.

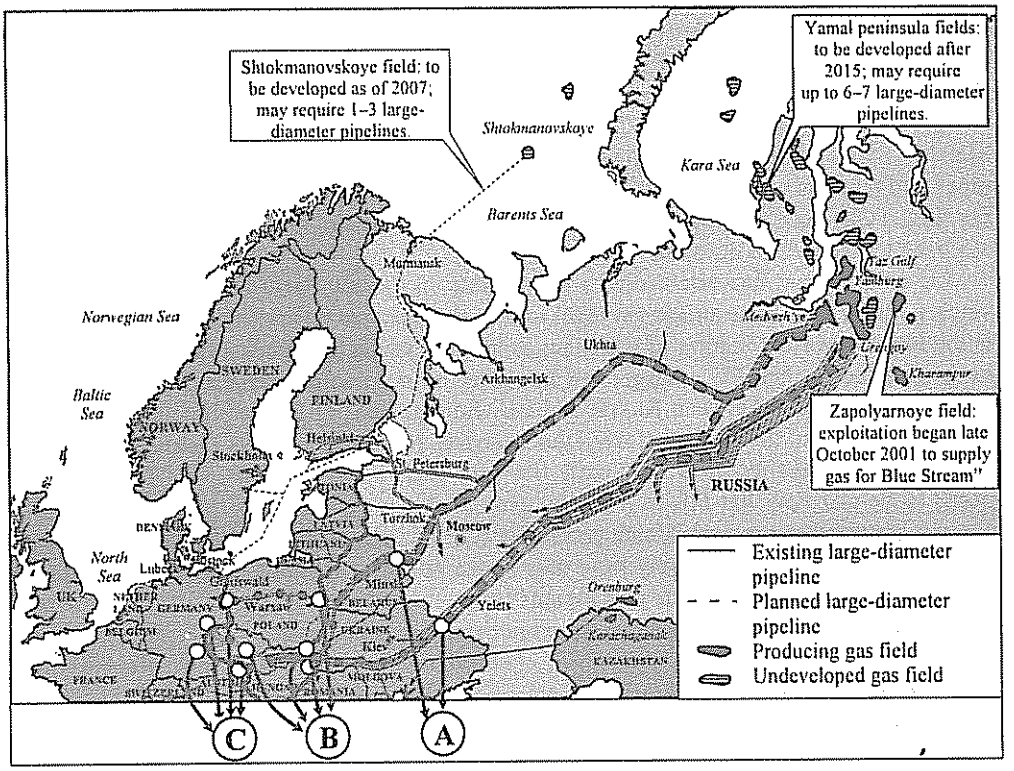


Fig. 1. Russian gas exports to Europe: on-border sales and transit arms.
A, B, C – points of change of ownership for gas and/or pipelene.
International Energy Agency is the reference source for the map and the relevant comments on the development of the Yamal peninsula, Zapolyarnoye and Shtokmanovskoye fields.

Thus, using the traditional foreign trade terms, i.e. "CIF price – FOB price" we inevitably and obviously come to the conclusion on objective character of the "destination clauses" in the international contractual practice in particular, as applied to contractual structure of Soviet/Russian gas supplies to Europe.

Let's take a specific example. Baumgarten is the delivery point for Russian gas supplies to Austria, Italy and France – three countries located at different transport distances from this delivery point and having different energy price levels and energy pricing environments within their domestic markets. As shown in fig. 3, which is created by the author on the basis of (Frisch 2003a; 2003b) the price at the French market (*F*) is higher than in Austria (*A*), which in turn is higher than in Italy (*I*). It means that for

* So-called "cif" price.

maintaining/retaining competitiveness of any gas, imported gas inclusive, its contracted CIF price shall be adequate to prices A, I, F. Owing to the different distances of these markets from the delivery point, the effective price at this point for deliveries to Austria (A_e) is higher than to Italy (I_e), which in turn is higher than to France (F_e).

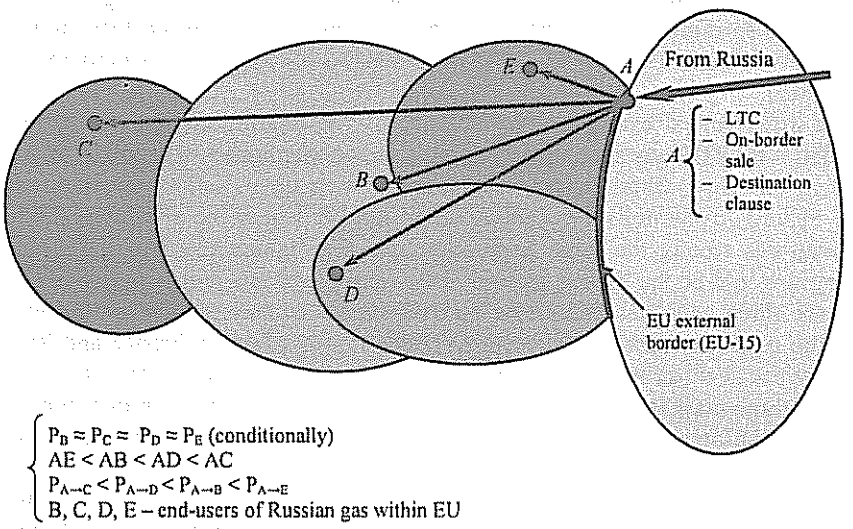
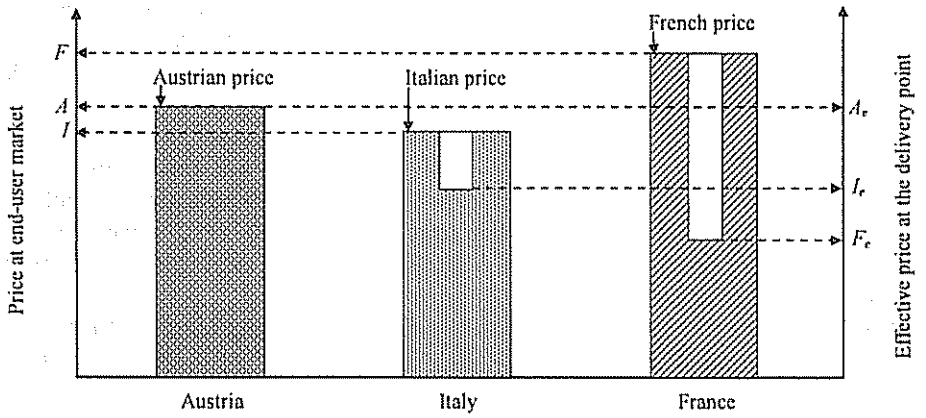


Fig. 2. Destination clauses (territorial sales restrictions) – economically motivated integral part of existing Russian export schemes to Europe.



$F - F_e$ – French transportation adjustment
$A_e - F_e$ – French Baumgarten "discount"
$I - I_e$ – Italian transportation adjustment
$A_e - I_e$ – Italian Baumgarten "discount"

Fig. 3. "Destination clauses" – gas price arrangements (schematic) for Russian gas at Baumgarten.

"Destination clauses" prevent buyers of Russian gas for deliveries, say, to France from reselling it in/to Austria (perhaps even at the same point – in Baumgarten) or in/to Italy and thus from receiving a windfall profit (or undue benefit) caused by the presence of the different prices from one supplier to different destinations in one and the same geogra-

phical location. The absence of "destination clauses" within supplies with fixed contractual volume obligations will establish gas-to-gas competition in this delivery point between contractual arrangements from the very same supplier.

When there is enough transmission capacity within a given transportation system and enough opportunities to change destinations of supplies within this system – gas-to-gas competition will lead to diminishing of prices in the consumer market, when there is not enough such capacity – it may lead to chaos or to discrimination of some players/participants in the gas value chain.

Let's look at a theoretical example – the absence of "destination clauses" in Baumgarten for Russian LTC TOP gas supplies to the three above-mentioned EU states. Buyers of Russian gas in this case, while having choice, would first try to sell as much gas as possible at the nearest to the delivery point Austrian market where the effective selling prices for Russian gas among the three destinations are the highest and thus the "price rent" of reselling it would be the highest as well. That would lead to a redistribution of gas flows between the three countries and create an over-supply of gas in Austria (and will move prices in the Austrian market down) and an under-supply of gas in France and Italy (and will move prices at those two markets up). That would in turn change the gas price correlations in the three markets in question and would stimulate the reverse redistribution of gas flows from Austrian market to Italian and French ones. No doubt, the redistribution of the flows will affect other European countries, the neighboring ones, above all. But would there be enough pipelines with adequate capacities for quick changes of gas flows in Europe between the different countries in the opposite directions (in this case between the three above-mentioned states)? Would an effective TPA exist within the EU market that would enable such fluctuations in the directions and volumes of the gas flows? Since these fluctuations would be rather short term, would an effective mechanism of short-term trade in gas (including effective congestion management) be in place in Continental Europe? The author's answer is rather negative (see below) – at least for the moment.

And finally, the absence of "destination clauses" in the LTC TOP now in force would entail essential upsetting of stable and security gas supply to European consumers.

That is why it is impossible in principle to cancel all the "destination clauses" in all the long-term contracts just for technical and logistical reasons – that might stimulate a number of blackouts in gas similar to those that Europe has experienced recently in electricity (e.g. in the United Kingdom, Italy and Switzerland). That is why, in this author's view, the European Commission has been trying to deal with "destination clauses" on a case-by-case basis.

In 2003–2004, under the strong influence of the Commission, significant changes were incorporated into two major Russian gas contracts for supplies to EU states relating to destination clauses: with Italian ENI (2003) and with Austrian OMV (2004). Let's analyse them, bearing in mind the explanations above.

4.1 *2004 OMV-Gazprom deal*

Russian gas supplies to Austria are equal to 5.5 bln m^3/year, which amounts to two-thirds of its domestic demand. Supplies are based on LTCs TOP with a delivery point at Baumgarten. Destination clauses were included, anticipating a restriction to use the gas in Austria only, which implies a ban imposed on re-sale beyond the bounds of the country.

In May 2004, OMV and Gazexport agreed to roll over existing gas supply contracts to 2012 and up to 6.5 bln m^3/year. The pricing formula was changed: the current price reference benchmark has now switched from the official German market Wiesbaden gas index to Rotterdam oil product prices (which reflects the switch from pricing based on

local market energy price fluctuations to pricing based on global oil market price behaviour, i.e. it reflects the further internationalisation of contractual gas structures due to further globalization of energy trade and further interdependence of the markets of different energy resources). According to European Commission, contracts have been adjusted to the "conditions of the liberalised gas market", i.e. "destinations clauses" are scrapped – as preventing free competition – and OMV is no longer restricted to using gas in Austria only.

Taking into account the explanations shown in fig. 3, we can conclude that the 2004 OMV-Gazprom deal on "destination clauses" – taken as a separate case – has no immediate negative consequence for Gazprom since its "effective" gas price in Baumgarten for deliveries to Austria is the highest compared to deliveries to France and Italy. Meanwhile, CIF and FOB prices for the (Austrian) contract actually coincide. So any reselling to other neighbour markets of Russian gas supplies originally destined for Austria will not generate – in the given circumstances – any windfall profit (or undue benefit) for the buyers of Russian gas at the expense of its producer/exporter. That is to say, the market risk will stay with the buyer/importer of Russian gas.

4.2 *2003 ENI-Gasprom deal*

Russian gas supplies to Italy are equal to 16.9 bln m^3/year, which amounts to one-quarter of domestic demand. Supplies are based on LTCs TOP with a delivery point at Baumgarten and are shipped on further to Italy via the TAG pipeline. Destination clauses were included anticipating restriction to use the gas in Italy only.

The 2003 EU Commission-ENI-Gazprom solution presents a package stipulating the deletion of destination clauses from all existing gas supply contracts. Two delivery points will be envisaged in the new contracts instead of one as in the existing contracts. ENI is free to resell gas to any destination, including outside Italy. ENI committed to offer significant gas volumes to customers outside Italy over a five-year period, starting on 1 October 2003. If sufficient volumes have not been sold during the first half of the period (until 1 April 2006), ENI is to organise an auction at Baumgarten. ENI would refrain from introducing consent clauses in its new contracts in Italy. ENI is to promote a capacity increase in 2008–2011 of its majority controlled TAG pipeline (through which 100 per cent of Russian gas to Italy has been supplied) and is to promote an improved TPA to use TAG for transit (WP 2004).

In view of the explanations shown in fig. 3, we can conclude that the 2003 EU Commission-ENI-Gazprom solution provides negative consequences for Gazprom since its "effective" gas price in Baumgarten for deliveries to Italy is lower compared to that of deliveries to Austria. At least that would present undue preferences to ENI in case of immediate reselling at the auction at the delivery point in Baumgarten of the gas bought from Gazprom if the incremental profit received from the auction were to come solely to ENI.

Is this conclusion correct? Has ENI received undue advantages? Is the deal balanced, including the time-balance of cost-benefit effects as well ("destination clauses" are deleted from *currently* existing contracts, while TAG capacity improvements and TPA are to be delayed in the *future* period of 2008–2011)? Would an 'incremental-profit-sharing' mechanism (similar to the Algerian LTC model) if used at the proposed auction to start on 1 April 2006 would be a fairer solution?

According to some experts, the removal of destination clauses should be strictly tied to and conditional on the introduction of full and unrestrictive TPA in the EU gas transmission system. Removal of destination clauses without unrestrictive transmission system

TPA would give gas importers undue advantages over gas exporters (Frisch 2003a; 2003b).

But today an unrestrictive TPA to gas transmission systems within the European Union is a stated political aim and established legal obligation – which has not yet been implemented in full in practice. It is likely that it will not be implemented in full in the near future – that is how the European gas community itself sees the picture.

At the March 2004 FLAME Conference (perhaps the most important and reputable annual gas event within the European Union) a polling session took place* aimed at providing an expert view of the European gas community present at that conference on the prospects of internal EU gas market developments. According to FLAME Conference organisers, around 250 conference delegates participated in the poll representing all segments of the gas business, gas business regulation, academia and consultancy in Europe.

The results of the FLAME 2004 session show that, according to the European gas business community, and despite the activities of the Commission aimed at further liberalisation of the internal EU market, the internal EU gas market within the next 5–10 years will continue to be monopolised by a few international (Western) energy companies and access to pipeline capacities (lack of effective TPA in practice) will remain a major problem.

That is another argument for a conclusion on the unbalanced character of the "destination clauses" solution in respect to Russian LTCs TOP gas supplies to Europe. We will have to wait and see what the solution will be for the Gasprom-E.ON/Ruhrgas deal ...

5 Transit

About two-fifths of the world's production of oil, one-fifth of gas and one-fortieth of electricity are exported, i.e. are being sold with the crossing of at least one border.

Only a limited portion of external trade in oil is related to transit supplies which predetermines crossing of at least two borders since the bulk of oil export is undertaken by sea in oil tankers.

The role of transit in the trade of electricity in the global context is even less significant owing to abrupt incremental losses due to increase in transit distance and dominating principle of electric power supply to the electricity grid rather than to a specific consumer from a specific supplier in the framework of physical supplies beyond the electricity grid. However electricity transit might be crucial for some individual states, i.e. for the Central Asian states of the FSU in the Fergana Valley region – the result of straightforward electricity grid layout in the USSR period.

At the same time, for gas export the transit component is key. Transit accounts up to 40% in international gas trade or about 7% of global gas production.

For Russia, the problem of accomplishing the transit supplies of its energy exports is more important than for any other energy-exporting country, including those that are competing with Russia in Europe, especially in gas. Direct supplies amount to only about 40% in the case of Russia's gas export, compared to two-thirds in the case of Norway and three-quarters in the case of the Netherlands. The portion of direct supplies in Algerian gas export is only 5% higher than in the case of Russia, but Russian gas has a higher portion of transit through the territories of two and more countries (see table 2).

* Flame Industry Insights (Deloitte & Touche LLP, 2004), personal note of the author participating in the polling session.

Table 2. Role of gas transit for its main existing exporters in Europe (2000).

Country-exporter	Direct supplies, % of export volume	Transit through the territory of, % of export volume:			
		one country	two countries	three countries	four countries
Netherlands	76.2	13.8	10.0	–	–
Norway	67.7	7.5	21.4	3.4	–
Algeria	44.9	14.8	9.6	24.3	6.4
Russia	39.5	9.4	11.4	28.1	11.6

Therefore, Russian gas export faces higher potential transit risks than those of its (today's) competitors due to transit difficulties (stemming from multi-tier character of transit) characteristic of Russian gas export.

That is why transit issues and the Energy Charter Protocol on Transit negotiations have been so much important for Russia. As was stated by the State Duma of the Russian Federation at the Parliamentary Hearings on the ratification of the Energy Charter Treaty in January 2001 (the latest public official measure in Russia dealing with ECT issues), successful finalisation of the Energy Charter Protocol on Transit, taking full consideration of Russia's interests, is essential for eventual ECT ratification by Russia, which signed the Treaty in 1994 but has yet to ratify it.*

In legal terms, there are three different options for carrying out supplies of energy materials and products (EMP) from the territory of one contracting party (say, from point A located within the CP2 Area) to the territory of another (say, to point B located within the CP3 Area) if there is at least one more contracting party (CP1 Area) in between them (see fig. 4).

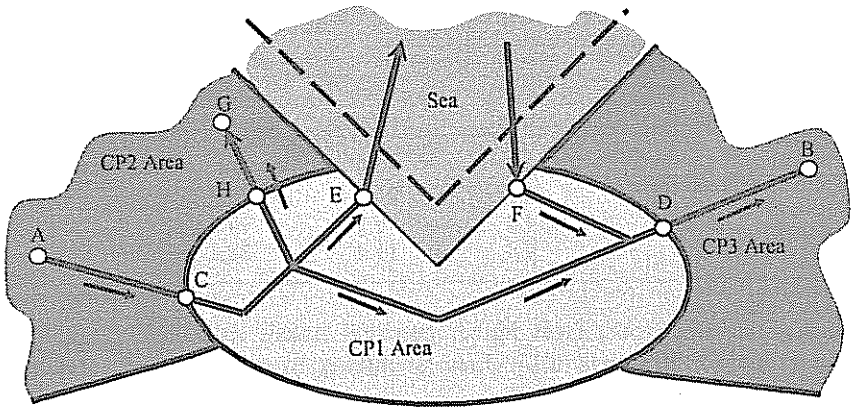
Option one: without transit at all

In this case on-border sales will take place at delivery points C and D in fig. 4, at which points both the title of ownership for the pipeline and for the gas in this pipeline is transmitted from one legal entity to another. Under such conditions all Russian gas supplies to the EU 15 have been taking place, as was shown above. Recent long-term gas supply agreements of Russia with Turkmenistan and Kazakhstan have been based on on-border sales terms as well – on the external border of the mentioned states for gas supplies to Russia (or through Russia). But on-border sales are not only a prerogative of the Russian supply contracts to Europe, they are also an integral part of, say, the Algerian pipeline gas supply schemes to Italy and Spain.

Another option to escape transit is to bypass the neighbouring states with pipeline layout through international waters where it is possible. This task is solved for instance by the "Blue Stream" pipeline, which directly connects Russia with Turkey through the Black Sea. The route of the Northern-European gas pipeline project also aims to connect Russia with Western Europe through the Baltic Sea**.

* Consideration of reasons for still unratified ECT and outlooks for ECT ratification by Russia are beyond the scope of this article. The following publications of the author (Konoplyanik 2001; 2002c; 2003c) etc. enlarge on the issues, the author believing that ECT ratification meets long-term objective interest of this country. Nonetheless, it is noteworthy that there is no consensus of opinion on the necessity of ECT ratification by Russia in the governmental bodies so far. Arguments of opponents to ECT ratification by Russia are provided in publications by V Yazev, O Fomenko (in diverse issues of Journal "Neftegazovaya Vertikal" (Oil and Gas Vertical), specifically.

** The project was launched on December 9, 2005.



Three possibilities of energy supplies from A to B:
No transit (on-boarder sales at C, D):
Russia-EU, Turkmenistan-Russia, Kazakhstan-Russia, Algeria-Italy, Algeria-Spain.
Transit:
— through the pipe owned/leased by shipper: France-Germany, Norway-France,Italy-Austria; planned Russia-CIS/EE; or
— through the pipe not owned by shipper.

Fig. 4. Transit is not the only option ...

Option two: transit through the pipe that is owned/leased by the shipper of gas
Under this scheme the gas originating from Russia and destined, for instance, for France has been shipped by Gas de France from the delivery point at Waidhaus on through the territory of Germany to the French border; or gas destined for Italy has been shipped by ENI from the delivery point at Baumgarten and through the territory of Austria through the TAG pipeline partly owned by ENI. A similar scheme is used in supplies of Norwegian gas to France through the pipeline leased by the Norwegian supplier. Gazprom has been implementing the same approach throughout the 1990s in the FSU and Central Europe, trying (in some cases successfully, in other cases – not yet) to purchase stocks in the pipeline companies of the countries that historically have been transit states for Russian gas supplies to Europe (Slovakia and the Czech Republic, Poland, Belarus and Ukraine).

Option three: transit through the pipe not owned by the shipper of gas
Options two and three are the cases for the international law regulation by the Energy Charter Protocol on Transit. Its successful finalisation would not prohibit all the other ways and means of carrying out supplies from point A to point B (see fig. 4) except the transit ones, but would provide more legal guarantees for transit as the cheapest way of carrying out cross-border supplies. Between two transit options, option two is certainly more costly than option three (see fig. 5). Finally, it is for business to decide which of the three above-mentioned options to carry out for cross-border gas supplies.

6 Energy Charter Transit Protocol

The aim of the Energy Charter Transit Protocol is to establish a clear set of intergovernmental "rules of the game" governing cross-border flows of energy in transit via pipelines and grids, building on the existing transit-related provisions of the 1994 Energy Charter Treaty. The Transit Protocol will thereby lower the level of political and financial risks associated, among others, with those oil and gas projects that require transit flows across

Eurasia. This will make trans-border energy supplies within the developing Eurasian energy market more stable, diminish the cost of raising capital (equity and debt financing), increase the investment availability for upstream (production and transport) projects in energy, and make them more competitive both in the energy and capital markets.

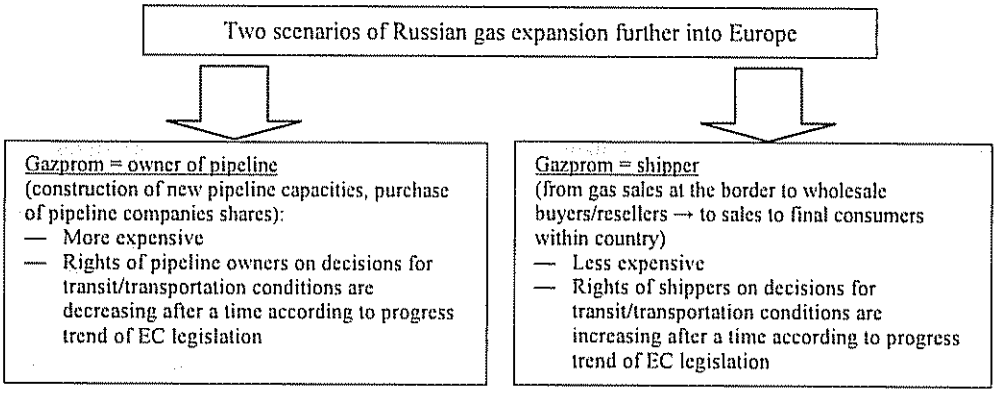


Fig. 5. ...but it might be the cheapest one – if adequately legally protected.

Therefore, the Transit Protocol, as well as the other legally binding documents relevant to the Energy Charter, is geared to ensuring not only the security and reliability of energy supplies, but also the consistency of demand by economic means. In other words, it is designed to benefit not only consumer-states, but also producer- and transit-ones. The Transit Protocol (after its finalisation, signing, ratification and coming into force) will assure within ECT generally recognized by all countries (at different levels and stages of economic development) the mutually acceptable nondiscrimination level for transit supplies, which is a legally compulsory regulation rather than merely a political declaration.

Among the Protocol's key features are its definition of the concept of "available capacity for transit" in national pipeline and grid systems; the obligation it contains for signatory states to negotiate access to such "available capacity" in good faith and on a non-discriminatory basis with interested third parties; and its establishment of the rule that transit tariffs must be non-discriminatory, cost-based and free of distortions resulting from any abuse of a dominant market position by pipeline or grid owners*.

The major issues of ECT transit protocol are following:

— Obligation to observe Transit Agreements.
— Prohibition of unauthorised taking of EMP in transit.
— Definition of available capacity in energy transportation facilities used for transit.
— Negotiated TPA to available capacity (mandatory TPA is excluded).
— Facilitation of construction, expansion or operation of energy transport facilities used for transit.
— Transit Tariffs shall be non-discriminating, objective, reasonable and transparent, not affected by market distortions, and cost-based including reasonable ROR.
— Technical and accounting standards harmonised by use of internationally accepted standards.
— Energy metering and measuring strengthened at international borders.

* To read in more detail about the Energy Charter Treaty and draft Transit Protocol one can visit the Energy Charter website at www.encharter.org, where both documents have been placed as well as a number of publications by the ECS staff on the issue.

— Coordination in the event of accidental interruption, reduction or stoppage of transit.
— Protection of International Energy Swap Agreements.
— Implementation and compliance.
— Dispute settlement.

The history of the Energy Charter draft Protocol on Transit began in March 1998 when six Caspian/Central Asian states highlighted the necessity to create a commercially attractive environment for investments in oil and gas pipeline projects, by addressing political considerations and the technical, financial, commercial and legal issues for the realisation of such projects. In February 2000, negotiations started on this legally-binding agreement under international law among the governments of 51 European and Asian ECT member states.

In December 2002, the multilateral phase of Transit Protocol negotiations was considered to be finished with only three outstanding issues left open, which related almost exclusively to differences in position between Russia and the European Union on:

— the European Union's proposal for a Regional Economic Integration clause (REIO clause);
— the Russian proposal for a so-called 'Right of First Refusal' for existing transit shippers; and
— the issue of methodology of transit tariffs calculations*, when using the transport congestion management mechanisms like auctions, specifically.

Bilateral consultations of Russia and EU on the three unsettled issues are continued. In the course of the meetings the parties' experts reached almost complete understanding on the problem of the methods used for transit tariff calculation, inclusive of mechanisms for congestion management, and advanced essentially in the understanding of concerns of the parties about two other unsettled problems of the Transit Protocol**.

7 Gas transit and the problem of contractual mismatch

A natural question arises: in which geographical areas does the transit (in legal terms) of Russian gas to Europe exist? The answer is not obvious, since it is a mistake to consider that the "transit" leg of Russian gas supplies to Europe is a distance between the external border of Russia and the external border of the particular EU state that is the final destination of the Russian gas supplies, and thus all the countries between Russia and the final destination are considered to be "transit states".

However, it is far from being so. The transit arm of Russian gas supplies to Europe – from legal viewpoint – is noticeably shorter.

Fig. 1 shows principal – Ukrainian (Southern) and Belarusian (Northern) – routes used to export gas produced in Russia to the European Union. There are several key points worth marking out on these routes. Let's first have a look at this picture, based on the realities of the political map of Europe prior to and after 1 May 2004 (i.e. prior to and after the EU enlargement).

"A" points are located on Russia's borders with CIS countries. There, title of ownership to the corresponding pipelines passes from Gazprom to companies in the respective CIS countries, but Gazprom retains ownership rights to the gas further shipped through the

* For more details on the substance of the positions of the parties on these issues see, e.g. (Konoplyanik 2003b; 2003c)

** It is not author's aim to discuss in detail the substance and development of Transit Protocol negotiations. The state of negotiations on Transit Protocol is described in the Document CC299 "Energy Charter Draft Transit Protocol. Secretariat Working Paper", prepared for the 16th session of the Energy Charter Conference that took place on December 9, 2005, which is available on web-site www.encharter.org within the member states access-zone.

territories of Russia's neighbours within these pipelines. It is also there that the international transit of Russian gas to Europe (across such CIS countries) commences.

"B" points are located on the borders between CIS countries (the former USSR frontier) and Eastern European nations (former COMECON members). There, title of ownership to the corresponding pipelines passes to companies of the respective Eastern European countries, but Gazprom still retains ownership rights to the gas that has been shipped further to Europe within these pipelines. Also at those points, the latter's transit leg through the territories of CIS countries (A-B at fig. 1) is replaced by a transit leg across the corresponding Eastern European countries (B-C at fig. 1).

"C" points are located on the Eastern European countries' borders with EU nations (EU 15). It is there, on the EU 15 outer boundaries, that Russian gas has been sold to its Western European customers – companies of EU nations. It is also there that the "transit" (in legal terms – as defined in Art. 7 ECT) of Russian gas through European countries has been ending (prior to 1 May 2004), and title to both the corresponding pipelines and to the gas itself within these pipelines passes to the respective companies in EU nations.

Furthermore, if gas originated in Russia, being supplied to final destination countries, crosses the territory of one or several EU states after points "C", the supplies are referred to transit ones according to transit definition provided in ECT Article 7, though from legal point of view this transit supplies are no longer considered as transit of Russian gas, since proprietary rights were transferred to European buyers in delivery point "C", the liabilities for the delivery and the relevant risks were also transferred to European wholesale buyers in the same points. Thus, after delivery points "C" the gas originated in Russian ceases to be Russian according to the title of ownership and becomes "French", "German", "Austrian", "Italian" etc. according to the country that registered the buyer company of the Russian gas in the delivery points "C".

Hence, when considering the situation prior to May 1, 2004, the transit arm for Russian gas (from legal viewpoint) starts from the borders of Russia with Commonwealth of Independent States and ends in the Western border of the East European countries (formerly COMECON countries) with the "old" EU 15 states.

Nonetheless, EU by suggesting its "integration clause" (REIO clause)*, in the course of negotiations on Transit Protocol, in the opinion of the Russian party, thus offered a new definition of transit in the draft Protocol on Transit (differing from transit definition in ECT), according to which "transit" – from legal viewpoint – of Russian gas (like any other gas coming from outside of EU) shall end on the external border of the enlarged EU, i.e. even before reaching (not reaching) the Russian gas delivery points envisaged by contracts on gas supply to EU. Based on this logic, transit of Russian gas within EU 25 shall stop and be transformed into other type of EMP movement (transportation) somewhere in the middle of its contractual route, as the new boundary of the European Union passes between the points of Russian gas shipping and delivery to Europe. Is it possible in the contractual practices?

In the framework of "old" EU (with 15 member states) the new interpretation of the term "transit" suggested by EU in the context of the established structure of contractual supplies of Russian gas to Europe did not affect the interests of Russian suppliers, concerning solely their West European contractors-buyers of Russian gas for its further supplies to third countries. Moreover, the above-mentioned conflict never arose within EU 15, as the delivery points were arranged on the border rather than inside the EU bounds. Putting it different, the "integration clause" offered by EU within EU 15 was

* Refer, for instance, (Konoplyanik 2002d).

economically neutral for Russia and did not pose additional risks related to transit for the country and its economic agents.

However, in the framework of the enlarged EU 25 the economic consequences of applying the "EU integration clause" may be far from neutral and accompanied by additional risks for any of the parties, Russian and other suppliers from outside of EU specifically.

After 1 May 2004, when EU enlargement took place and ten new EU Member States entered the EU family, including the former transit states for Russian gas to Europe, the delivery points "C" of Russian gas to the European Union – which prior to 1 May were located at the external border of the EU (EU 15) territory – became located within the EU (EU 25) territory. And the points "B" became the points located at the new external border of the new EU (EU 25) territory, though they failed to become new delivery points for Russian gas: up to and after the points the title of ownership for the Russian gas being shipped through these pipes still remains with the Russian suppliers, as well as their responsibility for its conveyance to the contractual delivery points.

After EU enlargement, the provisions of the 1958 Treaty of Rome, establishing the common internal European market, including, *inter alia*, "free movement of goods", and other provisions of the EU *acquis communautaire*, became dominant in the territories of all the new EU Member States, as they have been dominant within the territories of the old EU members.

According to the REIO clause (Article 20.1), proposed by the EU in the draft Transit Protocol, Transit in case of REIO means transit through the territory of the whole REIO and not through the territory of its individual states (in the case of fig. 4 if the symbol 'REIO' would relate under REIO clause to the CP1 Area, that would mean not the Area of the individual EU Member State, but the Area of the whole REIO, i.e. the Area of the European Union as a whole)*. To put it differently, the REIO clause suggested by EU imply that the supplies crossing the REIO (EU) territory will be considered as transit ones solely in the case when both gas shipping and gas delivery points specified within each individual contract are located outside the REIO (EU) territory. That means that according both to the concept of "free movement of goods" in the Treaty of Rome, on the one hand, and to the REIO clause in the draft Transit Protocol, on the other hand, there is no "transit" within the European Union. That, in turn, means that, according to the draft REIO clause proposed by the EU in the draft Transit Protocol, there are no more transit supplies of Russian gas within the new EU Member States where Russian gas (in legal terms) is still physically available, i.e. that Russian gas supplies between points "B" and "C" (see fig. 1) are not "transit" any more.

That means that prior to 1 May 2004, transit states for Russian gas supplies to Europe were all the states of Zones II and III, including both former CIS and Eastern European former COMECON countries; after 1 May 2004, according to REIO clause proposed by EU for Energy Charter Protocol draft on transit they were only the states of Zone II (see fig. 6). And only there the Transit Protocol draft will apply to them (if approved in today's version of the draft).

The Russian party continues voicing its active disagreement with this interpretation of the REIO clause proposed by EU, according to which the regulations of the multilateral Transit Protocol cease to be valid in the REIO territory, while the norms of "internal" EU legislation (*acquis communautaire*) will be effective in the EU territory, even in parallel with obligations put down in the draft article 20.2 in the draft Protocol.

* That and other consequences of Transit Protocol implementation for Russian gas supplies to Europe were analysed, *inter alia*, in (Konoplyanik 2003d; 2003e).

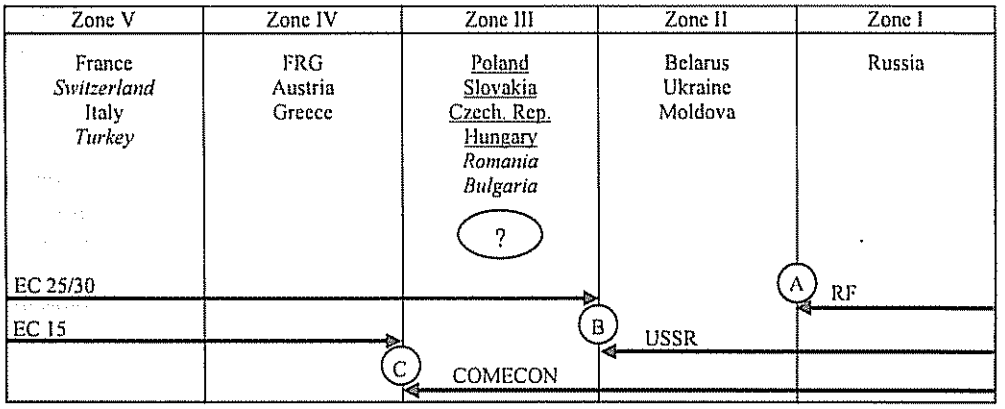


Fig. 6. Russian gas export to Europe: On-border sales and transit arms (2).
Italic – non-EU countries, underlined – new EU accession states since 01.05.2004.
A, B, C – points of change of ownership for Russian gas and/or pipeline on its way to Europe.

The Russian party continues insisting on definition and clarification of this obligations, believing that the current version of article 20.2 in the draft Protocol permits ambiguous interpretation. Among other things, in the opinion of the Russian party the use of the "integration clause" will permit EU and its institutions to introduce new regulation conditions, which may affect essentially compliance with contractual obligations on "transit" supplies to the delivery points. Transit of Russian gas (as well as other gas supplied from beyond EU) will become less protected, new risks will appear, though the liabilities for supplies to the delivery point will stay with Russia (Gazprom/Gazexport, etc.) as before.

During their meetings the experts delegated by both parties have been discussing the compromise settlement options suggested by the Russian party, which can protect the country well-founded economic interests (at least in the framework of current and future contractual obligations of the Russian gas supplies for European buyers to the delivery points) in the context of EU enlargement processes superimposed on further integration and liberalization of the EU internal gas market and the existing contractual structure of the Russian gas supplies to Europe.

The key element of proposals made by the Russian party in the course of 2005 export consultations is the clause within the draft article 20.3 stating that "free movement of EMP in the REIO territory" starts from the Russian gas (and any other gas from outside REIO) delivery points in the REIO territory, i.e. from the moment of the first transfer of the title of ownership for gas in the territory of REIO. In this case (provided the approach is approved):

— if the delivery points are located on the REIO border (as it used to be in the case of EU 15), transit – in its contractual sense – ends on REIO external border*;
— if the delivery points are located not on the REIO external border but inside the territory of a REIO Member State, which is the "external" REIO country (i.e. national frontier of the country is also the REIO external border), transit – in its contractual sense – ends on REIO external border, as well;

* REIO may also have "internal" border – like, for example, REIO – Switzerland border, Switzerland not being the EU Member State.

— if the delivery points are located inside the territory of a REIO Member State, which is not "external" REIO country (i.e. national frontier of the country is not the REIO external border), transit – in its contractual sense – also ends on the national frontier of the country, but in this case already within the REIO territory.

The proposal made by the Russian party articulates unambiguously that article 20.1 applies to contracted gas volumes rather than to physical ones. It means that it may apply to all supplies, both originating from and destined to REIO. In my opinion, it permits applying different ("national" and "international") rules of regulation to different contracted gas volumes within the same pipe (depending on "national" or "international" character of gas flow within the pipe, determined by the type of the relevant contract), which can serve as an efficient outcome of the so far unresolved issue of the EU proposed "REIO clause" implications.

According to draft article 20.3 the Transit Protocol regulations will apply to gas originating outside of EU from the REIO external border to gas delivery points located inside REIO territory. However, the Transit Protocol regulations will apply solely to the gas volumes in the relevant pipelines, which have been contracted to supply from outside the EU to the points indicated (where the title of ownership for gas will be transferred). Hence, in the REIO territory the Transit Protocol regulations will apply solely to contractual obligations within import contracts with transit (as defined by article 7 of ECT) component. If the same pipe contains simultaneously additional (other) gas volumes in "free movement", i.e. originnating from and destined to REIO, the "*acquis communautaire*" regulations apply to them.

The discussion of the "REIO clause" is continued ...

8 Gas transit and problem of a mismatch between expiry dates of contracts

EU enlargement might have some economic consequences for Russian gas transit supplies to Europe within the acting long-term contracts – in cases of mismatch between the expiration date of supply and related transit agreements. The nature of such potential problems relates to a potential mismatch between expiry dates of the longer-term gas supply contracts, on the one hand, and of the shorter-term transit contracts, providing access to the transport capacities within these transit states, which enables implementation of such supply contracts, on the other hand. In the particular case of Russian gas supplies to Europe that means a mismatch between longer-term Russian gas supply contracts (LTCs TOP) with the EU companies, on the one hand, and shorter-term transit contracts with the corresponding companies of the transit states, or, as in the case of new EU Member States, based on REIO draft proposal for the Transit Protocol draft, shorter-term transport contracts with the pipeline owners of these states up to the Russian gas delivery points, on the other hand.

A mismatch between expiry dates of long-term supply (delivery) contracts and transit/transport contracts as its integral part to fulfil the delivery contract obligations creates a risk of non-renewal of the transit/transport contract, especially in cases when supply and transport are legally separated business operations (i.e. as a result of unbundling). It results in transit price rise (any risk shall be compensated, e.g. insured), which is not to the advantage of either supplier or buyer/consumer. A core issue regarding the problem of mismatch is the guarantee of access to transport capacity for the shipper within the duration of the existing delivery contract, i.e. supply contract being in force (see fig. 7).

There are two main avenues for solving the problem of mismatch: to exclude mismatch completely; and/or, when mismatch still exists, to use mechanisms minimising risks related to it.

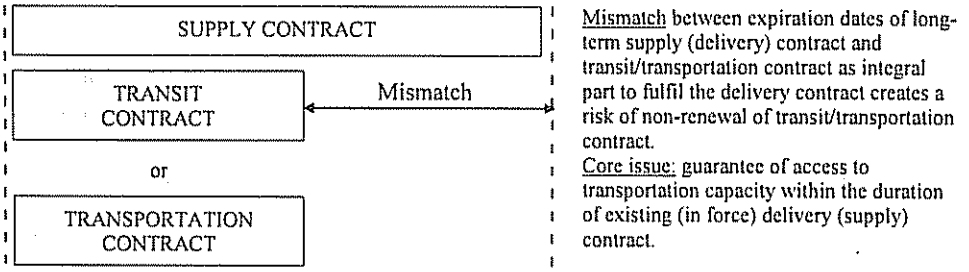


Fig. 7. Mismatch between long-term supply contract and contracted transportation/transit capacity.

In the first case there are two possibilities:

— to reduce the duration of supply contracts to the duration of transit/ transportation contracts; or

— to increase the duration of transit/transportation contracts to the duration of supply contracts.

Diminishment of the average duration of supply contracts is a current trend of energy markets development: according to Hirschhausen and Neumann, it has diminished from 30 to 15 years between 1980–2003 (Hirschhausen-Neumann 2005). The strong recent fight of the European Commission against LTCs has also been moving – nominally – in this same direction (although market evolution of contractual structures has not been done by the administrative restrictions for particular types of contract). However, there is an essential difference: reduction of average duration of a contract in the market is usually evolutionary (due to expansion of the range of contracts, increase in their number being largely provided by shorter-term contracts in the countries with a well-developed transport infrastructure) rather than administrative, e.g. bans and/or restrictions of the use of this or that generally applicable contractual relations. Besides, as shown above, there is no alternative so far to LTCs TOP as a tool of financing new investment projects. That is why duration of supply contracts reduced to transit contract one, if there is a mismatch, will hardly be considered as an effective general rule for settling the problem in the entire Energy Charter domain, outside and inside EU bounds inclusive.

Gazprom adheres to the approach envisaging increase in duration of transit contract to match duration of supply contract in East Europe/CIS (recent long-term transit contracts signed with Poland, Czech Republic, Ukraine, Turkmenistan, Uzbekistan, Kazakhstan).

In the second case (if full coincidence of duration of supply and transit contracts is impossible), there might also be a few ways to solve the problem. The one that has been discussed for quite a long period of time in the course of Transit Protocol negotiations is a so-called "Right of First Refusal" (RFR). It has been proposed by the Russian delegation as a universal solution to the problem of mismatch, but was strongly opposed by the European Union, which has quite clearly stated that RFR would never apply within the European Union as it is incompatible with EU competition laws. As a working compromise, an EU delegation has preliminarily agreed that RFR might apply only to existing Russian supplies within ex-EU territories within the ECT member states*.

As was shown above, within the European Union, long-term contracts provide the bulk of gas supply (see table 1). That means that the problem of mismatch within the European Union not only might exist in theory, but does exist in business practice. The European Commission recognized that as for opening of energy markets in EU, the overwhelming

* Regarding the debate on RFR see (Konoplyanik 2001; 2002c; 2002d; 2003b; 2003c; 2003f; 2004c).

majority of the EU Member States still contemplate transposing of the EU new legal regulations to their national legislation.

The above-mentioned means that the issue of access to transport capacities within the duration of long-term supply contracts within the European Union is a valid one for consideration. In this regard some natural questions arise to which answers from the European Union could be very helpful, at least for the successful finalisation of Transit Protocol negotiations:

— Does the problem of access to transportation capacity exist within the European Union?
— Does the mismatch between duration (expiration dates) of supply contracts and transportation contracts exist within the European Union?
— Is there a risk of non-renewal of transportation contracts within the duration of long-term supply contracts within the European Union?
— What are the procedures for renewal of transportation contracts within the duration of long-term supply contracts (if any) within the European Union?
— Do these procedures adequately address the risks faced by shippers and (in the case of new investments) by the financial community?

Judging by repeated utterances made by EU experts within informal meeting of experts from Russia and EU attended by representatives of the Secretariat, in the framework of enlarging EU no lack of coincidence problem in contractual terms will arise, since the pipeline system owner/operator, when addressed in due time, must provide – in the context of "available pipeline/transit capacities" – the opportunity to reserve access to the capacities for the period required from the necessary moment. Experts of both parties are taking effort to clarify the issue further and to transform it into mutually acceptable legal terms within the Transit Protocol.

This and other issues are still argued actively by the experts of the Russian and EU delegations in the course of informal meetings resumed autumn of 2004. At the same time the Russian party handed over to the EU delegation a more extensive list of questions*, answers to them being presumably able to help each party in understanding better the other party concerns and in formulating more distinctly its viewpoint for continuing the bilateral consultations. On the one hand, EU failed to answer all the relevant questions put by the Russian party in writing.

Though, on the other hand – probably it was the main positive role of the questions asked by the Russian party in the consultation process – they "gave impetus" to the consultations/informal meetings, promoting intensification of contacts between the experts and better understanding by the parties of the problems discussed.

Hopefully, the intensive and more efficient search for mutually acceptable solutions will permit the experts to reach ultimate understanding of still unresolved issues and to find a compromise for developing the contractual structure of Russian gas supplies to Europe, while the compromise will reflect as appropriate the long-term economic, financial and legal issues, arousing concern of both parties and suggest a balanced solution acceptable for the entire Energy Charter community.

9 Conclusion

The 16th session of Energy Charter Conference that took place on December 9, 2005 made the decision, that Russian and EU should elaborate by the end of February, 2006, a time schedule of meetings of the parties aimed at concurrence of Transit Protocol issues still

* The questions asked by the Russian party and the answers given by EU are available on the Energy Charter web-site within the member states access-zone.

remaining unresolved, including both informal consultations of the experts delegated by the parties and official – presided by the Energy Charter Conference Chairman – consultations of Russian and EU delegations for expeditious approval of the Transit Protocol.

However, late in 2005 – early in 2006 the energy transit issues raised additional international resonance after the dispute between Russia and Ukraine in gas sector. On January 4 the conflict was settled, while all the parties to the conflict (Russia, Ukraine, EU) referred officially to the Energy Charter principles as the base for reaching an agreement. The events strengthened the international community attitude to importance of multilateral documents considering energy transit issues, ECT and complete Transit Protocol specifically, for energy security of all Energy Charter Member States. Therefore, on January 10, 2006 the Conference Chairman addressed Russia and EU suggesting intensification of the consultations for completion of Transit Protocol in 2006.

Successful completion of Transit Protocol can be mentioned among prerequisites, which were identified by State Duma in due time for returning to the issue of ECT ratification by Russia. In this respect the year 2006 is outstanding: Russia presides at G8 meetings, advancing the "energy security" subject as a basic one for its G8 Presidency. Sustainable and uninterruptible (even by disputes of the parties) transit is an integral component of energy security. If positions held by Russia and EU on the remaining issues are concurred and the agreements are approved by consensus of the rest ECT Member States in the first half of 2006, it would create prerequisites for possible initiation of the ECT ratification procedure, which may be declared by Russia during the G8 summit in St. Petersburg in July, 2006. The statement could be a culmination of the Russian chairmanship in G8, while subsequent ratification of ECT would be a worthy contribution of this country into strengthening of international energy security.

References

Cayrade P 2004, "Investments in gas pipelines and LNG Infrastructure. What is the impact on the security of supplies?" *CEPS. INDES Working Papers* N 3 March 2004

CD, 2003 Directive 2003/55/EC of the European Parliament and of the Council (26 June 2003) concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC

CD 2004, Council Directive 2004/67/EC of 26 April 2004 concerning measures to safeguard security of natural gas supply

Communication 2002, "The internal market in energy: Coordinated measures on the security of energy supply" Communication from the Commission to the European Parliament and the Council (COM (2002) 488 final) dated 11 September 2002

EC, 2000 "Opening up to choice – Launching the single European gas market' (Luxembourg; Office for Official Publications of the European Commission) 17

Frisch M, 2003a "The forced removal of destination clauses: European gas security of supplies implications" Conference "Eurasian Natural gas: Opportunities and Risks" organized by the Energy Charter Secretariat, 12–13 November 2003, Brussels, Belgium

Frisch M, 2003b "Can price review and destination clauses undermine gas security of supply in Europe?" Conference "NGas Summit" 1–3 July, 2003, Paris, France

GP 2000, Green Paper "Towards a European strategy for the security of energy supply", 29 November 2000 (COM (2000) 769 final)

Hirschhausen C, Neumann A, 2005 "Less long-term gas to Europe. A quantitative analysis of European long-term gas supply contracts", *Oil, Gas & Energy Law Intelligence (OGEL)* 3 N 1, March 2005, www.gasandoil.com/ogel

Konoplyanik A, 2001 "There is only one way to ECT ratification. Coming to an agreement necessitates comprehension of the opponent's objections" *Oil & Capital* N 3 8–10 (in Russian)

Konoplyanik A, 2002a "Time rules the move from monopoly to competition" *Oil & Capital* N 4(3) 40 (in Russian)
Konoplyanik A, 2002b "Evolution of gas markets, long-term contracts and Energy Charter Agreement" *Neftegaz (Oil and gas)* N4 25–33 (in Russian)
Konoplyanik A, 2002c "ECT ratification by Russia: shattering the opponents bona fide ignorance above all" In the book "Energy Charter Agreement – a way to investments and trade for the East and West" Edited by T Valde – English edition and by A Konoplyanik – Russian edition (Moscow: International Relations, 2002, 632 p) 545–614
Konoplyanik A, 2002d "ECT Transit Protocol: problems arousing Russia's concern and possible solutions" *Neft, gaz i pravo (Oil, gas and law)* N5 (47) 49–62 (in Russian)
Konoplyanik A, 2003a "Financing Russian oil and gas sector: The effects of international law instruments" *Journal of World Investment* 4 N6 941–962
Konoplyanik A, 2003b "Russian gas to EU markets – 1: Thorny issues impede progress toward final Transit Protocol" *Oil & Gas Journal* October 20 **101** N 40 60–64
Konoplyanik A, 2003c "Russian gas to EU markets – 2: Compromise is best course for Russia, EU in Protocol negotiations" Oil & Gas Journal October 27 **101** N 41 68–75
Konoplyanik A, 2003d "Energy Charter Protocol on Transit: On the way to agreement – what kind of treatment will be accorded to Russian gas in EU countries" *Oil, Gas & Energy Law Intelligence (OGEL)* **2** N 1 (February 2004) www.gasandoil.com/ogel
Konoplyanik A, 2003e "Stiff competition ahead – as Russia moots ways to increase presence on European gas market", *Oil, Gas & Energy Law Intelligence (OGEL)* **2** N 1 (February 2004) www.gasandoil.com/ogel
Konoplyanik A, 2003f "Energy Charter and Russian economy: The role of the Energy Charter process in enhancement of Russian competitiveness in the world energy and capital markets" (Moscow: INP RAS Publishing House) 63 p
Konoplyanik A, 2004a "Russia in the emerging Eurasian energy area: competitiveness issues" (Moscow: "Nestor Academic Publishers") 655 p (in Russian)
Konoplyanik A, 2004b "Energy security and the development of international energy markets" in "Energy security: managing risk in a dynamic legal and regulatory environment" Ed. By B Barton, C Redgwell, A Ronne, D N Zillman (International Bar Association/Oxford University Press) 47–84
Konoplyanik A, 2004c "Transit Protocol finalization" *Petroleum Economist* July 2004 34
Outlook, 2003 "IEA World Energy Investment Outlook 2003" (IEA/OECD, Paris)
Konoplyanik A, Lebedev S, 2000 "Project financing in gas-and-oil industry: global experience and beginning of application in Russia" *Neft, gaz i pravo (Oil, gas and law)* № 25–40 № 2 23–42 (in Russian)
Razavi Hossein, 1996 "Financing energy projects in emerging economies" (PennWell Publishing Company, Tulsa, Oklahoma)
Outlook 2003, "IEA World Energy Investment Outlook 2003" (IEA/OECD, Paris)
WP, 2004 "Commission press release on territorial destination clauses with Gazprom and ENI, IP/03/1345, 6 October 2003" Commission Staff Working Paper, "Energy dialogue with Russia. Update on progress", 28 January 2004, SEC (2004) 114, Annex 6