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## Third Country Relations in EU Unbundling of Natural Gas Markets: The “Gazprom Clause” of Directive 2009/73 EC and WTO Law

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### I. Introduction

The liberalization of the natural gas market, its grid infrastructure in the European Union and the supply of energy is essentially built upon mutual trust among Member States. Traditional perceptions of national security and control make way to co-operation and integration among Member States and industries concerned. Under recently adopted legislation, it is readily possible that grid infrastructure will be controlled by companies located in another Member State, and gas will be equally traded in a company by non-national operators. However, since European gas supplies largely depend upon imports from abroad, in particular Russia, the relationship to third countries and grids and gas supplies controlled by these countries is of crucial importance. This paper addresses the status of third country operators in the EU. It describes obligations and conditions imposed by what was readily called the *Gazprom Clause* of Directive 2009/73/EC adopted July 13, 2009<sup>1</sup> (the Directive). It asks whether this clause amounts to a requirement of reciprocity and assesses whether the clause is compatible with current obligations of the EU under the World Trade Organisation (WTO), in particular the General Agreement on Trade in Services (GATS).

Article 11 of the Directive refers to the certification requirements for a transmission system operator from third countries. Article 11(a) requires a foreign operator to comply with all and the same conditions as EU operators under Article 9, in particular unbundling, while the second requirement under Article 11(b) requires that the granting of a certification does not jeopardize the security of energy supply.

The question arises to what extent the EU is entitled to impose additional requirements to third State operators under WTO rules. While the issue also bears upon free movement of capital – an issue not examined here – we conclude that the EU is entitled to operate privileged rules under Article Vbis GATS relating to regional integration. The third country clause, entailing additional conditions, neither establishes reciprocity nor is inconsistent per se with WTO law as no obligations to grant national treatment can be currently found in the field. Its operation, however, needs to take into account MFN obligations under Article II GATS. WTO Members are entitled that like and comparable operators are granted most favored nation treatment in the application of ownership rights. It is a question to what extent authorization can take into account diverging levels of supply and thus dependence. We argue that such differences affecting supplies and thus public security can be taken into account, either within MFN or under exceptions relating to public order and national security under Article XIV and XIVbis GATS respectively.

The paper sets out with a brief introduction to the EU internal market in natural gas and the concept of unbundling (II). It analyses the third country regime and assesses reciprocity (III) and thus leads to examination of WTO compatibility of the third country regime (IV). It concludes on a note proposing a future framework agreement in energy in the WTO (V).

### II. Setting the scene to EU internal market in natural gas

#### A. *Enhancing Competition and Efficiency*

The Commission has consistently argued that liberalisation increases the efficiency of the energy sector and the competitiveness of the European economy as a whole. Liberalisation

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<sup>1</sup> Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC (OJ L 211, 14.8.2009).

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of energy markets in Europe was supposed to facilitate consumers to freely select their gas suppliers and achieve competitive deals out of various providers.

While most member states had implemented the electricity and gas directives by September 2000, a Commission inquiry concluded that further measures were necessary in order to complete the internal energy market and to reap its benefits. The second gas and electricity directives, adopted in June 2003, includes 'unbundling', whereby energy transmission networks mandatorily have to be run independently from the production and supply side. According to the directives, markets for all non-household gas and electricity customers are to be liberalised by July 2004. For private households, the deadline is July 2007. After these dates, businesses and private customers would theoretically have been able to choose their power and gas suppliers freely in a competitive marketplace.

However, the majority of consumers still require a real choice as there have been a very few new entrants in the energy market due to "a number of serious malfunctions"<sup>2</sup>, which has been revealed by a Commission's enquiry into the energy market.<sup>3</sup> Among others the following shortcomings were identified:<sup>4</sup> a lack of liquidity, preventing successful new entry; an inadequate current level of unbundling between network and supply interests; customers being tied to suppliers through long-term downstream contracts. This compelled the EU Commission to propose a third energy liberalisation package.

### ***B. The Third energy liberalization package: Unbundling***

The proposed text of third energy liberalisation package was published in September 2007, it comprised European Commission recommendations for the reforms of EU electricity and gas regulatory frameworks and mainly aimed to enhance its transparency, competitiveness and flexibility of the European energy market.

The new energy liberalisation package contains main provision for separation of production and distribution operations ("unbundling") of vertically integrated energy companies. This new provision would be also applicable to foreign companies bidding to acquire a significant control or interest over an EU network which would have to adhere with the similar hiving-off needs as EU firms. The aim of unbundling is that it would not only end in increasing the competition but also in separation of grids. Then, grids can cooperate on a European level, and it is possible to support to construct a European grid.<sup>5</sup>

Originally, the package provided companies in the member states with two options for separating gas and electricity production from supply provision: ownership unbundling and independent system operator (ISO).<sup>6</sup> A third option, Independent Transmission Operator (ITO), was added later.

Unbundling is the process of separating production and supply of vertically joined transport activities in the monopolistic markets. Unbundling can be achieved from various ways such as using transportation system operators, legalizing bundling to separate enterprise from operators and full ownership unbundling.<sup>7</sup> Ownership unbundling involves division of the integrated vertical entities of network operations to be owned and managed separately. An

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<sup>2</sup> Europa press report, *Energy: Member States must do more to open markets; competition inquiry identifies serious malfunctions*, dated 15/11/2005, reference: IP/05/1421.

<sup>3</sup> The European Commission launched an inquiry into competition in gas and electricity markets in 2005, pursuant to Article 17 of Regulation 1/2003 EC.

<sup>4</sup> DG Competition report on energy sector inquiry, SEC(2006)1724, 10 January 2007.

<sup>5</sup> House of Lords, Parliament Standing Committee on EU, *The European Union and Russia*. The Stationery Office of UK, London, 2008

<sup>6</sup> See Common rules for the internal market in natural gas COM (2007) 0529, Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 and Access conditions to the gas transmission network COM (2007) 0532, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1775/2005.

<sup>7</sup> S.Nies, *Ownership Unbundling in Energy Markets –An overview of a heated debate in Europe – 2008*. Viewed on May 21,2009. Available at [http://www.ifri.org/frontDispatcher/ifri/publications/actuelles\\_de\\_1\\_ifri\\_1197584475485/publi\\_P\\_actuelle\\_editito\\_jan\\_\\_\\_1204897066616](http://www.ifri.org/frontDispatcher/ifri/publications/actuelles_de_1_ifri_1197584475485/publi_P_actuelle_editito_jan___1204897066616).

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independent system operator is the process of separating the operators to work individually from the original owner using the network assets on contracts.<sup>8</sup>

Transmission networks, under the scheme of full and 'legal unbundling', may still be managed by an integrated company but required to be administered by a diverse legal entity. According to the Commission, legal unbundling is unsatisfactory for the several reasons. One of these reasons relates to the network access. It was noted that the "basic conflict of interest" is not yet resolved by the legal unbundling which happens when giant integrated groups work with companies that require access to their own networks like storage facilities, gas pipelines etc.<sup>9</sup> Another problem lies with information flows, as network managers of the integrated company will be lured to release delicate information about the gas storage or pipeline first to either the generation or supply branch, rather than to competitors. And finally, present operators have an intrinsic interest in restricting investments in new network capacity if it entices new competition to their native market.

Ownership unbundling has seen many arguments in light of third energy liberalization package. It is generally accepted that ownership unbundling is more advantageous economically and will obviously improve the energy markets internally.<sup>10</sup> As a legal requirement, the authority should therefore accept its introduction since it reduces costs and enhances effective management. Ownership unbundling enhances competition; it also promotes solidarity in using the existing networks and limits the transmission boundaries.<sup>11</sup>

At the same time, it is argued that unbundling is not a panacea. Even though it is a recommended policy for the energy markets, it cannot work on its own efficiently.<sup>12</sup> Another challenging issue is whether ownership unbundling will truly result in improving network investments. Researchers have argued that there is no evidence guaranteeing success, and that it is not easy to identify the benefits from network ownership unbundling.<sup>13</sup>

Furthermore, there is a widespread concern that ownership unbundling will place the supply company in a weaker bargaining status vis-à-vis external energy source suppliers upon which they depend.<sup>14</sup>

The latter concern was addressed by introducing additional requirements applied to third country operators.

### **III. The Third Country Regime**

#### ***A. Scope of Obligations***

EU legislators see a serious threat posed to one of the fundamental interests of society – security of energy supply - in allowing persons from third countries to control a transmission

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<sup>8</sup> Frontier Economics, Further unbundling in European energy markets. Different types and approaches to ownership unbundling specifically in energy markets. February 2007. Viewed on May 21, 2009. Available at [http://www.frontier-economics.com/\\_library/publications/frontier%20paper%20-%20further%20unbundling%20in%20european%20energy%20markets%20-%20feb%202007.pdf](http://www.frontier-economics.com/_library/publications/frontier%20paper%20-%20further%20unbundling%20in%20european%20energy%20markets%20-%20feb%202007.pdf).

<sup>9</sup> Neelie Kroes, Improving Competition in European Energy Markets through Effective Unbundling, Federal Corporate Law Institute Annual Seminar, 2007.

<sup>10</sup> F. Lévesque and J. M. Glachant, European University Institute. September 20, 2007. Available at <http://www.energypolicyblog.com/?p=63>.

<sup>11</sup> F. Leveque and J.M. Glachant, *ibid* 2007.

<sup>12</sup> Regulating unbundled utilities is harder than regulating vertically integrated utilities and may require strong pro-competitive policies. See I.N. Kessides, Reforming infrastructure: privatization, regulation and competition, World Bank and Oxford University Press.

<sup>13</sup> M. Pollitt, The arguments for and against ownership unbundling of energy transmission networks. 7th August 2007. Viewed on October 21, 2009 Available at <http://www.electricitypolicy.org.uk/pubs/wp/eprg0714.pdf>.

<sup>14</sup> Neelie Kroes, Improving Competition in European Energy Markets through Effective Unbundling, Federal Corporate Law Institute Annual Seminar, 2007.

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system or a transmission system operator. In recital 22 of the Directive they elaborate this concern as follows:

“The security of energy supply is an essential element of public security and is therefore inherently connected to the efficient functioning of the internal market in gas and the integration of the isolated gas markets of Member States. Gas can reach the citizens of the Union only through the network. Functioning open gas markets and, in particular, the networks and other assets associated with gas supply are essential for public security, for the competitiveness of the economy and for the well-being of the citizens of the Union. Persons from third countries should therefore only be allowed to control a transmission system or a transmission system operator if they comply with the requirements of effective separation that apply inside the Community...The security of supply of energy to the Community requires, in particular, an assessment of the independence of network operation, the level of the Community’s and individual Member States’ dependence on energy supply from third countries, and the treatment of both domestic and foreign trade and investment in energy in a particular third country. Security of supply should therefore be assessed in the light of the factual circumstances of each case as well as the rights and obligations arising under international law, in particular the international agreements between the Community and the third country concerned.”<sup>15</sup>

Thus, the third energy liberalization package sets forth provisions for the prevention of control of transmission systems or their owners by companies from non-members of the European Union until they satisfy certain requirements. In order to regulate the open gas markets and ensure security of supply, Article 11 sets the certification requirements for a transmission system operator from third countries. The clause addresses concerns that ownership unbundling would lead to the acquisition of strategic EU energy transmission assets by foreign companies.<sup>16</sup> National regulators have the right to refuse certification of a transmission system operator controlled by an individual or group of individuals from a third country if the said company fails to comply with the following requirements:

“*Article 11*

Certification in relation to third countries

1. Where certification is requested by a transmission system owner or a transmission system operator which is controlled by a person or persons from a third country or third countries, the regulatory authority shall notify the Commission.

The regulatory authority shall also notify to the Commission without delay any circumstances that would result in a person or persons from a third country or third countries acquiring control of a transmission system or a transmission system operator.

2. The transmission system operator shall notify to the regulatory authority any circumstances that would result in a person or persons from a third country or third countries acquiring control of the transmission system or the transmission system operator.

3. The regulatory authority shall adopt a draft decision on the certification of a transmission system operator within four months from the date of notification by the transmission system operator. It shall refuse the certification if it has not been demonstrated:

(a) that the entity concerned complies with the requirements of Article 9; and

(b) to the regulatory authority or to another competent authority designated by the Member State that granting certification will not put at risk the security of energy supply of the Member State and the Community.”<sup>17</sup>

In considering the level of such a risk the regulatory authority should take into account:

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<sup>15</sup> Recital 22 of the Directive, OJ L 211/96 14.8.2009.

<sup>16</sup> Europa press release, *Energising Europe: A real market with secure supply*, reference: MEMO/07/361, Date: 19/09/2007

<sup>17</sup> OJ L 211/107.

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“(i) the rights and obligations of the Community with respect to that third country arising under international law, including any agreement concluded with one or more third countries to which the Community is a party and which addresses the issues of security of energy supply;

(ii) the rights and obligations of the Member State with respect to that third country arising under agreements concluded with it, insofar as they are in compliance with Community law; and

(iii) other specific facts and circumstances of the case and the third country concerned.”<sup>18</sup>

Implementing these provisions, the opinion of the Commission as to whether the applicant complies with the requirements of Article 9 and whether granting certification will not put at risk the security of energy supply to the Community is required.<sup>19</sup> The national regulatory authority eventually adopts its final decision on the certification. In doing so, the national regulatory authority has to take into account the Commission’s opinion to the utmost extent. In any event, Member States have the right to refuse certification where granting certification puts at risk the Member State’s security of energy supply or the security of energy supply of another Member State.<sup>20</sup>

This Article does not affect the right of Member States to exercise national legal controls to protect legitimate public security interests.<sup>21</sup>

In order to provide the national regulators with further information on the procedure to be followed for the application of this Article, the Commission may adopt the relevant guidelines.<sup>22</sup>

### ***B. Reciprocity or Conditionality?***

Reciprocity requirements were first applied between EU Member States, granting a country access to other Member States’ markets, provided that it equally opens its own market. This principle allows for the protection of markets against “free riders” who opted out from liberalising their energy market. It is recognised that reciprocity can play the role of a political instrument which moderates the market opening in the strategic sectors of economy.<sup>23</sup>

#### **1. UNBUNDLING REQUIREMENT**

The third liberalization package somehow extends the idea to third countries. Article 11(a) discussed above, requires a foreign operator to comply with all and the same conditions as EU operators under Article 9, in particular unbundling. The provision, however, is addressed to the foreign economic entity, and not the Government. It does not address foreign States as Article 9 para. 1 requires Members States to install a regime compatible with the requirements of unbundling. The provision therefore does not extend, in our view, obligations of reciprocity comparable to other regulatory areas. The clause is not comparable to reciprocity requirements found in access to electricity among Member States within the EU. Reciprocity has often been traditionally used as a tool for market opening, for example in the banking sector.<sup>24</sup> Foreign banks were allowed to operate subsidiaries to the extent only that

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<sup>18</sup> Article 11, para 3(b), OJ L 211/108.

<sup>19</sup> Article 11, para 5, OJ L 211/108.

<sup>20</sup> Article 11, para 8, OJ L 211/108.

<sup>21</sup> Article 11, para 9, OJ L 211/108.

<sup>22</sup> Article 11, para 10, OJ L 211/108.

<sup>23</sup> Andrei V. Belyi, *Reciprocity as a factor of the energy investment regimes in the EU–Russia energy relations*, Journal of World Energy Law & Business, 2009, Vol. 2, No. 2, p. 117.

<sup>24</sup> E.g. the 1934 Swiss Banking Act which states that permission to operate a foreign bank is made dependent upon the grant of reciprocal rights, subject to international obligations

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domestic banks were able to obtain licenses in the partner country. The same technique was applied in international law to organize air travel which is built of the reciprocal grant of landing rights.<sup>25</sup> Reciprocity, as a technique in international law essentially makes the granting of particular rights dependent upon the receipt of similar or comparable rights. Reciprocity is one of the oldest concepts in international law. It has a long history<sup>26</sup> and is commonly seen as one of the underlying principles of human conduct based upon *do ut des*.<sup>27</sup> It has been a main tool in international treaty making.<sup>28</sup> However, legal or strict reciprocity is essentially inconsistent with unconditional MFN and no longer can be used as a tool in order to enhance market access. For example, the EC in protecting geographical indications made registration within the EU dependent upon a comparable system of protection in the exporting country. The obligation was held to be inconsistent with the TRIPs Agreement.<sup>29</sup> While the WTO system is economically based upon reciprocity and the balance of concessions, rights and obligations, MFN excludes to qualify the system similarly in legal terms.<sup>30</sup>

It may be partly for such reasons that the EU refrained from formally imposing full reciprocity of unbundling requirements to third parties. The conditions imposed by Article 11(3) in accordance with Article 9 merely affect operations within the EU. In principle, they do extend to domestic regulation in third countries. In conclusion, the regime is, in our view, mistakenly called a reciprocity clause. It simply states that foreign companies need to comply with domestic regulations of unbundling with EU countries. Thus, a foreign monopoly company, in order to be allowed to operate in the EU, is required to separate grid operations from trading in EU countries and cannot impose its monopolistic structure. It is unclear as to how such unbundling within a foreign controlled operator will be enforced. EU law does allow one the same company to run both grid and trading operations provided that cross subsidization is avoided. While this can be monitored within the EU on the basis of competition rules (Articles 101-109 Treaty on the Functioning of the European Union), it is difficult to see as to how such control can effectively be exercised with foreign controlled companies, short of mutual cooperation in matters of competition control. Sanctions may be exclusively imposed on the foreign grid company or the supplier operating within an EU Member country.

## 2. SECURITY OF ENERGY SUPPLIES

The second condition for certification of the non-EU company is that its entry into the market does not jeopardize the interest of security of supply of the member state concerned or of the EU in general.<sup>31</sup> The text offers a wide range of considerations Member States and the Commission may take into account in assessing whether to allow a third-country company onto their territory. It requires a certification by the Member State that does not jeopardize the security of energy supplies of the Member and the European Union.

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to the contrary (“*Gewährleistung des Gegenrechts durch Staaten, in denen die Ausländer mit qualifizierten Bedingungen ihren Wohnsitz oder Sitz haben, sofern keine anderslautenden internationalen Verpflichtungen entgegenstehen*”), SR 952.0, see Thomas Cottier & Matthias Oesch, *International Trade Regulation: Law and Policy in the WTO, The European Union and Switzerland* (Cameron May & Staempfli, Berne, London 2005) p. 367.

<sup>25</sup> Koebele, *Commentary on Annex on Air Transport Services* in R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008, p.601.

<sup>26</sup> Keohane, Robert O., “*Reciprocity in international relations*”, in *International Organisation*, 1986, Vol.40, No.1, p.1-27.

<sup>27</sup> Serge-Christoph Kolm, *Reciprocity: An Economics of Social Relations* (Cambridge: Cambridge University Press 2008).

<sup>28</sup> Bruno Simma, *Das Reziprozitätselement im Zustandekommen völkerrechtlicher Verträge* (Duncker & Humblot: Berlin 1972).

<sup>29</sup> European Communities – Protection of Trademarks and Geographical Indications for Agricultural Products and Foodstuffs, Report of the Panel, 15 March 2005, WT/DS174/R.

<sup>30</sup> Thomas Cottier & Matthias Oesch, *International Trade Regulation: Law and Policy in the WTO, The European Union and Switzerland* (Cameron May & Staempfli, Berne, London 2005) p. 367.

<sup>31</sup> Recital 22 of the Directive, OJ L 211/96 14.8.2009.

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In assessing the situation, rights and obligations under international agreements and particular circumstances shall be taken into account. The provision essentially allows the EU to make the granting of a certification dependent upon adequate guarantees to offer and secure supplies or to secure transit rights. It allows the EU to impose open-ended conditions by which security of energy supplies is secured in return of rights to operate grids within Member States of the European Union. These obligations are in excess of what Members of the EU have to commit to. Providing energy supplies among Members is considered part of the system and supported by federal principles which are absent in relation to third countries. These additional obligations raise concerns with major partners, in the particular Russia.

### ***C. The Role of Russian gas in EU energy supply***

As the EU embarks on the third wave of energy reforms, political observers are cautioning that the gas sector must be administered with additional care as the present schemes may cause nervousness with Russia, Europe's largest gas supplier.<sup>32</sup>

The main European gas supplies are from Russia (42 %), Norway (24 %), Algeria (18 %), Nigeria (3,1 %), Libya (2,0 %), Qatar (1,4 %), Egypt (1,1 %) and others (1,7 %).<sup>33</sup> Moreover, the dependence of individual Member States on Russian gas differs significantly and for some member nations, it may amount up to 100% of all consumption.<sup>34</sup>

Gazprom is Russia's largest oil and gas company. It is said to control about 17% of the globes' gas reserves.<sup>35</sup> Gazprom contributes about one-fourth of Russia's tax revenues. Though, the company was government –owned initially, it was later converted into a joint-stock company in 1993. Initially, the Russian government had about 40 percent of its shares, which was increased to fifty one percent in 2003.

Two reasons have reiterated European cautioning of Russian energy blackmail. First, in January 2006 and then in 2009, Russia temporarily stopped the gas supply and Western European consumers were potentially strongly affected. Second, EU efforts to formalise energy relations with Russia did not succeed, Russia has consistently refused to sign any kind of binding agreements, such as the European Energy Charter Treaty. After numerous failed attempts to finalise bilateral energy co-operation agreements with Russia, the Commission proposed strict rules for energy relations with third countries. The move is widely seen to be targeted at Russian energy giant Gazprom.

## **IV. WTO Compliance**

### ***A. Scope of application of WTO law***

The two elements of the "Gazprom Clause" are examined below in light of its compatibility with international obligations under WTO Law. It goes without saying that WTO rights and obligations are granted only to its members.<sup>36</sup> Potential inconsistencies only apply in relation to WTO Members. At the moment of writing WTO consists of 153 members. From the main EU gas suppliers only Nigeria, Qatar and Egypt are WTO members, representing all together 5-6% of EU imports of gas. Norway is a Member, but falls under EU legislation as a Member of the EEA Agreement.

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<sup>32</sup> Eur Activ Network, Liberalisation of EU Gas Sector, retrieved 24 November 2009 <http://www.euractiv.com/en/energy/liberalisation-eu-gas-sector/article-171067>.

<sup>33</sup> Commission, Assessment Report of Directive 2004/67/EC on Security of Gas Supply, SEC (2009) 978 = COM (2009) 363, p. 63; Commission, Second Strategic Energy Review, Annex II: An EU Energy Security and Solidarity Action Plan, Europe's current and future energy position, COM(2008) 744 vol II, p. 7.

<sup>34</sup> House of Lords, Parliament Standing Committee on EU, The European Union and Russia. The Stationery Office of UK, London, 2008, p 47.

<sup>35</sup> Gazprom, Gasprom in figures 2004-2008, 2009.

<sup>36</sup> Thomas Cottier & Matthias Oesch, International Trade Regulation: Law and Policy in the WTO, The European Union and Switzerland (Cameron May & Staempfli, Berne, London 2005) p. 77.



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Non-member states can be granted an observer status.<sup>37</sup> The purpose of observer status is to allow a government to better acquaint itself with the WTO and its activities, and to prepare and initiate negotiations for accession to the WTO Agreement.<sup>38</sup> 30 nations are currently observers in the WTO, with the exception of the Holy See, they are in the accession process. The EC is a genuine WTO member. It had to accept the single undertaking of the agreements concluded during the Uruguay Round. The subsequent accession to the WTO is concluded upon agreement between the prospective member and the WTO. Protocols of accession vary in each specific case, concessions being negotiated bilaterally with interested members. Since Russia's accession has not been completed, and conditions negotiated into the future Protocol of Accession are not known to the authors, the analysis remains theoretical and is practical relevance only in relation to existing WTO members. Nevertheless, the analysis is of interest with a view of identifying existing shortcomings in WTO law and with a view to developing a agenda of reform in WTO on energy services.

### ***B. Status of gas under WTO law***

Traditionally, the energy industry did not distinguish between energy goods and energy related services. Market reforms resulted in a conceptual separation of goods and services trade. Hence, the need of the clear legal framework to address this distinction emerged.

Oil and solid fuels like coal clearly fall in the category of goods; they are easily stored and traded across borders.<sup>39</sup> The same applies to natural gas that like most other commodities can be stored for an indefinite period of time. Natural gas is extracted and traded via pipelines; local pipeline networks also allow its distribution to consumers. It can be stored in its gaseous form, however for its storage and transportation to geographically distant regions not served by pipelines, it is transformed in liquefied natural gas.

Within the existing WTO framework, production of energy goods comes within the scope of the goods agreements, while transmission, distribution and related services come within the scope of the GATS.<sup>40</sup> Trade in services includes the cross-border movement of the factors of production and the GATS provides legally binding rules (including MFN, national treatment, market access and domestic regulation) applying to the establishment and operation of energy services suppliers.

### ***C. Trade in services***

Energy transmission constitutes a service under WTO law. GATS aims at liberalisation of services trade, recognises the rights of member states to impose regulations related to their national policy objectives and takes into account the economic conditions and difficulties of the developing and least developed countries.<sup>41</sup> At the same time, WTO Members' GATS obligations serve as security that foreign services and service providers will be granted a certain level of market access and non-discrimination in the host WTO Member's territory.

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<sup>37</sup> WTO, Rules of Procedure for Sessions of the Ministerial Conference and Meetings of the General Council, 25 July 1996, WT/L/161, Annex 2.

<sup>38</sup> Ibid. para 3.

<sup>39</sup> For more on analysis of the current status of energy in WTO Law (oil, gas, coal and electricity) see T. Cottier et al, Energy in WTO law and policy, Synthesis report, May 2009. Available at <http://www.nccr-trade.org/images/stories/projects/ip6/IP6%20Working%20paper.pdf>

<sup>40</sup> WTO, Energy Services, Background Note by the Secretariat, S/C/W/52 (9 September 1998), para 36.

<sup>41</sup> The General Agreement on Trade in Services is included in the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, April 15, 1994, The Legal Texts: Results of the Uruguay Round of Multilateral Trade Negotiations (Cambridge University Press, Cambridge and New York, 1999).

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The GATS Agreement does not define the concept of a service as such.<sup>42</sup> However, what it identifies is four different ways to provide a service, usually referred to as the 'modes of supply'.<sup>43</sup> First, there is cross border supply of services. This indicates a service provided from the territory of one WTO Member to the territory of any other WTO Member, for instance, a supply of natural gas through pipelines. The second mode is consumption of a service abroad. In this case, a service is consumed in the territory of one WTO Member by a consumer from another WTO Member; this mode is less relevant for energy services. The third mode is the case of commercial presence wherein, a service supplier of one WTO Member has a commercial presence in another WTO Member's territory, for example, a company opening up a branch in the territory of another WTO Member with the purpose of engaging in producing, selling or supplying electricity and/or gas in that country. Under this mode, the supplier of the service is a locally established branch, subsidiary or representative office of a non-resident service supplier. While the actual service provision is by a resident entity, the investor is of foreign origin. Mode 4 is the supply of service through the presence of natural persons which involves a physical person of any WTO Member traveling to the territory of another WTO Member for the purpose of providing services.

It is recognised that liberalisation is more likely achieved when countries make commitments across all the relevant modes.<sup>44</sup> However, it is interesting to note that modes 3 and 4 essentially protect the investment.

The General Agreement on Trade in Services is composed of three elements: a core framework agreement containing general obligations and disciplines; annexes dealing with specific sectors rules; and individual Members' market access specific commitments (schedules), including the list of exceptions, indicating where the "most-favoured-nation" principle of non-discrimination is temporarily not applied.<sup>45</sup>

#### 1. GATS' GENERAL OBLIGATIONS AND MFN PRINCIPLE

GATS' general obligations are applicable to all WTO Members. This includes commitments on most favoured nation treatment (Art II GATS), which is the first provision of Part II of the GATS and is considered to represent the WTO's main effort towards liberalising energy markets among the member states.

The aim of the article is to put an obligation on the member states to treat other member states' service providers not less favorable than the treatment granted to any third country operator, whether or not it originates in a WTO member State. This means that any foreign service provider is entitled to receive similar treatment in the member state's marketplace: "with respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country".

MFN is based on a non-discrimination principle that is applicable to all scheduled and non-scheduled services.<sup>46</sup> An exception is granted under Article V to regional integration which, *inter alia*, allows to EU to operate privileged relations among Member States which need to be extended to third WTO countries, provided the provisions of Article V GATS are complied with. During the negotiations it was also decided that if a country otherwise chooses not to grant full unconditional MFN to other Members, it must list the exemptions in an Annex.

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<sup>42</sup> The GATT does not define the concept of goods either. It is worth mentioning that the GATT already contained some obligations regarding the treatment of some services whose discriminatory regulations distort the competitive situation of foreign goods in the importing country's market. A typical example is transportation, including transit services. See Arts III and V of the GATT 1994.

<sup>43</sup> Article I:2(a)-(d) of the GATS.

<sup>44</sup> See P.C.Evans, „Strengthening WTO member commitments in energy services: problems and prospects“, in A. Mattoo, P. Sauvé (eds), *Domestic regulation and services trade liberalization*.

<sup>45</sup> For more see T. Cottier, M. Oesch, *International trade regulation, law and policy in the WO, the European Union and Switzerland*, Cameron May, 2005, pp817-915.

<sup>46</sup> For a detailed review of Art II, including legislative history and commentaries on exceptions and exemptions, see R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008.

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## 2. GATS' SPECIFIC COMMITMENTS AND NATIONAL TREATMENT

Part III of the GATS attempts to capture a wide range of trade barriers to trade in services and establish a mechanism for scheduling specific commitments on them.<sup>47</sup> It is mainly composed of the market access and national treatment obligation articles. Unlike GATT, national treatment commitments in GATS are applicable only in so far as a Member has positively accepted them for a specific sector or sub-sector of services using the four modes of supply. This is being reflected in the 'schedules' of specific commitments.

Art XX of GATS requires each Member to maintain a schedule of the specific commitments it undertakes. Such schedule consist of two parts: Part I lists provisions that apply to foreign services and service suppliers of any service that has been schedules (horizontal commitments) and Part II sets out commitments undertaken for each listed sector or sub-sector (sector-specific commitments).<sup>48</sup> The schedule lists such sectors and sub-sectors in accordance with the Services Sectoral Classification List, discussed below.<sup>49</sup>

### ***D. Transmission and distribution services in the WTO classification system***

Energy services are not clearly identifiable in the schedule of commitments of WTO Members as commitments for other sectors like construction, distribution or financial services. While all these other services sectors are explicitly mentioned in the classification system used by GATS members (W/120), and are given separate entries, there is no specific entry for energy services. This does not mean that energy services are not covered by GATS, the agreement being based on the principle of universal coverage, but rather that these are covered under other categories and services sectors, to which they can be assimilated.

The existing GATS classification is based on the document "Services Sectoral Classification List", generally referred to as W/120, which was adopted during the Uruguay Round negotiations and represents the reference document that members should use for scheduling commitments, even if this does not represent an obligation. This document includes 11 major sectors which are subdivided into several sub-sectors and entries/activities. Each sector, sub-sector and activity is identified by an additional code which refers back to the detailed classification system of the United Nations, (i.e. the provisional Central Product Classification, hereinafter the CPC).<sup>50</sup> In addition to these 11 major sectors, the W/120 also includes an additional category of "Other services not included elsewhere" to cover all other services which cannot be identified in the enumerated sectors.

Currently, some of the energy related products and services are listed under different headings. "Transportation of fuel" described in CPC as "transportation via pipeline of crude or refined petroleum and petroleum products and of natural gas"<sup>51</sup> comes under the broad category of transport services which is not truly appropriate. It is a fact that transportation of energy-related products and services are very specific and technically complicated procedures, concerns of safety and security are always attached to it. Classifying energy services sector into a separate category will simplify the regulatory process for transmission and transportation of energy products and services. "Services Incidental to Energy Distribution"<sup>52</sup> are listed under "Other Business Services", and refers to "transmission and distribution services on a fee or contract basis of electricity, gaseous fuels and steam and hot water to household, industrial, commercial and other users".

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<sup>47</sup> Delimatsis and Molinuevo in R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008.

<sup>48</sup> For more see T. Cottier, M. Oesch, *International trade regulation, law and policy in the WO, the European Union and Switzerland*, Cameron May, 2005, p 833.

<sup>49</sup> WTO, *Services Sectoral Classification List*, Note by the Secretariat, 10 July 1991, MTN.GNS/W/120.

<sup>50</sup> The provisional Central Product Classification (CPC) of the United Nations is a complete product classification covering goods and services. It provides a framework for the international comparison of various types of statistics dealing with goods and services.

<sup>51</sup> CPC subclass 71310.

<sup>52</sup> CPC 88700.

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In the absence of a specific separate sector under the W/120, identifying and listing energy services appears quite problematic, mostly because the list of activities of the W/120 is too generic and non-exhaustive. Most importantly, the more comprehensive CPC provisional list of the United Nations, which the W/120 refers to, does not appear adequate to identify commercial energy activities and to represent the vast (and changing) horizon of energy services. Indeed, the CPC was drafted at the end of the 1980s, before the wave of reforms and reorganisation of the energy sector.

The problem of the classification and coverage of energy services was already addressed in a document of the WTO secretariat,<sup>53</sup> and it re-appeared when WTO Members submitted their negotiating proposals<sup>54</sup> at the beginning of the services negotiations in 2000. Most negotiating proposals included a comprehensive list of energy activities, but did not always provide an appropriate classification for all the activities.

Most of the negotiating proposals are drafted like model schedules where energy services cut across a very large number of services sectors of the W/120 existing classification. However, some energy activities did not find an immediate classification in the W/120 and the CPC. This does not mean that these activities are not covered under the existing classification or that they should be classified under "services not included elsewhere", but it raised the problem of clarifying the correspondence between the business activities in the energy sector and the specific GATS classification.<sup>55</sup>

In practical terms the fragmentation of different activities relating to energy service sector while placing them under different sub heading unnecessarily complicates trade in energy. In order to understand EU commitments and reservations for transmission and distribution of natural gas, one has to go to entirely different sub headings of the schedule. Considering that the energy sector consists of a chain of interrelated activities, an energy services supplier may likely need coherent market access rights in a number of relevant services sectors in order to adequately provide his service. While these services are spread throughout the classification system, the actual market access situation in a given market is quite unclear and may create unpredictability on the actual possibility to deliver the energy service effectively.

### ***E. Assessment of third-country certification requirements***

It is recalled that the "Gazprom Clause" in the 3<sup>rd</sup> Energy Package is only one of the requirements for service providers from third countries. Article 11 sets out two main criteria of certification: unbundling of transmission systems and transmission system operators and the security of supply risk assessment.

At the same time, certification procedure of domestic service supplier refers only to unbundling criteria and doesn't entail security of supply test. Hence, it is clear that foreign service suppliers are granted less favourable treatment. However, as it was noted above, national treatment applies only in sectors with specific commitments.

Since the energy services, including transmission, are not listed as a separate category in the WTO schedules of specific commitments, in order to determine the real level of market access for TSO from third countries it is necessary to examine EU schedules for a range of activities covered in "Other Business Services", transportation service sector and the limitations on market access and national treatment pertaining to the different modes of supply. Since EU did not include services related to gas transmission into its 'positive list' of specific commitments, this additional requirement to examine security of supply of the Member State and the Community does not violate its WTO obligations.

Nevertheless, given that the decision on certification of a third country TSO is made on a case by case basis, it is possible that two TSO from third countries satisfy unbundling

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<sup>53</sup> Background note of the WTO Secretariat on energy services, Document S/C/W/52, dated September 9, 1998.

<sup>54</sup> Negotiating proposals on energy services are available at the WTO website [www.wto.org/english/tratop\\_e/serv\\_e/s\\_propnewnegs\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/s_propnewnegs_e.htm).

<sup>55</sup> With a view to avoid the present confusion in the energy services classification, in the W/120, it is therefore advisable to identify the core energy services and confine the present negotiations in those areas. For more detailed proposal of classification reform see O. Nartova, 'Trade in Energy Services under WTO Law: The Impact of Competition Policies', PhD thesis University of Bern (2009).

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requirement, but only one of them passes certification. In this case, one might think of possible MFN violation. Nevertheless, if both approved and rejected third country TSO are WTO Members and the dispute settlement is initiated, EU could try justifying its certification decisions under general exceptions.

## **F. Exemptions**

### 1. 'PUBLIC ORDER' EXCEPTION

Quite often the protection of interests such as public order requires the adoption of trade-restrictive measures, which as a result conflict GATS obligations. WTO law seeks to establish a proper balance between different policy goals. In part such balance is sought to by allowing for general exceptions applicable to the provisions and commitments under an agreement. Art. XIV of GATS follows the model of Art. XX GATT 1994 which has been the cornerstone of the multilateral trading system allowing for the pursuit of other legitimate non-economic policy goals and, at the same time, avoiding the use of general exceptions to pursue rent-seeking, protectionist policies, undermining existing obligations and commitments.<sup>56</sup>

With respect to the burden of proof, the application of the provision follows the standard patterns of WTO law: after the complaining party has established a prima facie case of inconsistency with a GATS substantive obligation, the burden of proof shifts to the responding party if the latter claims an affirmative defence.<sup>57</sup>

In order to assess whether a certain measure is covered by one of the listed objectives of Art. XIV GATS or not, the following analysis should be made: first, the content or scope of a listed objective must be determined by examining if the specific policy goal falls within one of the listed public interests. Second, it must be analyzed whether trade in goods or services in question impairs or jeopardizes the achievement of the policy objective at stake.<sup>58</sup>

The Community considers that the gas transmission system sector is of high importance to the Community and therefore additional safeguards are necessary regarding the preservation of the security of supply of energy to the Community to avoid any threats to public order and public security in the Community and the welfare of the citizens of the Union.<sup>59</sup> Thus the policy objective of the EU is to protect its public order and security.

Art. XIV GATS embodies five legitimate public interests that can justify the government intervention with respect to trade in services.<sup>60</sup> This list is exhaustive and lit. a of this Article identifies the maintenance of public order as a justification that allows for a departure from the substantive GATS obligations.<sup>61</sup>

The term "public order" was defined in the *US-Gambling* case where the Art. XIV lit. a was invoked for the first time in GATT/WTO history. Based on the relevant dictionary definition in combination with the footnote 5, the Panel held that public order "refers to the preservation

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<sup>56</sup> Cottier, Delimatsis and Diebold, Commentary to Article XIV GATS, in R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008, p. 290.

<sup>57</sup> Appellate Body Report, *US-Gasoline*, WT/DS2/AB/R, 22-23;

<sup>58</sup> The complexity of either of the two analytical steps varies with respect to the nature of the specific interest set out in the relevant paragraph. These steps need to be distinguished from the Member's right to determine its own level of protection, which primarily relates to the question of the adequacy and necessity of a given measure in relation to the level of protection chosen by the Member. See more in Cottier, Delimatsis and Diebold, Commentary to Article XIV GATS, in R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008, pp 287-328.

<sup>59</sup> Recital 22 of the Directive, OJ L 211/96 14.8.2009.

<sup>60</sup> In comparison to ten in case of Art. XX GATT. For analysis of Art. XX GATT exceptions see S. Matteotti-Berkutova, "Oil supply management activities of OPEC under the WTO rules and national competition laws", PhD thesis University of Bern (2010).

<sup>61</sup> Art. XX GATT doesn't identify the public order justification. Thus, the GATS allows for greater regulatory autonomy than GATT 1994, as the public order justification is broad and fairly inclusive. This is further corroborated by footnote 5 to Art. XIV lit. a: "The public order exception may be invoked only where a genuine and sufficiently serious threat is posed to one of the fundamental interests of society."

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of the fundamental interests of a society, as reflected in public policy and law. These fundamental interests can relate, *inter alia*, to standards of law, security and morality”.<sup>62</sup>

The concept of public order is broad enough and actually includes public morals. It is however necessary to pay attention to the footnote 5 to the Art. XIV lit. a, which separates these two concepts. This footnote limits the scope of the public order exception with respect to the required seriousness of the threat on the one hand, and the importance of the interest of society at stake on the other hand.<sup>63</sup> Assume that a certain policy objective invoked by a Member qualifies as a matter of public order, but the objective at issue, or the threat it is exposed to, does not reach the level of importance or seriousness required by footnote 5. Any measure adopted in order to pursue this policy objective, therefore, not be justified under the public order exception.<sup>64</sup>

A measure found compatible with Art. XIV lit. a still has to comply with the requirement of applying a given measure in a manner that does not lead to “arbitrary” or “unjustifiable” discrimination, or a “disguised restriction” on trade in services, set out in the *chapeau* of the provision. Due to the very similar wording of the *chapeau* of Art. XIV GATS and Art. XX GATT, and similar functions of these provisions, the extensive GATT 1994 case law is to be applied *mutatis mutandis* for the interpretation of Art. XIV GATS.<sup>65</sup>

## 2. NATIONAL SECURITY EXCEPTION

The *US-Gambling* Panel’s reference to standards of security, mentioned above, must not lead to misapprehension that the public order exception also covers national security interests. Such interests are exclusively subject to Art. XIV<sup>bis</sup>, whereby only societal interests fall under Art. XIV lit. a.<sup>66</sup>

Art. XIV<sup>bis</sup> provides for three general security exceptions, which allow derogating from any of the GATS provisions for security reasons.<sup>67</sup> The perception of unfettered discretion cannot be sustained in connection with the security provisions of the WTO law. This perception and interpretation is not compatible with a rules-based system that seeks to ensure stability and predictability in the international trade order.<sup>68</sup>

Main uncertainty appears under Art. XIV<sup>bis</sup>:1 lit. b (iii) and the scope of the terms “other emergency in international relations”. It is also unclear whether this Article covers merely actual threats or, in addition, potential threats – this would be an important distinction applicable to the European energy security. Thus judicial restraints should be expected under this provision more than under any other GATS rule also due to the political sensitivity of the issues involved.<sup>69</sup>

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<sup>62</sup> *US-Gambling*, WT/DS285/R, para 6.467. See the US stance in paras 3.278, 6.458, where the United States equates the term “public order” to the concepts of “ordre public” in French law and “public policy” in common law.

<sup>63</sup> Cottier, Delimatsis and Diebold, Commentary to Article XIV GATS, in R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008. p. 300.

<sup>64</sup> *Ibid.*

<sup>65</sup> *Ibid.*, p 321; *US-Gambling*, WT/DS285/R, para 6.571.

<sup>66</sup> Cottier, Delimatsis and Diebold, Commentary to Article XIV GATS, in R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008. p. 299.

<sup>67</sup> Art. XIV<sup>bis</sup>:1: “Nothing in this Agreement shall be construed: (a) to require any Member to furnish any information, the disclosure of which it considers contrary to its essential security interests; or (b) to prevent any Member from taking any action which it considers necessary for the protection of its essential security interests: (i) relating to the supply of services as carried out directly or indirectly for the purpose of provisioning a military establishment; (ii) relating to fissionable and fusionable materials or the materials from which they are derived; (iii) taken in time of war or other emergency in international relations; or (c) to prevent any Member from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security.

<sup>68</sup> H.L. Schloemann and S. Ohlhoff, „Constitutionalization“ and Dispute Settlement in the WTO: National Security as an Issue of Competence, *AJIL* 93 (1999), p. 424, 425.

<sup>69</sup> Cottier, Delimatsis and Diebold, Commentary to Article XIV GATS, in R. Wolfrum et al (eds.), *WTO-Trade in Services*, Koninklijke Brill NV, 2008. p. 343.

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While measures adopted purely for security reasons qualify for an exception under Art. XIV<sup>bis</sup>, measures that serve a Member's essential security interests only in part, along with other interests, also fall within the ambit of this provision. To the extent that the measure contributes to securing essential security interests, it may be justified under Art. XIV<sup>bis</sup>. As with Art. XIV, the WTO judiciary is likely to apply a balancing test. The more essential a security interest is and the more the adopted measure contributes to its achievement, the more likely it is that the measure at hand will be justified under the security exception provision.<sup>70</sup> Members are to define their essential security interests in good faith, as they would otherwise undermine the continuation of the multilateral trading system.<sup>71</sup> Balance should be kept and Members should continue using the national security exceptions in very exceptional circumstances. Open markets are an important prerequisite of peaceful relations and thus an important ingredient in preserving peace.<sup>72</sup>

## V. Towards an Energy Agreement in the WTO

Energy security is essential for both daily operations, as well as long-term investments. The contemporary era has witnessed increasing concentration and awareness being paid to the issue.<sup>73</sup> There is large number of apprehension and fears, such as oil and fossil fuel depletion,<sup>74</sup> dependence on foreign resources of energy, solidity of nations which are energy suppliers, energy demands of developing countries and escalating competing demands from advanced developing countries, economic efficiencies and environmental issues. Globally, there have been several energy crises which have drawn attention towards energy security.<sup>75</sup>

Policies such as the promotion of energy efficiency, enhanced variety of supply, market reforms, etc are important tools for promoting energy security. Dependable and reliable legal frameworks are essential components that encourage investment and technology transfer that contribute towards the energy security.<sup>76</sup>

At the moment, regulation of international energy trade is highly fragmented with multiple instruments involved. It is noted that the bulk of regulation is with domestic law, and the role of regional and global law in addressing energy and secure production and supplies has remained unclear and unsettled. Doctrines of multilayered governance hardly have been applied to the sector.<sup>77</sup>

The examination of third country relations in liberalising gas markets in Europe shows that international disciplines channelling access and providing legal security are insufficiently developed. Energy services are insufficiently scheduled, and recourse to national security interests offers large avenues to escape policies of non-discrimination. The problems of

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<sup>70</sup> Ibid, p. 339.

<sup>71</sup> H.L. Schloemann and S. Ohlhoff, „Constitutionalization“ and Dispute Settlement in the WTO: National Security as an Issue of Competence, *AJIL* 93 (1999), p. 424, 444.

<sup>72</sup> T. Cottier and A. Dengg, *Der Beitrag des Freien Handels zum Weltfrieden*, *Basler Schriften zur Europaeischen Integration* No. 81 (2006), p. 41.

<sup>73</sup> De Vries, Bert J., van Vuuren, Detlef P. Hoogwijk, Monique M., 'Renewable energy sources: Their global potential for the first-half of the 21st century at a global level: An integrated approach', *Energy Policy*, vol. 35, no. 4, 2590-2610 (2007).

<sup>74</sup> Botchway, Francis N., summer 2001, *International Trade Regime and Energy Trade*, 28 *Syracuse Journal of International Law and Commerce* 1, pp 9-10.

<sup>75</sup> Milford, Lewis, Allison Schumacher, and Marc Berthold. *A Possible Turning Point for Climate Change Solutions: How Innovations in Investment, Technology and Policy Are Needed for Emissions Stabilization*. Montpelier, VT: Clean Energy Group; Berlin, Germany: Heinrich Boll Foundation, 2005.

<sup>76</sup> T. Pollitt, M., 'Security of supply and regulation of energy networks', *Energy Policy*, vol. 36, no. 12, 4584-4589 (2008).

<sup>77</sup> T. Cottier et al, *Energy in WTO law and policy*, NCCR Working Paper No 2009/25, May 2009. Available at <http://www.nccr-trade.org/images/stories/projects/ip6/IP6%20Working%20paper.pdf>

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energy security as well as the efforts to overcome unnecessary fragmentation in energy regulation can best be addressed in seeking comprehensive negotiations within the WTO. As much as specialized agreements emerged over time under GATT, deepening and addressing specific issues, such as trade in agriculture, or technical barrier to trade, specialized and sectoral agreements also offer an avenue to address specific problems of specific sectors which need special attention. In the field of energy, access to energy grids calls for shared disciplines on unbundling, comparable to the reference paper in telecommunication.<sup>78</sup> We submit that future negotiations should turn to work on a comprehensive sectoral agreement on energy.<sup>79</sup>

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<sup>78</sup> O. Nartova, 'Trade in Energy Services under WTO Law: The Impact of Competition Policies', PhD thesis University of Bern (2009).

<sup>79</sup> T. Cottier et al, *Energy in WTO law and policy*, NCCR Working Paper No 2009/25, May 2009. Available at <http://www.nccr-trade.org/images/stories/projects/ip6/IP6%20Working%20paper.pdf>