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THE ENERGY CHARTER TREATY

An East-West Gateway for Investment & Trade

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Introduction
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The Energy Charter Treaty

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Chapter 22

Transit of Network-bound Energy: the European Experience

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I. INTRODUCTION

Article 7 of the Energy Charter Treaty deals with the subject of transit of energy materials and products. It is clearly an important part of the Treaty. It is also a concept which has figured prominently in discussions in the European Community in recent years in connection with the Internal Market in Energy and the implementation of new Directives governing the transit of natural gas and electricity. Although transit may be considered to be a fairly new phenomenon in the energy sector, it is in fact a legal concept States have used for many centuries. The aim of this chapter is to reflect on the broader experience already available on transit issues and to provide a summary and preliminary assessment of that experience. Although there are examples of transit of networkbound energy from all over the world,[1] this chapter will focus on the "European experience" because the most recent established transit agreements mainly apply to this part of the world.

II. THE FREEDOM OF TRANSIT IN INTERNATIONAL LAW

The freedom of transit has been recognised in international law since the 17th century when Grotius claimed that there is a general right of transit across the territory of another State in the interest of the community of nations.[2] As a result of the fact that in the present international community, States are becoming increasingly interdependent, each individual country, by turns, will need the possibility of transit. On the other hand, there is the doctrine of territorial sovereignty, which holds that States have sovereign rights over their territory. This gives them the right to prevent the construction or use of

[1] See my article on transit published in *World Competition Law and Economics Review* (Geneva, Vol. 19, no.2), December 1995, pp. 119–146.

[2] See E. Lauterpacht, "Freedom of Transit in International Law" in: *Problems of Public and Private International Law* (Grotius Society, vol. 44, London, 1958–1959), p. 320 in which he refers to Grotius' work *De Jure Belli ac Pacis*, II, 2, 13, as translated in "Classics of International Law" (1925), pp. 196–197.

devices dedicated to transit of persons or goods.[3] Freedom of transit can therefore be characterised as trying to find a balance between the needs of international traffic and the interests of individual States. Consequently, individuals and/or States cannot invoke a right to transit just like that. Previous to any transport in transit, States have, in practice, entered into multilateral conventions.[4] When examining the major international agreements on transit and trade of this century, it is striking that these conventions have emerged in or after a period of political instability, such as both World Wars and the break up of the former Soviet Union. Obviously, this is the immediate result of States' desire to improve their economic position by stimulating international trade, including transit.

This study will focus on the following four international agreements dealing with transit:

— the Barcelona Convention on Freedom of Transit of 1921 which was drafted under the auspices of the League of Nations after World War I. The reason for this was the fact that the Treaty of Peace (or Treaty of Versailles) in 1919[5] provided for the realisation of such a Convention;
— Article V of the General Agreement on Tariffs and Trade (hereinafter "GATT"), which emerged after World War II;
— the Energy Charter Treaty, i.e. Article 7 on Transit. This Treaty has been initiated after the break up of the former Soviet Union; and
— the Treaty Establishing the European Economic Community[6] and the EC Transit Directives.

Whereas the Barcelona Convention is of special importance because it is an agreement dealing solely with matters of transit, the Energy Charter Treaty is unique in a way in that it specifically deals with trade in energy and, subsequently, with transport in transit of networkbound energy. Finally, attention will be paid to the developments in the European Community. The establishment of the European Economic Community (hereinafter "EEC or EC"[7]) in 1957 can also be considered as a consequence following the events of World War II. The EEC aims at the establishment of a common market with free movement of goods, services, persons and capital. Although the need for a common market for energy was recognised in the 1950s,[8] the EC Treaty does not explicitly refer to energy as one of the fields in which Community legislation should be developed. The most recent attempts, however, to establish

[3] E. Lauterpacht, "Freedom of Transit in International Law", in: *Problems of Public and Private International Law* (Grotius Society, vol. 44, London, 1958-1959), p. 317.

[4] Some authors, however, argue that a legal right to freedom of transit exists independently of a treaty and that the transit State is under the obligation to give its consent to transit anyway. See E. Lauterpacht, "Freedom of Transit in International Law" in: *Problems of Public and Private International Law* (Grotius Society, vol. 44, London, 1958-1959), p. 349.

[5] Article 379 Treaty of Peace signed at Versailles on 28 June 1919. This convention should be issued within five years after the coming into force of the Treaty of Peace.

[6] Rome, 25 March 1957.

[7] Since the Single European Act of 1986 the aim of the Community is not limited to economic integration. Consequently, the Community is referred to as "EC" instead of "EEC".

[8] See, for example, the Spaak report of 1956 in which the aims and means of the establishment of the EEC were set out.

case is of special importance as it, *inter alia*, examines the application of Article V GATT to the issue of piped transportation of crude oil.[41] Although the Court ruled that Article V GATT does not apply to transit within the European Community and does not have direct effect in relation to third countries, the relevance of Article V with regard to transport of networkbound energy was not questioned at all. Consequently, it can be assumed that the transit provisions of the GATT also apply to transit of networkbound energy such as oil, natural gas and electricity.

Be that as it may, it has to be noted that since the establishment of GATT in 1947, Article V has scarcely been applied.[42] Reason for this may be that Article V is considered to be a difficult and complex article from which it is hazardous to try to draw conclusions.[43]

V. ENERGY CHARTER TREATY

1. Introduction

The most recent attempt to establish an international agreement on energy trade is the Energy Charter Treaty which was signed in December 1994. This Treaty is unique in the way that it is the first global agreement governing trade in energy. The break-up of the former Soviet Union has to be considered as the impetus for this Treaty. The former Dutch Prime Minister Ruud Lubbers suggested at an EC Council meeting in 1990 that an agreement between the EC and the FSU in the energy sector could enhance the economic recovery of the FSU and, simultaneously, secure Western Europe of sufficient energy in the future. Although the original idea was pan-European in scope, it soon resulted in a world-wide undertaking. The first step was the signing of the European Energy Charter on 17 December 1991 by some 50 States and the EC. The Charter is based on the principles of State sovereignty; non-discrimination; and the concept that a free and competitive market also should apply to the energy sector.

The Charter, however, is not a legally binding document. It is merely a political declaration of intent by the signatories to pursue the objectives and principles of the Charter. In addition, they agree to broaden their co-operation as soon as possible by negotiating in good faith an Agreement.[44] This resulted

[41] In this case the legality was discussed of certain import charges on crude oil. This crude oil was discharged in the port of Trieste and pumped through the Transalpine pipeline operated by the company SIOT to Germany and Austria. Under Italian law charges were to be paid for the loading and unloading of goods in Italian ports, regardless of the origin or destination of these goods. Consequently, these charges were also payable for goods in transit. SIOT challenged the imposition of these charges on the ground that it was incompatible with Community law and with the provisions of the GATT, more specifically Article V(3) of the GATT.

[42] See, e.g., *Analytical Index: Guide to GATT Law and Practice*, 6th edition (1994), p. 197, and E.U. Petersman, G. Jaenicke, "Adjudication of International Trade Disputes in International and National Law", *Progress and Undercurrents in Public International Law*, Vol. 7, (University Press Fribourg Switzerland), Annex: GATT Dispute Settlement Proceedings under Article XXIII 1948-1990.

[43] J.H. Jackson, *World Trade and the Law of GATT*, Virginia, 1969, pp. 510-511.

[44] See Title III European Energy Charter.

in the signing of the Energy Charter Treaty on 17 December 1994 in Lisbon by some 40 States and the EC.[45]

2. Transit under the Energy Charter Treaty

2.1. *Energy Charter Treaty and GATT*

The Energy Charter Treaty (hereinafter "ECT") is based on the principles of GATT. The importance of GATT appears from the preamble as well as from Article 4 and Article 29 ECT. The relationship with GATT is governed by Article 4 ECT which rules that ECT shall not derogate from the provisions of GATT and Related Instruments. A complicating factor in negotiating the ECT was the fact that not all signatories were parties to GATT. Article 29 ECT provides for interim measures for contracting parties not yet being a member of GATT. Parties not yet members of GATT are basically, as far as the energy sector is concerned, treated as if they are party to GATT.

Whereas GATT applies to international trade in general and the ECT specifically relates to international trade in energy, it is not surprisingly that the ECT also is referred to as the "Energy-GATT". In the following the transit provisions of Article 7 ECT will be examined. It has been argued that the rules for transit of energy goods in the ECT are so-called GATT-plus provisions. However, when taking into account that Article V GATT is based on the provisions of the Barcelona Transit Convention and the way in which "freedom of transit" is treated in international law, one could also conclude that the ECT is in line with the previous agreements and does not include any specific extra requirements. Moreover, some provisions could also be considered as the codification of some general principles of transit in international law.

2.2. *Definition of transit*

Like Article V GATT and the Barcelona Transit Convention, Article 7 of the Energy Charter Treaty provides for so-called through-transit. "Transit" according to the ECT means:

> the carriage through the Area of a Contracting Party, or to or from port facilities in its Area for loading or unloading, of Energy Materials and Products originating in the Area of another state and destined for the Area of a third state, as long as either the other state or third state is a Contracting Party.[46]

Basically, any type of "through-transit" requires the involvement of three Contracting States. However, an express reservation is made for the situation in which "through-transit" can be achieved by two Contracting States, i.e. the situation in which the Area of origin and destination belongs to one

[45] The conference resulted in a Final Act including a number of Understandings (mostly interpretative) and Declarations, the Energy Charter Treaty and its Protocol on Energy Efficiency and Related Environmental Aspects. An exact overview of the number of signatories is provided by the Legal Counsel of the IEA in: "The Energy Charter Treaty – a description of its provisions", Paris, 1995.

[46] Article 7(10)a under (i) ECT.

Contracting Party and the transit Area to the other one. The transit provisions of Article 7 ECT apply to this type of transit as well, "unless the two Contracting Parties decide otherwise and record their decision by a joint entry in Annex N [. . .]".[47] Both Canada and the United States, not yet being signatories to the Treaty, have made the express reservation that at least three separate areas should be involved in a transit agreement. This exception is remarkable as both States during the last decades have entered into a number of transit agreements regulating transit of petroleum from the US to Alaska, or vice versa, through Canadian territory.[48]

2.3. *The freedom of transit*

Compared to Article V GATT, Article 7 ECT is rephrased in such a way that it puts less emphasis on the principle of freedom of transit and more on the principle of State sovereignty which, after all, is one of the main principles of the preceding European Energy Charter. Instead of the wording used in Article V GATT "there shall be freedom of transit", Article 7 states that "contracting parties shall take the necessary measures to facilitate transit [. . .] consistent with the principle of freedom of transit".[49] Which principles does the Article refer to? Although it is generally assumed that this provision is a direct reference to Article V GATT,[50] it has to be concluded that the wording used in the ECT is not as strong as in Article V GATT. Moreover, as members of GATT virtually have no experience with the way in which Article V GATT operates, it cannot be expected that Contracting Parties can draw any conclusions from established practice.

Due to the ECT's emphasis on territorial sovereignty, the freedom of transit is more limited in scope. As a consequence, the ECT only requires that the "Contracting Parties shall take ***all necessary measures to facilitate transit*** of Energy Materials and Products . . .".[51] This definition is rather loose, as it is not clear what is covered by the wording "measures to facilitate". The following paragraph gives some indications as it rules that Contracting States shall encourage relevant entities to co-operate in:

(1) modernising Energy Transport Facilities necessary for transit;

[47] Article 7(10)a under (ii) ECT.

[48] During World War II pipelines were constructed to transport oil from the US to Alaska in order to supply the American forces in Alaska (UNTS vol. 99, pp. 223–285, UNTS vol. 6, p. 279). In 1953 it was agreed to construct another pipeline from Haines to Fairbanks in Alaska crossing US territory (UNTS 1955, no. 2786, pp. 94–114). After the discovery of hydrocarbons in Alaska in the 1970s, the governments of the US and Canada entered into a "Transit Pipeline Treaty" which presents a legal framework for the construction and operation of all transit pipelines (see "Agreement between the Government of the United States of America and the Governments of Canada concerning Transit Pipelines" of 28 January 1977, ***United Treaties and Other International Agreements***, Vol. 28, pp. 7451–7460).

[49] Article 7(1) ECT.

[50] Legal Counsel IEA, ***The Energy Charter Treaty - a description of its provisions***, (Paris, 1995), p. 17.

[51] My emphasis added. See for a similar definition the EC Transit Directives which will be discussed further below. Article 1 of both Transit Directives reads: "Member States shall take the measures necessary to facilitate transit of gas/electricity between high pressure transmission grids . . .".

(2) the development and operation of facilities serving the area of more than one contracting party, i.e. the construction of an "international" (pipe)line;
(3) facilitating interconnections of transport facilities (this can be internal as well as cross-border interconnections); and
(4) measures to mitigate the effects of interruptions in energy supply.

From this it can be concluded that the Energy Charter Treaty goes further than the Barcelona Transit Convention as far as the transit facilities are concerned. In the latter convention it was made clear that Contracting States could not be required to improve their facilities. On the other hand, it should be noted that the Energy Charter Treaty is limited in effect again because it only applies to transport in transit through some specific facilities such as high-pressure pipelines and transmission lines.[52] Notwithstanding the fact that cross-border (pipe)lines generally are high-pressure transmission lines, this could be considered a restriction of the definition of transit in GATT which rules that "[t]here shall be freedom of transit (. . .), *via the routes most convenient for international transit* . . .".[53] That there may be a need for the establishment of cross-border facilities other than the above, can be illustrated by a recent case in Germany, i.e. the so-called *Kleve* case, in which the request was disputed of the German town Kleve to enter into a direct supply contract with a Dutch utility instead of a renewal of a contract with the German power supply company RWE. In case the Court had accepted the request it would probably have resulted into the construction of a cross-border distribution grid.[54]

In addition to the use of existing transit facilities, the ECT seems to include a new aspect of transit rights, i.e. the construction of additional transit facilities. Although the needs for such new infrastructure can be essential for international trade, its construction can also be considered a serious infringement of a State's territorial sovereignty. Nevertheless, the Energy Charter Treaty opens the possibility that parties, in the first place, will try to enter into a commercial transit agreement. If transit "[. . .] cannot be achieved on commercial terms, contracting parties shall not place obstacles in the way of new capacity being established".[55] The right to construct such transit facilities is limited by the national legislation of the transit State which equally applies to the transit State and other Contracting Parties. The applicable national legislation would include provisions of environmental protection, land use, safety, or technical standards.[56] On first sight the right to construct additional transit facilities could be considered as adding a new element to the existing interpretation of the right of transit. However, although the possibility to construct transit facilities is not explicitly included in the Barcelona Transit Convention and Article V GATT, one could certainly interpret these provisions this way. Moreover, the right to construct such facilities has been included in the Convention on Transmission in Transit of Electric Power of 1923. Maybe even of

[52] Article 7(10)b ECT.
[53] Article V(2) GATT. My emphasis added.
[54] *Gas Matters*, January 1995.
[55] Article 7(4) Energy Charter Treaty.
[56] When signing the Final Act, the representatives agreed to adopt a number of Understandings to the Treaty. This exception is included as Understanding nr. 8 to Article 7(4) ECT.

greater importance is the actual practice established by several regional transit conventions.[57]

Whichever type of transit is involved, i.e. transit through existing facilities or the construction of additional transit facilities, transit States may under the Barcelona Transit Convention and Article V GATT, limit such transit if it would endanger the security or efficiency of its energy systems, including the security of supply.[58] Unlike the situation under the Barcelona Convention, the ECT has clearly adopted a "nationalistic" approach because the Contracting Parties have now made a clear choice with regard to the question whether a Contracting State is obliged to transport in transit under all circumstances, even if it is contrary to its own interests. This prerequisite, however, seems to correspond with the emphasis of the ECT on State sovereignty.

2.4. *Transit obligations*

It seems that the Treaty at least specifically refers to one generally accepted principle of transit, i.e. the aspect of non-discrimination. Article 7(1) holds that the measures to facilitate transit should be taken without distinction as to origin, destination or ownership of energy or discrimination as to pricing and without imposing any unreasonable delays, restrictions or charges. This principle of non-discrimination is also the basis for para. 3, which provides that national provisions regarding transport of energy and use of energy facilities should not treat transit of energy in a less favourable way than internal transport of energy.

Finally, if transit has been realised, it is of utmost importance that the transport-flow will continue. Article 7(5) therefore obliges the Contracting Parties to secure established flows of energy. In the event of a dispute over any matter arising from transit, a transit State shall not interrupt or reduce, or permit any entity subject to its control or jurisdiction to interrupt or reduce the existing flow of energy, prior to the conclusion of one of the dispute settlement procedures of the ECT. Unless the contract or other agreement renders special provisions regarding the interruption or reduction of transit, the dispute settlement mechanism of Article 7(7) applies. This Article provides for a conciliation procedure according to strict time limits.[59]

In case of a dispute over the construction of new or additional transit capacity, the ECT provides for two separate dispute settlement mechanisms as far as it concerns investment protection. Article 26 covers a dispute between a contracting Party and an investor of another Contracting Party. Following a failure to settle a dispute amicably, it gives an investor a choice between submitting the unresolved dispute

[57] Such as, for example, the Canadian-US Transit Pipeline Treaty. See note 47.

[58] Article 7(5) ECT.

[59] A Contracting Party to the dispute may refer it to the Secretary-General by a notification summarising the matter in dispute. Within 30 days the Secretary-General, in consultation with the Parties involved, shall appoint a conciliator. If the conciliator has not succeeded to find an agreed resolution within 90 days, he shall recommend a resolution or the procedure to achieve such resolution. The Contracting Parties agree to be bound by and to observe the recommendations until the dispute is solved, or for a period of 12 months, whichever is earlier. After this period, parties can notify the Secretary-General again if the dispute has still not been solved.

to the fora of the host State or for binding arbitration. Article 27 provides for binding State-State arbitration of disputes concerning the application or interpretation of the Treaty.

Although the above safeguard provision seems to add a new element to the concept of transit, it could be argued that it originates directly from the "principle of freedom of transit" which according to Article 7(1) is one of the basic elements of the whole regulation concerning transit. However, the need to include this provision is a logical consequence of the number of transit disputes arising from the break-up of the former Soviet Union. This may be illustrated by the fact that Russia, for example, restricted transit of oil from Kazakhstan at the beginning of 1994,[60] and Uzbekistan interrupted gas supplies from Turkmenistan to Armenia in 1995 in order to get higher transit fees.[61]

2.5. *Some concluding remarks*

When comparing Article 7 ECT with Article V GATT and the Barcelona Transit Convention, it can be concluded that the basic principles are analogous indeed. It seems that the fundamentals of the Barcelona Transit Convention, through Article V GATT, have found their way into the Energy Charter Treaty. All treaties have striven to find a balance between the economic interdependence of States and the notion of State sovereignty. Contrary to GATT where the economic interdependence of States is the decisive factor,[62] the European Energy Charter turns the scale towards the principle of State sovereignty and a State's sovereign rights over its natural resources. This difference in approach is also revealed in the wording of Article 7 ECT. Instead of emphasising the freedom of transit, Article 7 highlights the sovereign rights of Contracting Parties. Otherwise the provisions are more or less similar, except that some transit obligations are specified in greater detail in the ECT. Although these provisions in themselves are not GATT-plus, they could be referred to as such as they bring more transparency to the way in which transit problems might be solved. Possibly more distinctness with respect to the scope of transit, will also increase its value in practice. After all, parties have seldom turned to Article V GATT in transit disputes. This has been explained by the fact that this article is considered to be a difficult and complex proviso from which it is hazardous to try to draw conclusions.[63] Another element which should be taken into account is the way in which the dispute settlement mechanisms will work. Dispute settlement procedures under GATT have often been slow and not very successful.[64] Given the more detailed approach in the ECT with regard to dis-

[60] East European Energy Report, *Financial Times*, Issue 24, September 1993, p. 13.

[61] "Russia: Turkmen Gas Supplies to Armenia Resumed", *Reuter Texline*, 18 April 1995, available at Lexi/Nexis.

[62] See also M. Montaña i Mora, "A GATT with Teeth: Law Wins Over Politics in the Resolution of International Trade Disputes", *Columbia Journal of International Trade*, 1993, vol. 31, p. 105.

[63] H.J. Jackson, *World Trade and the Law of GATT*, (Virginia, 1969) pp. 510-511.

[64] See also M. Montaña i Mora, "A GATT with Teeth: Law Wins Over Politics in the Resolution of International Trade Disputes", *Columbia Journal of International Trade*, 1993, vol. 31, p. 105.