FROM THE CONFERENCE: THE EFFECT OF THE YUKOS CASE & PROCEEDINGS ON THE EU-RUSSIA ENERGY RELATIONSHIP

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Participants at ESCP Europe Business School's conference on the EU/Russia Energy Relationship on 15th February, 2013, were treated to a wide-ranging discussion initially centred on the pending Yukos case that broadened to include developments that could dramatically change the relationship.

Dr Maxi Scherer, special counsel at international law firm Wilmer Hale, and Energy Law professor Dr Alan Riley from City University, London, painted a largely perilous picture of future policy-related developments for an audience of academics, students, journalists and energy analysts at the ESCP Europe campus in London.

The conference opened with the following note: there is not one single case, rather many Yukos-related disputes raised by various investors and treaties, the most famous being that which occurred in 2009. Dr David Chekroun, Professor of Economics, Law and Social Sciences at ESCP Europe and moderator for this discussion, compared the Yukos disputes with war or a tsunami.

The Background to the Dispute

Fully privatised in 1996, Yukos Oil Corporation OJSC was one of the biggest and most successful petroleum companies in Russia. On the verge of implementing its merger with Sibneft in 2003, Yukos was on its way to becoming the fourth largest oil company in the world.

In 2003, following a tax reassessment, the Russian government presented Yukos with a series of tax claims that amounted to almost 30 billion USD. With their assets frozen by the government, Yukos was unable to pay this tax demand, resulting in the Russian legal system declaring Yukos bankrupt in August 2006 and accusing it of being a "criminal enterprise". Its CEO, Mikhail Khodorkovsky was convicted of fraud and jailed; following this, oil and gas companies owned by the Russian government bought most of Yukos's assets at auction for a fraction of its previous worth.

Yukos claimed that the Russian government's actions were "unlawful, disproportionate, arbitrary and discriminatory, and amounted to disguised expropriation" of the company. The Parliamentary Assembly of the Council of Europe also condemned Russia's campaign against Yukos and its owners, labelling its reasons as manufactured for political gain and a violation of human rights. The suspicion was that the Russian government was frightened, firstly by Khodorkovsky's political career intentions, and secondly by the potential partnership of Yukos with a foreign investor: Exxon Mobil.

In 2005, Hulley Enterprises Limited, Yukos Universal Limited, and Veteran Petroleum Limited - which collectively owned over 60% of the shares in Yukos Oil Company - initiated three arbitration proceedings against the Russian Federation under the Energy Charter

Treaty (ECT), seeking compensation for an aggregate amount evaluated between 50 and 100 billion USD. Although the 2009 ruling on jurisdiction was in favour of the majority of Yukos shareholders, this decision only related to jurisdiction and was not merits; and due to substantial questions concerning expropriation, a final ruling will not be made for some time.

The Energy Charter Treaty and its Implication for the Yukos Case

The ECT is a multilateral convention which establishes a framework for cross-border co-operation, binding for 50 parties. The treaty covers all aspects of commercial energy activities, including trade, transit, investments, energy efficiency, and dispute resolution procedures. It contains substantial provisions on the protection of investments in the field of energy, and provides a dispute resolution mechanism through binding Investor-State arbitration, allowing investors to enforce their rights under the Treaty. The Russian Federation is bound by the ECT even though the Treaty was never ratified by the Russian Duma; as such, it is bound by the Investor-State arbitration provisions of the ECT. The legacy provisions of the ECT ensure that the Yukos ruling will apply to a wide range of existing energy investments in Russia for the next 20 years, as explained Maxi Scherer. This made the Russian Federation wonder if the ECT may well be an instrument due for replacement.

On one side, the Yukos dispute and the legacy provisions situation brought Russia to reassess the previous commitment it has taken in relation to the Charter, thus reassessing its relationship with Europe at the same time. On the other side, Russia, in particular, has increased its dependency for massive injections of foreign investment and know-how to rebuild its energy infrastructure. With this in mind, the Russian Federation may rethink its approach to the Charter: without such a treaty, there may be a reduced interest from foreign investors as well as a insecurity in the transit of the energy product to market. Given the problem of capital scarcity being reinforced by the economic crisis and the huge need for investment in the energy sector, providing reassurance for investors is vital. Moreover, with the advent of new gas competitors from LNG and unconventional gas, the expensive alternative pipeline strategy is threatened. A new ECT deal between the European Union and Russia may prove to be more vital to Moscow than Brussels.

More Factors Affecting the Future Energy Relationship

The Yukos dispute is perhaps simply the beginning of an evolving EU/Russia energy relationship, said Alan Riley, with the past relationship defined by mutual dependency; Russia needed to sell gas and oil to the EU, and the EU required Russian fossil fuels to power its economy. Russia's heavy dependence on high prices for fossil fuel exports maintains its current economic and political system, and it cannot easily withstand any diminishment in leverage over customers. However, leverage is not the only defining aspect of this relationship: for legal and value-based decisions, Europe could limit future opportunities to find negotiated solutions, turning what might have been minor issues in the past to enduring major obstacles in the future.

Alan Riley discussed three factors in particular that could affect the EU/Russia energy relationship. Firstly, the combined impact of the Yukos case and the European Commission's antitrust investigation of Gazprom, launched last September to punish Russian leaders deemed responsible for Russian auditor Sergei Magnitsy's death in 2009 (as well as the prospect of similar EU or member-country legislation). Secondly, the impact of the North American shale revolution and its direct and indirect effects on world gas and oil supplies.

With the development of spot prices, the European gas market already benefits from cheaper prices than those provided by Russian contracts. With the prospects of shale development both in Europe and worldwide already putting even more pressure on Russian gas pricing, it is likely that unconventional gas development will have an impact on Russian fossil fuel exports as well in the future. Third, as previously mentioned Russia requires massive future capital investments in its oil and gas industries, much of it non-Russian. A changed or changing energy relationship – one not based on mutual dependency, but rather one where Russia's leverage is significantly diminished – will most certainly affect the terms and forms of future investment agreements.

An Uncertain and Evolving Future Relationship

The convergence of multiple rule of law issues (to include Yukos), the impact of the growing shale revolution, and looming Russian external capital investment requirements threaten to upend the traditional EU/Russia energy relationship. Furthermore, a growing perception of Russian weakness could reduce Russian political and economic leverage over certain EU countries, feed traditional Russian cultural paranoia and affect Russian domestic politics, and increase the inability to find common agreement on non-negotiable EU legal realities. Russian hostility to European agreement could also accelerate the process of switching to alternative sources of energy. These factors have the potential to affect the EU/Russia relationship in ways that were unimaginable just a few years ago and complicate efforts to resolve differences.

One could argue that there is not an EU/Russia energy relationship. After all, EU member countries have bilateral gas agreements with Russia, and pricing practices between EU countries and Russia are non-uniform. On the one hand there are, in some instances, historically stable bilateral supply relationships dating from the Cold War years; on the other hand, there are, in other instances, strong resentment of Russian gas pricing practices and occasional politically-rooted gas supply disruptions. Even so, the current mutually dependent energy relationship between the EU and Russia, and between Russia and individual EU member countries, may be diminishing. This process may result in a new relationship wherein traditional rule of law and political imperatives no longer exist. While the evolving EU/Russia energy relationship will certainly differ to the current one, its future form remains to be seen.