

INTERNATIONAL FRAMEWORK FOR THE TRANSIT OF OIL AND GAS

The Caspian Sea Perspective

Ana Stanič

Transit of oil and gas,¹ and the international rules regulating it, are matters of concern to most countries in the world and, in particular, to countries of the Caspian Sea region. Petroleum is of key significance in all regions of the world in economic, political and military terms. It is essential for achieving growth, competitiveness and employment, and its control and supply are of strategic importance to all states.²

The world's consumption of petroleum is forecast to increase rapidly in the coming years. In the EU alone, gas consumption is forecast to rise by 60 per cent by 2020.³ At the same time, the EU's dependence on imported petroleum will increase. By 2010, 90 per cent of oil and 70 per cent of all gas consumed in the EU will be imported.⁴ Similar rises in petroleum dependence and consumption are forecast for the US and the Central European and South East Asian countries. Thus, safe and reliable transportation from petroleum producing regions is, now more than ever, vital for the economic development of petroleum dependant countries. Consequently, the need for and importance of rules governing petroleum transportation at the international level is growing, and will continue to grow in the future.

¹ Hereinafter oil and gas will be referred to as 'petroleum'.

² Indecog, 'Hydrocarbon Transport in Practice: Legal, Managerial and Economic Aspects', <www.inogate.9704.gr/lc.htm>, at 4.

³ Commission of the European Communities, *Proposal for Decision of the European Parliament and of the Council amending Decision No 1254/96/EC laying down a series of guidelines for trans-European energy networks*, 20.12.2001, COM(2001) 775 final, at 27.

⁴ B. Page, 'Transit Project Implementation', Vol. 5 No. 7 *Caspian Investor*, 30 August 2002. At present, the EU imports a substantial portion of its oil from OPEC countries and gas from Russia. The Caspian Sea region is a region of hitherto untapped sources of petroleum, the access to which is regarded by the EU and the US as a way of addressing their concerns over security of supply and diversification.

Transit of petroleum, and the rules governing it, are of particular importance for the Caspian Sea region for the three reasons. First, the development of this landlocked region is inextricably linked to oil and gas development. Since its petroleum resources are located in remote locations, transportation by pipelines across several borders is a key part of the process by which the region's hydrocarbon wealth will be tapped. Any attempt by the region to develop its energy markets is, thus, predicated on the success of the efforts to secure freedom of transit of petroleum.⁵

Second, the collapse of the USSR has given rise to an increased number of transit disputes in the region.⁶ As a result of such collapse and the formation of new states, previously internal petroleum transport routes have been transformed into international ones, thereby adding political, legal and strategic complexity to the flow of petroleum. Therefore, the regulation of petroleum transit is seen as an important tool to minimise the likelihood of transit related disputes in the region.

Third, significant financial resources are needed for the development of the energy sectors in the region.⁷ According to the World Bank, a total investment of USD140-220 billion is needed to realise the full potential of the Caspian Sea region's petroleum reserves.⁸ Pipeline projects are, by their nature, long term and large in size. By way of an example, the total cost of the Baku-Tbilisi-Ceyhan (BTC) pipeline projects, whereby Azeri oil will be shipped through Azerbaijan, Georgia and Turkey, is currently estimated at USD 2.9 billion.⁹ Attracting foreign investment is, therefore, crucial to the development of such projects and the region. In order to increase foreign investor confidence, encourage investment and reduce political risks associated with it, rules ensuring unimpeded transit and protection of investments are necessary at the regional and international level.

Thus, without binding rules regulating cross-border transport there can be little international investment and trade in energy on which the economic development of the Caspian Sea region and the world as a whole are dependant.¹⁰ For these reasons, transit is an area of international law that is growing rapidly.

⁵ B. Clark, 'Transit and the Energy Charter Treaty: Rhetoric and Reality', [1998] 5 *Web JCLI* 1, at 4. <www.webjcli.ncl.ac.uk/1998/issue5/clark5.html>.

⁶ In the winter of 2000, Russia turned off its supply of gas to Georgia as a way of emphasising its demands to keep military bases in Georgia. Russia had used similar 'blackmailing' tactics in relation to Ukraine in 1993. For further details on these incidents see for example, *The New York Times*, 8 June 2001, at 8.

⁷ Due to their size, in the past pipeline projects were carried out by states. However, increasingly such projects are carried out by private companies. The Caspian Pipeline Consortium (CPC) pipeline is the first privately owned oil trunk line in Russia and Kazakhstan. For further details see, 'Russia's Transneft Captures Transit Business', *Petroleum Economist*, November 2001, 5.

⁸ J. Walters, 'Caspian Oil and Gas: Mitigating Political Risks for Private Participation', [July-December 2000], Volume 7 Article 5, *CEPMLP Journal*, <www.dundee.ac.uk/cepmlp/journal/html>.

⁹ 'Amid ceremony, BP set to sanction new phase of Azeri Caspian Development', *Platts Oilgram News*, Vol. 80, No. 179, 1, 18 September 2002.

¹⁰ P. Andrews-Speed, 'The Energy Charter Treaty and International Petroleum Politics', [1998] Vol. 3, Article 6, *CEPMLP Journal*, at 3.

This chapter offers a compendious guide to the nascent international treaty-based regime regulating the transit of petroleum, with a particular focus on the Caspian Sea region.¹¹ In particular it analyses the transit rules that relate to pipelines since three quarters of all gas¹² and a substantial proportion of all oil consumed is transported via cross-border pipelines.¹³ The concept of transit is defined in Part 1 of this chapter. Part 2 examines the transit rules under the Barcelona Convention and Statute of Freedom of Transit of 1921 (the Convention), the first international treaty to deal with transit.¹⁴ In Part 3, the nature, scope and the effectiveness of rules adopted under Article V of the 1947 General Agreement on Tariff and Trade (GATT) are discussed. Part 4 reviews the nature and scope of the transit rules adopted under the 1998 Energy Charter Treaty (ECT), a regional energy transit treaty to which all Caspian states are a party. The draft provisions of the Protocol on Transit currently being negotiated under the auspices of the Energy Charter Conference is analysed in Part 5.

1. DEFINITION OF TRANSIT

Transit is commonly understood to refer to the transportation of people and/or goods from one country to another. Under international law, transit has a more specific meaning and describes the passage across the territory of a state of persons or goods, where such

¹¹ A discussion of the nature and scope of transit rules under international customary law is beyond the scope of this chapter. It should be noted that whether such rules exist under customary law is the subject of much debate. Whilst some authors, such as Lauterpacht, have argued that a right of transit exists under international law, others, like Shaw, are of the view that the principle of freedom of transit has not yet crystallised into a principle of customary international law. In the author's view, on balance, certain transit rules such as non-discrimination, prohibition on imposing customs duties on goods in transit, are rules of customary international law. However, it is unlikely that the scope of these rules extends to the transit of petroleum by pipelines as the treaties from which such customary rules are derived from, such as the 1921 Barcelona Convention (discussed below), the 1982 United Nations Law of the Sea Convention and the 1965 Convention on the Rights of Landlocked States exclude pipelines from their purview. The fact that at the time GATT was promulgated transportation by pipeline was not possible, adds further support to the view that transit rules set out in GATT which have now crystallised into principles of customary law are not likely to extend to transit by pipelines. See E. Lauterpacht, 'Freedom of Transit in International Law', [1958-1959] Vol. 44, *Problems of Public and Private International Law*, 313. See also A.M. Sinjela, 'Freedom of Transit and the Right of Access for Landlocked States - The Evolution of Principle and Law', [1982] Vol. 12 *GA J. INT'L & COMP. L.*, 31. The lack of customary rules regarding transit by pipelines means that the need for treaty based rules is even more important.

¹² This is because the alternative means of supplying gas by tanker is more expensive and technically more complex as the gas must be liquefied and then re-gasified.

¹³ S. Zarilli, 'Energy Services in International Trade: Development and Implications', [2001] Vol. 8, Art. 15, *CEPMLP Journal*, <www.dundee.ac.uk/cepmlp/journal/html>.

¹⁴ See <www.jurisint.org/pub/01/en/doc/249_1.htm>. 49 states are party to it.

passage is a portion of a complete journey, beginning and terminating beyond the border of such state.¹⁵

2. BARCELONA CONVENTION 1921

The Barcelona Convention was the first multilateral agreement to address the transit of goods. Article 2 requires a transit state to 'facilitate free transit', without detailing the nature and scope of this obligation.¹⁶ Articles 3 and 4 set out certain conditions a transit state must ensure are accorded to goods in transit through its territory. In particular, Article 3 prohibits a transit state from subjecting goods to customs duties, the rationale being that goods in transit are not destined for the transit state and, thus, should not be subject to its import or export duties. That said, Article 3 does not prevent a transit state from requiring that such goods comply with its customs and other laws. Moreover, this provision expressly permits a transit state to levy duties which will allow it to defray expenses of supervision and administration entailed in transit, provided that such dues are 'imposed under conditions of equality'. Such duties may only be levied at a rate which 'as nearly as possible corresponds to the expenses which they are intended to cover'. In other words, Article 3 requires a transit state to ensure that the duties it levies are reasonable and are applied on a non-discriminatory basis. This obligation is further detailed in Article 4 of the Convention which requires states to apply tariffs on a non-discriminatory and reasonable basis. The meanings of these requirements are not defined. As similar requirements have been imposed on a transit state under the GATT and the ECT, their scope will be discussed later in this chapter.

It should be noted that the abovementioned obligations are only imposed on a transit state in respect to transit by rail and waterways. The failure of the Convention to apply to pipeline transit is not surprising given that at the time of its adoption it was not feasible to transport petroleum through pipelines. However, this means that the Convention's provisions can only be invoked in respect of petroleum transported by rail and waterways.

3. GATT

GATT is a key multilateral agreement relating to transit, to which 144 states are currently party.¹⁷ The rules concerning transit are set out in Article V of GATT. It should be noted that the states in the Caspian Sea region are not members of the WTO and are thus not bound by Article V. Nevertheless, as will be illustrated in Parts 4 and 5 below, because

¹⁵ See, for example, Article 1 of the Barcelona Convention, Article V (1) of GATT and Article 7 of the ECT. See also Lauterpacht, above n. 11.

¹⁶ For discussion on the scope of this obligation see Part 4 of this chapter.

¹⁷ For the list of current members see <www.wto.org/English/thewto_e/whatis_e/tif_e/org6_e.htm>.

Article V has been incorporated into the ECT and the Protocol on Transit, treaties to which they are party, these states are indirectly required to comply with its terms. The rules of transit embodied in Article V will be discussed below by examining in turn: the scope of Article V, the nature of the obligations it imposes and the applicability of such obligations.

3.1 Scope of the Article

Article V concerns the transit of 'goods'. There was some debate in the past whether oil and gas came within the scope of this term, as the term 'good' is not defined in GATT.¹⁸ After the oil crisis of 1973, petroleum was treated as *de facto* outside the reach of GATT on the basis that neither oil nor gas were goods.¹⁹ However, today the prevalent view is that oil and gas fall squarely within the common definition of a 'good' since they are produced, can be bought and sold and have physical identities.²⁰ Indeed, already in 1983 the European Court of Justice (ECJ) in the *SIOT* case assumed the applicability of Article V to transport of network-bound energy.²¹

3.2 Nature of Obligations

Paragraph 2 of Article V provides that 'there shall be freedom of transit through the territory of each contracting party *via* the routes most convenient for international transit'. Some authors have argued that this provision 'proclaims the existence of the freedom of transit' under international law.²² However, it is more likely that paragraph 2 is no more than a declaration, because it neither imposes a concrete and enforceable obligation on states to ensure freedom of transit exists through their territory, nor accords an enforceable right of transit to states vis-à-vis one another.

In contrast, paragraphs 3, 4 and 5 do impose concrete obligations on a transit state concerning conditions of transit. They build on the provisions of the Convention and extend their application to network bound energy. So, for example, as under Article 3 of

¹⁸ See M.M. Roggenkamp, 'Transit of Network-bound Energy: the European Experience', in T.W. Wälde (ed.), *The Energy Charter Treaty: An East-West Gateway for Investment and Trade*, Kluwer International, 1996 at 506.

¹⁹ *Ibid.*

²⁰ See definition of good in *Deardorff's Glossary of International Economics*, <www.personal.umich.edu/~alandear/glossary/g.html#pagetop>. Also see definition of good adopted by the ECJ in *C-2/90 Commission v. Belgium* [1992] ECR 4431. Roggenkamp, loc. cit. and T.W. Wälde and A.J. Gunst, 'International Energy Trade and Access to Energy Networks', to be published in the forthcoming UNCTAD publication, *Trade in Energy and Environmental Services: Bridges to Sustainable Development*.

²¹ See C-266/81 *Società Italiana per l'Oleodotto Transalpino (SIOT) v. Ministère Italien de Finances* [1983] ECR 731.

²² M.M. Roggenkamp, 'Implications of GATT and EEC on Network bound Energy Trade in Europe', [1994] *Journal of Energy and Natural Resources Law*, 59, at 68.

the Convention, petroleum in transit must be 'exempt from custom duties'.²³ Paragraph 3 of Article V also provides that petroleum in transit must not be subject to any unnecessary delay or restrictions, and may only be subject to two types of charges, namely, charges for 'transportation' and 'those commensurate with the administrative expenses entailed by transit or with the cost of services rendered' by the transit state. Furthermore, paragraph 4 requires that any charges imposed 'must be reasonable, having regard to the conditions' of the goods. However, the terms 'reasonable', 'unnecessary delay' and 'unnecessary restrictions' are not defined in Article V. Thus, if a claim is ever brought for a breach of this provision these terms will need to be interpreted by looking at the way they have been defined under customary international law and thus, invariably under other transit treaties. Lastly, and most importantly, paragraph 5 obliges each transit state to accord most favoured nation (MFN) treatment to petroleum transiting its territory. In other words, such transiting petroleum must be accorded treatment which is no less favourable than that accorded to petroleum which originates from, or is destined for, the territory of any other GATT signatory. Thus, paragraph 5 introduces the principle of MFN treatment for the first time in the sphere of international transit law.

3.3 Applicability of the Rules

As an inter-state treaty, GATT accords rights and imposes obligations on signatory states only vis-à-vis one another. It does not grant rights to, or impose obligations on, corporate entities or private persons. Thus, only another state can commence arbitration proceedings against a transit state which is in breach of Article V. Given that trade is predominately carried out by non-state enterprises, such a limitation in the scope of its application explains why Article V has scarcely been relied upon in the past.²⁴

Some authors have argued that the scope of Article V extends to state-owned and privileged enterprises as a result of the operation of Article XVII of GATT.²⁵ Article XVII requires a state to ensure that such enterprises 'act in a manner consistent with the principles of non-discrimination prescribed' under GATT. Arguably, this requires a transit state to ensure that any charges imposed by state-owned pipeline operators and concession-holding companies are reasonable and non-discriminatory in nature.²⁶ However, a close reading of Article XVII reveals that the obligation only extends to state-owned enterprises in respect of their 'purchases and sales involving either imports or exports' and thus, does not extend to their transportation activities. Accordingly, it is

²³ See Article 3.

²⁴ See n. 42 in Roggenkamp, n. 18 above, at 507.

²⁵ Privileged enterprises are privately owned companies, to whom the state has granted special privileges with respect to their operations such as exclusivity of operation in a particular area.

²⁶ Roggenkamp, n. 22 above, at 69.

submitted that the scope of Article V does not extend to encompass state-owned pipeline operators and concession-holding companies, which own and operate pipelines.²⁷

It is unlikely that Article V can be invoked by companies before national courts of any state party. Whether or not it can depends on the constitutional frameworks of the individual state party. In the EU, the provisions of GATT have been held by the ECJ not to be directly effective.²⁸ The ECJ held that the features of GATT, 'characterised by a great flexibility of its provisions, in particular concerning the possibility of derogation, the measures to be taken when confronted with exceptional difficulties and the settlement of conflicts' prevented the provisions of GATT from being directly effective.²⁹ Thus, a company is precluded from challenging national provisions which conflict with GATT in the courts of an EU member state. A similar position is likely to be taken by the courts of other states party to GATT.³⁰ However, it should be borne in mind that states party to GATT may have enacted domestic legislation in order to comply with GATT's provisions, which may, in turn, be invoked by companies in domestic courts.

In summary, Article V prescribes certain fundamental conditions in respect of petroleum in transit with which a transit state must comply. It requires a transit state to (i) ensure goods in transit are not subject to any unreasonable restrictions or delays, (ii) ensure that all charges on goods in transit and regulations in respect to such transit are reasonable and (iii) ensure MFN treatment to transit petroleum. However, it neither imposes an obligation on a state to grant transit nor grants a corresponding right of transit to a state.

4. ENERGY CHARTER TREATY

The ECT is the first multilateral treaty to deal specifically with the issue of petroleum transit, albeit on a regional level only.³¹ The impetus behind the negotiations of the ECT in the 1990s was the realisation that Eastern and Western European energy sectors were interdependent, with Eastern Europe and CIS countries dependent on the EU's investment and the EU dependent on their petroleum resources.³² Accordingly, the creation of a regional energy transit framework was seen as means of encouraging the exploitation and transportation of petroleum resources from the land-locked Caspian

²⁷ As will be seen in Part 4, the scope of the ECT extends to state-owned and privileged enterprises.

²⁸ A provision of Community law is considered to have direct effect if it is clear, unconditional (i.e. it does not require any further measure to be adopted for its implementation) and is intended to provide rights to individuals. See further, P. Craig and G. De Burca, *EU Law: Text, Cases and Materials*, Oxford University Press, (2nd Ed) (1998), 163 et seq.

²⁹ See n. 21 above.

³⁰ Moreover, in the *SIOT* case the ECJ held that GATT could not be invoked in relation with intra-community transit.

³¹ It also covers transit of electricity, which, however, is not examined in this chapter. For the current list of members see <www.encharter.org>.

³² Clark, n. 5 above.

states to the petroleum dependant European market.³³ The ECT came into force on 16 April 1998, creating a pan-European transit network covering the European Union, Central and Eastern Europe and the CIS countries.³⁴ Since the CIS countries and many Central and Eastern European countries are not members of the WTO, the ECT is the main source of transit rules binding them.

Although its scope is limited to the energy sector, the ECT addresses a wide variety of topics which relate to it, including investment, transit, competition, the environment and trade. The discussion in this chapter is confined to those provisions of the ECT which deal with transit, investment, competition and settlement of disputes because, collectively, these provisions form the framework of transit rules.

4.1 Transit Provisions

The ECT builds on Article V of GATT and adapts it in order to tackle the particular issues that concern fixed pipelines through which most petroleum is traded today.³⁵ In this section, ECT's definition of transit will be examined first, followed by an analysis of the scope of application, nature, and limitations of the transit rules propounded by the ECT.

4.1.1 Definition of Transit

Under paragraph 10 of Article 7, transit is defined as the carriage of petroleum through the territory of a participating state which originates in the territory of another state and is destined either (i) for the territory of a third state or (ii) for the territory of the originating state, provided that either the originating state or the state to which the petroleum is destined is party to the ECT.³⁶

This definition is broader than that adopted under GATT and the Convention. First, it covers transit even if some of the countries involved in such transit are not parties to the treaty. Provided that the transit state is a signatory, it is sufficient if either the state of departure or destination of the petroleum is party to the ECT. This does not mean, however, that rights accrue to states that are not party to the ECT, but simply that a broader range of instances of transit fall within its scope. Second, carriage of petroleum

³³ K.P. Waern, 'European energy security and cooperation: the Energy Charter Treaty and its Protocol on Transit', [2002] *Law in Transition*, 16, 19.

³⁴ O.Q. Swaak-Goldman, 'The Energy Charter Treaty & Trade', [1998] Vol. 30, No. 5, *Journal of World Trade*, 115.

³⁵ Energy Charter Secretariat, *The Energy Charter Treaty and Related Documents*, 11, <www.economy.gov.sk/angl/charter.htm>.

³⁶ States can opt to exclude transit that crosses only the borders of two states by submitting a joint declaration under Annex N of the Treaty. Canada and America were the only countries that sought to do so, however, neither of them became a party to the ECT.

originating in, and destined for, the same country over the territory of another state also falls within ECT's ambit. This expanded definition of transit is of particular relevance to the Caspian Sea region because its geography is such that, often, the shortest route for transporting domestically produced petroleum for domestic consumption involves transit across the borders of another state. However, the transportation of petroleum originating in one country through its territory to another country does not fall within the scope of the ECT. In order to qualify as transit the transportation of petroleum must involve the crossing of at least two borders.³⁷ Lastly, the definition of transit encompasses all means of transportation and extends to all territory over which a state has sovereignty in accordance with international law including land, its territorial sea and continental shelf.

4.1.2 Scope of application

As under GATT, transit obligations under the ECT are only owed by one state to another. Moreover, as in the case of GATT, Article 7 of the ECT does not directly impose any obligations upon, or accord any rights to, privately owned companies. However, in line with current general principles of international law, the scope of application of Article 7 is broader than that previously adopted under international agreement as it covers regional and local authorities. Article 23 places responsibility with the central government for the observance by regional and local authorities of the provisions of the ECT.³⁸ Accordingly, the state is liable for any breaches by such authorities of the transit provisions. This is significant given that, in most countries and especially in the Caspian Sea region, local and regional governments act with a high degree of autonomy and generally have *de jure* or *de facto* power to regulate matters concerning transit, such as access to natural resources and the setting of certain taxes. Thus, a failure to bring such governments, at least indirectly, within the ambit of the treaty would have undermined its effectiveness.³⁹ Consequently, by expanding the application of the transit provisions, the ECT has enhanced its operability.

In addition, the transit rules indirectly apply to state-owned and privileged entities because a transit state is required under Article 22 of the ECT to ensure that such entities adhere to such rules. This expansion in the application of transit rules is important for addressing transit issues in states of the Caspian Sea region whose energy sectors are dominated by state-owned companies.⁴⁰ The power of such companies to facilitate or obstruct the implementation of the transit provisions is considerable. Even though the

³⁷ It should be noted that the definition of transit under EU law is different and encompasses transit that crosses only one intra-community border. See Article 2 (1) Council Directive 91/296/EEC referred to in n. 41 below.

³⁸ Andrews-Speed, n. 10 above, at 10.

³⁹ The insertion of this provision proved highly contentious and was one of the reasons why the USA did not sign the ECT.

⁴⁰ For example, in Russia Transneft, a state company owns and operates all the pipelines. Similarly, Kazmunaigaz owns and operates all pipelines in Kazakhstan.

ECT does not directly impose obligations on such companies, it does so indirectly as signatory states enact domestic legislation applicable to such companies in order to comply with their obligations under the ECT. Thus, in this way too, the ECT has effectively expanded the scope of the application of transit rules from that set out under GATT.

4.1.3 *Nature of the transit obligations*

Petroleum transit is dealt with in Article 7 of the ECT. Like Article V of GATT, it does not expressly grant another state the right to transit, nor does it impose an obligation on the transit state to grant transit. Instead, Article 7 imposes certain transit obligations on the transit state, some of which extend beyond those previously imposed under international treaty law. Accordingly, a transit state is required: (a) to take measures to facilitate transit; (b) not to discriminate; (c) to act reasonably; (d) to encourage increases in capacity; (e) not to place obstacles on the establishment of new capacity; and (f) not to interrupt or reduce the existing flow of oil and gas.

The nature and scope of each of these obligations is examined in turn below.

(a) *To take measures to facilitate transit* Paragraph 1 of Article 7 requires states to 'take the necessary measures to facilitate energy transit, consistent with the principle of freedom of transit'. This wording was borrowed from the Council Directive on the transit of natural gas through grids (known as the Gas Transit Directive) adopted in 1991.⁴¹ The nature of this obligation has been the subject of much debate. The debate has primarily concerned the meaning of the phrases 'to take measures to facilitate' and the 'principle of freedom of transit'.

Liesen has argued that the obligation to take measures to facilitate transit requires a transit state to grant companies of other signatory states access to its existing pipelines and permit them to construct new ones.⁴² However, such an expansive view is not supported by the wording of paragraph 1 because no obligation to grant such access or permission to construct is imposed. Moreover, mandatory third party access is specifically excluded from the scope of Article 7 obligations in Understanding I(b)(i) of the Final Act, pursuant to which the ECT was adopted. Thus, other authors, such as Roggenkamp, have argued that the requirement 'to take the necessary measures to facilitate transit' simply imposes an obligation on a transit state to enact laws and regulations the effect of which is to promote transit.⁴³ Moreover, the use of the term 'facilitate' rather than 'ensure' highlights the limited nature of the obligation imposed

⁴¹ See 91/296/EEC, OJ L147, dated 12 June 1991, at P0037.

⁴² See R. Liesen, 'Transit Under the 1994 Energy Charter Treaty', [1994] *Journal of Energy and Natural Resources Law* 56, at 63. For opposing view see C. Bamberger, J. Lineham and T. Wälde, 'Energy Charter Treaty in 2000: in a New Phase', [2000] Vol. 18 No. 4 *Journal of Natural Resources Law*, 30.

⁴³ Roggenkamp, n. 18 above, at 511.

under this paragraph.⁴⁴ However, it is arguably the failure of paragraph 1 to spell out the means by which a transit state must facilitate transit, rather than the failure to use words such as 'ensure' or 'encourage', which renders the scope of this obligation unclear.⁴⁵

Most leading authorities consider the reference in paragraph 1 to the 'principle of freedom of transit' as a reference to a rule of transit under public international law.⁴⁶ Whether such a principle exists under international law continues to be the subject of much debate.⁴⁷ If Liesen's view that no principle of freedom of transit exists under customary international law is adopted, then this additional wording adds nothing to the provision.⁴⁸ However, if it is argued that such a principle exists under customary international law, albeit not in respect of pipelines, then the effect of this additional wording is to require states to take measures to facilitate pipeline transit in line with, and by reference to, customary international law rules imposed on states in respect of other means of transport.⁴⁹ Others authors, such as Wälde, have argued that the reference to 'principles of freedom of transit' is a reference to rules set out in Article V of GATT because GATT first coined this phrase. If this interpretation of the meaning of the phrase is adopted, then the effect of this additional wording is to require states to comply with the provisions of Article V of GATT, discussed in Part 2 above, even if they are not members of the WTO. It is unclear which of the latter two interpretations of the meaning of these phrases is correct.

From the above it can, nevertheless, be concluded that the obligation under paragraph 1 to 'take measures to facilitate' is a 'soft law' obligation which leaves a transit state with substantial discretion to determine the nature and the scope of the measures it takes to facilitate transit. Thus, due to its nature it will be difficult for a state to claim that paragraph 1 has been breached. Consequently, the practical effect of this obligation is likely to be limited and will depend largely on the willingness of transit states to open their energy sectors.

(b) *Not to discriminate* The principle of non-discrimination is as fundamental to the ECT as it is to GATT. First, paragraph 1 of Article 7 requires states to take measures to facilitate transit 'without distinction as to the origin, destination or ownership of the goods in transit'. In other words, it requires petroleum in transit to and from contracting

⁴⁴ European Commission, *Transit Provision of the Energy Charter Treaty, Final Report*, December, 1999 (Synergy Programme).

⁴⁵ The obligation on states under paragraph 1 is to 'take necessary measures to facilitate' and not merely to 'facilitate transit'. Thus, an actual obligation to take necessary measures to facilitate, though not well defined, is imposed on the transit states. Thus, Sas's criticism of Paragraph 1 is mistaken. See B. Sas, 'Legal issues in the Control of the Construction and Operator of Pipelines and the Issue of Transit in the Caspian and Black Sea Regions', [1995] 7 OGLTR 274.

⁴⁶ See Liesen, n. 42 above; Sas, *ibid*; Roggenkamp, n. 18 above; Bamberger, n. 42 above.

⁴⁷ See n. 12 above.

⁴⁸ See Liesen, n. 42 above.

⁴⁹ For a brief discussion on transit rules under customary international law see n. 11 above.

states to be accorded MFN treatment. So, for example, if a transit state imposes higher charges on petroleum in transit to, or from, another state than on petroleum destined for, or originating in, a third state, it may well be in breach of its obligation to accord MFN treatment. In such a case, the other state may have recourse to arbitration, as further discussed in Section 4.4 below.

Second, paragraph 3 of Article 7 requires a transit state to ensure that its laws regarding transport and use of pipelines treat petroleum in transit 'no less favourably than' petroleum originating in, or destined for, such transit state. Accordingly, a transit state must grant petroleum in transit only 'quasi' national treatment, as it is not required to treat such petroleum the same as petroleum that is both produced and consumed in the transit state. So, as Kemper argues, by charging lower tariff rates for the transportation of Russian gas consumed within Russia than for that exported abroad Gazprom, the Russian state-owned pipeline company, does not breach the terms of this paragraph.⁵⁰

Moreover, in analysing this provision it should be borne in mind that non-discrimination does not mean that the same tariff rates must be imposed on all petroleum in transit. In other words, a state is not prohibited from imposing different tariff rates if (i) it offers shippers from different states different types of services, such as energy banking or quality management, or (ii) the costs it incurs differ in respect of shippers from different states, whether, for instance, as a result of credit risk or cost of capital.⁵¹

(c) *Act reasonably* Under paragraph 1 of Article 7, measures adopted by a transit state to facilitate transit must not result in the imposition of 'unreasonable restrictions' and 'delays'. In line with GATT, charges imposed on petroleum in transit or transportation of such petroleum must be reasonable. Unlike under GATT, the requirement of reasonableness is not spelled out. Arguably, reasonableness should be construed as requiring tariffs to reflect a transit state's cost of transporting petroleum and providing administrative and other services in respect to transit.

Notably, the requirement of 'reasonableness' is not likely to eliminate the differences between national tariff systems since the rate of the tariffs depends on the domestic costs of transporting petroleum and other related costs.⁵² As in the case of the requirement of non-discrimination, it will also not result in equality in the rate of tariffs imposed by the transit state on internal transportation and transit transportation because the costs incurred by such state in respect of the two are unlikely to be the same.

Nevertheless, paragraph 1 seems to provide a means for challenging distance-related tariffs on the basis that they typically do not reflect the actual costs incurred by the pipeline operators and are thus, unreasonable. Commonly, petroleum which is to be

⁵⁰ Energy Charter Secretariat, 'Rules of the Game, Interview with Secretary General of the Energy Charter Conference', March 2002, <www.encharter.org/index.jsp>.

⁵¹ European Commission, n. 44 above.

⁵² Nor does it need to do this because such differences *per se* are not regarded as the main obstacle to cross border trade.

transported long distances is swapped under swap agreements rather than physically transported. Therefore, it can be argued that distance-related tariffs breach paragraph 1 because no distance-related costs are actually incurred by the pipeline operator and any distance-related tariffs are unreasonable.⁵³

(d) *Encourage increase in capacity* Paragraph 2 of Article 7 provides that states 'shall encourage relevant entities'⁵⁴ to co-operate in' (i) modernising, developing and operating oil and gas pipelines,⁵⁵ (ii) mitigating the effects of interruption in the supply of oil and gas and (iii) facilitating the interconnection of pipelines. This provision is a key innovation of the ECT because no similar obligation has been imposed on states under preceding multilateral agreements.

However, like the obligation to 'take measures to facilitate transit', the obligation to 'encourage' is a soft law obligation.⁵⁶ It does not impose upon entities a duty to modernise, nor require the transit state to ensure that such entities modernise the existing pipelines or facilitate interconnection of pipelines. Despite this limitation, Liesen argues that paragraph 2 is likely to act as 'a motor for general co-operation on an international scale'.⁵⁷ Thus, the inclusion of paragraph 2 in the ECT presents an important step in the evolution of the international transportation network as states take steps to open up their energy sectors and link them with those of other states parties to the ECT.

(e) *Not to place obstacles for the establishment of new capacity* Since adequate infrastructure is the *sine qua non* for the transfer of petroleum and a prerequisite to securing greater security of supply, paragraph 4 of Article 7 is an important provision. It requires a transit state 'not to place obstacles in the way of new capacity being established'. In other words, it prevents a transit state from hindering the construction of new or additional pipelines within its territory.

Clark argues that this provision essentially provides companies with a right to establish new or additional transportation capacity.⁵⁸ Paragraph 5, which sets out the circumstances under which a transit state is not required to permit the construction of new pipelines, seems to support his view as it may be construed as implying that, in all other

⁵³ M. Khor, 'WTO, The Post Doha Agenda and the Future of the Trade System: a Development Perspective', <www.twinside.org.sg/title/mkadb.htm>, at 24.

⁵⁴ The term 'relevant entities' is not defined in Article 7. Most likely it should be construed to refer to 'state owned and privileged enterprises' since the scope of the ECT is expressly extended to include them pursuant to Article 23.

⁵⁵ Oil and gas pipelines fall within the definition of 'Energy Transport Facilities'.

⁵⁶ C.S. Bamberger, 'An overview of the Energy Charter Treaty', in T.W. Walde (ed.), *The Energy Charter Treaty: An East-West Gateway for Investment and Trade*, Kluwer International, 1996, 6-7. Clark, n. 5 above, at 5.

⁵⁷ Liesen, n. 42 above, at 64.

⁵⁸ Clark, n. 5 above, at 5. Roggenkamp concurs with this view and argues that the existence of such a right should be implied in Article V as well. See Roggenkamp, n. 18 above, at 510.

circumstances, the transit state must grant permission. Although this might have been the intention of the drafters of the ECT, the wording of these provisions does not support such an expansive interpretation for the following two reasons. First, paragraph 4 phrases the obligation in the negative by requiring states 'not to place obstacles'. Accordingly, a transit state 'does not undertake any direct obligation to permit the establishment of new pipelines'.⁵⁹ Second, paragraph 4 provides that the obligation 'not to place obstacles' only arises if transit cannot otherwise be achieved on commercial terms using existing transit capacity. Consequently, paragraph 4 should not be construed as requiring a transit state to take any specific action to permit the construction of new capacity, but merely to abstain from hindering such construction. Due to the nature of the obligation imposed, paragraph 4 is likely to be difficult to enforce in practice.⁶⁰

(f) *Not to interrupt or reduce the existing flow of petroleum* Under paragraph 5 of Article 7, a transit state must secure existing flows of petroleum, subject to the provisions of paragraphs 6 and 7. According to Bamberger, paragraphs 5, 6 and 7 of Article 7 are the most operationally relevant provisions of the ECT.⁶¹ They were inserted to reduce the likelihood of transit disputes similar to those which took place in CIS countries in the 1990s.⁶²

In the event of a dispute arising from transit, a transit state must not, pursuant to paragraph 6, 'interrupt or reduce' the existing flow of petroleum, or permit an entity subject to its control⁶³ from doing so, 'prior to the conclusion of the dispute resolution procedure set out in paragraph 7'. In turn, paragraph 7 provides that a state party to the dispute may refer the dispute to the Secretary General of the Energy Charter for conciliation. If an agreement is not reached within 90 days, the conciliator can (i) recommend a procedure for resolving the dispute; or (ii) propose a resolution, and, in either circumstance, impose interim tariffs and other measures. States must comply with such interim measures for a period of 12 months. If the parties fail to reach an agreement within this 12-month period then, Wälde and Andrews-Speed argue, either state can refer the matter to arbitration pursuant to Article 27.⁶⁴ The nature of the arbitral procedure is discussed in Section 4.4 below.

⁵⁹ European Commission, n. 44 above, at 13.

⁶⁰ Ibid.

⁶¹ Bamberger, n. 56 above.

⁶² For details see n. 6 above.

⁶³ The term 'entity subject to its [the transit state's] control' is not defined in the ECT and thus its scope is unclear. Does it only extend to companies owned by the state, or to all companies that operate under a state's jurisdiction?

⁶⁴ T. Wälde and P. Andrews-Speed, 'Will the Energy Charter help international investors?', 12th Biennial Conference on International Energy and Resources Law, International Bar Association, Prague 24-29 March 1996. However, other authors have eschewed this notion and taken the view that the only remaining course of action is to recommence the Article 7 (7) procedure.

The importance and effectiveness of these provisions in practice are likely to be limited for a number of reasons. At first glance, paragraphs 5 and 6 would seem to prohibit a transit state from interrupting or reducing petroleum in transit. However, in practice this is not likely to be the case as paragraph 6 permits a transit state to interrupt or reduce the flow of petroleum if it has reserved itself rights to do so under transit agreements. Since typically a transit state retains such rights to interrupt or reduce the flow of petroleum in transit agreements, paragraphs 5 and 6 may be relied upon only in rare circumstances.

Second, their importance is further circumscribed by their failure to cover cases of interruption which occurred in Caspian Sea region in the past and are likely to occur again in the future.⁶⁵ For instance, in the 1990s, Ukraine siphoned-off Russian oil destined for Germany and other countries. It did so when Russia refused to continue supplying it with oil after Ukraine failed to pay for such oil under its purchase agreements with Russia. However, this act of siphoning-off by the Ukraine would not itself trigger the operation of paragraph 6 because the obligation by a transit state not to interrupt the flow of petroleum only arises in respect of 'a dispute over any matter arising from...transit'. Ukraine's failure to pay for oil destined to it under the oil purchase agreements cannot be construed as a 'matter arising from...transit'. However, it should be noted that a transit state will generally be prohibited from curtailing the flow of petroleum if a shipper fails to pay it the transit tariff because a failure to pay the transit tariffs can be construed as a dispute in respect of a 'matter arising from transit'.

Third, the effectiveness of the dispute resolution mechanism they prescribe is questionable. Paragraph 7 provides that conciliation may only be resorted to upon exhaustion of all other contractual and other dispute resolution remedies. As a general rule, transportation and other transit-related agreements often provide for international arbitration as a means of resolving disputes. Thus, by providing the dissatisfied state with a means of appealing, by way of conciliation, a decision reached pursuant to such arbitral proceedings, paragraph 7 may have the unintended effect of prolonging a transit dispute. Moreover, paragraph 7 fails to provide the disputing parties with a speedy dispute resolution mechanism because it only requires them to submit the dispute to conciliation. Therefore it effectively merely prescribes a cooling-off period in which retaliatory measures cannot be taken.

⁶⁵ Some others, including Sas, have argued that another shortcoming of these provisions is their failure to prohibit interruption of transit in cases where the petroleum has not been paid for. However, since the obligation to pay for petroleum arises under sales agreements a failure to make payment cannot be construed as a matter arising from transit. There is no reason why the ECT would seek to prescribe a mechanism for preventing interruptions in the flow of petroleum in such circumstances. See Sas, n. 45 above.

4.2 Investment Protection

As mentioned in the introduction, the development of transit infrastructure, especially in the Caspian Sea region, is heavily dependent on investment. This close link between the two was acknowledged in the ECT, which is the first international treaty to contain rules on both investment and transit. As will be seen in this section, investment rules provide companies involved in transit with directly enforceable rights against a transit state, thereby granting additional and, in certain respects, greater protection than transit rules.

The provisions of the ECT relating to investment adapt and extend the application of the investment rules set out in bilateral investment protection agreements to the energy sector.⁶⁶ Part III of the ECT requires a transit state to grant certain rights to foreign companies in relation to investments made by them in such transit state. An 'investment' is defined broadly to mean any kind of asset owned, or controlled, by such companies, including tangible and intangible assets, shares or bonds, and any rights conferred by law or contract. Accordingly, pipelines owned or operated by such companies, as well as any right granted to them under transportation, concessions and other similar agreements qualify as 'investments', in respect of which rights accrue.

The rights accorded to an investing company under Part III of the ECT include the right: (i) to fair and equitable treatment; (ii) to national treatment; that is a right to treatment no less favourable than that conferred on companies incorporated in the transit state; (iii) to MFN treatment; (iv) not to have its investment impaired in any way by any unreasonable or discriminatory measures, whether in respect of management, maintenance, use, enjoyment or disposal of such investment; (v) not to have its investment expropriated, nationalised or subjected to any measure which has the effect equivalent to nationalisation or expropriation, unless any such measure is undertaken for a public purpose, is carried out on a non-discriminatory basis and such company is appropriately compensated; and (vi) to commence arbitration proceedings against the transit state for a breach of any of the above-mentioned rights.

These rights are of particular relevance to companies engaged in transit. Unlike the other ECT provisions, investment rules are addressed to companies and provide them with a right of redress against a transit state which breaches their rights. So, for example, investment rules enable a company to commence arbitral proceedings for a breach of its right to MFN treatment if a higher charge is imposed by the transit state on such company than on companies from other states. In other words, unlike transit rules, investment provisions have direct effect.

In addition, the scope of rights imposed under the investment provisions are in certain instances broader. For example, the imposition by a transit state of a higher charge on foreign companies in respect of petroleum in transit than that imposed on local shippers

⁶⁶ These agreements represent an additional source of rights for foreign investors, which, although they fall outside the scope of this chapter, should be considered when discussing issues concerning transit. However, it should be noted that the scope of the majority of these agreements does not extend to the energy sector.

in respect of petroleum used for domestic purposes may breach such foreign companies' right to national treatment as granted under the investment provisions. Thus, the scope of the obligation to grant national treatment under the investment rules extends to charges imposed on internal transportation, unlike the similar obligation imposed on a transit state under paragraph 3 of Article 7.⁶⁷ That the scope of investment provisions is broader is of particular relevance to companies like Gazprom, which impose higher tariffs on transit gas than on gas transported for Russian domestic purposes. Although such action may not, as Kemper argues, breach the transit provisions, it may well breach investment provisions.⁶⁸

Lastly, these rights provide foreign companies with additional protection in respect of their transit activities. For example, a change in the law of a transit state, its failure to issue a permit to construct a pipeline or the imposition by it of high taxes may, under certain circumstances amount to an expropriation for which such company will have a right of redress under investment rules.⁶⁹ Moreover, the right to the transfer of profits and revenue related to transit is accorded to such foreign companies under the ECT.

Consequently, due to the nature and the scope of their application, in practice, investment rules are likely to be more important tools for addressing transit issues than transit rules and should therefore be carefully analysed in the case of any transit dispute.

4.3 Competition Provisions

The energy sectors of the majority of the states signatory to the ECT are dominated by monopolies and vertically integrated companies and, thus, suffer from high barriers to trade and substantial market distortion. Since liberalisation of the energy sector, removal of such barriers and the alleviation of market distortions are crucial to enhancing and promoting transit, the ECT introduces, for the first time, competition rules at the international level.

Article 6 of the ECT 'aims to create modern and compatible competition legislation' in all signatory states.⁷⁰ It requires states to adopt laws aimed at preventing discriminatory and other anti-competitive behaviour in their energy sectors, such as abuse of dominant position by monopolistic operators of pipelines and concerted practices between operators, producers and/or distributors of petroleum. Since, to date, many of the

⁶⁷ For discussion on the nature of the obligation imposed under Article 7 see Section 4.1.3 (b).

⁶⁸ For discussion of transit rules see Section 4.1.3 (b).

⁶⁹ See for example the *Metal Clad Corporation v. United Mexican States*, 40 ILM 36 (2001), *Pope & Talbot Inc Henke Claim*, (1958-II) ILR 26, *Re Revere Copper and Brass, Inc and Overseas Private Investment Corporation* (1978) ILR 56 and *Equalisation of Burdens Taxation Case* (1968) ILR 61. See also Brownlie, *Principles of Public International Law* (4th ed), Clarendon Press, 1995, at 910ff.

⁷⁰ Energy Charter Secretariat, *Energy Charter Treaty, A Readers Guide*, <www.encharter.org>, at 34.

signatory states do not have competition laws, the imposition of this obligation on such states is of particular importance to the development of cross-border transit.⁷¹

The ECT's competition provision is less comprehensive than European Community (EC) competition laws.⁷² Article 6 simply requires a signatory state to 'ensure that within its jurisdiction it has and enforces such laws as are necessary and appropriate to address unilateral and concerted anti-competitive conduct' in the energy sector. It does not detail the steps required to achieve this nor does it define what amounts to 'market distortion' or 'unilateral and concerted anti-competitive'. This contrasts with the approach adopted under Article 82 of the EU Treaty. Moreover, unlike under EC law, under the ECT neither a state nor a company can take action against a state in which an anti-competitive act has taken place. The dispute resolution mechanism of the ECT specifically excludes from its ambit breaches of the competition provisions.⁷³ Instead, under paragraph 5 a state has only the right to notify another state of any anti-competitive conduct occurring in the latter state and only if any such act 'adversely affects' its 'important interest'.

That the ECT's competition rules are less comprehensive than those of Community law is not surprising, given that many of its signatories, and in particular the Caspian Sea states, do not have competition laws or have only limited experience with enforcing such laws. The adoption of more prescriptive provisions in line with EU law was, thus, unrealistic given the state of development of the energy sector and the competition laws in the majority of the signatory states.

Despite their limitations, the ECT's competition rules will create a web of national competition laws pursuant to which companies will be granted rights and remedies they previously did not have. As a consequence, companies from other states will be able to commence actions in the national courts of the host state against an owner/operator of a pipeline who imposes discriminatory tariffs or denies access, on the grounds that such acts amount to an abuse of such owner's/operator's dominant position.⁷⁴ Therefore, it is likely that the effect of the ECT competition rules on transit, although indirect, will be considerable and similar to that which EU competition laws have had on the liberalisation of the energy sectors of EU member states.⁷⁵

⁷¹ K. Holmes, 'Legal Implications of the Energy Charter Treaty Competition: Rules and Liberalisation', in T. Wälde (ed.), n. 18 above, 24 at 548.

⁷² H.J. Schroth, 'The Energy Charter Treaty in the Context of the Treaties of the European Union', in T. Wälde (ed.), n. 18 above, at 244.

⁷³ See paragraph 2 of Article 27.

⁷⁴ The ECJ has held that such acts amount to an abuse of dominant position in a number of competition cases. For details see K. Holmes, n. 71 above, at 549.

⁷⁵ *Ibid.*

4.4 Settlement of Disputes

Pursuant to Article 27 of the ECT, a transit state must submit to *ad hoc* arbitration instigated by another signatory state in the event of its alleged breach of the transit and investment provisions. The mechanism for resolving disputes under the ECT is simpler and more efficient than under GATT. Pursuant to Article 27, the dispute is to be resolved in accordance with the provisions of the ECT and the applicable rules and principles of international law. The arbitral proceedings are to be conducted in accordance with UNCITRAL Arbitral Rules. Article 27 also provides that the award is final and binding on the states party to the dispute.

It is unclear from the ECT which states have standing to bring a claim for a breach of Article 7. On the one hand, an expansive interpretation would accord standing to the originating state and the destination state, as well as to the state of which the company owning the petroleum is a national.⁷⁶ On the other hand, based on a narrow view standing would not be accorded to the latter state. However, if the narrow interpretation is adopted, the effectiveness of Article 7 is likely to be in practice minimal as the originating or destination states may not necessarily have an interest in bringing claims against the transit state in case of a breach. This would particularly be so in the Caspian Sea region where it is companies from outside the region with no links with the originating state or state of destination that are the main investors in the energy sector.

4.5 Conclusion

The ECT represents the first time international principles of transit have been applied specifically to the energy sector. Although its transit rules are not as comprehensive as those set out in EC law on which they are based⁷⁷ and are 'soft law' obligations, as discussed above, the ECT is likely to have a substantial impact on the energy sector of transit states.

In addition, the ECT extends the application of investment rules to the energy sector and, for the first time at the multilateral level, accords private investors directly enforceable rights vis-à-vis states. As discussed in Section 4.2, certain investment provisions may, in practice, provide better tools for protecting companies involved in transit than the transit rules prescribed under Article 7.

Moreover, the ECT for the first time imposes an obligation on a transit state to adopt competition laws within its jurisdiction. In the case of the Caspian Sea region, this means that the states in this region are required to grant companies involved in transit rights and remedies under their domestic legislation which such companies most likely did not enjoy previously.

⁷⁶ In other words, the transit obligation discussed in Section 4.1 above would be considered as owed *erga omnes*.

⁷⁷ K. Holmes, n. 71 above. See also the Gas Transit Directive referred to in n. 41 above.

However, the value of the ECT as a legal regime governing petroleum flows from the Caspian region is at present unclear. At present, the ECT applies only provisionally in Russia and Belarus, each a key transit country in the region, as neither has yet ratified the ECT.⁷⁸ Article 45 of the ECT provides that its provisions bind these states only to the extent they are 'not inconsistent with' such states' constitutions, laws or regulations. Accordingly, whether a particular provision of the ECT applies will need to be determined on a case-by-case basis involving an analysis of the constitutional laws of the particular state in question.⁷⁹ Moreover, it is unlikely that all of ECT's provisions will apply to them as they may have laws and regulations which are inconsistent with the ECT. Thus, at present the practical application of the ECT is limited and uncertain.⁸⁰ It is paramount that these key transit states ratify the ECT as soon as possible, as otherwise the ECT is likely to have only limited value in resolving transit disputes in the Caspian Sea region.

5. PROTOCOL ON TRANSIT

A consensus has emerged in recent years within the Energy Charter Conference, the ECT's governing body, that some of the ECT's shortcomings discussed above needed to be addressed.⁸¹ Accordingly, at the time of writing this chapter final touches are being put on the Protocol on Transit.⁸² The Protocol is expected to be finalised in 2003 and all parties to the ECT are expected to become party to it.⁸³

The Protocol is closely based on the Directive 98/30/EC,⁸⁴ however, unlike the said directive, the Protocol governs oil, as well as gas, transit. The Protocol requires transit states, *inter alia*, to: (a) comply with the terms of transit agreements; (b) prevent unlawful taking of petroleum in transit; (c) promote access to, and use of, available capacity; (d) facilitate the efficient use of transit pipelines; and (e) facilitate the construction and operation of transit pipelines.⁸⁵

⁷⁸ Energy Charter Secretariat, n. 50 above. In fact, there is strong resistance in Russia to the ratification of the ECT particularly from Gazprom which is worried it will lose its monopoly position and ability to impose its will on others.

⁷⁹ Bamberger, n. 42 above.

⁸⁰ Bamberger, n. 42 above.

⁸¹ Article 33 authorises the Energy Charter Conference to conclude protocols in order to achieve the objectives set out in the ECT.

⁸² Energy Charter Secretariat, *Draft Energy Charter Protocol on Transit*, 17 May 2002 (unpublished).

⁸³ R. Kemper, 'Creating a Pan-European Transit Framework: The Role of the Energy Charter', [2002] IELTR 37.

⁸⁴ Of 22 June 1998, concerning common rules for the internal market in natural gas, OJ L245, 21 July 1998, hereinafter referred to as the 'Gas Directive'. Waern, n. 33 above, at 20.

⁸⁵ In addition, the Protocol requires each state signatory to: (i) use best endeavours to agree on generally accepted international technical standards for the construction, expansion, extension, reconstruction, operation and maintenance of pipelines used for transit (Article 12); (ii) use best endeavours to implement internationally acceptable accounting standards (Article 13); (iii) ensure that owners/operators of pipelines

As in the case of transit provisions under the ECT, the Protocol provides that only a state can commence arbitral proceedings for any breach of the above obligations by the transit state.

Each of the above obligations will be examined in turn.

5.1 Comply with Transit Agreements

Paragraph 1 of Article 5 of the Protocol requires a transit state to 'observe all obligations' it owes to an owner/operator of pipelines under transit agreements. Any breach by a state of such transit agreements is, thus, now a breach of international law. The state of which a relevant owner/operator is a national is accorded a right of redress for such a breach, which it otherwise does not have under international law.

Thus, this provision imposes upon a transit state the same obligations vis-à-vis transit agreements as the ECT does in Article 10 (1) in respect of investment agreements. However, unlike ECT's investment provisions, paragraph 1 does not accord an owner/operator of pipelines a direct right of recourse in case of a breach of a transit agreement by a transit state. Instead of granting directly enforceable rights, paragraph 3 of Article 5 requires a transit state to ensure that owners/operators are granted non-discriminatory means of resolving disputes and effective remedies in respect of transit agreements under domestic laws. Since rights granted under transit agreements constitute 'investment', as defined in Article 2 of the ECT, owners/operators are able to invoke the rights granted to them under ECT's investment rules, including the right of recourse to arbitration in case of a breach of their rights under a transit agreement. Thus, it is likely that in practice the investment rules under the ECT will prove to be more important to the protection of companies engaged in transit activities than the provisions of Article 5 of the Protocol.

5.2 Unauthorised Taking of Petroleum in Transit

As discussed in Section 4.1.3 (f) above, there have been numerous instances of unauthorised taking of petroleum in the CIS region. Over the past few years, Ukraine has on several occasions siphoned-off Russian oil and gas passing through its territory on the way to Western Europe, causing Russia to breach the terms of its sale agreements with third parties.

Article 6 seeks to prevent such unauthorised takings from occurring in the future. It, for the first time, grants states whose petroleum has been illegally taken a right to

measure the quantity and quality of the petroleum being transported (Article 14); and (iv) not place obstacles to the conclusion of energy swap agreements and observe obligations it has entered into pursuant to such agreements (Article 17). According to Waern, the use of energy swap agreements will enhance cross-border transit of petroleum. A set of non-binding Model Transit Agreements have been developed by the Energy Charter's Transit Working Group since 1999 in order to standardise the terms of transit agreements, thus simplifying and aiding their negotiation.

commence arbitral proceedings. It, thus, provides aggrieved states with a simpler and more efficient mechanism for resolving transit disputes than they otherwise have under international law.

Nevertheless, the importance of Article 6 should not be overstated. For example, Ukraine may in the future nevertheless breach its obligations under Article 6 on the assumption that ultimately Russia will agree to terms dictated by it as Russia is, due to its geographical location, Ukraine's 'hostage'. In other words, transit disputes are often influenced by broader political, economic and military considerations, and the law *per se* may not be enough to prevent the occurrence of transit disputes.

5.3 Promote Access to Available Capacity

Article 8 is a key innovation of the Protocol. It addresses what Wälde regarded as the main drawback of the ECT: its failure to require transit states to grant access to pipelines. According to Wälde, third party access is essential to creating a competitive cross-border energy market, given that petroleum is predominantly transported through cross-border pipelines.⁸⁶

Paragraph 1 of Article 8 requires a transit state to ensure that owners and operators of pipelines within its jurisdiction 'negotiate in good faith' with companies which request 'access to and use of available capacity' in their pipelines. Available capacity is defined as the difference between the total physical operating capacity of a pipeline and the aggregate capacity which (i) is booked under existing transit agreements, (ii) is required to be made available under the laws of the transit state and (iii) can reasonably be expected to be required by the operators of pipelines or their affiliates for their own use.

Thus, paragraph 1 requires states to implement a negotiated access regime in their domestic energy markets closely resembling that set out in Article 14 of the Gas Directive. It therefore indirectly ensures that companies wanting to transport petroleum through a signatory state are granted a right to negotiate access under the domestic laws of a transit state.

In addition, paragraph 3 of Article 8 obliges states to ensure that where the terms of transit and petroleum supply contracts do not match, the owners/operators must consider renewing transit contracts based on good faith and competitive conditions. This provision was added to the latest draft of Article 8 to address Gazprom's concern that Russian petroleum exporters may potentially be disadvantaged as a result of them having entered into long-term supply contracts with European customers, whilst only being able to secure short-term transit agreements.⁸⁷ However, it seems that the present draft does not

⁸⁶ T.W. Wälde, *Access to Energy Networks: A Precondition for Cross-Border Energy and Energy Services*, [2001] Vol. 9 Art. 2, *CEPMLP Journal*, at 9, <www.dundee.ac.uk/cepmlp/journal/html>.

⁸⁷ Energy Charter Secretariat, n. 50 above, at 5.

address Russia's concerns fully and that its wording will be subject to much negotiation.⁸⁸ Russia has requested that this Article accord such exporters a so called 'right of first refusal', that is a right of preference to renew transit agreements before transit capacity is offered to other parties.⁸⁹

There are several noteworthy issues concerning the nature and scope of application of Article 8, which will limit its effectiveness and operability. First, a right to third party access is not granted to companies wishing to transport petroleum through existing pipelines.⁹⁰ Article 8 only requires states to ensure that owners/operators negotiate access in good faith. Thus, the effect of this provision on improving access to pipelines will likely be limited.

Second, its scope of application is uncertain and likely to be circumscribed. Most pipelines in the Caspian Sea region will in the future be privately owned and operated, and thus the obligation to negotiate access ought to have been imposed on such owners/operators directly. However, as Article 8 is contained in an international interstate treaty, it imposes obligations only on states. Thus, in practice its efficacy is dependant upon the willingness of transit states to promulgate the requisite domestic laws in compliance with the terms of Article 8 and the effectiveness of such laws.⁹¹

Third, the obligations imposed on a state are narrowly defined. Unlike under the Gas Directive, Article 8 does not require transit states to set up an authority to oversee the operation of the access regime and to settle related disputes.⁹² Moreover, it does not require transit states to grant companies wishing to obtain access remedies in case of a refusal by the owner/operator to negotiate or their refusal to grant access.

Fourth, in practice, Article 8 will be ineffective in establishing an access regime so crucial for transit of petroleum because the obligation to negotiate only arises if capacity is available. However, available capacity is defined by reference to booked, rather than actual, availability. As capacity in take-or-pay agreements is usually booked based upon the forecast peak amount of petroleum expected to be transported through the pipeline at any given point in time, owners/operators are required to ensure that such peak amounts of capacity are available throughout the term of the contract, although such amounts may never be shipped. Because capacity is booked on a long-term basis, pipelines are generally not utilised to their full capacity. Therefore, Article 8 fails to address the under-utilisation of pipeline capacity, the key issue with respect to transit by pipelines.

⁸⁸ Energy Charter Secretariat, *Multilateral Transit Negotiations Move Towards Finalisation*, Press Release, 19 December 2002, <www.encharter.org/index>.

⁸⁹ Ibid.

⁹⁰ Third party access is when a party not associated with the pipeline owner/operator is legally entitled to use such pipelines either for unused capacity or on the basis of fair sharing of existing capacity against a reasonable fee and on practical technical terms. Wälde, n. 22 above, at 8. The latter is the extreme version of third party access and is known as 'common carriage'.

⁹¹ The two biggest oil pipeline development projects, the BTC and CPC, are being developed by a consortium of largely private companies.

⁹² See Article 21.

Moreover, unlike the proposed amendments to the Gas Directive, it does not require signatory states to unbundle vertically integrated companies which dominate the petroleum transportation sectors of most countries and inhibit third party access to pipelines.⁹³ Nor does it require states to shorten the term of the transportation contracts as has been done in the UK, whereby the difference between booked and actual capacity is minimised and the pipelines are thus better utilised.

For the above reasons, Article 8 is likely to be ineffectual in establishing pipeline access regimes so crucial for the transit of petroleum.⁹⁴ However, any such expectation would have been unrealistic given the level of development of the energy markets of the signatory states. Article 8 represents the initial step in the process of establishing third party access. The signatories to the Protocol have chosen to follow the same step-by-step process to third party access previously adopted by the EU with respect to gas. It is likely that as energy markets of the signatories mature and liberalise further, amendments to this provision will be adopted in line with the proposed amendments to the Gas Directive.⁹⁵

5.4 Facilitate Efficient Use of Transit Pipelines

Arguably the most important provisions of the Protocol are Articles 10 and 11. They seek to facilitate the efficient use of pipelines by detailing the obligations of states under the ECT in respect of transit tariffs and charges. Specifically, Article 10 (1) provides that a transit state must take 'all necessary measures to ensure that transit tariffs and other conditions are objective, reasonable, transparent and non-discriminatory' and not 'affected by market distortions, in particular those resulting from abuse of a dominant position by any owner or operator'.⁹⁶ Paragraph 3 of the same Article details for the first time the requirements of reasonableness and objectiveness. It provides that transit tariffs must be based upon the 'actual operational and investment costs' of the owner/operator of the pipeline and 'include a reasonable rate of return'. Thus, Article 10 builds upon the requirements set out in Article V of GATT and Article 7 (1) and (3) of the ECT and provides further guidelines on how these requirements are to be applied in practice.

In addition, Article 10 (1) imposes an additional obligation upon states to ensure transit tariffs and other conditions are 'objective' and 'transparent'. The method and means for ensuring this are left to the discretion of the states. Compliance with this

⁹³ Commission of the European Communities, *Amended Proposal for a Directive Amending Directive 96/92/EC and 98/30/EC concerning rules for the internal markets in electricity and natural gas*, COM (2002) 7 June 2002.

⁹⁴ According to Wälde and Gunst, without unbundling of vertically integrated transport companies an access regime cannot be effective. See Wälde, n. 21 above, at 8.

⁹⁵ The current proposal to amend the Gas Directive provides for the unbundling of vertically integrated transportation operators and requires states to adopt a regulated rather than a negotiated access regime. For details see n. 93 above.

⁹⁶ A transit tariff is defined as any payment required by the owner/operator of a pipeline for transit of petroleum through such pipeline.

obligation will, at a minimum, require a transit state to mandate that owners/operators publish transit tariffs and other terms and conditions related to transit, as is required under Gas Directive. Waern goes a step further and construes this obligation as requiring a transit state to also ensure that owners/operators publish expected available capacity of pipelines.⁹⁷ By introducing the requirements of transparency and objectivity into a market dominated by vertically integrated companies a transit state will force owners/operators of pipelines to operate a more transparent and fair access regime. Thus, the implementation of Article 10 will have a substantial impact on how owners/operators of pipelines manage their activities.

Article 11 requires that 'any charges' on petroleum transit imposed by a transit state shall fully comply with Article V of GATT, whether or not it is a member of the WTO. In other words, a transit state must (i) exempt petroleum in transit from customs charges and (ii) ensure that charges on petroleum in transit are reasonable and non-discriminatory. Accordingly, Article 11 details the obligations implicitly imposed upon a transit state under paragraph 1 of Article 7 of the ECT.⁹⁸

In addition, Article 11 clarifies that a distinction must be drawn between transit tariffs and charges. That such a distinction exists was first hinted at in Article V (3) of GATT which referred to two types of charges: (i) charges which relate to transportation and (ii) charges which need to be commensurate with the administrative costs incurred by the transit state in relation to transit. The Protocol for the first time expressly distinguishes between transit tariffs, payable to owners/operators of pipelines (which are now increasingly private companies), and charges, which are payable to the transit state for the services rendered and costs incurred by it in respect of transit. The Protocol imposes more stringent conditions on the imposition of transit tariffs than on charges. As discussed above, the former are required to be objective and transparent in addition to being non-discriminatory and reasonable.

Importantly, Article 4(3) of the Protocol acknowledges that states are entitled to compensation for facilitating the construction, expansion or extension of pipelines used for transit within their territory. Such compensation usually takes the form of royalties or other such similar concession payments. Thus, the Protocol for the first time distinguishes such compensation from transit tariffs and charges. This clarification is important because Article V (2) of GATT may be construed as prescribing that states are not entitled to receive any payments other than transit tariffs and charges. By drawing the distinction between royalties and transit tariffs and charges, the Protocol gives credence to the argument that Article V (2) of GATT should be interpreted as prescribing rules only concerning dues payable in respect of actual transit and, thus, does not preclude a transit state from receiving royalties and other such payments for facilitating the

⁹⁷ Waern, n. 33 above, at 21.

⁹⁸ As discussed in Section 4.1.3 (a), by requiring states to take measures to facilitate transit consistent with the 'principle of freedom of transit', the ECT implicitly requires states to comply with the provisions of GATT and other rules of international law relating to transit.

construction of pipelines through its territory. Thus, the Protocol clarifies international law on this point. It is possibly based upon this distinction that Georgia is demanding a yearly payment of USD50,000,000 from the BTC Consortium, in respect of the section of the BTC pipeline which lies on its territory, even though the host government agreement it entered into with the BTC Consortium does not provide for such royalties and prohibits Georgia from imposing any charges other than those set out in the agreement.⁹⁹

5.5 Facilitate the Construction and Operation of Pipelines

Since lack of capacity is a major impediment to increased trade in petroleum, the Protocol seeks to encourage investment in the energy sector of a transit state by establishing a level playing field for foreign investment. It adopts the same approach to facilitating the construction and operation of pipelines as that prescribed in Article 4 (2) of the Gas Directive. Accordingly, Article 9 requires states to adopt transparent, objective and non-discriminatory licensing procedures for the construction, expansion, extension and operation of pipelines. More specifically, paragraph 3 of Article 9 obliges a state to (i) reply in writing within a reasonable time to any application for permission to construct, expand, extend or operate a pipeline and (ii) ensure that its decision is fair, transparent, non-discriminatory and objective. Paragraph 2(b) obliges a state to ensure 'that measures adopted relating to the construction, expansion, extension' of transit pipelines are 'no less favourable' than those for pipelines used for internal transportation.

The Protocol does not grant freedom of network construction as states are not obliged to issue licences to construct new pipelines or expand existing ones. Accordingly, it preserves the right of the transit state to decide its energy strategy. It instead establishes a framework of principles that must underlie a transit state's licensing process, thereby obliging it to exercise its discretion in accordance with such principles. A state whose national is refused a licence has the right under Article 9 to submit the decision, whereby such licence was refused, to other signatory states to the Protocol. Although no right of review of such decision is granted, Article 9 nevertheless, accords such state a means of exerting diplomatic pressure on the transit state and, thereby, takes a further step to ensure that the licensing decision is fair.

In summary, the Protocol contains more precise and detailed transit rules with respect to transit tariffs and charges and, thus, builds upon the transit rules previously promulgated under GATT and the ECT. Moreover, it seeks to address existing transit disputes such as those relating to unauthorised taking of petroleum which have plagued the Caspian Sea region. In addition, the Protocol, for the first time, introduces rules concerning access and licensing regimes at the international level and, therefore, takes significant steps to ensure that cross-border transit is liberalised and internationalised.

⁹⁹ See *Platts Oilgram News*, Vol. 80, No.180, 30 September 2002.

6. CONCLUSION

Transit is an area of international law which is developing rapidly. Regulating cross-border transit is of fundamental importance in fostering and developing international energy trade crucial for the economic development of all states. This is particularly crucial for countries in the Caspian Sea region, whose economic development is so closely intertwined with the export of petroleum.

This chapter examines the evolution of the international treaty framework for the transit of petroleum and provides a guide to its rules. For the Caspian Sea region, the most important treaties dealing with transit are the ECT and the Protocol on Transit. Article V of GATT is not directly applicable to countries in this region, because they are currently not members of the WTO. However, as discussed in Parts 4 and 5, the states of this region are indirectly obliged to comply with Article V of GATT due to its incorporation into Article 7 of the ECT and Article 10 of the Protocol.

At present, no right of transit by pipelines exists under international law. Instead, the treaties discussed above create a web of rules governing the conditions under which petroleum transit is to be effected by states party to such treaties. In keeping with traditional rules of public international law, transit rules are addressed solely to states. The rules do not directly impose obligations on owners/operators of pipelines. However, ultimately, as transit states translate these rules into domestic legislation in order to give effect to their obligations under these rules, the activities of private owners/operators will be affected. Moreover, by requiring a transit state to ensure compliance by state-owned and privileged enterprises with their provisions, the ECT and the Protocol are likely to have a substantial indirect impact on the activities of such enterprises.

As a general rule, transit treaties impose obligations on a state only vis-à-vis another. The only exception are investment rules which accord directly enforceable rights to investors vis-à-vis the contracting state. Consequently, the practical impact of the international transit framework on petroleum transit will largely depend upon the willingness of states to comply with their treaty obligations. It is reasonable to expect that the fear of being perceived as a renegade state by the international community and the ensuing economic and other consequences will deter states from contravening international law.¹⁰⁰

The limited application and the nature of the obligations imposed by the transit rules may explain why, so far, they have rarely been invoked. However, the fact that the treaties in question are relatively new is, arguably, also a contributing factor. Hopefully, as more companies involved in transit realise the relevance of these treaties and, in particular, the investment protection rules, they will (i) rely upon these rules for protection in the case of, for instance, an expropriation of their investments or the imposition of discriminating charges and tariffs, and (ii) exert pressure on states to ensure

¹⁰⁰ Bamberger, n. 42 above.

compliance with their terms. The adoption of the Protocol on Transit in 2003 will doubtless enhance the effectiveness of the international framework of rules on transit.

Moreover, despite the limitations, the existing and incoming international rules of transit represent an important step in creating more secure and more reliable international energy markets. First, the ECT and the Protocol create a legal framework for resolving transit disputes between states. This framework is particularly important for countries in the Caspian Sea region where transit disputes are common. Second, these rules will encourage the development of more open and compatible legal frameworks for petroleum transit as states pass laws to facilitate transit, encourage increased capacity, adopt negotiated access regimes, facilitate the construction and operation of pipelines and foster competition. Third, the international transit rules present a backdrop against which a project specific legal regime may be negotiated, ensuring investors certain minimum standards with regard to transit.¹⁰¹

It is worth reiterating that the key transit agreements regarding petroleum, the ECT and the Protocol, are regional inter-state agreements. As such, Middle Eastern countries, which together possess 65 per cent of the world's proven reserves of oil and 32 per cent of the world's reserves of gas, and are thus crucial players in the world energy sector, are not bound by their rules.¹⁰² In fact, the majority of these countries are also not members of the WTO and, therefore, no transit treaty rules bind them. In view of this, the next step in the evolution of the international transit regime needs to involve the broadening of its scope of application by promoting the adoption of transit rules by states throughout the world.¹⁰³ It is too early to say whether this will be done under the *aegis* of the ECT or the WTO.¹⁰⁴

¹⁰¹ P. Griffin, 'Transnational Gas Projects and Their Agreements: Part I', [2002] *IELTR* 117.

¹⁰² Andrews-Speed, n. 10 above, at 12.

¹⁰³ The first step in this direction has been taken at the meeting between the Secretary General of OPEC and the Secretary General of the Energy Secretariat on 2 December 2002 at which the prospects of future co-operation between the two organisations were discussed. See Energy Charter Secretariat, 'Dialogue to Develop between OPEC and the Energy Charter', Press Release, 2 December 2002, <www.encharter.org>.

¹⁰⁴ At the ministerial conference in Doha in November 2001, members of the WTO agreed that preparatory work for the future negotiations on trade facilitation should concentrate on Article V of GATT amongst other provisions. It seems that the EU has submitted a proposal of measures in relation to transit to be

adopted at the next round of the WTO negotiations. However, the author has not been able to obtain this document at the time of writing this chapter.