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The Yukos Decision: Profound implications for the EU-Russia energy relationship?

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Following the bankruptcy of the oil giant Yukos by the Russian Federation in 2004 on grounds of alleged tax evasion, the majority shareholders GML (originally Group Menatep Limited), together with the Yukos pension fund, filed an arbitration suit against the Russian Federation. The suit was filed under the Energy Charter Treaty (ECT), the world's only multilateral investment treaty. GML relied on the investor protection provisions of the ECT to argue that it had been expropriated and sought recovery for all losses, which may well top $100 billion. The Russian Federation argued that the ECT did not apply as Russia had signed but not ratified the Charter. However, fatally for its case, Russia had accepted provisional application of the Treaty from the date of signature. It was on this basis that the arbitrators held that the ECT applied in full to Russia. There is now expected to be a hearing on the merits of the case in the next couple of years. At first sight this ruling looks like a pyrrhic victory for Yukos, particularly after the Russian withdrawal from provisional application of the Charter in October. However, on closer examination, this ECT case is likely to have a significant impact on the EU-Russia energy relationship for at least the next two decades, and may well result in the Russian Federation reconsidering its approach to the Charter.

It could at first sight be argued that the 30th November decision in favour of Yukos shareholders under the investor protection provisions of the Energy Charter Treaty in *GML v. Russian Federation* is the pyrrhic victory of pyrrhic victories. And at first sight the ruling on jurisdiction in favour of the Yukos shareholders in respect of a $100 billion claim for expropriation does look like it will not have much real world effect. Sceptical commentators can argue that while the ruling may improve the morale of Yukos shareholders, this decision is not going to result in any payment by Russia for the expropriation of Yukos assets. It of course true that enforcement of any final ruling in Russia would be problematic to say the least. However, that does not mean that the GML ruling does not provide a vital first step to recovery for the shareholders. It is also clear that the ruling has a significant broader impact on the EU-Russian energy relationship.

While recovery of any assets would be extremely difficult in Russia, if a final decision on the merits in the shareholders' favour is handed down (no final ruling is expected for at least two years) it could be enforced outside Russia. Ironically the political and industrial strategy adopted by former President, now Prime Minister Putin, over the last decade makes execution against Russian assets easier than many

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investment cases against sovereign states. The principal assets owned by most states outside its own jurisdiction are diplomatic, cultural and military assets – all protected by sovereign immunity. However, the strategy adopted by Premier Putin has been to acquire significant state shareholdings in a range of Russian energy and commodity businesses, and then encourage those firms to go on to acquire significant overseas assets. This strategy may well permit firms like Gazprom to capture more of the energy value chain and increase Russian commercial and political influence. Unfortunately by creating classes of assets outside Russia that are owned by state-owned Russian companies that are not able to benefit from sovereign immunity, the Kremlin has created attractive targets for seizure by Yukos shareholders. Execution could be enforced against Russian assets in any court in Europe or North America with a significant chance of success. One of the first effects of the jurisdiction ruling is likely to be a greater degree of Russian caution as to where and how state-owned Russian energy companies invest. For example, it is very doubtful that we will now hear any more discussion of Gazprom acquiring British energy company Centrica.

The broader legal implications of the case focus on the ruling of the panel that the Russian Federation is bound by Article 45(1) of the ECT. Article 45(1) provides for provisional application of the Charter from date of signature. Provisional application is a well-known procedure under international law, which allows states to benefit from the immediate legal effect of treaties without waiting for the often laborious and politically fraught process of ratification.

Despite a strong Russian defence, the Russian position was always vulnerable to legal challenge. One major point overlooked in the debates over the application of the Charter to Russia was that Article 45(1) was a voluntary provision. The Russian Federation did not have to accept Article 45(1). Indeed, Norway refused to accept Article 45(1) and was never in fact provisionally bound by the ECT. By accepting that the ECT would be fully legally binding from signature and thereby make the provisions on investor protection contained in the Charter fully applicable to Russia, it hoped that foreign investment would flow into the country.

It could however be argued that, notwithstanding this finding, the decision cannot have any broader effect because in July the Russian Federation formally withdrew its consent to provisional application. This came into force on 19th October, and therefore from that date the Russian Federation is no longer bound by provisional application rules of the Charter.

While this withdrawal does have legal effect on all new energy investments made after 19th October, it has no effect on all *prior* investments. Under the legacy provision of the ECT on withdrawal from provisional application, the binding effect of the Charter remains in place for twenty years. In other words, the Russian Federation is bound under the investor protection provisions of the ECT for all existing investments until 19th October 2029.

It is the legacy provision that makes the Yukos decision of 30th November so significant. As a consequence of the *GML v. Russian Federation* case it is now very clear that Russia is fully bound by the ECT for all energy investments made prior to 19th October 2009. As a consequence, the decision has significantly strengthened the legal protection of a wide range of European companies with energy investments in Russia, from BP, to Shell, to Total, to RWE and E.ON.

In fact there is a strong case for saying that by withdrawing from provisional application the Russian Federation has managed to achieve the worst of all possible worlds. As a result of the GML case it now bears the burden of significant investor protection provisions for the next 20 years, while at the same time by withdrawing from the ECT it has thrown away the advantage of encouraging new investment gained by full compliance with the Charter.

In respect of the GML case itself, it is likely that ultimately neither side will actually want the embarrassment or media frenzy of the execution of arrest warrants of Russian assets all over North America and Europe, and a private settlement will be arrived at.

However, the broader predicament created by the ruling, combined with Russia's need for capital in the energy sector, is likely to result in a reconsideration in Moscow of the Russian approach to investor protection and the ECT. The numbers are compelling. The International Energy Agency estimated that the Russian Federation needed to invest $157 billion in new generating capacity, and approximately $200 billion in new electricity transmission networks. It is not only in the electricity sector that huge sums and high oil prices – well beyond the means of Russia – are required. In the gas market, to open up major new gas fields such as Yamal, Cambridge Energy Research Associates estimate that Gazprom needs to invest approximately $200 billion, most of which is upfront in the building of roads and pipelines across Siberia, before a single molecule of gas can reach consumers.

Furthermore, domestic sources of capital are likely to be limited. The domestic Russian banking system prior to the financial crisis was unable to provide the scale of capital required to develop the natural gas and oil sectors. The Russian energy majors relied on their own cash flows and foreign capital. Given the damage suffered by Russian banks in the crisis, it is difficult to see how those banks are going to be able to act as a major source of capital to the energy sector. It is also difficult to see how the energy majors such as Gazprom can easily generate the cash themselves on the scale necessary to complete the investment and infrastructure projects it needs to keep the gas supply flowing. Gazprom particularly has difficulties, as it is dragged down by $40 billion of corporate debt and is facing significant and potentially long-lasting gas to gas competition.

One option for Russia is to argue for an ECT Plus, which recognises key Russian interests. Russia does have significant leverage that it can bring to bear to reform the ECT in return for compliance with its core rules in terms of market access to Russian energy markets. The Russian Federation should be able to negotiate a revised ECT which, while it recognises investor protection rules, gives Russia and the European Union (now granted partial competence under the Lisbon Treaty amendments in relation to investor protection rules) a greater role in the development of the ECT.

For any state so dependent on energy resources for export income as Russia, a multilateral investment treaty such as the ECT is vital. Without such a treaty foreign capital is far less likely to be willing to invest and the transit of energy products to market is insecure. It may well be time, following the GML ruling for Moscow, to rethink the approach it has been taking to the Charter and its broader energy relationship with the European Union.