

# Using WTO rules to enforce energy transit through pipelines



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As the membership of the WTO expands to include more countries that play an important role in energy production and transport, it looks increasingly attractive to use WTO rules to enforce oil and gas transit through pipelines. Governments and energy companies are well advised to closely watch this area in the coming years.

| by *Arnoud R. Willems and Jung-ui Sul*

A transnational pipeline project is a notoriously tricky affair. Not only are there the complexities of negotiating the commercial agreements and getting the pipeline built, but there are also the political uncertainties of government

intervention and disturbances. Indeed, it often appears that the economics of a project are overruled by the politics. The proposed Nabucco gas pipeline through Turkey is a current favourite not because it is the cheapest but because it avoids transit

through Russia and Ukraine, both seen as problematic transit countries. However, transit through Turkey is not problem-free either and the relative attractiveness of Nabucco is diminishing as concerns emerge about Turkey's cooperation on the project.

The debate about transit difficulties tends to focus on politics and neglects a valuable legal tool that exists through the World Trade Organisation (WTO). The WTO rules provide for the freedom of transit through every member of the WTO. Application of this provision could have a significant impact on the terms of competition between energy players and on security of supply.

The Energy Charter Treaty (ECT) also provides for an obligation to facilitate transit that could offer relief in certain situations. As will be seen below, however, the WTO is in several ways a better forum for handling transit disputes.

### The reality of transit |

The basic situation is simple: many energy-rich (oil and gas-producing) countries like Iran, Algeria, Russia and Kazakhstan, are located far from the main energy consuming countries like China, the US and the EU. As a result, energy needs to be transported through various countries and over a considerable distance to reach its consumers. At the moment, the infrastructure to transport energy is limited and therefore hinders the security of supply and effective competition. Indeed, most oil pipelines run from the production site to the closest port (often in the same country where the oil is loaded on a ship) and sold for the price prevailing on the exchange. For countries without sufficient port facilities, like Kazakhstan and Russia, this is not an option and transnational pipelines are needed. With respect to gas, the situation is even more complicated, since gas tends to be sold on long term contracts and is more difficult to transport by ship. (The trade flows of LNG are developing quickly, but it will take a generation before the volumes can compare with normal gas deliveries, if ever.)

In the case of Kazakhstan, supplying the EU with oil and gas requires transporting the energy through one of three routes: Russia and Ukraine; Turkmenistan, Iran and Turkey; or the Caspian Sea, Azerbaijan, Georgia/Armenia and Turkey. At present, Kazakhstan is heavily reliant

on two pipelines, both running through Russia, namely the Atyrau-Samara pipeline and the Caspian Pipeline Consortium (CPC) pipeline. With both pipelines at or near full capacity, Kazakhstan needs more channels to export its vast reserves of oil and gas. Numerous projects have been proposed, including a trans-Caspian underwater pipeline and a Kazakhstan Caspian Transport System (KCTS), which would link Kazakhstan to the BP-run Baku-Tbilisi-Ceyhan pipeline. Towards the East, an ambitious project that is already under construction will supply gas through a pipeline stretching from Turkmenistan, across Uzbekistan and Kazakhstan, and into China.

In this complex web of pipelines and countries, there are multiple problems that can arise. The transit country may do any or all of the following: charge excessively high transit tariffs; obstruct the supply of energy or divert it for its own use; oblige access for its national producers; obstruct the construction of the pipeline itself.

The WTO or ECT rules could enable the

However, this does not mean that the generally applicable rules of the WTO are any less relevant for energy. Indeed, they are sure to become increasingly relevant and useful as more energy producers join the WTO. The WTO already includes important energy players, such as Turkey, Ukraine, Saudi Arabia and Oman. Further, Russia, Kazakhstan and Algeria are in the process of acceding to the WTO. All these countries, as well as large energy consumers, such as the EU and China, have an interest in applying the WTO rules to their advantage.

The WTO rules provide the WTO member countries with a right to transit through other member countries. Article V of GATT states that 'There shall be freedom of transit through the territory of each contracting party, via the routes most convenient for international transit' and that 'All charges and regulations [...] on traffic in transit [...] shall be reasonable'. In addition, WTO members may not discriminate between imports and local production, and must grant the same preferences to all WTO members.

## *The attractiveness of Nabucco is diminishing as concerns emerge about Turkey's cooperation*

energy-producing country (or the company concerned) to force the transit country to allow it access to transit networks for its energy, and even help in facilitating the transit. Moreover, the use of this pipeline must not be burdened by customs duties, taxes, charges and so on. The transit country may only request compensation for actual transportation costs, expenses or services rendered.

### International rules |

The original contracting countries to the General Agreement on Tariffs and Trade (GATT, the precursor to the WTO) were not large energy producers. Hence, there had been less focus on energy trade and so far it has not been treated as a separate sector within the GATT and WTO agreements.

To date, there has been no WTO dispute or agreement on the interpretation of this provision. The interpretation of WTO rules, including the right to transit, would depend on the circumstances of any particular case, but on the surface, GATT Article V appears to cover energy. The Director-General of the WTO, Pascal Lamy, confirmed the application of the WTO rules to energy at the World Energy Congress on November 15 2007 by saying '[GATT rules] also apply to trade in energy goods [and] can be enforced through the WTO dispute settlement mechanism even if they were not negotiated with energy in mind'. Indeed, energy played an important role in the accession of various new WTO countries like Saudi Arabia and Ukraine. Therefore, the time is ripe for a



Director General Pascal Lamy looks on after a press conference at the World Trade Organisation (WTO) headquarters. Photo: Fabrice Coffrini/AFP

government to make full use of the right to transit under the WTO. A WTO decision on how a transit country must grant access to pipelines and levy only reasonable charges would bring greater legal and political certainty to all parties involved in a pipeline project. In view of the number of pipelines under discussion, this is likely to happen sooner rather than later. Formally, the government of a WTO member can raise this issue through the WTO dispute settlement procedure or in an accession working party. The latter option would be a friendly way to, for instance, discuss the scope of the transit

the behaviour of another WTO member may be violating the existing rules. This may help convince the government of the transit country to address the issue seriously, or face formal proceedings at WTO level.

Alternatively, as the economic stakes of trade in oil and gas increase, and the WTO membership includes more and more energy-rich countries, WTO members may find it preferable to negotiate a separate energy agreement instead of relying on the basic WTO rules. A separate energy agreement, similar in principle to the separate agreement on agriculture, would

### Energy Charter |

Complementing the WTO rules, the Energy Charter Treaty (ECT) also covers energy transit. The ECT was developed by a number of countries in order to have specific rules on energy. Although a multilateral treaty, its coverage and enforceability is much less than that of the WTO. At the moment, 51 countries have signed the ECT, while 152 have signed the WTO Agreement.

On first sight, the ECT seems to follow the WTO rules but a closer look shows many exceptions. On the one hand, the ECT is more limiting than the WTO rules. Indeed, the WTO rules aim to facilitate free trade while the ECT rules focus on regulating energy trade, in particular investment protection. On the other hand, the ECT seems to go further than the current WTO rules, since it expressly refers to pipelines and (subject to exception) obliges governments not to place obstacles in the way of new capacity being established (Article 7(4)).

The key provision on transit in the ECT is Article 7. This Article obliges '[Transit country governments to] take the necessary measures to facilitate the Transit of Energy Materials and Products consistent with the principle of freedom of transit [...] without imposing any unreasonable delays, restrictions or

### *WTO members may find it preferable to negotiate a separate energy agreement*

provision. A discussion on the scope of the transit provision is already underway as part of the negotiations on trade facilitation in the WTO. Interestingly, several members, including the EU, have proposed that it be expressly recognised that the right to transit covers pipelines. Any WTO member or company could prepare a memorandum outlining why

increase legal certainty and stimulate free trade, or at least increase competition. Energy rich countries may support the conclusion of an energy agreement under the WTO rules, since this would allow them to participate in developing an appropriate legal framework instead of working with rules that were developed without their input.



charges'. Basically, governments have to refrain from interrupting energy transit for political reasons. Moreover, '[Transit country governments shall] encourage [...] the development and operation of Energy Transport Facilities serving the Areas of more than one Contracting Party'.

As with Article V of GATT 1994, Article 7 of the ECT has not yet been tested in a specific case. Thus, the opportunity is open for a country to use the provision to enforce another country's obligation to facilitate the transit of its energy. Seeking to enforce the existing provision may be more fruitful than seeking to develop the transit obligations under the ECT by further negotiations. Nevertheless, ECT signatories are currently taking the latter approach by negotiating a so-called transit protocol to supplement and refine the rules applying to the transit of energy. As evidenced by the many uncertainties around pipeline projects, there is a need to have more clarity about countries' legal obligations, for instance regarding the transit tariffs that countries can charge. Perhaps unsurprisingly, negotiations on this protocol have been difficult and no text has yet been agreed upon.

As with the WTO, the ECT rules are binding. Any matter arising with respect to transit can be brought to conciliation by one of the signatory countries of the ECT. This action requires that other relevant contractual or dispute resolution remedies previously agreed between the relevant parties have been exhausted. A signatory country could also bring state-to-state arbitration against another signatory country regarding the interpretation of the transit obligation under Article 7 of the ECT. This would help ensure that the relationship between the two countries on a particular pipeline project is clearly delineated.

## *The Energy Charter has fewer signatories and is not focused on free trade*

The ECT also offers a right of private action. Therefore, companies can bring claims directly against a government without having to go through their own or another government. However, such private action could only be brought for investment disputes and not for transit disputes per se. If the transit dispute could be seen as an investment dispute, for example if a company had invested in a pipeline as well as supplied energy for the pipeline, the company may be able to bring a claim directly against the government of the transit country. To benefit from the potential dispute resolution mechanisms under the ECT, it is important for companies to consider the ECT protections in structuring contracts covering energy transit.

Some would argue that the existence of the ECT means that there is no need to apply the WTO rules to energy or to develop a specific energy agreement in the WTO. The ECT, however, has a much lower number of signatories and is not focused on free trade. Moreover, important energy players have not been involved in the design of the ECT and may therefore favour the start of a new initiative in the WTO, even if this would result in a less ambitious initiative. As remarked earlier, the ECT provides a regulatory framework. Its main advantage is that it supports the development of new transportation capacity and thereby facilitates the diversification of supply and of export.

### Enforcing transit rights |

WTO and ECT rules are binding for states. This means that energy companies that are

deprived of their rights to transit normally have to convince a government of a country that is a member of the WTO or ECT to raise this with the government of the country that is blocking the transit. However, even companies that are established in a country that is not a WTO/ECT member may have the possibility to invoke these rules. This could be done by convincing the government of a country in which they are also established, or where a partner in the project is established, and that is a member of the WTO or ECT (for instance in the user country), to raise the issue. Or it could be done by verifying whether it is possible to invoke WTO rules in a domestic legal action in the country refusing the transit. Countries that recognize the direct effect of WTO rules include, for instance, Argentina, Chile, Philippines and Venezuela. It may also be possible to invoke ECT rules in a similar manner in some countries. If this does not resolve the problem, the government of the relevant WTO or ECT member can initiate a formal state-to-state dispute settlement procedure.

In the field of energy, little practice exists relevant to the applicable international WTO and ECT obligations, and there can be disagreement as to the scope and meaning of these obligations. This absence of binding precedents may be a disadvantage, but could it also be worked to a party's advantage as the interpretation of the rules can still be shaped. Use of the WTO and ECT rules could certainly influence the current negotiations on South Stream and Nabucco. ■

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