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Transit Under the 1994 Energy Charter Treaty

By Rainer Liesen¹

Article 7 of the 1994 Energy Charter Treaty deals with access, conditions and non-interference with transit. It is addressed to state authorities and therefore does not impose specific transit agreements. This leaves the details to be settled by the parties involved in a transit project and makes it possible to do justice to the particular political, economic and legal situation of the potential transit country. The Treaty's transit provisions are at least a useful catalyst for limiting the risks and building an atmosphere of mutual trust between partners in transit matters.

The nations of the world are growing together. Closer global integration and the effective handling of environmental issues require measures on an international scale; as a result, governments have recognised the value of cooperation in solving supra-national problems. Multi-national agreements play a crucial role in this cooperation.

The Energy Charter Treaty² of 1994 ('Treaty'), in force since April of this year, is a multi-national treaty focusing on the energy sector signed by 49 countries, including almost all European countries and the European Communities.³ As Article 2 of the Treaty sets out, its purpose is to establish 'a legal framework in order to promote long-term cooperation in the energy field' between its signatories, or as the Preamble puts it, to 'catalyse economic growth by means of measures to liberalise investment and trade in energy'. The aim of the Treaty is the creation of an international energy market by promoting 'access to international markets on commercial terms' and developing 'an open and competitive market for Energy Materials and Products' (Article 3).

This article describes and analyses one of the most important

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² The Energy Charter Treaty, 17 December 1994, 33 *International Legal Materials* 381-443 (1995), reprinted without appendices in Wälde, T W, ed, *The Energy Charter Treaty – An East-West Gateway for Investment and Trade* (1996), pp 617-655.

³ It should be emphasised that the EC was the signatory rather than the European Union.

provisions of the Energy Charter Treaty: the article on transit (Article 7).

Transit has always been considered a major issue for energy markets, which by nature develop on an international basis. Political volatility in transit states threatens the enormous investments typical of energy ventures; from an investor's viewpoint, energy projects, particularly in eastern European countries, involve a high political risk. The total absence of a reliable legal framework, or muddled and contradictory laws and regulations continue to make it difficult, if not impossible, to invest on a long-term basis.⁴

On the other hand, safe and reliable transportation from the producing regions to consumer nations is vital for the economies of many countries. Since the oil crisis in the early 1970s, western Europe in particular has been seeking more security in energy supplies. The reserves in the Netherlands, Norway and the North Sea are not sufficient to meet Europe's oil and gas demand. Looking at the development of natural gas supplies until 2010, most gas used in western Europe will come from indigenous production, but some 18 per cent is expected to be delivered by Russia, 12 per cent will come from Algeria and 10 per cent from Nigeria and Libya plus potential volumes from new projects.⁵ As far as oil is concerned, Europe is highly dependent on oil imports from Russia, Africa, Saudi Arabia and other Gulf states.⁶ Western energy security must therefore be safeguarded by the creation of a privileged relationship of investment and trade between West and East.⁷

The Treaty's transit provisions are an attempt to abolish or at least decrease transportation risk arising from political or economical disputes between states involved. It is a significant step towards security of energy supply, since producer and consumer states depend on the willingness of the transit state to act according to international law or bilateral agreements. Legal obligations, however, can be determined by political considerations and shutting down the flow of gas or oil may therefore be used as a way to blackmail either the producer or the consumer state, or even both.

A well-known example is the dispute between Russia and the Ukraine over the Black Sea fleet. In August 1993, Russia cut off Ukrainian gas supplies for a few days to exert pressure regarding negotiations concerning control of the Black Sea fleet;⁸ the Ukraine responded by siphoning off gas meant for Italy and Germany and thus used its role as a transit state.⁹ Other examples could be taken from the Middle East; due to political hostilities between neighbouring countries, none of the eight international pipelines in the region has operated continuously since it was built.¹⁰ And some of the new pipeline projects under study face an extremely high political risk. For example, a gas pipeline is planned from the Caspian Sea via Armenia, north through Bulgaria, Romania, Hungary and Austria and connecting with European gas grid; another pipeline is located from the Egyptian Nile Delta through the Sinai Peninsula to

⁴ For an in-depth analysis see Wälde, T W, *Internationale Investitionen im Energiesektor der früheren Sowjetunion: Zwischen wirtschaftspolitischem und rechtlichem Anspruch und der chaotischen Wirklichkeit jenseits des Kommunismus [International Investment in the Energy Sector of the Former Soviet Union: Between Politico-Economic and Legal Pretension and Chaotic Reality Beyond Communism]* (1997).

⁵ Estimates of the development of natural gas supplies in western Europe differ. Many studies identify Algeria and the FSU as the most important gas exporters.

⁶ See International Energy Agency, *Oil Supply Security: The Emergency Response Potential of IEA Countries* (1995), pp 10f for OECD countries.

⁷ See Wälde, T W, 'Introductory Note', 33 *International Legal Materials* 360-367 (361) (1995).

⁸ Ukraine's debt toward Gazprom evolved to well above one billion US dollars during 1994, see International Energy Agency, *The IEA Natural Gas Security Study* (1995), p 241.

⁹ The problems arising between Russia and other former members of the Soviet Union are discussed by Dorian, J P, and Kort, P S, *Russian Dominance Over 'Near Abroad' Linked to Energy* (1995).

¹⁰ See Stevens, P, 'A History of Transit Pipelines in the Middle East: Lessons for the Future', paper presented to Boundaries and Energy: Problems and Prospects 4th International Conference of the International Boundaries Research Unit, Durham (18-19 July 1996).

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Palestinian Gaza Territory, then on to Tel Aviv. A further very ambitious project is a gas pipeline from Turkmenistan to Japan through Kazakhstan and China.

Premises: meaning, methods and relevance of transit

Meaning of the word 'transit'

Transit, in general terms, can be defined as the 'passage or carriage of people or goods from one place to another'.¹¹ Instead of 'from one place to another' the phrase 'through a specific territory' could be used without any change in meaning.¹² In this sense, transit is nothing other than movement of something or someone from point A to point B.

In international law, however, the word 'transit' also contains a more political dimension and is understood in a narrower sense, that is to say movement of something or someone by crossing at least two state frontiers.¹³ For example, the Convention on Freedom of Transit, concluded by the League of Nations in 1921, gives the following definition: 'Persons (. . .) and goods (. . .) shall be deemed to be in transit across territory of one of the Contracting States, when the passage across such territory (. . .) is only a portion of a complete journey, beginning and terminating beyond the frontier of the State across whose territory the transit takes place'.¹⁴ The GATT provides an almost identical provision on transit.¹⁵

With respect to this definition, petroleum pipelines, being of special interest for the purposes of this article, are 'pipelines which cross another territory to deliver oil and gas to market in a third country'.¹⁶

Therefore, transit in international law always comprises a relevance for the territorial sovereignty of at least one state (the transit state). And this is what makes it critical. The transit state may grant the transit due to its own interests, but it may also decide to deny or limit any transportation through its territory or even to interrupt a formerly permitted transit.

Methods of transit

Transit as a form of movement from one point to another can be executed by all possible means of transport, ie for example, cables and wires, aircraft, automobiles, trains, ships, even waves, and, most important for energy, pipelines.

The various means of transit transport can be divided into two categories: those which access and leave the transit state together with the people or goods being transported (automobiles, aircraft, ships), and those which remain on the territory of the transit state (ie all fixed networks such as cables, wires or pipelines).

This distinction between non-networkbound and networkbound transit is relevant for the transit state; the degree of relevance depends on the ownership of the means of transport. A pipeline, for example,

¹¹ Brown, L, ed, *The New Shorter Oxford English Dictionary on Historical Principles*, 4th ed, Vol 2 (1993), p 3370.

¹² See Burchard, F V, and Eckert, L, *Natural Gas and EU Energy Law* (1995), p 61.

¹³ The European Communities, however, adopted the concept of transit in the sense of mere cross-border transportation: transit of natural gas and electricity through grids includes transport involving the crossing of only *one* intra-Community frontier. See Art 2 (1) (c) of the Council Directive of 31 May 1991 on the Transit of Natural Gas Through Grids 91/296/EEC – OJ L147 12.6.91, p 37.

¹⁴ See Roggenkamp, M M, 'Transit of Networkbound Energy: the European Experience', in Wälde, T W, ed, *supra* note 2, pp 495-515 (498).

¹⁵ See Roggenkamp, M M, *ibid*, p 501.

¹⁶ Stevens, P, *supra* note 10, p 1.

owned by a foreign state or entity signifies greater interference in territorial sovereignty than a pipeline owned by the transit state. This is why the question of ownership sometimes determines the transit route. When, in the late 1960s, the Netherlands sold natural gas to Italy, the potential transit states Belgium and France refused to concede at least joint ownership of the transport network to the Italian buyer; in the end, it was Germany and Switzerland which decided to grant joint ownership and therefore became transit states for Dutch gas.

Of course, it is not always political reasons which compel a potential transit state to refuse or grant ownership to foreign parties; economic considerations may also play a crucial role in the decision-making process. But in any case, it is of great importance for a state to have the ability to freely decide about ownership of any transport network leading across its territory.

Relevance of transit

General relevance

Since transit is transportation in the first place, its relevance for all fields of human life is obvious. International trade, tourism, telecommunications, to name only a few, would be inconceivable without the possibility of transport through the territory of a third state which is not the final destination.

Especially for oil and natural gas, the political aspect of transit becomes vital. Petroleum is of key significance in all regions of the world in both economic and military terms.¹⁷ Due to the location of petroleum reserves, many countries are dependent on pipelines and other means of transport to deliver the fuel over great distances from the point of production to consumers. Major trade movements of oil and gas include routes from the FSU and the Middle East to Europe, North America and Asia Pacific, from Africa to USA and Europe, from South America to North America.¹⁸ The possibility of transporting the fuel to its destination is in most cases built on transit through third states. As a result, unimpeded transit is crucial for adequate energy supplies in many countries.

The relevance of transit for energy supply would not be that significant if any alternatives existed which minimise or exclude the risk of supply cuts due to transit interruptions. But choosing a different route normally means longer distances and higher costs which can lead to the rejection of a project on economic grounds. This is illustrated by pipelines, which are the most important means of transport for natural gas in transit.¹⁹ Since construction costs are high and projects require a long period of negotiation,²⁰ a much longer or even additional pipeline taking a different route through different countries remains only a theoretical possibility. Rail is an alternative for oil only and still contains the risk every transit transport has to face.²¹ Transportation of gas by tanker sometimes seems to be the

¹⁷ Oil and natural gas together account for most of the fuel consumption in all regions of the world. The only exception is the Asia-Pacific region due to the exceptionally high consumption level of coal in China. For details, see The British Petroleum Company, *BP Statistical Review of World Energy 1997* (1997), pp 38 f.

¹⁸ The British Petroleum Company, *ibid*, pp 18 f., 28 f.

¹⁹ Oil pipelines sometimes serve to shorten the distances, but oil trade is characterised by maritime transport. See Masseron, J, *Petroleum Economics*, 4th ed (1990), pp 159-169.

²⁰ See, eg, Jensen, J T, 'Gas Supplies for the World Market', in 15 *The Energy Journal* 237-250 (240) (1994).

²¹ See, eg, Seck, A, 'Pipelines from Central Asia and the Transcaucasus: A Maze of Alternatives', paper presented to Boundaries and Energy: Problems and Prospects 4th International Conference of the International Boundaries Research Unit, Durham (18-19 July 1996), pp 43 f.

main alternative to pipelines,²² but is not always the best; gas must be liquefied before being shipped which is not only very expensive, but considerable volumes of gas are wasted during the liquefaction process and later during regasification.²³

In specific: relevance for the transit state

It has already been noted that due to the location of petroleum reserves, the producer and consumer states have vital interests in transit as a factor of both foreign trade and security of energy supply. In most cases, transport through the area of a third state seems to be the only economically viable and probably the only possible way of moving energy materials from the origin to their destination.

What, however, is the relevance of transit for a potential transit state? At first glance, transit would seem to bring some striking disadvantages for transit countries. A distinction can be made between three scenarios.

In the first scenario, the potential transit state itself may be a producer of energy materials. If this is the case, the transit state probably already brings or intends to bring its production surplus to a market in the very country meant as the destination of the transit route. By granting transit it will be possible for the consumer country to cover its demand for energy from a source which would be out of reach without transit. As a result, the transit state feeds its own competitors. For example, the Russian Federation may not be interested in allowing Turkmenian natural gas to be delivered to west or central European countries through pipelines established on Russian territory, although sufficient transport capacities are available. Russia is keen to significantly extend its gas sales in western Europe and undertakes massive investments to achieve this goal.²⁴

The second possible scenario is based on the potential transit state also being an importer of energy materials. Transit opens new markets for producer countries and could, therefore, weaken the transit state's position as a buyer on the international energy market. This is shown, for example, by the case of gas procured from the North Sea. In the beginning, only those countries located near the production fields were potential buyers. As transit through North Sea bordering states became more favourable, southern European countries became interested in buying gas originating from that region. This development strengthened the producers' role on the energy market and made it more difficult for consumers, including the transit countries, to achieve an advantageous position in sales negotiations.

The third scenario concerns the risk of transit resulting in more competition in the transit state. The buyer, ie the consumer and destination state, probably wants to market shares of the transported energy en route within the transit state. This risk occurs only in countries where national law permits the sale of energy in transit, which is the case in Germany, for example. In these countries, the

²² Stevens, P, 'The economics of hydrocarbon pipelines in the 21st Century', in *5 Pipes & Pipelines International* 10-14 (12) (1984).

²³ See Masseron, J, *supra* note 19, pp 456-465.

²⁴ This was again expressed recently by the Chairman of Gazprom, see Vyakhirev, R, 'Global natural gas: meeting the challenges', in The Petroleum Economist, ed, *The Fundamentals of the Natural Gas Industry* (1997), pp 5 f (6). Present gas export projects include the Yamal-Europe pipeline and expansion plans for the Balkan and Turkish markets. Russia considers refusing ratification of the Treaty, because the Treaty would limit the ability to reject transit pleas from its neighbouring countries.

national companies involved used to try making transit contingent on the buyer's commitment to refrain from selling energy in transit within the transit state; but under European anti-trust law, this strategy is becoming increasingly problematic. In other countries, such as France, the risk is avoided from the outset by national legislation.

All scenarios threaten the economic interests of the transit state. On the other hand, granting transit can also deliver enormous economic and even political benefits which might outweigh the disadvantages.

In the first place, transit leads to an improvement in the trade balance. This is true for transit which has recourse to existing transportation facilities, as well as for transit calling for the installation of new transport capacities. Particularly in those countries where a new infrastructure, ie mainly pipelines, must be constructed, a transit project always means new jobs and thus may be an important vehicle to boost the national economy.

Transit is also an opportunity to serve as a motor for the indigenous energy market. In those cases where new transport capacities are needed, they may improve the existing infrastructure and enable national companies to extend their energy supply network. Another crucial point concerning energy supply is that transit opens the country to receive foreign energy reserves under conditions which, without transit, could never be achieved; by bundling the transit agreement with the sale of some of the transported energy, the transit state probably gains access to new energy sources with an extremely low investment risk.

Good examples of the benefits of granting transit are the Soviet Union and Switzerland.

In the first half of the 1970s, a very ambitious project was developed to deliver gas from Iran to western Europe. This project was never implemented because of the Iranian revolution in 1979, but it is still a model case for how transit can be seen as an impressive chance for the transit state to improve its economy. Of all technically feasible transport variants, the transit from Iran through what was at that time the Soviet Union proved to be the only commercially feasible possibility. The sole problem was the price calculation. For the buyers, the prices for transport through Soviet territory had to be determined by economic considerations concerning the project as a whole and not only by looking at the specific transportation costs. The Soviet Union agreed to limited transit prices only because of another very crucial incentive: the opportunity to improve national gas supplies. The project was a welcome way for the Soviet Union to modernise and expand its own gas transportation system by supporting new pipelines serving transit gas as well as gas for consumers located within the country.

Switzerland could benefit considerably from the transit of Dutch gas to Italy. It is doubtful whether Switzerland would have experienced such a positive development of its gas market structure

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without the transit project. The transit pipeline, leading from North to South, helped to establish new infrastructure and opened the Swiss energy market for gas originating in the Netherlands and later for gas from other producing countries, too.

The possible benefits and disadvantages of transit referred to above cannot be weighed on an abstract basis. Whether transit should be granted or not depends on the very individual situation of the potential transit state.

Germany, for example, has always been open to transit proposals, such as gas from the Netherlands to Italy, Russian gas to France, Norwegian gas to Austria; further projects, especially concerning Russian gas, are also under preparation. One reason for this may be the wish to open the country, which is a typical energy importer, to new sources.

The Russian situation is different. Russia is a typical energy exporting country with proved gas reserves representing 34.4 per cent share of the world total and a 4.7 per cent share in world oil reserves;²⁵ the country had already been able to improve its pipeline infrastructure. Therefore, Russia could be more interested in marketing its own reserves than granting transit for petroleum from, for example, Kazakhstan and Turkmenistan.

Another case is Algerian gas going through Tunisia and Italy to western Europe. Italy would probably not refuse transit through its territory but, on the other hand, has no interest in making transit a profitable project for other countries keen on buying Algerian gas. Transit could weaken Italy's position as a buyer and thus weaken the courageous decision made to connect the African continent with Italy via a pipeline crossing the Mediterranean Sea.

Some of the aspects for transit through Italy are also valid for the transportation of Algerian gas via Spain to other European countries. The Spanish energy supply infrastructure, however, is by no means developed. The construction of a south to north transit pipeline would strengthen the Spanish gas market; this may lead to a positive stance vis-à-vis transit requests from other European consumer countries.²⁶

Concept of transit in the 1994 Energy Charter Treaty

Transit relevant provisions

The Treaty mentions transit in Article 7. This provision is included in Part II of the Treaty which deals with 'commerce' (Articles 3 to 9). Pursuant to Article 3, the signatories 'shall work to promote access to international markets on commercial terms, and generally to develop an open and competitive market, for Energy Materials and Products'. The relevance of transit for the international energy markets has already been mentioned: due to the location of energy resources, international trade in energy would not be conceivable without transit. Article 7, therefore, covers a very important and vital issue.

Other provisions complete and influence the coverage of Article 7:

²⁵ See The British Petroleum Company, *supra* note 17, pp 4, 20.

²⁶ For the Spanish gas market see Alfonso, L P, 'Zur aktuellen Situation des "servicio publico" in Spanien' ['The Recent Situation of the Spanish "servicio publico"'], in Tettinger, P J, ed, *Strukturen der Versorgungswirtschaft in Europa [Structures of the European Public Utilities]* (1996), pp 33-45.

the understandings of the Final Act of the European Energy Charter Conference [No 1 (b) and No 8], the declarations of the very document (No 3), the Treaty's articles on environmental protection, transfer of technology, competition, and others. In the following, the focus will be on Article 7 itself.²⁷

Definition of transit: Article 7 (10)

Article 7 (10) defines transit as '(i) 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, so long as either the other state or the third state is a Contracting Party; or (ii) the carriage through the Area of a Contracting Party of Energy Materials and Products originating in the Area of another Contracting Party and destined for the Area of that other Contracting Party, unless the two Contracting Parties concerned decide otherwise and record their decision by a joint entry in Annex N'.

This definition leans on typical definitions of transit in previous international agreements, but a few peculiarities have to be mentioned.

Firstly, not all countries involved in the transit project must be signatories to the Treaty. Beside the transit state, either the state of departure or the state of destination have to be a member but not both of them. It is, however, self-evident that a party to the transit project not being a member of the Treaty cannot execute dispute settlement procedures set out by the Treaty in the event of a conflict.

In addition, the transit article also applies where only two countries are involved. This refers to cases where, for example, a gas pipeline starts in Azerbaijan, then enters Armenian territory and later on leads back to Azerbaijan. A similar situation is existent concerning Ukrainian pipelines crossing Moldova, Russian pipelines leading through Ukrainian territory, and pipelines on Turkmen territory crossing Uzbekistan. In all cases, Article 7 is fully applicable since no signatory opted for the possibility set out in Paragraph (10) (ii) to limit the meaning of transit; only Canada and the USA (due to Alaska) are listed in Annex N of which both did not sign the Treaty.

Finally, it should be noted that Article 7 refers to the carriage 'through the Area' of a contracting party. The term 'Area', described in Article 1 (10), includes maritime zones over which a state has sovereign rights according to the international law of the sea.

Obligations concerning transit: Article 7 (1) – (6)

Overview

Article 7 deals with three aspects of transit: access, conditions and non-interference.

Access to transit implies the use of existing or the installation of new transportation capacities. This issue is covered by Paragraphs (1),

²⁷ The influence of the Treaty's competition rules (Article 6) on transit matters is not the subject of discussion in the following sections, but is discussed in-depth by Nihoul, P, and Smeers, Y, 'Energy Transit Principles in the Context of the Energy Charter Treaty', Report for the Directorate General for Energy (DG XVII) of the European Commission under the Synergy Programme (1997).

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(4) and (5). Article 7 (1) contains a general obligation 'to facilitate' transit, whereas Paragraphs (4) and (5) modify or specify this obligation.

The core provisions for conditions of transit are Article 7 (1) and (3) by introducing non-discriminatory and reasonable treatment of existing flows of energy materials and products in transit.

Non-interference is dealt with under Paragraph (6) and covers interruption and reduction of the flow of energy in transit.

Only for the sake of completeness, Article 7 (2) must be mentioned which obliges the contracting parties to 'encourage relevant entities to cooperate' mainly in modernising and developing energy transport facilities, mitigating the effects of interruptions in energy supplies and facilitating the interconnection of transport facilities. Although using legally binding treaty language ('shall encourage'), this provision is meant more as a motor for general cooperation on an international scale and addresses issues going far beyond transit problems.

Access to transit

Article 7 introduces concepts for the treatment of transit requests, which are common in international law. Non-discrimination and the prohibition of unreasonable restrictions are well-known and cannot cause many problems when it comes to interpretation of the Treaty. Also, the transit article imposes a general obligation to grant a transit request, which is expressed by mentioning the 'principle of freedom of transit'. But it is questionable whether such a principle exists in public international law. And since the Treaty only refers to such a principle rather than establishing it, the implementation of the 'freedom of transit' will not be of practical significance.²⁸

Several note-worthy limitations are set out in Paragraph (5). Transit services can be denied when they endanger security of supply, safety or efficiency of the energy systems. In fact, under normal circumstances all of the mentioned issues can be compensated by proper pricing schemes and hence do not constitute an economic argument for denying transit.²⁹ Only where new or additional transit results in the impossibility to compensate endangerment, the objection of transit is acceptable.

Conditions of transit

Pursuant to Article 7 (1) and (3), the Treaty introduces non-discriminatory and reasonable treatment also for the conditions under which transit is granted. Access conditions and transit fees must not significantly differ depending on the origin or destination of the product, or on the nationality of the owner of the product as well as on the nationality of the customer.

In the event that transport capacity is limited, an extreme literal interpretation of Article 7 would lead to a situation where the transport

²⁸ It is not of importance for this article to repeat what has been written on the freedom of transit over and over again. For a detailed discussion see, eg, Lauterpacht, E, 'Freedom of Transit in International Law', in *44 Problems of Public and Private International Law* 313-356 (1962); Wilfred, B, 'The Legal and Political Issues of the Transit of Energy in the Commonwealth of Independent States: Will Oil or Blood Flow?', unpublished LLM thesis at the University of Dundee, Centre for Petroleum and Mineral Law and Policy 1996, pp 10-12; Fotheringham, I, 'International Pipelines: Their Problems in International Law', unpublished LLM thesis at the University of Dundee, Centre for Petroleum and Mineral Law Studies 1982, pp 60-72.

²⁹ See Nihoul, P, and Smeers, Y, *supra* note 27, p 31.

company is forced to reduce transport for all transactions in order to fulfil the requirements of non-discriminatory treatment. Since this seems impossible due to binding transit agreements, the obligations under Paragraphs (1) and (3) may indirectly compel the network company to undertake the necessary investments to establish sufficient transportation facilities.

Non-interference of transit: Article 7 (6)

Article 7 (6) provides that a 'Contracting Party through whose Area Energy Materials and Products transit shall not, in the event of a dispute over any matter arising from that Transit, interrupt or reduce, permit any entity subject to its control to interrupt or reduce, or require any entity subject to its jurisdiction to interrupt or reduce the existing flow of Energy Materials and Products'.

This provision has been accepted as 'most significant'³⁰ and 'most operationally relevant'³¹ and has been considered to be of 'self-evident' importance.³² However, it must be asked whether this enthusiastic reception is based on the actual legal significance of the provision or whether it is merely a product of wishful thinking.

First of all, Article 7 (6) does not prevent an interruption of or reduction in energy flow by the country of departure. For example, if Russia interrupts its fuel deliveries for Germany because gas supplies are 'poached' by the transit country (the Ukraine, Poland or Belarus³³), it is not Russia which is breaking the obligation under Paragraph (6) (although it may be breaking other contractual obligations), but the transit country. Germany, therefore, could not call Russia to account for the incident under the provisions of the Treaty, although Russia may be fined for non-delivery under the terms of a sales contract.

Further, by emphasising that a transit state shall not 'in the event of a dispute over any matter arising from that transit'³⁴ interrupt or reduce the flow of energy, the obligation is limited, for instance, to conflicts over transit tariffs, which have become very common between FSU countries during recent years. In the event of a dispute over matters concerning anything other than the transit itself, the transit country would not contravene its obligation by interrupting fuel deliveries.³⁵ This interpretation is based on the precise wording of Article 7 (6) and, therefore, cannot be superseded by the overall intention of the Treaty to secure the supply of energy. One significance of Article 7 (6) worthy of note is the following: in the event of a conflict over transit issues, the transit state should not be allowed to argue that it is a dispute other than the transit conflict that led to the interruption or reduction of energy flow.

In conclusion, Article 7 (6) does not generally prevent the interruption or reduction of energy in transit. This is supported by the fact that the provision allows interference of transit 'where this is specifically provided for in a contract or other agreement'. Normally, transit agreements contain a clause concerning the circumstances

³⁰ Baragona, K, 'Transit Rights under the Energy Charter Treaty', paper presented to The Legal and Business Implications of the European Energy Charter Treaty Conference, London (13-14 February 1995), p 6.

³¹ Bamberger, C S, 'An Overview of the Energy Charter Treaty', in Wälde, T W, ed, *supra* note 2, pp 1-34 (7).

³² Fatouros, A A, 'Energy Transit and Investment in the Energy Charter Treaty', in *2 Greek Journal of International Law* 185-221 (200) (1996).

³³ See, eg, the newspaper reports in *Leipziger Volkszeitung*, 9 January 1997 ('Russian gas did not pass the Polish-German border') and *Izvestija*, 17 January 1997 ('The Slavic brothers have stolen Russian natural gas meant for Germany').

³⁴ Author's italics.

³⁵ See Fatouros, A A, *supra* note 32.

under which the transit may legally be interrupted, although most agreements do not provide for the situation if transit tariffs are not paid. If interruption or reduction is not stipulated in the transit agreement, then, and only then is Article 7 (6) of importance.

What is not covered by Article 7?

Article 7 only provides for a legal framework and does not make contractual agreements superfluous.³⁶ The Article's provisions address the contracting parties of the Treaty and leave aside most issues typically dealt with in transit agreements. Such issues³⁷ are, eg, ownership of the infrastructure (such as pipelines), transportation route, applicable legal regime, construction and licensing, safety and environmental protection and construction finance. Some of these matters are covered by other terms of the Treaty (mainly the investment regime), but all of them have to be stipulated in detail by the negotiators of transit agreements.

Access to transit and non-interference of transit are the main concerns of Article 7. Detailed provisions on the contents of bilateral agreements could have never been reached in the course of Treaty negotiations, and, more important, would not make much sense given the wide range of different political and economic interests and abilities of potential transit states.

Settlement of disputes over transit matters: Article 7 (7)

Relevant provisions

Article 7 (7) is the sole provision of the Treaty that expressly addresses conflicts over transit. As it explicitly refers only to disputes mentioned in Paragraph (6), ie disputes over existing transit, one question remains unanswered: what about the obligations set out in the other paragraphs of Article 7?

The answer to this question is very important should a potential transit state refuse to grant a transit request or stipulates unacceptable conditions. Two other articles concerning dispute settlement may be applicable in such a situation, namely Articles 26 and 27.

Article 26³⁸ provides for 'disputes between a Contracting Party and an Investor of another Contracting Party (. . .), which concern an alleged breach of an obligation of a (Contracting Party) under Part III (. . .)'. Part III of the Treaty deals with 'Investment promotion and protection', whereas transit matters are covered by Part II which is titled 'Commerce'. However, 'investment' as defined in Article 1, No 6, lit f, also includes 'any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector'. Since the term 'economic activity in the energy sector' explicitly refers to 'land transport' (Article 1, No 5), the right to transport energy and energy materials through a contracting party's territory is an 'investment' in the sense of the Treaty. On the other hand, Article 26, although

³⁶ Cameron, P, *Gas Regulation in Europe – From monopoly to competition*, Vol 2 (1995), p 125.

³⁷ See Cameron, P, *ibid*, p 124.

³⁸ For a detailed analysis see Wälde, T W, 'Investment Arbitration Under the Energy Charter Treaty – From Dispute Settlement to Treaty Implementation', *4 Arbitration International* 429-466 (442-464) (1996); Paulsson, J, 'Dispute Resolution', in Pritchard, R, ed, *Economic Development, Foreign Investment and the Law. Issues of Private Sector Involvement, Foreign Investment and the Rule of Law in a New Era* (1996), pp 209-246 (238-243).

covering all kinds of investments, only relates to obligations under Part III of the Treaty, with the result that the specific transit obligations set out under Article 7 are not included. This conclusion is not mandatory in dogmatic terms but best meets the overall structure of the Treaty with its clear separation of trade respectively investment provisions.³⁹

Article 27, relating to ‘disputes concerning the application or interpretation of this Treaty’ [Paragraph (1)], is not limited to specific parts or provisions of the Treaty and is therefore applicable to all disputes related to any transit obligation set out in Article 7. However, it is arguable whether arbitration under Article 27 also applies to conflicts over existing transit. Article 7 (7) provides for a specific dispute settlement procedure and could therefore have exclusive priority (*lex specialis derogat legis generalis*). On the other hand, principles such as the *lex specialis* rule, although common in national jurisdictions, cannot be used as a general and definitive means of interpretation in international law.⁴⁰ In the final analysis, however, it is the unanimous intention of the signatories which is the deciding factor. But as neither Article 7 nor Article 27 indicates the signatories’ intention clearly, no reason can be found why a party to the dispute should not be entitled to choose between the two arbitration methods.⁴¹

Should the parties decide in favour of Article 27, the arbitral award will be final and binding [Article 27 (3) (h)] and therefore makes a further procedure under Article 7 (7) unnecessary; if the parties decide on conciliation pursuant to Article 7 (7), there will be an agreement finally resolving the dispute or an interim decision by the conciliator [Article 7 (7) (c)]; only the latter possibility will open the dispute for additional arbitration under Article 27, which is reasonable since the conflict could otherwise remain unsolved.

All in all, the parties to a dispute are free to choose between Articles 7 and 27, with one exception, however: should the transit state want to interrupt or reduce the existing flow of energy materials and products, it is obliged to execute the conciliation procedure of Article 7 (7) first [Article 7 (6)].

Applicability: ‘dispute over any matter arising from transit’

The dispute settlement procedure under Article 7 (7) ‘shall apply to a dispute described in paragraph (6)’. Referring to Paragraph (6), no detailed description of the kind of dispute can be found, but merely a general wording referring to a ‘dispute over any matter arising from an existing transit’ of energy materials and products through a contracting party’s area. This provision includes all conceivable conflicts about transit matters, with the sole limitation that the transit state and, in addition, either the country of destination or departure has to be a signatory to the Treaty.

Typical disputes to be solved under this provision are the conflicts over transit tariffs between FSU states.

³⁹ Wälde, T W, ‘International Investment Under the 1994 Energy Charter Treaty’, in Wälde, T W, ed, *supra* note 2, pp 247-316 (302) comes to the same conclusion. Baragona, K, ‘Transit Rights under the Energy Charter Treaty’, paper presented to The Legal and Business Implications of the European Energy Charter Treaty Conference, London (13-14 February 1995), p 7, has a different view without presenting arguments, also Roggenkamp, M M, *supra* note 14, p 507. It must be noted that Art 26 is, of course, applicable in case of expropriation of a transit pipeline.

⁴⁰ See Seidl-Hohenveldern, I, *Völkerrecht [Public International Law]*, 9th ed (1997), p 79.

⁴¹ Wälde, T W, *supra* note 38, p 441 fn 45.

Course of dispute settlement: Article 7 (7)

In the event of a dispute over transit matters as described in Article 7 (6), the dispute settlement procedure set out in Paragraph (7) starts with a notification to the Secretary-General of the Charter Conference Secretariat by a party to the dispute [Article 7 (7) (a)].

The Secretary-General examines whether the parties to the dispute have exhausted 'all relevant contractual or other dispute resolution remedies previously agreed between the Contracting Parties party to the dispute or between any entity referred to in Paragraph (6) and an entity of another Contracting Party party to the dispute' [Article 7 (7)]. Since the Treaty refers to 'contractual' and 'agreed' remedies only, the Treaty's conciliation method can be used without trying to solve the conflict before the national courts under general national law.⁴²

The Secretary-General then notifies all signatories of the notification [Article 7 (7) (a)] and thus gives other contracting parties concerned with the dispute the opportunity to take part in the settlement procedure.

In consultation with the parties to the dispute and other contracting parties concerned, the Secretary-General appoints a conciliator within 30 days [Article 7 (7) (b)]. The conciliator seeks an agreement to resolve the dispute or an agreement on a procedure to resolve the dispute. In the event that an agreement is reached the parties are bound by the terms of that agreement.

If the conciliator is not successful within 90 days of his appointment, he recommends a resolution and has to decide interim tariffs and other terms and conditions to be observed for transit [Article 7 (7) (c)]. The parties to the dispute are legally bound to the interim decision for 12 months or until resolution of the dispute, whichever is earlier [Article 7 (7) (c)-(d)].

After 12 months and if an agreement has not been reached by then, the transit state could interrupt or reduce the flow of energy in transit without breaching its obligation under Article 7 (6); also, the parties to the dispute could either turn to arbitration under Article 27, or they could commence the conciliation procedure. In the latter case, however, the Secretary-General may elect not to appoint a conciliator [Article 7 (7) (e)].

Article 7 (7) does not provide for the enforcement of the conciliator's interim decision. Since only signatories of the Treaty, ie states, have access to the conciliation procedure, they 'undertake (. . .) to ensure that the entities under their control or jurisdiction observe any interim decision' [Article 7 (7) (d)].

⁴² Although the wording of this provision is clear, Wälde, T W, *ibid*, seems to doubt such a consequent interpretation, but suggests that 'access to national courts – if not specifically agreed – should not delay the conciliation procedure'.

Epilogue: does transit need Article 7 (7)?

As discussed earlier, transit is crucial especially for energy supply in most countries. An interruption in the flow of energy in transit can jeopardise entire sectors of a national economy. A vital step in the direction of limiting the risks typical for international energy trade is

therefore a provision in the Treaty prohibiting any hasty or abusive interruption or reduction of existing transit in case of a dispute concerning that transit [Article 7 (6)].

Hence, it is reasonable for the Treaty to also provide for a dispute settlement procedure in case of a transit dispute, as set out in Article 7 (7). In general, an obligation must be followed by a procedure suitable for enforcing this obligation, otherwise it is nothing more than a mere declaration of intent and, at the most, puts some political pressure on the party in breach. The procedure provided for in Article 7 (7) is quick, at least in comparison with the arbitration course offered by Article 27, and it contains the opportunity to amicably solve the most common problems arising in conjunction with energy in transit, such as a controversy over tariffs.

It has already been shown by briefly analysing the European gas market that potential transit states have certain interests in granting transit; but many good reasons can be found for refusing a transit request, too. The actual situation in western and south Europe alone leaves no doubt that the general obligation to grant transit might become very useful, to say nothing of the circumstances regarding the FSU and other eastern European regions. A procedure to enforce this obligation, as in Article 27, is of great help since the discussion of an unreasonable violation of the Treaty brought before an international forum can cause embarrassment to the party in breach.

On the other hand, a special arbitration method in case of a dispute concerning transit which already exists does not appear meaningful. Article 7 (7), applicable only for existing transit, gives express order that the procedure set out in the appropriate paragraph is only available after 'the exhaustion of all relevant contractual or other dispute resolution remedies previously agreed between the Contracting Parties party to the dispute'. Transit agreements normally provide for disputes, with the result that the procedure in Paragraph (7) is not the main means of settling conflicts, but looks more like a chance for the dissatisfied party to appeal for a new decision.⁴³ What happens if the contractual arbitration method has led to a final and binding award is unclear: Did the signatories of the Treaty agree to have such an award superseded by the decision reached in the conciliation procedure offered by the Treaty? The answer could be 'yes' by calling upon the *lex posterior* rule if the Treaty did not expressly provide that nothing in Article 7 shall derogate from any rights and obligations under international law including existing bilateral agreements [Article 7 (8)].

Regarding the possible results of a procedure under Article 7 (7), it becomes obvious that conciliation is meant more as a 'cooling off mechanism'⁴⁴ in case previous arbitration does not lead to an acceptable solution for one or all parties involved in the conflict. If conciliation under Article 7 results in an agreement, the terms agreed would clearly supersede the previously pronounced arbitral award. And if an agreement is not reached, the conciliator just recommends

⁴³ The same concern is expressed by Wälde, T W, *supra* note 41.

⁴⁴ Baragona, K, *supra* note 39, p 6.

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a resolution or a procedure to achieve a resolution to which the conflicting parties are not bound. But they have to observe the interim decision on tariffs, terms and conditions for a maximum of 12 months, and this may turn out to be the major bone of contention, assuming that the previous arbitral decision under a bilateral agreement is more favourable for one of the parties than the conciliator's interim decision. To avoid such a new conflict, the conciliator is well advised to bear in mind the previous award before deciding on the conditions due to Article 7 (7) (c). The interim decision thus may become an adequate tool for avoiding transit interruptions or reductions, but it may also produce new conflicts between the parties and, therefore, would lose its 'cooling' attribute.

All in all, the specific procedure for disputes seems to be meaningful only in cases where no bilateral agreement is in force or where such an agreement does not provide for a dispute settlement procedure either in part or in full.

Despite the theoretical and quite limited need for a specific dispute settlement procedure as set out in Article 7 (7), the question remains whether interference in existing transit is a problem in real life.

Most of the major energy export routes lead through politically volatile regions and carry the potential for closure; hostility between neighbours is one of the the main reasons for transit risks. However, by looking at the FSU, of which all countries are signatories to the Treaty, it is the economic constraints which form the background to the difficulties concerning transit. After the collapse of the Soviet Union, FSU states had to switch the terms of energy supply contracts to world market conditions, and transit agreements had to be put on a new economic basis. It is therefore no surprise that most energy transit disputes between FSU countries were and still are about money.⁴⁵

A model case is the relationship between Russia and the Ukraine. The Ukraine holds a strategic location between Russia and eastern Europe and serves also as a major transit route for pipelines to west European gas markets. On the other hand, the Ukraine is dependent on Russian oil and gas supplies and also heavily indebted to Russia.⁴⁶ It can no longer afford the energy imports needed to sustain its energy-intensive economy. Recent attempts, however, to remedy the bad economic situation have so far not been successful in solving the problems. The Ukraine does not seem willing and able to forego the desperately needed volumes of imported energy. As a result, the number of conflicts between Russia and the Ukraine concerning gas and oil in transit is legion.⁴⁷

The usual procedure starts with the Russian petroleum exporters cutting off or reducing supplies designated for the Ukrainian markets if debts are not paid. In response, the Ukraine siphons off energy in transit meant to serve, for instance, Germany, Hungary, Slovakia, Bulgaria or Turkey. Then, the Ukrainian authorities promise to look for money, and Russia – in the meantime being fined by European

⁴⁵ Probably only due to national animosity and not about money, Azerbaijan blocked a gas pipeline in 1992, thus preventing delivery of Turkmen gas to Armenia; see *Petrostrategies*, 27 April 1992. For an in-depth analysis of the relationship of FSU states where energy is concerned, see Dorian, J P, and Kort, P S, *Russian Dominance Over 'Near Abroad' Linked to Energy* (1995).

⁴⁶ The Ukraine owes Gazprom US\$3.5 billion for 1992-94 gas supplies alone. For the Ukraine's role and situation regarding energy see <http://www.jurock.com/tradex/ukraine.htm>. Belarus holds a similar position. The disputes between Russia and Belarus over bad payment records have a tradition; Belarus is said to owe Russia around US\$125 million; see *Dagens Naeringsliv*, 26 July 1997.

⁴⁷ The conflict over the Black Sea fleet is a well-known example. Other incidents include supply cuts by Russia in October 1992 (gas; *Reuters News Service*, 19 October 1992; *Frankfurter Allgemeine Zeitung*, 17 October 1992), in November 1994 (gas; *Reuters News Service*, 30 November 1994), in January 1997 (gas; *Rzeczpospolita*, 10 January 1997), in January 1995 (oil; *BBC Monitoring Service*, 27 January 1995), in April 1996 (oil; *Reuters News Service*, 5 April 1996).

consumers for non-delivery of fuel – takes up deliveries again.

Despite all historically founded animosities between the two countries, the conflicts normally have no political background. Incidents over the last few years indicate that both Russia and the Ukraine undertake considerable efforts to find a solution. However, the problems, originating in the Ukrainian economy, cannot be resolved just by reaching a bilateral agreement or a decision imposed on the parties to the dispute by some conciliator. All contractual actions must be accompanied by measures to boost the Ukraine's economic situation. In any case, a mere conciliation under Article 7 (7) does not have the power to bring such disputes to an end.

One could argue that under Article 7 (7) a party not willing to undertake measures to solve the dispute could be forced into action. But the Russia-Ukraine case, typical for FSU transits, makes it clear that all parties involved in the relevant transit have a particular interest in settling the dispute. The Ukraine, heavily dependent on fuel imports from Russia, is not in the position to blackmail Russian petroleum suppliers by interrupting or reducing the flow of energy in transit, and Russia cannot afford to cut off all gas or oil supplies to the Ukraine because of its obligations towards European fuel buyers. This strong interdependence constrains both sides at the negotiating table in the event of a dispute, anyway.

After all, the multilateral dispute settlement procedure of Article 7 (7) is a blunt weapon. In fact, it is not even a settlement procedure, but more a negotiation course under the supervision of a neutral person, with either an agreement or an unsolved problem at its end. Of course, there is still the possibility to agree upon a tribunal [Article 7 (7) (c)] with a final and binding arbitral award instead, but it is questionable whether the parties involved are willing to follow this uncertain approach. Unfortunately, the Treaty negotiators limited the scope of a specific transit arbitration method to a mere annex of previous bilateral agreements, notwithstanding the urgency of effective measures concerning transit disputes as demonstrated by recent incidents. The procedure set out in Article 7 (7) is another indication that the signatories of the Treaty, despite the good will to create an adequate legal framework for energy trade, have not missed the chance to leave themselves an 'emergency exit'.

Conclusion

Article 7 covers three major aspects of energy transportation: access to transit, conditions of transit and non-interference of transit. Not all of these aspects are particularly well defined. It seems that the entire Article 7 is more of political and psychological meaning than legal significance.

Access to transit seems to be the most important issue covered by Article 7. Access can be refused only if it would endanger the security

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or efficiency of existing energy systems [Article 7 (5)]. The wording of the relevant provisions is very sensitive to opportunistic arguments in order to deny transit and, therefore, of dubious usefulness.

Conditions of transit is an issue strongly related to access of transit. To grant a transit request is meaningless for the investors if the conditions result in unfair and economically unreasonable treatment. Article 7 provides for reasonable and non-discriminatory conditions, but the Treaty's obligations have to be transferred to domestic law. Since the concepts of 'reasonableness' and 'non-discrimination' are not new, the problem is rather to decide whether the signatories succeeded in translating them into their national legal systems than to find the right interpretation of the provisions covering these concepts. All in all, the provisions concerning conditions of transit seem to be the most substantial part of Article 7.

The significance of Article 7 (6), dealing with non-interference of transit, will be very slight in real life. This provision prohibits interruption and reduction of the flow of energy in the event of a dispute arising from the transit. But it also stipulates that interference is legal if specifically provided for in a contract or any other legal agreement. As a result, this paragraph is applicable only to cases where no transit agreement or no appropriate contractual clause exists. It indicates, however, the efforts undertaken by the Treaty negotiators to deal with recent problems in the FSU states. Transit agreements between these countries lack to a great extent of substance and neither provide for non-interference of the flow of energy nor for a dispute settlement in the event of a conflict. This provision seems to be a made-to-measure instrument to solve the somewhat chaotic situation in that region and is of great value, so far.

Article 7 does not cover all problems related with transit. It is a provision addressed to state authorities and therefore unable to substitute specific transit agreements. But this circumstance should not be considered a disadvantage. On the contrary, it is of great importance to leave the details to the parties involved in a transit project. This is the only way to do justice to the particular political, economic and legal situation of the potential transit country.

On the other hand, Article 7 uses unclear and obscure language and terms. What, for example, does the phrase 'necessary measures to facilitate' [Article 7 (1)] imply? Is there really a 'principle of freedom of transit' to which Article 7 (1) refers and if so, what exactly is its meaning in practice? The transit article also needs clarification with respect to many other issues.⁴⁸ It is safe to say, therefore, that the transit issue in the Treaty should be recognised as a 'work in progress'.⁴⁹

Another significant disadvantage is that none of the major oil and gas producers in North Africa and the Gulf states is involved with the Treaty. Transit, however, is a major concern in these regions and an important issue for Europe's energy supplies.

As one author puts it, the Energy Charter Treaty and, therefore, its

⁴⁸ See Sas, B, 'Legal Issues in the Control of the Construction and Operation of Pipelines and the Issue of Transit in the Caspian and Black Sea Regions', 7 *Oil and Gas Law and Taxation Review* 274-279 (1995); Carver, J, 'The Energy Charter Treaty and Transit', in Wälde, T W, and Christie, K M, eds, *Energy Charter Treaty: Selected Topics* (1995), chapter 7.

⁴⁹ Bamberger, C S, 'Doing Business in the Signatory States', paper presented to The Energy Charter Treaty: What it Means for Business Conference, Brussels (14 June 1996), p 6, however, referring to the whole Treaty.

transit provisions, too, are 'one of the foremost diplomatic efforts involving energy matters to be accomplished in the 20th Century'.⁵⁰ This may be true, but efforts alone do not always lead to a satisfactory result. Article 7 is a good example. Its legal meaning is very arguable as regards the considerable lack of precision and effectiveness.⁵¹ It is impossible to bring the ideas and concerns of so many countries with such a great variety of economic and political interests under one umbrella.

On the other hand, no one familiar with the peculiarities of international agreements would have expected an overall precise, complete and highly effective article on transit issues. The transit provisions as set out in the Treaty will be confronted in the future with the same problems which all multinational agreements have to face. Their success depends on the willingness of the signatories to act in accordance with their rights and duties laid down in the Treaty. There is no guarantee that transit issues will not be determined by political considerations rather than legal obligations.

But it is reasonable that a signatory will think twice before acting against the provisions of the Treaty. To risk a negative political reputation may also mean to risk hindering the chance of further economic development and partnership. Hence, the transit provisions certainly are an important step in the direction of safe and reliable international energy markets. The transit regime of the Treaty has created a situation which makes it impossible for a signatory to legally hinder or disrupt flows of energy without justification or without the threat of a dispute settlement procedure.

In conclusion, it is important to note that no international agreement can exempt investors from the responsibility of weighing up all economic and political risks associated with any country for which transit is required. But the Treaty and its transit provisions are at least a useful momentum to limit the risks and to build an atmosphere of mutual trust and respect between potential partners in transit matters.

⁵⁰ Fox, W, 'The United States and the Energy Charter Treaty: Misgivings and Misperceptions', in Wälde, T W, ed, *supra* note 2, pp 190-197(197).

⁵¹ Cameron, P, *supra* note 36, p 125, seems to be the only author who openly doubts the importance of Article 7: 'Each flow of gas will have to be covered by a bilateral agreement, so the question arises of how much, if anything, Article 7 can add to such agreements.'