

**Gas Transit through Georgia
in the light of Energy Charter
and Energy Community provisions**

by Tamar Tsurtsunia



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Table of Contents

Abbreviations	8
Introduction	10
Scope of Work.....	10
Background.....	11
Chapter 1.	
Information on Natural Gas Transport infrastructure and transit flows in Georgia.....	16
1.1 Supply Sources/Existing Contracts	18
Chapter 2.	
Existing multilateral/bilateral legal frameworks for trade and transit of natural gas and cross-border transport infrastructure	22
2.1 GATT/WTO agreements and the Energy Charter Treaty	22
2.1.1. Most-favoured-nation treatment (MFN).....	22
2.1.2 National Treatment	23
2.1.3 Freedom of Transit.....	23
2.1.4 Differences between GATT and the ECT.....	26
2.1.5 Exceptions provided to members of Customs Unions and Free-Trade Areas	26
2.1.6 Access conditions to transmission infrastructure and tariffication within the ECT constituency.....	27
2.1.7 The Energy Charter draft Transit Protocol	28
2.1.8 The role of the Energy Charter in cross-border trade and cooperation in the South Caucasus	28
2.1.9 Investment protection under the ECT	29
2.2 Bilateral Trade Treaties/FTAs.....	30
Chapter 3.	
Access conditions for the utilization of transport infrastructure in Georgia.....	32
3.1 Transportation Tariffs for Gas.....	32
3.2 Third Party Access (TPA).....	32
3.3 Access to cross-border Gas Transportation Infrastructure.....	33
3.3.1 Regulatory regime applicable to the South Caucasus Pipeline (SCP) passing through Georgia’s territory.....	33

Chapter 4.

Energy Community legal framework with regard to the utilization of transport infrastructure and cross-border energy trade.....	36
4.1 Regulation (EC) No 715/2009 of 13 July 2009 on conditions for access to natural gas transmission networks.....	36
4.2 'Transit' in EU Energy Law/Energy Community Treaty	37
4.3 Potential conflict between EU Energy Law (Third Energy Package) and existing long-term transit contracts.....	37
4.4 Basic requirements of EU Competition Rules (Art. 101-102)/EnC Treaty (Art. 81-82).....	38

Chapter 5.

Implications of the implementation of Energy Community regulations with regard to cross-border gas trade in Georgia.....	42
5.1 Legal convergence/shortcomings	42
5.1.1 Cross-border capacity reservation.....	42
5.1.2 Compliance of access conditions to cross-border transmission (South Caucasus Pipeline) with the requirements provided by GATT Article V/ECT Article 7 and Regulation (EC) 715/2009.....	42
5.2 Geographical scope/prospects for harmonized cooperation/approach at the regional level	44
5.3 Possible risks and potential benefits.....	45
5.3.1 Isolation in terms of Security of Supply (Energy Community Mechanism for Safeguarding Security of Supply)	45
5.3.2 Application of Energy Community/EU competition rules to agreements between undertakings in Georgia	47
5.3.3. The South Caucasus Gas Pipeline as an important component for Security of Supply (SoS).....	48
5.3.4. Effects of Energy Charter Treaty investment protection on regulatory changes pursuant to the Energy Community membership of Georgia	51

Chapter 6.

Indicative guidelines for handling MFN and national treatment under the Energy Community regime	54
Summary of main findings	58

Abbreviations

Abbreviations

AA	Association Agreement
AGRI	Azerbaijan-Georgia-Romania Interconnector
BTC	Baku Tbilisi Ceyhan (Pipeline)
CU	Customs Union
DCFTA	Deep and Comprehensive Free Trade Agreement
DSO	Distribution System Operator
ECT	Energy Charter Treaty
EnC	Energy Community
ECU	Eurasian Customs Union
EWGP	East-West Main Gas Pipeline of Georgia
FTA	Free Trade Agreement
GOGC	Georgian Oil and Gas Corporation
GGTC	Georgia's Gas Transportation Company
GNERC	Georgian National Energy and Water Supply Commission
GATT	General Agreement on Tariffs and Trade
GATS	General Agreement on Trade in Services
GSA	Gas Supply Agreement
HGA	Host Government Agreement
LNG	Liquefied Natural Gas
MFN	Most-Favoured-Nation treatment
NSGP	North South Gas Pipeline
Option SPA	Option Gas Sales and Purchase Agreement
PCI	Project of Common Interest
SOCAR	State Oil Company of Azerbaijan Republic
SCP	South Caucasus Gas Pipeline
SCPX	South Caucasus Gas Pipeline Expansion Project
Supplemental SPA	Supplemental Gas Sales and Purchase Agreement
SoS	Security of Supply
SEE	South East Europe
TANAP	Trans Anatolia Natural Gas pipeline
TAP	Trans Adriatic Pipeline
TPA	Third Party Access
TSO	Transmission System Operator
WTO	World Trade Organization

Introduction

Introduction

Scope of Work

Georgia ratified the Energy Charter Treaty (ECT) in 1995. Since then, cross-border energy trade and transit activities in Georgia have been regulated within the Energy Charter multilateral legal framework.

In January 2013 Georgia applied for membership in the Energy Community, which is the basic platform for Southern and Eastern European markets for access to the common energy market of the European Union.

The main purpose of this report is to assess the core pillars of the new legal framework provided by the Energy Community Treaty (EnC Treaty) and EU Energy Law with respect to cross-border gas trade and access conditions for natural gas transportation infrastructure. At the same time, it seeks to distinguish the differential treatment provided in the existing multilateral legal frameworks (ECT and GATT/WTO) and the EnC Treaty/EU rules with regard to transit and cross-border trade. The report shows in particular how the EnC Treaty/EU energy rules may be implemented in the geographically isolated energy market of Georgia with respect to gas transit pipelines crossing the territory of the country, taking into account Georgia's existing commitments in the WTO and the Energy Charter Treaty (ECT) and, to the extent possible, the Association Agreement concluded between Georgia and the EU on 27 June 2014. Electricity is only addressed to the extent it falls under general trade measures of an agreement analysed in the report.

Regulation of grid-bound energy significantly differs from that of other sectors in that it is closely linked to the transportation grid (e.g. pipelines, compressor stations, etc.). The report assesses the possible implementation of EnC Treaty/EU energy rules with respect to cross-border trade in an isolated energy market such as Georgia's, and analyses it as a potential future member of the Energy Community constituency with the viewpoint of bringing sufficient benefits in terms of Security of Supply (SoS) to the country and, subsidiarily, to the region.

The main point is that, unlike in EU Energy Law, the Energy Charter Treaty, which for Georgia is the foundation for predictable, stable and non-discriminatory energy trade, does not impose any specific market structure and detailed regulatory framework for the management of energy transport infrastructure and trade. Rather, it concentrates on international transit of goods as an important factor for international energy trade, and on some basic WTO principles incorporated in the ECT.

Differently from the ECT, the Energy Community Treaty/EU Energy Law is aimed at creating a common single market with shared responsibilities and approaches toward Security of Supply (SoS) at the regional level. As a result of the EU's single market without internal borders, the concept of international transit is lacking in EU Energy Law (and hence in the EnC Treaty). The latter completely abolishes differential treatment of transportation of energy goods within the internal borders, but introduces instead the concept of an independent Transmission System Operator (TSO). Such an approach is considered justified in the EU market where Member States want to abolish internal borders and have a common external border.

The report analyses what this means for Georgia, which is geographically isolated from the rest of EnC and EU energy markets and has no common border with any EU or EnC members.

The present report does not provide a full assessment of the entire set of requirements of the Energy Community/EU Energy Law related to regulatory gas market models. Rather it focuses

on the core elements included in Regulation 715/2009 (EC) concerning the access conditions to natural gas transmission networks and cross-border gas trade. This Regulation reflects the importance of regional market integration and, unlike the ECT, illustrates the relevance of geographical proximity within the constituency of the Energy Community for the full implementation of the requirements and improvement of Security of Supply (SoS).

In order to better understand the main implications of the implementation of this new legal regime in Georgia, this paper is confined to the following aspects. Firstly, it reviews the existing multilateral legal frameworks of ECT and GATT/WTO rules with regard to cross-border energy trade and the regulatory regime applicable to the natural gas (internal and cross-border) transportation system in Georgia. Secondly, it examines the rules of the Energy Community/EU and their possible application in the (geographically isolated) energy market of Georgia in particular, with respect to existing contracts (between the government of Georgia and investors) related to gas transportation flows. In this context, prime attention will be paid to the main cross-border gas pipeline passing the territory of Georgia, the South Caucasus Gas Pipeline (SCP). The paper also address how ECT investment provisions affect regulatory changes pursuant to the Energy Community membership of Georgia.

Background

Since 1991, shortly after the collapse of the Soviet Union, the main priority of the foreign policy of Georgia has become Euro-Atlantic integration. In this regard, the European Energy Charter was signed in December 1991, followed by the Energy Charter Treaty in December 1994. The first EU-Georgia 'Partnership and Cooperation Agreement' (PCA¹) was signed in 1996 and entered into force in 1999. In 2004 Georgia joined the 'European Neighborhood Policy' (ENP²) and since 2009 it has been an active participant of the 'Eastern Partnership Platform'³ (together with Azerbaijan and Armenia). On 28 November 2013, during the 'Eastern Partnership' Vilnius summit, Georgia initialled an Association Agreement (including the Deep and Comprehensive Free Trade Agreement (DCFTA⁴)) with the European Union. These comprehensive Agreements, which were signed by the parties on 27 June 2014, are part of the 'bilateral' (between the EU and members (Georgia)) dimension of the Eastern Partnership initiative, which also envisages cooperation in a 'multilateral' format together with all participants.

The DCFTA is a type of Association Agreement (AA) used by the EU as main instruments to bring the countries in the Eastern Partnership closer to EU standards and norms. The DCFTA is comprehensive, covering all areas of interest. It offers enhanced cooperation in almost all policy areas, including political dialogue and cooperation in the field of foreign and security policy, a chapter on justice, freedom and security, a chapter on trade and trade-related matters, chapters on economic cooperation, financial assistance and anti-fraud provisions, as well as on institutional provisions. Of particular importance for this report is the chapter on trade and trade-related matters. It includes a specific chapter (11) on energy⁵, applicable to oil, natural gas and electricity, restating inter alia the engagements of both sides in the ECT and WTO agreements and some substantive parts of the ECT draft Transit Protocol. It also states that in case of conflict between this chapter and the Energy Community Treaty, the latter shall prevail, in case Georgia will become a member of the Energy Community. The DCFTA also

1 Official Journal L 205 , 04/08/1999 P. 0003 – 0052, European Union, External Action

2 EU/Georgia Action Plan, European Union, External Action

3 Joint Declaration of the Prague Eastern Partnership Summit, 7 May, 2009

4 http://eeas.europa.eu/georgia/assoagreement/assoagreement-2013_en.htm. Note that this is a provisional version, subject to scrutiny by both sides.

5 http://eeas.europa.eu/georgia/assoagreement/pdf/ge-aa-title-iv-trade-related-matters_en.pdf (provisional version, subject to scrutiny)

contains a chapter (13) on Trade and Sustainable Development and a chapter (14) on Dispute Settlement. The latter creates specific dispute settlement mechanisms, including remedies for urgent energy disputes. The Annexes to the AA/DCFTA⁶ provide for an extensive list of areas where approximation of national legislation of Georgia with the EU legislation is convened. No approximation has been agreed concerning the two directives and three regulations that are part of the EU third energy package⁷ nor the specific directives and regulations of the second energy package⁸. The Annexes however provide for a large list of reservations made by parties, including on energy services (all modes).

With the purpose of advancing the integration process in the region, the government of Georgia officially applied for membership in the Energy Community, which serves as a basic platform for the countries willing to join the European Union and its energy market. The Energy Community extends the European Union's internal energy market to South East Europe (SEE). The signatories of the Energy Community Treaty agree to implement the *acquis communautaire* related to natural gas, electricity, competition, renewables, and energy efficiency, with the purpose of implementing the key priorities of the Treaty and creating a regional gas and electricity market within South East Europe.

According to the official statement of the government, Georgia pursues the following objectives when acceding to the Energy Community:

- ***Enhancing the integration process in the EU energy market***, as it serves as a platform for sharing experiences with member countries close to Georgia with their market structure and experience.
- ***The membership will contribute positively to the improvement of the investment climate in the sector*** through increasing reliability.
- ***Facilitate access to funds of the energy community***, as well as international financial institutions, which are defined for the members of this organization.
- ***Increase energy security***, as the contracting countries of this community have mutual obligations during the emergency situations.
- ***Enhance the development of renewable and clean energy sources*** of Georgia, which possesses a large unused hydro potential and, as a producer of clean energy, is intending to trade its resources with European markets through (via the Black Sea Transmission Line) Turkey and develop mutually beneficial relations.

Shortly after the official application of Georgia to join the Energy Community it was revealed that neither Azerbaijan nor Armenia is intending to sign Association Agreements (AA) with the EU, as had been expected before. Instead Armenia announced its intention to enter a completely different legal regime of the Eurasian Customs Union (ECU⁹), which is wholly incompatible with the AA/DCFTA content. While a DCFTA provides for a reduction of tariffs, CU membership entails their rise. Azerbaijan officially announced its intention to sign a new agreement (Strategic Modernization Partnership) instead of the originally planned Association Agreement, on account of which Azerbaijan will not join the EU's free trade zone and neither follow the approximation policy of the AA. As far as Turkey is concerned the country concluded an

6 http://eeas.europa.eu/georgia/assoagreement/pdf/ge-aa-annexes-part-i-annexes-i-to-xv_en.pdf (provisional version, subject to scrutiny)

7 Directive 2009/72/EC, Directive 2009/73/EC, Regulation (EC) No 714/2009, Regulation (EC) No 715/2009, Regulation (EC) No 713/2009

8 Directive 2003/54/EC, Directive 2003/55/EC, Regulation (EC) No 1228/2003, Regulation (EC) No 1775/2005

9 Statement by Serzh Sarkisian, President of the republic of Armenia, 3 Sep. 2013, Moscow

Association Agreement with the EU in 1963¹⁰, which has been extended to a Customs Union with the European Union in 1995¹¹. The scope of this customs union, based on the status of goods in free circulation in either side, is limited to industrial products (including natural gas¹², but not electricity) and processed agricultural products. Uncertainties remain with regard to Turkey's membership in the Energy Community and the EU¹³.

Bearing in mind all the above, this report intends to assess the regulatory aspects of the Energy Community Treaty with respect to cross-border energy (especially gas) trade and transportation, and its possible implementation in the energy market of Georgia in the Caucasus region.

10 http://eur-lex.europa.eu/en/dossier/dossier_07.htm#1

11 Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union

12 cf. e.g. 2009/ 403/ EC: Decision No 1/ 2009 of the Joint Committee established under the Agreement between the European Coal and Steel Community and the Republic of Turkey on trade in products covered by the Treaty establishing the European Coal and Steel Community of 24 February 2009 amending Protocol 1 to the Agreement

13 EU Turkish Energy Relations in the Context of EU Accession Negotiations: Focus on Natural Gas, by David Koranyi and Nicolo Sartory, Atlantic Council Dinu Patriciu Eurasia Center and Istituto Affari Internazionali (IAI), December, 2013. Chapter: Energy and Negotiations with the EU

Chapter 1. Information on Natural Gas Transport
infrastructure and transit flows in Georgia

Chapter 1. Information on Natural Gas Transport infrastructure and transit flows in Georgia

Even though Georgia is not an important energy producer, it is a significant transit country in terms of its geostrategic position between Western Europe and Central Asia.

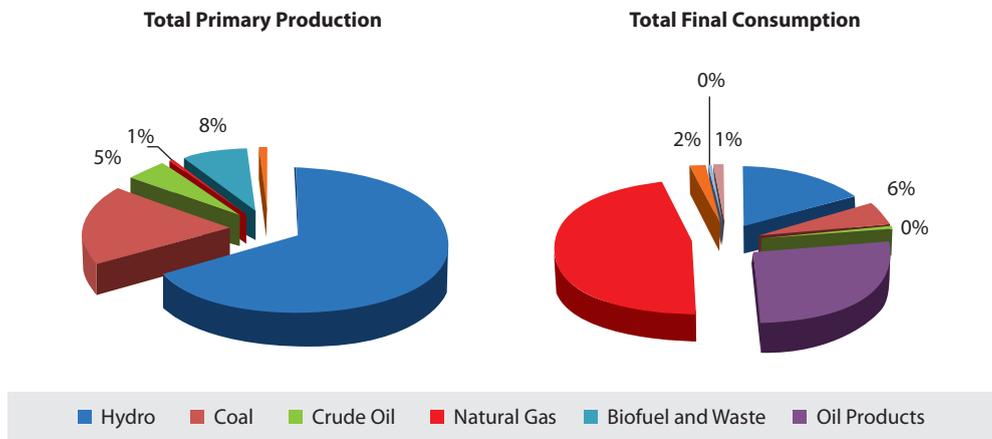
Georgia remains, to a great extent, dependent on foreign suppliers of natural gas to meet domestic demand and provides an important part of the land corridor for the transportation of Caspian hydrocarbons to Western energy markets.

The priority supply source for Georgia’s gas market is Azerbaijan, which possess significant export potential and relevant transport infrastructure for supplying Georgia’s energy market with gas. On that basis a strategic interrelationship between the two countries developed in terms of politics and economy, which is one of the key aspects of the energy security of the country.

The gas from Shah Deniz field in Azerbaijan flows through the South Caucasus Gas Pipeline (SCP) to Azerbaijan, Georgia and Turkey. The pipeline, operated by BP, was put into use in 2007 and currently has the capacity to transport about 8-9 billion cubic meters (BCM) of natural gas per year. Gas from other fields of Azerbaijan, in the ownership of Azerbaijan’s state oil company, SOCAR, is transported through Azerbaijan’s and Georgia’s trunk pipeline systems.

Georgia imports natural gas, crude oil and petroleum products as its main energy sources. It also possess significant potential for developing hydro resources. Power generation in the country significantly increased during recent years, thus allowing the country to be a net electricity exporter in the region since 2007. Due to its high dependence on imports for hydrocarbons, Georgia’s economy still remains exceedingly vulnerable to global energy price movements.

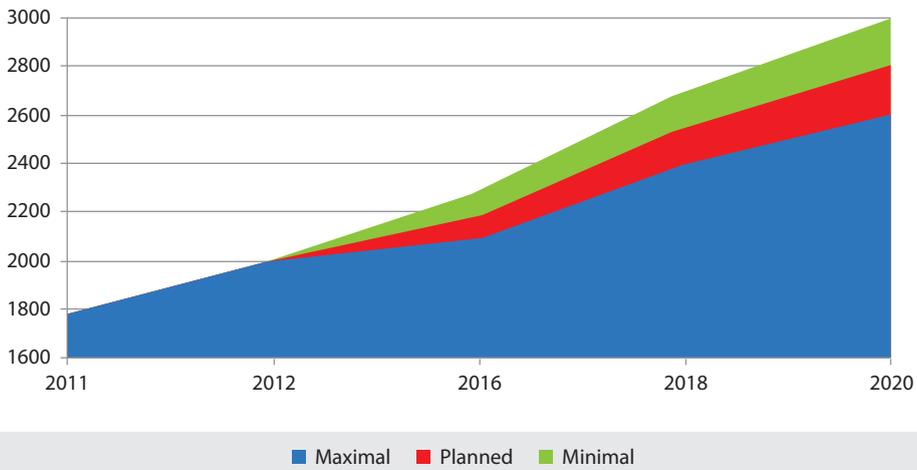
Figure 1.



Source: Ministry of Energy of Georgia, 2013

Over the current decade, demand and consumption of gas in Georgia may increase from an average of 1,6 billion m³ in 2006-2010 to about 2,5-3 billion m³ in 2020-2021¹⁴.

14 Teimuraz Gochitashvili, Georgian Energy Sector - Main Priorities of Gas Sector Developments 2012, Chapters 2.1 Demand forecast and 2.2, Supply Sources

Figure 2. Demand of natural gas (million m³/y).

There are many discussions and alternative projects under development for the enhancement of transportation of gas from Azerbaijan and Central Asian fields through Georgia to European energy markets.

Currently all export volumes of gas from the Caspian region and the above mentioned fields are transported through the existing SCP. After the operation of the Shah Deniz II field begins, expected to start by 2018, increased supply volumes will be transported through SCPX (the SCPX project, which is currently underway, envisages construction of a new parallel pipeline to the existing line across Azerbaijan and Georgia, as well as two new compressor stations in Georgia)¹⁵. The annual volumes of throughput capacity of the SCP will be increased from 8-9 (current capacity) to 22-24 BCM. At the Georgia-Turkish border the pipeline will link to TANAP¹⁶ and further downstream to the TAP¹⁷ pipelines. This route also envisages construction of the Trans Caspian Gas Pipeline¹⁸, for delivering Central Asian natural gas to western energy markets.

However, due to the complexity of supply schemes, diversification of supply routes (i.e. the possibility of gas supply to the Georgian market from Kazakhstan, Turkmenistan and Iran, via Russia, Azerbaijan or Armenia) for the short- and medium-term period is not projected¹⁹.

There are political, commercial and technical trade barriers in the region related to the transportation of natural gas beyond the Shah Deniz fields from the above-mentioned alternative sources. With respect to Russia, the politically fragile situation between the two countries does not allow for a reliable supply of gas from Russia. This was highlighted in 2006 when two pipelines importing gas from Russia to Georgia were exploded, creating an energy crisis in the country²⁰.

15 Shah Deniz II and opening of the Southern Corridor, BP, 2013

16 The Trans Anatolia Natural Gas Pipeline (TANAP) Project intends for the transportation of the natural gas to be produced in Shah Deniz II field and other fields of Azerbaijan (and other possible neighbouring countries) through Turkey to Europe, see: <http://www.tanap.com/en/what-is-tanap>

17 The Trans Adriatic Pipeline (TAP) will transport natural gas from the giant Shah Deniz II field in Azerbaijan, via Greece and Albania, and across the Adriatic Sea to Southern Italy, and further to Western Europe, see: <http://www.trans-adriatic-pipeline.com/tap-project/concept/>

18 Prague - Declaration of the Southern Corridor Summit, May 8, 2009

19 Teimuraz Gochitashvili, Georgian Energy Sector - Main Priorities of Gas Sector Developments 2012, Chapters 2.1 Demand forecast and 2.2 Supply Sources

20 Ibid.

The transportation of Central Asian natural gas (in particular, from Turkmenistan) through a subsea pipeline across the Caspian has been a core element of the EU's Southern Gas Corridor strategy. However, due to the lack of infrastructure and political and diplomatic obstacles to building it between Azerbaijan and Turkmenistan, and conflicts with Russian and Iranian interests²¹, transportation of Central Asian gas in the short and medium term is not expected. The possibility of importing gas from Iran is also impeded by political tensions and international sanctions²². This situation might evolve, however, with current Iranian leadership. Russian gas to Armenia is transited through Georgia by the North-South gas pipeline (NSGP), which is the second largest cross-border pipeline passing through Georgia. Another East-West main gas pipeline (EWGP) is the only system connecting the west and east part of Georgia and the only system used for gas supply for local consumers.

The operation of the NSGP and EWGP pipelines is done by Georgia's Gas Transportation Company (GGTC), which serves as a Transmission System Operator (TSO) for these main trunk pipelines. The transmission system in the country (excluding, however, the SCP) is owned by the Oil and Gas Corporation of Georgia (GOGC). The state-owned GOGC was established in 2006 and is responsible for management and operation of natural gas imports in the territory of the country.

1.1 Supply Sources/Existing Contracts

Georgia has limited sources of gas supply. Russia was the dominant supplier, covering almost 100% of Georgian gas demand until 2007. However, continuous attempts to use this factor as an effective political tool in interstate relations, evidenced by politically-driven price hikes and disruptions of supplies, have pushed Georgia to diversify its supply portfolio. Based on this, although Russia, with its rich hydrocarbon resources, potentially represents an alternative supplier in the region for energy deficit markets, at present Russian gas share constitutes roughly 10% of Georgia's total gas consumption.

Currently three of four existing sources of supply are from Azerbaijan positioned partners. A Host Government Agreement (HGA) concluded between the Government of Georgia and the South Caucasus Pipeline participants provides Georgia with the option to purchase certain volumes of gas from those participants. The general conditions for sale and purchase of Option Gas and Supplemental Gas are provided in Appendix 7 to the SCP HGA, and further detailed in corresponding agreements.

According to Option Gas Sales and the Purchase Agreement (Option SPA), Georgia has an option to purchase natural gas in a volume of up to 5% of the quantities of gas transited through the Georgian part of the SCP. Option gas prices are fixed through the term of the Option SPA.

Based on the projection, the volume of Option Gas will be increased starting from 2018 up to approximately 1 – 1,1 BCM per year, alongside with the commencement of commercial production on Shah Deniz II.

A Supplemental Gas Sales and Purchase Agreement (Supplemental SPA) fixes the volume and prices of Supplemental Gas. Georgia receives up to 500 million m³/y of Supplemental Gas each contract year.

Certain volumes of natural gas are received by GOGC from SOCAR and the Georgian Gas Transportation Company.

21 The Greatest Game for gas in the Caspian, a report from the Economist Intelligent Unit, 2013, Chapter: the Trans-Caspian Pipeline

22 Iran Sanctions, Kenneth Katzman, specialist in Middle Eastern Affairs, Oct. 11, 2013

There is an insignificant amount of indigenous production. Almost all volumes of natural gas supplies from the above-mentioned sources (collectively, 'Georgian Gas') are allocated to meet the demand of households and thermal power generation, which forms the so-called social sector of the Georgian gas market.

Based on the long-term memorandum of understanding concerning the supply of natural gas to the social sector of Georgia concluded between the government of Georgia and SOCAR, and the corresponding gas supply agreement (GSA) between GOGC and the Georgia-based SOCAR affiliate, the latter has undertaken a commitment to ensure stable and sustainable supply (including imports) of natural gas for the consumption of the population and power generation of Georgia. The conditions of the GSA also provide a balance of high seasonal divergence between supply and consumption, which is a significant problem for the country due to the absence of gas storage. Existing arrangements provide an opportunity to address the seasonal unbalance in Georgian Gas supply by handling the winter deficit and securing the reasonable price of gas for the social sector.

Gas supply to the commercial sector is also carried out mainly by Georgia-based SOCAR affiliate companies.

The total volume of gas delivered to Georgia from different suppliers in Azerbaijan currently accounts for up to 90% of the total Georgian gas consumption.

Chapter 2. Existing multilateral/bilateral legal frameworks for trade and transit of natural gas and cross-border transport infrastructure

Chapter 2. Existing multilateral/bilateral legal frameworks for trade and transit of natural gas and cross-border transport infrastructure

2.1 GATT/WTO agreements and the Energy Charter Treaty

In order to assess the value-added of potential Georgian membership in the Energy Community, it is necessary to analyse the existing legal frameworks applying to Georgia.

Georgia (together with the EU, Turkey, Armenia and Russia) is a Contracting Party to the Marrakesh Agreement Establishing the World Trade Organization. Georgia (together with the EU, Turkey, Armenia, Azerbaijan, Turkmenistan and other Central Asian states) is also a Contracting Party to the Energy Charter Treaty (ECT). Russia, which has never ratified the ECT, revoked its provisional application in 2009, thus withdrawing from the Treaty. Russia remains a member of the Energy Charter Conference.

The ECT incorporates by reference parts of the WTO Agreements, namely those dealing with trade in goods relevant to the energy sector. The WTO provisions made part of the ECT apply to trade in goods (energy materials and products listed in Annexes EM I and energy related equipment listed in EQ I).

Neither general WTO law nor the ECT provide for mandatory third party access (TPA) to energy grids. The provisions of the WTO which are applicable under the ECT concern market access treatment of goods (border measures such as import or export tariffs, quotas, import licensing, technical regulation and standards of goods, etc.) and domestic regulations that affect market access of imported products (e.g. internal taxes, transportation and distribution conditions) and commit to eliminate discrimination of imported products, which will be elaborated further down.

Nevertheless, the WTO and ECT provisions applicable to trade between Georgia, its neighbours and the EU have important implications for trade in gas through cross-border transmission infrastructures.

The most important WTO provisions incorporated in the ECT and relevant for the present study are the following:

2.1.1. Most-favoured-nation treatment (MFN)

Article I of the GATT sets forth one of the core principles of the multilateral trading system – that of the most-favoured-nation treatment (MFN). MFN means that WTO or ECT Members are obliged to extend any advantage, favour, privilege or immunity granted to any product originating in or destined for any country to ‘like’ product²³ originating in or destined for the territories of all other WTO or ECT Members. **Georgia, with memberships in both WTO and the ECT, must grant that advantage to all members of both constituencies.**

The MFN clause applies to border measures (customs duties, other charges or any import or export formalities or rules) and internal measures (internal taxation or any other regulation of products). According to Article I GATT, whenever a WTO or ECT Contracting Party confers any advantage or privilege to energy products from any given country with respect to such measures, then that advantage or privilege also has to be conferred – immediately and unconditionally – to like products from any other WTO or ECT Contracting Party.

What does this mean in practice for energy producing countries? Whenever a WTO or ECT Contracting Party imposes border measures (customs duties, other charges or any import or

²³ See e.g. http://www.wto.org/english/tratop_e/dispu_e/repertory_e/d1_e.htm for descriptions of likeness.

export formalities or rules) or internal measures (internal taxation or other regulation of products) that confer any advantage or privilege to energy products from any given country, then that advantage or privilege also has to be conferred – immediately and unconditionally – to the like product from any other WTO or ECT Contracting Party. In sum the implication of the obligation of WTO or ECT members to apply MFN treatment is that in respect of any policy affecting trade, and no discrimination can be made between imports on the basis of their origin or between exports on the basis of their destination.

MFN status for energy trade means that all WTO or ECT Contracting Parties, in all areas of their energy policy, cannot discriminate between energy products based on the origin of these products. Similarly, in respect of customs duties or taxes on exports, no distinction can be made based on the destination of the energy product.

2.1.2 National Treatment

The second cornerstone of the multilateral trading system is national treatment. Article III of GATT establishes the principle that imported products cannot be discriminated against compared to domestic products. Article III sets forth that, with respect to internal taxation and domestic laws, regulations and requirements, imported products shall be accorded treatment ‘no less favourable’ than that accorded to domestic products. While MFN status applies to all policies – both border measures and internal measures – national treatment applies to treatment of products after entering the territory of a state, i.e. after customs clearance. Another important distinction is that MFN applies to both imports and exports, but national treatment is applicable only to imports.

Internal taxes and other internal charges of any kind: The non-discrimination requirement with respect to internal taxes and charges, laws and regulations is applicable only to treatment of ‘like’ products. All internal taxes (VAT, excise duties, etc.) have, e.g., to be the same for domestic energy and like imported energy.

Thus, e.g., all government measures setting minimum prices for energy products or the way such prices are to be calculated, such as defining environmental standards (for example, against air pollution by petroleum products), imposing charges for the use of transmission networks, regulating access to transmission or distribution channels, or subsidizing energy prices for certain categories of people, all must make sure that imports are not treated less favourably than domestic products. In this respect, feed-in tariffs for renewable energy could be problematic under the WTO, as they are not normally granted to imported energy. Feed-in tariffs in the EU have benefited from the absence of claimant state parties under the WTO. The recent entry of Russia to the WTO could significantly change this situation.

With respect to transportation and distribution, Article III:4 of the GATT provides justification to impose different charges as long as the difference is “based exclusively on the economic operation of the means of transport and not on the nationality of the product concerned.” For instance, different charges may be due to different distances and parameters of pipelines used.

2.1.3 Freedom of Transit

Natural gas transportation often takes place via pipelines (and in the case of electric power, through a transmission network). Sometimes transportation networks cross third countries in transit. Freedom of transit, which is established in GATT by Article V, is a crucial factor for cross-border energy trade. Article V provides the definition of traffic in transit, namely “when the passage [of goods] across [the territory of a member] ... is only a portion of a complete

journey beginning and terminating beyond the frontiers of the [member] across whose territory the traffic passes"²⁴.

Article V:2 provides that "there shall be freedom of transit through the territory of each [member], via the routes most convenient for international transit, for traffic in transit to or from the territory of other [members]". Thus, a WTO or ECT Contracting Party cannot refuse goods transiting their territory if these goods either come from another WTO or ECT Contracting Party, or if they are going to another WTO or ECT Contracting Party. It would not seem necessary that the good both comes from a WTO or ECT Contracting Party and goes to a WTO or ECT Contracting Party. Either of the two would seem sufficient for the principle of freedom of transit to apply. In addition, pursuant to Article V:2, it is not sufficient to just grant any form of transit; it has to be transit "via the routes most convenient for international transit".

Article V:3 GATT prohibits "any unnecessary delays or restrictions" to the transit of goods, "except in cases of failure to comply with applicable customs laws and regulations".

However, compliance with applicable customs laws and regulations does not extend to customs duties. Indeed, the same paragraph 3 provides that traffic in transit coming from or going to the territory of other members "shall be exempt from customs duties and from all transit duties or other charges imposed in respect of transit, except charges for transportation or those commensurate with administrative expenses entailed by transit or with the cost of services rendered." This means that, for example, the natural gas in transit through a territory of a WTO or ECT Contracting Party cannot be subject to customs duties or any other duties or charges. For instance, that Contracting Party cannot apply the customs duties that it levies on natural gas imports or exports to gas in transit. Thus, the Contracting Party concerned is barred from imposing, say, the usual 10 per cent customs duty it normally levies for imports or exports of natural gas. Neither can it impose any other duties or charges for transit, with the exception of charges that adequately represent the cost of transportation, administrative expenses or other services rendered in respect of the natural gas in transit.

The transit WTO or ECT country is allowed to charge a fee for the use of its pipelines (cost of transportation) and other administrative or service-related expenses which it has to bear for the natural gas to cross its territory (e.g., costs for maintaining a statistical database or costs incurred for ensuring safe transit). However, in order to be in line with Article V of the GATT, any such fee has to be "commensurate with" the actual expenses entailed. In this respect, Article V:4 further provides that any such fees or charges have to be "reasonable, having regard to the conditions of the traffic". In respect of other regulations (not entailing the imposition of a charge but, for example, prescribing safety requirements or notification or licensing requirements), the same "reasonableness" criterion applies (Article V:4). In addition, such regulations may not lead to "unnecessary delays or restrictions" (Article V:3).

Article V also contains a double MFN obligation.

a) No discrimination among goods in transit: First, equal treatment has to be given to traffic in transit without distinction based on "the flags of vessels, the place of origin, departure, entry, exit or destination, or on any circumstances relating to the ownership of goods, of vessels or other means of transport" (Article V:2). Put slightly differently, with respect to all charges or formalities in connection with transit to or from a WTO or ECT Contracting Party, "treatment no less favourable than the treatment accorded to traffic in transit to or from any third country" has to be ensured (Article V:5).

²⁴ GATT Article V:1

Pursuant to these provisions, traffic in transit to, or from, a WTO or ECT Contracting Party may thus not be accorded less favourable treatment than the treatment accorded to traffic in transit to, or from, any other country (even if this third country is not itself a WTO or ECT Contracting Party).

Thus, a WTO or ECT Contracting Party is not allowed to impose, for example, higher charges for the use of its pipelines or grids for traffic in transit coming from one WTO or ECT Contracting Party than the charges it imposes in respect of traffic in transit to, or from, any other country (unless, of course, the higher charge results from actual higher costs of transit). It is also worth mentioning that Article V:2 not only prohibits discrimination on the basis of origin or destination of the actual good in transit (as Article I of GATT, on MFN, does), but also outlaws discrimination on the basis of the ownership or flag of the vessel or other means of transport which ensures the transit.

b) No discrimination between direct imports and imports that went through transit: Equal treatment has to be given to products from a given WTO or ECT Contracting Party irrespective of whether they were imported directly or were previously in transit in another ECT Contracting Party (Article V:6). It is, therefore, inconsistent with GATT Article V for a WTO or ECT Contracting Party to favour goods imported directly from another WTO or ECT Contracting Party, as opposed to goods that first transited through a third Contracting Party. To take the example of electricity, a WTO or ECT Contracting Party is not allowed to impose, say, a lower customs duty for electricity coming directly from its neighbour, than for electricity also coming from this neighbouring country but which has transited first through the grids of a third WTO or ECT Contracting Party.

The WTO and ECT also contain other important principles that merit mention, such as the elimination of quantitative restrictions (GATT Art. XI), the elimination of Trade-Related Investment Measures (WTO TRIMS agreement or ECT Art. 5) or the provision on State Trading enterprises (GATT Art. XVII). **As the entry of Georgia into the Energy Community is presumably not entailing any problems in this regard, these principles need no further discussion in this report.**

The below-mentioned practices, which could be in violation of WTO and/or ECT obligations on the freedom of transit, have so far not been subject to dispute settlement claims under these agreements.

Since its recent entry to the WTO, Russia has openly questioned the applicability of GATT to fix energy infrastructure²⁵, which no other WTO Member has done so far. While transit of Central Asian gas through Russia to Ukraine did take place in the past, most of the time it was organised through middlemen companies like Itera, Eural Trans Gas and RosUkrEnergo. The Agreement on the Free Trade Area signed by the Presidents of Russia, Armenia, Belarus, Tajikistan, Kazakhstan, Ukraine and Moldova in St Petersburg on 18 October 2011 envisaged negotiations on a subsequent Agreement on pipeline transit by the parties interested. This Agreement has not yet been accomplished, however.

In Turkey the Gas Market Law (No. 4646) has provisions authorizing the regulator to determine transit conditions, including transit tariffs, according to procedures and principles different from those applicable to domestic transmission tariffs with the view to encouraging natural gas transit. Therefore, transit flows may be treated in a different manner than domestic gas

²⁵ Cf. e.g. the statement of Mr Medvedkov, chief negotiator of Russian WTO accession procedure, made at the joint WTO ECT high level seminar on 28 April 2013 in Geneva, audio-recording of session 2 available at <http://www.encharter.org/index.php?id=595&L=0>

transport. With regard to the future development of its gas market, the Turkish government favours the establishment of a regional hub rather than relying just on transit.

2.1.4 Differences between GATT and the ECT

It is clear that GATT and the ECT are highly similar as far as the above-mentioned provisions are concerned. However, one difference is relevant to the substance of this report.

Article 7 of the ECT, which also deals with transit, goes beyond GATT Art. V. Article 7(3), in particular, introduces a weak type of national treatment obligation, namely that a transit country may not treat energy materials and products in transit in a less favourable manner than such materials and products originating in or destined for its own area. For purposes of clarity, it should be recalled that neither GATT nor the ECT provide for a complete national treatment of goods in transit. Furthermore, the ECT addresses investments into new infrastructure, e.g. in Article 7(4), which prohibits Contracting Parties from placing obstacles in the way of new capacity being established if transit cannot be achieved on commercial terms by means of existing infrastructure, or in Article 10(2) and (3), obliging the Parties to endeavour to accord national treatment to investors in view of the making of investments in its area. Furthermore, Article 7(6) and 7(7) set out dispute settlement provisions, also not present under GATT Article V.

2.1.5 Exceptions provided to members of Customs Unions and Free-Trade Areas

In order to allow WTO or ECT members to push regional integration and grant each other favours of trade liberalization that they would not wish to grant to all other WTO or ECT members, the latter are allowed to liberalize trade stronger among themselves, without being obliged to extend such liberalization to other WTO or ECT members. This exception to the MFN principle is granted by GATT Article XXIV to members of so-called Free Trade Areas (FTAs) and customs unions (CUs). The ECT also recognizes FTAs and CUs created pursuant to these WTO provisions.

However, in order to ensure that FTAs and CUs become true trade liberalizing agreements (trade creation) and not tools of protection at the expense of non-participating WTO Members (trade diversion), GATT Article XXIV imposes certain conditions that members of FTAs or CUs must meet.

For a single CU to validly exist, two elements are required:

- First, in Article XXIV:8(a)(i), “duties and other restrictive regulations of commerce” (with some exceptions) have to be eliminated with respect to “substantially all the trade” between the parties of the union (or at least trade in products originating in such parties). This means that “substantially all the trade” between the parties has to be free.
- Second, in Article XXIV:8(a)(ii), “substantially the same duties and other regulations of commerce” apply in each of the parties of the union to trade with non-parties. This means that substantially the same trade policies have to apply in the entire union with respect to trade with non-parties.

For a FTA to be legitimate, only the first condition above has to be met: “substantially all the trade” between the parties of the area has to be free (Article XXIV:8(b)). There is no requirement that the parties also align their trade policies vis-à-vis third countries. A WTO state can therefore be party to many FTAs, but only to one CU.

Thus, the EU is a customs union also, in the sense of the ECT and WTO. Turkey is also part of this customs union.

Armenia may wish to enter the Eurasian Customs Union formed by Russia, Belarus and Kaza-

khstan. If the weighted average of applied Armenian customs tariffs increases when it enters this Customs Union, Armenia (or the Eurasian Customs Union) will be required to offer compensation to impaired WTO members with whom customs duties have initially been negotiated, or who are primarily concerned or have substantial interest.

The DCFTA agreement between the EU and Georgia constitutes a FTA in the sense of the WTO and the ECT. Contrary to the Eurasian Customs Union, the EU-Georgian DCFTA is not likely to introduce new trade obstacles and hence does not impair relations with any third country. Therefore, in light of WTO law, it will suffice that both sides notify the WTO and the ECT of the agreement once it is in force.

Energy Community countries commit to policies in the energy sector only. Creating a CU or FTA only for energy products does not actually result in a lawful CU or FTA, as it does not meet the definition of ‘substantially all the trade’. We therefore conclude that the Energy Community alone does not qualify for exemption from the MFN and national treatment obligations with respect to **trade measures** pursuant to GATT Article XXIV. **Georgian membership in the Energy Community alone does not waive it from the MFN and national treatment obligations it has to respect under the WTO and the ECT.**

For the same reasons as explained above, the Energy Charter constituency is neither an FTA nor a Customs Union.

The DCFTA agreement changes the above-mentioned assessment with regards to the Energy Community, as it would allow Georgia and the EU to grant each other preferences, according to the DCFTA provisions, which would not have to be granted to third parties. Strictly speaking, Georgia could not grant such preferences to Energy Community countries that are not EU members and with whom Georgia has no DCFTA covering ‘substantially all trade’. Third parties who believe they should also be entitled to receive such preferences by virtue of the principle of MFN or national treatment could challenge such situations in the WTO.

It remains to be further analysed which obligations imposed by membership in the Energy Community are ‘trade measures’, which are not affected by GATT Article I and III obligations, and which of these obligations would be waived due to inclusion in FTAs. The key question is to determine for which individual trade measure third countries (non-EU and non-EnC) may be excluded. Further down, some illustrative guidelines for handling MFN and national treatment will be given.

2.1.6 Access conditions to transmission infrastructure and tariffication within the ECT constituency

The ECT remains the only multilateral agreement that seeks to directly address the complex political, economic and legal problems associated with energy transit. The Treaty goes further than WTO/GATT in setting exports and imports as a benchmark for the treatment of energy transit and in providing rules related to the establishment of transport capacity for energy transit.

It also provides a conciliation procedure for disputes related to energy transit. In particular, ECT Article 7(6) and 7 set out dispute settlement provisions not present under GATT Article V.

As was also mentioned above, the ECT does not impose any kind of market structure, including mandatory third party access, unbundling or a detailed regulatory framework for the operation of energy transport infrastructure. In addition, it focuses on energy transit as an important component for international energy trade.

The current status of national and cross-border transmission access conditions and tariffication within the ECT constituency differs in member states. The majority of non-EU 'transit countries' (including Georgia) within the ECT membership treat national transmission flows differently from cross-border transmission, applying different tariff models, access and market rules including negotiated tariffs for transit. Furthermore, the existence of intergovernmental agreements allows for separate treatment with respect to transit in member countries. **Such agreements are often not subject to the authority of national regulators, but subject to dispute resolution defined in those agreements. These agreements are then complemented by private agreements which are not subject to regulation and where a consortium needing transit capacity builds it and allows third-party access only on a negotiated basis**²⁶.

2.1.7 The Energy Charter draft Transit Protocol

As was mentioned above, the Energy Charter Treaty is the primary international instrument regulating and establishing rules on energy matters in general, and on energy transit in particular. Shortly after the entry into force of the Energy Charter Treaty in 1998, the Charter Conference decided to go even further and to agree on more specific rules on energy transit with a separate Transit Protocol, on which formal negotiations started in early 2000. The Protocol would expand upon the existing provisions of Article 7 of the ECT by laying down a specific legal regime for cross-border transmission systems supplying uninterrupted transit of energy resources, both hydrocarbons as well as electricity to deal with transit issues in a more specific and proactive way than in the ECT²⁷.

One of the major goals behind the development of this new legal instrument, in the form of a Protocol, was to open up new energy production areas in, for example, the Caspian region and Central Asia, which have entailed a corresponding increase in importance of energy transit as an economic activity for many states.

Basic issues to be addressed were, among others: sanctity of transit and transparent and non-discriminatory access to transit infrastructure. When taken together, the transit-related provisions of the ECT and the Protocol itself, once adopted, will constitute the Energy Charter's 'transit regime'. It had the objective of offering concrete legal solutions for identified impediments to secure and efficient transit of crude oil, oil products, natural gas or electricity on the European continent, and would significantly improve energy security at the regional level through a common approach within the constituency.

However, in October 2011, due to the lack of progress in the negotiations and consultations on the Transit protocol, negotiations on a Transit Protocol were suspended. Based on the proposal of the European Union, the negotiations on the basis of a new document reflecting the common views of the constituency will be renewed only if an important number of stakeholders/contracting parties were to express a genuine interest in such negotiations and a commitment to be bound by the resulting agreement²⁸.

2.1.8 The role of the Energy Charter in cross-border trade and cooperation in the South Caucasus

The Energy Charter has assisted the process of regional cooperation in the South Caucasus by providing a rules framework for major cross-border energy infrastructure projects such as

²⁶ Energy Charter Secretariat, "Bringing Gas to the Market," published in 2012, page 23

²⁷ Official website of the Energy Charter Secretariat, "Transit Protocol", <http://www.encharter.org/index.php?id=37&L=0>

²⁸ *Ibid.*

the Baku-Tbilisi-Ceyhan (BTC) and South Caucasus Gas pipelines (SCP). The principles of the Energy Charter, as a multilateral framework for international energy cooperation, are shared by the countries of the region, which is well reflected in existing intergovernmental agreements as reference to 'Common Principles' in relation to the region's energy infrastructure projects²⁹.

The Energy Charter has facilitated some level of integration of oil and gas pipeline infrastructure in the South Caucasus, particularly from a regulatory perspective. However, it has not acted as a force for enhancement of an integrated energy market in the region. In fact, the different approaches among the South Caucasus states presently have important implications for efficient cross-border trade in the region, and currently there is no collaboration on converging the legislative energy frameworks of the countries. This will be discussed in greater detail further below.

Unlike the Energy Community Treaty/EU Energy Law, the ECT does not impose any specific market structure and detailed regulatory framework for the management of energy transport infrastructure, or create a common single market at the regional level.

2.1.9 Investment protection under the ECT

As the membership of Georgia in the Energy Community requires implementation of new legal provisions, and in some cases a possible change of the existing regulatory environment for investors, this Chapter intends to provide a better understanding of the obligations of the country under the ECT toward investment protection within its constituency.

The Energy Charter Treaty provides strong, binding provisions on investment protection for member countries. This legal regime provides availability of adequate legal protection in case of expropriation of investments made in the country.

According to the Article 10 umbrella clause of the ECT, each Contracting Party shall ensure that its domestic law provides effective means for the assertion of claims and the enforcement of rights with respect to investments, investment agreements, and investment authorizations.

In this sense, protection of investment agreements is the fundamental responsibility of the ECT contracting state. Moreover, according to Article 13 of the ECT, direct or indirect forms of expropriation of an investment will be addressed by adequate compensation from the state.

Expropriation is a governmental taking or modifying an individual's rights. Government taking or interference of property can range from an transfer of title to measures that leave the formal title of the property untouched, but impact the benefit of the property for its owner. Indirect expropriation may occur when measures, short of an actual taking, still result in the effective loss of management, use or control, or a significant depreciation of the value of the assets of a foreign investor. The three following criteria define forms of indirect expropriation:

- i. The degree of interference with the property right,
- ii. The character of governmental measures, i.e. the purpose and the context of the governmental measure,
- iii. The interference of the measure with reasonable and investment-backed expectations³⁰.

Thus, indirect expropriation envisages a range of government measures. This also includes

29 Rafael Leal-Arcas and Mariyaa Peykova, *Energy Transit Activities: Collection of Intergovernmental Agreements on oil and gas transit pipelines and commentary*, 2014

30 For further information see "Expropriation Regime under the Energy Charter Treaty" (2012), chapter 2.1

government measures aimed at regulating the economy that can deprive an investor of the value of his investment, including loss of management, use or control, or a significant depreciation of the value of the assets³¹.

The role of investment protection will be an element to be considered in light of the regulatory changes that the implementation of the EU Energy Law/Energy Community Treaty may require (see further down).

2.2 Bilateral Trade Treaties/FTAs

Trade agreements among the CIS countries, signed in 1994 by all three Caucasus states³², have largely been ineffective. As a result, they have been supplemented by different bilateral agreements. Georgia has concluded free trade agreements with Azerbaijan (1996) and Armenia (1995). The Free Trade Agreement between Georgia and Turkey entered into force on 1 November 2008³³. Since then, customs duties on the import of industrial products have been eliminated. None of these agreements establish strong legal provisions with respect to a harmonized approach toward freedom of transportation/transit (of energy goods) and access conditions to the cross-border transportation infrastructure between the neighbouring states.

Therefore, transit remains the subject of negotiations in all Caucasus states, including Turkey.

In particular, there is no specific domestic legislation dealing exclusively with natural gas transit/transmission across Georgia. Laws³⁴ in Turkey mostly regulate gas market operations and deals with domestic transportation activities rather than with transit. Transit is governed through regional and bilateral intergovernmental agreements in Azerbaijan and Armenia³⁵.

31 Ibid.

32 Free Trade Agreement between Azerbaijan, Armenia, Belarus, Georgia, Moldova, Kazakhstan, Russian Federation, Ukraine, Uzbekistan, Tajikistan and the Kyrgyz Republic, Moscow, 1994

33 Free Trade Agreement between the Republic of Turkey and Georgia (with protocols and annexes), Tbilisi, 21 November 2007, Treaties and Agreements, United Nations, Volume 2564, 2009

34 Natural Gas Market Law (Law No.4646 of 2 May 2001) and the Law of Petroleum Transit (Law no. 4586)

35 Reports on "Monitoring the Implementation of the ECT Transit Provisions for Natural Gas" (2006) and "Gas Transit and Transmission Tariffs in energy Charter Treaty Countries: Regulatory aspects and Tariff Methodologies" (2012), Energy Charter Secretariat

The background consists of several overlapping geometric shapes in shades of red and dark red. A large, dark red shape is positioned in the upper right, while a lighter red shape is in the lower left. The bottom of the page is a solid dark grey.

Chapter 3. Access conditions for the utilization
of transport infrastructure in Georgia

Chapter 3. Access conditions for the utilization of transport infrastructure in Georgia

Access conditions to internal natural gas transmission pipelines in Georgia are subject to regulation by the relevant regulatory body – the Georgian National Energy and Water Supply Regulatory Commission (GNERC). The conditions of supply and access rules for transport infrastructure are defined according to the Natural Gas Market Rules established by the Ministry of Energy of Georgia, including technical standards, which also regulate relations between suppliers, transport, distribution entities and direct consumers.

3.1 Transportation Tariffs for Gas

Charges for access to national transmission and distribution networks are determined and approved (under tariff resolution³⁶) by GNERC according to the (cost plus) methodologies envisaging recovery of investments and reasonable return, which are adopted by GNERC and publicly available. GNERC is empowered by the Law on Electricity and Natural Gas to resolve disputes between licensees, importers, exporters, suppliers and consumers (Article 4.5, Market Rules).

The Electricity and Natural Gas Law or the Natural Gas Market Rules do not envisage any kind of direct or indirect non-objective or discriminatory application of tariffs. Under Article 26 of the Natural Gas Supply and Consumption Rules, it is prohibited to put supply undertakings into/under unequal conditions. Thus, tariffs approved under the Resolution on Natural Gas Tariffs apply to all eligible customers and supply undertakings equally, without discrimination. Furthermore, under Article 16(4) of the Natural Gas Supply and Consumption Rules, distribution licensees using other networks are not allowed to pay such undertakings more than what is envisaged by GNERC for networks of the same technical specifications.

3.2 Third Party Access (TPA)

According to Article 46 (1) of the Law on Electricity and Natural Gas, which is the primary normative source for ensuring third party access to the national transmission and distribution system, natural gas transportation³⁷ or distribution licensees are obliged to transport natural gas through their network from producers to consumers under the tariff established by the regulatory authority. On a secondary legislation level, third party access and the obligation of transportation and distribution licensees to transport natural gas through their network is also covered by the Natural Gas Market Rules (Article 9, Connection) as well as Natural Gas Supply and Consumption Rules (Articles 16, 28).

'Dominant position' is defined in the Free Trade and Competition Law, which is also extended to cover the natural gas sector and includes equal treatment.

Grounds for refusal to connect to the network are provided in Article 9 of the Natural Gas Market Rules, under which a natural gas transportation licensee is obliged to refuse connection if such connection shall have adverse effect on the natural gas transportation system as a whole or on its ability to service other consumers on a standard level. A transportation licensee may refuse connection under the grounds of existence of other points of connection on the requested location, or existence of another natural gas network which can meet the requirements of the applicant for connection.

36 GNERC Resolution #30 of December 30, 2005 on Natural Gas Tariffs

37 Georgian natural gas sector legislation applies the term transportation rather than transmission.

Consequently, according to the Market Rules, duly substantiated reasons should be given for refusal of access to the natural gas transportation system.

3.3 Access to cross-border Gas Transportation Infrastructure

As was mentioned, internal market access is transparent and regulated by the Regulatory body. Conversely, the regulator in Georgia is not involved in allowing access to cross-border infrastructure.

The Law on Electricity and Natural Gas does not regulate transit. Similarly, tariff aspects for access to cross-border infrastructure are not approved by GNERC. Neither are procedures in place for the allocation of capacity or congestion management, which would define the rules of capacity allocation between the market players interested in access to such infrastructure.

Specifically, the Transmission System Operator (TSO) of the SCP, passing through the territory of Georgia, is not under the regulation of GNERC. The regulatory regime applicable to SCP is governed by the Agreements ('Project Agreements') governing the implementation and operation of the Transit Project, which set forth a specific legal regime limiting the discretion of the state to interfere in activities related to the Transit Project and guaranteeing the investor full flexibility with regard to the operation of the pipeline.

According to the Host Government Agreement (HGA) of the SCP, all access to Available Capacity associated with Available Services is the subject of negotiations³⁸.

3.3.1 Regulatory regime applicable to the South Caucasus Pipeline (SCP) passing through Georgia's territory

The regulatory regime applicable for the cross-border SCP is established by the Agreements ('Project Agreements') governing the implementation and operation of transit in Georgia through the SCP. According to the corresponding Project Agreements, Georgia assumed the following commitments stating that the government:

- (i) shall not amend, rescind, terminate, declare invalid or unenforceable, or otherwise seek to change the Project Agreements without the prior written consent of the parties to those agreements,
- (ii) shall take all actions (including appropriate measures to resolve promptly by whatever means may be necessary any conflict or anomaly between the Project Agreement and Georgian laws) to restore the economic equilibrium established under the Project Agreements, where such economic equilibrium is disrupted or negatively affected as a result of any change in Georgian law,
- (iii) shall request all local self-governing bodies, state entities, and independent regulatory bodies to comply with the terms of the project Agreements³⁹.

It should be noted that the Host Government Agreement is an attachment to the corresponding intergovernmental agreement. The intergovernmental agreement (including attachments) was ratified as an international agreement by the Parliament of Georgia.

It is evident that modification to the legal environment of the investor should be done on the basis of the consent of the parties to this agreement, in order to avoid conflict between the government and the investor, which granted full flexibility to the investor for the operation of the pipeline system in the territory of Georgia.

³⁸ Host Government Agreement (SCP) Appendix 3 – principles with respect to Contract Access to the SCP System

³⁹ Host Government Agreement (SCP), BP official website: http://www.bp.com/content/dam/bp-country/en_az/pdf/legalagreements/SHA_eng_HGA_Host_Government_Agreement_Georgia__English_.pdf

As was outlined above, there are different regulatory regimes applicable to internal and cross-border transmission in Georgia. Internal gas transmission is the subject of regulation, whereas access conditions to cross-border infrastructure remain the subject of negotiations (included in existing agreements and defined independently by the owner/operator of the SCP pipeline). **The existing legal regime applicable to SCP limits the establishment of appropriate rules related to capacity allocation and congestion management procedures by the state. Consequently, the capacity of the SCP is 100% reserved by the investor.**

Chapter 4. Energy Community legal framework
with regard to the utilization of transport
infrastructure and cross-border energy trade

Chapter 4. Energy Community legal framework with regard to the utilization of transport infrastructure and cross-border energy trade

4.1 Regulation (EC) No 715/2009 of 13 July 2009 on conditions for access to natural gas transmission networks

Contrary to the Energy Charter Treaty, EU Energy Law/the Energy Community Treaty provides for detailed provisions with respect to market organization, tariff regulation, access conditions, etc., aiming at establishing a single European energy market with common regulatory rules.

Creation of a single European gas and electricity market started with the adoption of the First Energy Directives, which evolved into the packages of Second and Third Energy Directives.

The latter regulation No 715/2009 of the European Commission concerning the conditions for access to natural gas transmission networks represents a part of the Third Energy Package, which was adopted in 2009. Conditions for the organization of access to the system, including in relation to cross-border transmission, are also covered in Directive 73/2009/EC concerning the internal market in natural gas.

The very scope of this Regulation, as part of the internal energy market legislation of the EnC Treaty/EU, is to establish barrier-free cross-border trade within the Community. As long as energy trade is applied through transmission services by fixed infrastructure (pipelines) for the creation of a common energy market, implementation of this regulation is a core aspect. Only the full implementation of this regulation by all member states guarantees compatibility of national approaches at the regional level and avoids mismatching between neighbouring gas systems. That is why coordinated and harmonized cooperation at the regional level is so important in this respect.

According to Article 12 of Regulation No. 715/2009, TSOs shall promote operational arrangements in order to ensure the optimum management of the Energy Community network and shall promote the development of energy exchanges at the regional level. In particular, the coordinated allocation of cross-border capacity and the integration of balancing and reserve power mechanisms are among the core aspects.

For the efficient management of the common gas network, the regulation provides for strong provisions establishing harmonized principles for a tariff setting mechanism on access to transmission networks or the method for their calculation. According to Article 13(1), tariffs for access to the transmission system should “reflect the actual costs incurred, insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent, whilst including an appropriate return on investments...”.

Article 13 (1) further notes that tariffs shall not be dependent on the transportation route but on the entry-exit points; “Tariffs for network users shall be non-discriminatory and set separately for every entry point into or exit point out of the transmission system.”

With the purpose of enhancing proper functioning of the regional market, establishment of minimum standards of common rules for Third Party Access (TPA) service is also obligatory, which will develop gas trade despite the location of transmission networks within the Community (Article 14).

For guaranteeing appropriate cross-border exchanges in natural gas between the TSOs in service, implementation of congestion management and capacity allocation principles (Article 16) is essential. Thus all TSOs are obliged to sell unused capacity (reserved by the existing

contracts) on the open market. For that reason, a harmonized approach by the TSOs operating in the market with regard to cross-border capacity exchanges is the central aspect for the full implementation of this regulation and creation of a Common market at the regional level.

4.2 'Transit' in EU Energy Law/Energy Community Treaty

The most distinctive divergence of the EnC/EU legal framework compared to the existing one (the ECT) is that it does not refer to 'Transit' flows of energy resources which cross at least two national boundaries. Instead, transit is considered simply as any other transmission of energy goods between the TSOs managing energy transportation systems within the community. Transit is also not specifically covered in any regulations/directives included in the Second or Third Energy Packages. Thus, tariffs (for internal and cross-border transmission) need to be approved by a regulator either directly or on the basis of a methodology, prior to their entry into force, and be published. Furthermore, TSOs as well as the regulators are required to closely cooperate among each other.

Accordingly, unlike the ECT, which mainly focuses on energy transit as an important factor for international energy trade across multiple borders on the regional and global level, transit (as a concept) has ceased to exist within the EU energy market. **Therefore, differential treatment of transit and transmission, which has been well practiced within the ECT constituency, has been abolished. Furthermore, different tariff models, access and market rules for transmission of natural gas are now subject to the regulatory rules envisaged in the Second and Third Energy Packages and are being determined by the independent regulatory authority.**

4.3 Potential conflict between EU Energy Law (Third Energy Package) and existing long-term transit contracts

A problem arises with the implementation of Article 32 (3) of the Third Gas Directive 2009/73/EC, as the validity and implementation of the old transit contracts referred to previously (before the adoption of the Third Package) is no longer foreseen.

The Second Gas Directive provided for an exemption for transit contracts concluded before 1 July 2004 under the old Transit Gas Directive, and pre-liberalization contracts could be valid even though they raised competition concerns: "Directive 91/296/EEC shall be repealed with effect from 1 July 2004, without prejudice to contracts concluded pursuant to Article 3(1) of Directive 91/296/EEC, which shall continue to be valid and to be implemented under the terms of the said Directive"⁴⁰.

Article 32 (3) of the Third Gas Directive (2009/73/EC) maintains the validity of long-term gas contracts concluded before the liberalization of the internal market in natural gas in so far as they do not undermine the objectives of the competition rules. As a result, under the Third Energy Package the validity and implementation of certain conditions of existing transit contracts is no longer possible or justified if they are incompatible with the provisions included in the Third Gas Directives/Regulations and the EU competition rules (articles [101] and [102] of the Treaty on the Functioning of the European Union), as well as the Energy Community (Articles 81-82), i.e. if the transit capacity is not offered in equal terms to all market players.

As the services and conditions are identical, the legal status and conditions of existing transit contracts should be aligned with those of domestic transmission, in order not to impede

40 Article 32 (1) of the Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC

competition. The provisions of Directive 2009/73/EC and Regulation (EC) 715/2009 – including those on tariffs, congestion management and capacity allocation – **are applicable equally to both national transmission and gas in transit**. As a result, implementation of the Third Gas Directive, in most cases, requires change of the terms and conditions of existing Transit contracts concluded before the adoption of this decision. Such treatment has become a subject of legal justification between the right of the state (which is willing to adopt new rules for enhancing competition in the market) and the investor (which has signed transit contracts reserving all capacity, which it cannot use and which it is unwilling to make available to the secondary market), by defending their rights based on the concluded agreements. Such contracts are challenged under the Community competition rules, which are primary Community law and are often subject of infringement procedures opened by the Commission for the non-transposition of the Third Package Directive⁴¹.

4.4 Basic requirements of EU Competition Rules (Art. 101-102)/EnCTreaty (Art. 81-82)

Article 81 applies to the agreements which have been concluded between undertakings and resulted in restriction of competition affecting trade between Member States. Such agreements infringe Article 81 and thus prevent competition within the common market:

1. “The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:
 - a) Directly or indirectly fix purchase or selling prices or any other trading conditions;
 - b) Limit or control production, markets, technical development, or investment;
 - c) Share markets or sources of supply;
 - d) Apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at competitive disadvantage;
 - e) Make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.
2. Any agreements or decisions prohibited pursuant to this article shall be automatically void.”⁴²

Article 82 applies where an abuse is undertaken by the dominant position of one or more undertakings, which affects trade between Member states⁴³:

“Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. These Articles are primary Community law and the provisions of gas Directives, being secondary law, cannot therefore prevent their application.

Such abuse may, in particular, consist in: a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; b) limiting production, markets

41 For further information please see: final results of ACER inquiry (Annex 1) – “Transit contracts in EU Member States”, 9 Apr. 2013

42 ANNEX III EC Competition Rules, Article 81 of the EnCTreaty

43 Christopher W. Jones, EU Energy Law–Volume II EU Competition Law and Energy Markets paras 3.4-3.14

or technical development to the prejudice of consumers;

- a) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- b) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts⁴⁴.

Therefore, all the competition-related factors need to be well examined in order to determine whether the existing contracts have any negative effects on competition in the energy supply market concerned. The harmonization of terms and conditions of existing contracts with the EnC Treaty is a necessary precondition for acceding to the common energy market of the Energy Community.

44 ANNEX III EC Competition Rules, Article 82 of the EnC Treaty



Chapter 5. Implications of the implementation
of Energy Community regulations with regard
to cross-border gas trade in Georgia

Chapter 5. Implications of the implementation of Energy Community regulations with regard to cross-border gas trade in Georgia

5.1 Legal convergence/shortcomings

As was discussed above, for the creation of the common energy market within the Energy Community, full implementation of the 715/2009 Regulation (including Directive 73/2009/EC) regarding access conditions to the transmission network is essential. Thus, any country willing to integrate into the common energy market of the Energy Community must comply with this Regulation, which provides comprehensive rules related to access conditions, tariff regulation and barrier free cross-border energy.

With respect to Georgia, regulated access conditions:

- to the national transmission system are transparent and regulated by the relevant Regulatory Authority;
- to the cross-border transmission system are not subject to the authority of the national regulator, but subject of Agreements ('Project Agreements') governing management of the transmission system (SCP) and subject to dispute resolution defined in those bilateral agreements. This is incompatible with the requirements of the EnC Treaty.

5.1.1 Cross-border capacity reservation

The lack of regulated access to the cross-border SCP is grounded by the fact that it is owned, controlled and managed by the investor, under the existing contract, including a 100% reservation of the capacity of the pipeline. Such bilateral agreements (without exemption) are incompatible with the EnC Treaty under which, with the purpose of enhancing competition in the market, full capacity needs to be offered to the open market.

In general such requirements are characterized for assets owned by the member state, where the capacity is 100% reserved by the investor, based on existing long-term contracts. However, with respect to the SCP passing through Georgia's territory, the conditions are more complex. Due to the existing agreements the investor not only reserves 100% of the capacity in the transmission system but also owns, manages, controls and operates the asset.

5.1.2 Compliance of access conditions to cross-border transmission (South Caucasus Pipeline) with the requirements provided by GATT Article V/ECT Article 7 and Regulation (EC) 715/2009

This chapter addresses whether, and to what extent, the provisions of GATT Article V and the EnC Treaty apply to a government with respect to gas traffic in transit in its territory using a wholly privately owned gas pipeline such as the SCP.

1. Applicability of GATT Article V to privately owned transit (SCP) pipelines

In the particular case of the SCP, the gas pipeline is owned, operated and regulated by the same private company and has the sole object of transporting natural gas from one border point to another.

From the above, it is clear that natural gas transiting from Azerbaijan to Turkey through the territory of Georgia via the SCP, and also the Georgian section of the SCP, are to be considered "traffic in transit" as per GATT V (1), which states that:

1. "Goods (including baggage), and also vessels and other means of transport, shall be deemed to be in transit across the territory of a contracting party when the passage across such ter-

ritory, with or without trans-shipment, warehousing, breaking bulk, or change in the mode of transport, is only a portion of a complete journey beginning and terminating beyond the frontier of the contracting party across whose territory the traffic passes. Traffic of this nature is termed in this article 'traffic in transit'."

The particular question arises whether the right to "freedom of transit" enunciated in GATT V (2) can be claimed by another WTO Member for its natural gas transiting through Georgia using the SCP.

GATT V (2) provides that:

2. "There shall be freedom of transit through the territory of each contracting party, via the routes most convenient for international transit, for traffic in transit to or from the territory of other contracting parties. No distinction shall be made which is based on the flag of vessels, the place of origin, departure, entry, exit or destination, or on any circumstances relating to the ownership of goods, of vessels or of other means of transport".

The question that arises is whether a gas owner or shipper can claim access to the SCP for the purpose of bringing gas from Azerbaijan to Turkey on the basis of paragraph 2.

To answer the question, the first consideration is that in all WTO Agreements the obligations stipulated therein are obligations of WTO Members (i.e. governments and state-owned enterprises), but not private business enterprises, and this is also the case with rights under WTO Agreements which accrue to Members (i.e. governments and state-owned enterprises), but not private business enterprises⁴⁵. Though paragraph 2 does not mention 'governments' or 'WTO Members', it is clear from the whole legal architecture of the WTO that GATT V imposes obligations on the Georgian government to provide 'freedom of transit' through its territory for natural gas transit and that it should grant MFN treatment as defined in the 2nd sentence.

Now the question remains whether this obligation of Georgia can be interpreted as shared with or transferred to the South Caucasus Pipeline.

At the time of negotiation of the GATT (1947) and the ECT (1994), grid-bound energies (gas, electricity) in practically all countries negotiating these agreements were de facto based upon a system of national or regional monopolies of integrated energy companies producing, transporting and also often selling their energy. Freedom of transit in this context could only mean freedom to negotiate transit with the owner of the grid and acceptance of their conditions. If the pipeline is privately owned, as is the case of the SCP, this is still the only valid interpretation of freedom of transit today. GATT Art. V does not oblige governments to legislate in this case. In a recent joint submission for Doha trade facilitation negotiations, Egypt and Turkey have eloquently noted that GATT V **cannot oblige a government to force private pipeline owners to grant access to third parties:**

"projects to build and operate pipelines often involve private sector partnership. In some cases, a private sector dominated consortium established under private law owns the pipeline and is responsible for its operation. Naturally, WTO Agreements create obligations for Members but not for private entities. While there can be extreme cases where Members are obliged to take necessary measures vis-à-vis the private entities to ensure freedom of transit through its territory, obviously, a privately owned border crossing pipeline through the territory of a Member would not fall under this category. Taking into account that such a pipeline would be built to transport a certain type of natural resource from one point to another for commercial reasons,

45 Only TRIPS provides rights to IP right holder 'persons'

this situation resembles more to a case where a private company builds a private railway line to transport coal from the mining site to a port. In such a case, a third party aspiring to transport coal on the same route would either have to build its own infrastructure or seek for access to the existing infrastructure on commercial terms.”⁴⁶

Therefore, it is concluded that GATT V provisions do not apply to the operation of a privately owned means of transport, nor to the charges and tariff regulation aspects.

2. Applicability of Regulation (EC) 715/2009 to privately owned transit (SCP) pipelines

Unlike GATT Art. V provisions, the access conditions to transmission infrastructure included in Regulation 715/2009 apply to all transmission assets operating in the market, without differentiating between state ownership and private business. Regulation 715/2009, which aims at setting non-discriminatory rules for access conditions to natural gas transmission systems (by establishing, in Article 13, that access tariffs, or the methodologies used to calculate them, shall be applied in a non-discriminatory manner between network users) implies a clear prohibition of discrimination among domestic gas flows and cross-border gas flows, including transit.

In the case of Georgia’s membership in the Energy Community, the access conditions defined by the regulatory regime applicable to the SCP (which limits the discretion of the state to interfere in activities related to the SCP and guarantees the investor full flexibility with regard to the operation of the pipeline), without derogation, shall be put under the regulatory power of the appropriate Regulatory Authority (GNERC). Accordingly, the terms and conditions of the existing agreement (including Tariff setting mechanism and conditions of Third Party Access) with the SCP consortium would have to be changed in line with the provisions and obligations envisaged in Regulation (EC) 715/2009 (including Directive 2009/73/EC).

5.2 Geographical scope/prospects for harmonized cooperation/approach at the regional level

Under the rules of the Energy Community, for the appropriate free cross-border gas flows and optimal use of gas infrastructure, application of transparent, non-discriminatory and market-oriented cross-border capacity allocation mechanisms as well as management of contractual and physical congestion is obligatory, which, in addition, should be harmonized among Transmission System Operators (TSOs) operating within the Energy Community. With respect to Georgia, the lack of regulated procedures for cross-border capacity allocation or congestion management regulation creates a barrier for the implementation of this requirement. In addition, it would be even more difficult to enhance harmonization of capacity allocation for cross-border trade between neighbouring TSOs in the region, as none of the states bordering Georgia are within the constituency of the Energy Community and apply such rules.

Accordingly, the most important barriers for Georgia seem to be not only legal shortcomings but also limited geographical scope, as the country does not have a direct border with Europe nor, similarly, with any of the member states of the Energy Community.

Georgia has limited physical access to the Energy Community/EU market. Therefore the implementation of the new regulatory system applicable in the Energy Community will not guarantee the establishment of a common regional market with Community member countries. Nor will a harmonized regional approach be achievable within the Caucasus region.

⁴⁶ WTO: Discussion Paper on the inclusion of the goods moved via fixed infrastructure into the definition of traffic in transit, Communication from Egypt and Turkey. Document TN/TF/W/179, 4 June 2012

As a result, Georgia will remain in isolation from the EU and Energy Community countries (technically and physically without common interconnection, and geographically without common border) until Turkey, which represents the main land corridor to Europe for the Caucasus, joins the Energy Community constituency or the EU.

5.3 Possible risks and potential benefits

Considering the existing legal and geographical obstacles, great attention should be paid to the effects resulting from the implementation of a new legal framework exclusively in Georgia. First of all, at least two questions should be answered:

- 1) whether the implementation of this Regulation in light of existing legal and political conditions may allow for competition to flourish in the gas market (otherwise, if such conditions are not met, implementation may produce negative aspects), and
- 2) whether the country may benefit in terms of increasing the quality of Security of Supply (SoS).

In particular, if a future member state (Georgia) cannot participate in the wider internal market of the Energy Community, since its gas network is not connected to the main system of the Energy Community, it is doubtful whether competition among Georgian and EU stakeholders can be effective. Georgia certainly fulfils the requirement of an isolated market that has one or very few suppliers of gas (Christopher W. Jones in his interpretation⁴⁷ of the Derogation for isolated markets refers to a state which has one or very few suppliers).

This is recognized by Article 49 of Directive 2009/73/EC (Third Energy Package):

“Member States not directly connected to the interconnected system of any other Member State and having only one main external supplier may derogate from Articles 4 (Authorization), 9 (Unbundling), 37 (Market Opening) and/or 38 (Direct Lines). A supply undertaking having a market share of more than 75 % shall be considered to be a main supplier. Any such derogation shall automatically expire where at least one of the conditions referred to in this subparagraph no longer applies. Any such derogation shall be notified to the Commission.”

In practice this derogation applies to Cyprus, Latvia, Estonia and Finland.

The natural gas market of Georgia is limited in terms of enhancing competition in the market, based on the complexity of supply schemes in the Caucasus. The implementation of the EnC Treaty will be effective in this context only after the gas market of Georgia is connected to the main system of the Energy Community, or after the region is opened for alternative gas suppliers. Consequently, Georgia will remain limited in receiving certain benefits in terms of Security of Supply. **Thus, until further connections are made, potential risks and benefits are too difficult to predict.**

5.3.1 Isolation in terms of Security of Supply (Energy Community Mechanism for Safeguarding Security of Supply)

One of the core assignments of the Energy Community Treaty is the implementation of an SoS (Security of Supply) mechanism in the common gas market. It provides strong provisions related to common approaches to SoS by identifying roles and responsibilities among its members. The Article 3 (1) Directive 2004/67/EC of the EnC Treaty, concerning measures to safeguard security of natural gas supply, establishes genuine solidarity between Member

47 Christopher W. Jones, EU Energy Law – Volume I: The Internal Energy Market (2004)

States in major emergency supply situations. Enhancing increased interdependence in terms of Security of Supply, by creating a common framework, requires a high degree of co-operation between the member states.

"In establishing their general policies with respect to ensuring adequate levels of security of gas supply, Contracting Parties shall define the roles and responsibilities of the different gas market players in achieving these policies, and specify adequate minimum Security of Supply standards that must be complied with by the players on the gas market of the Contracting Party in question. The standards shall be implemented in a non-discriminatory and transparent way and shall be published."⁴⁸

Article 9 (Community Mechanism) of the EnC Treaty establishes a three-step approach mechanism for major supply disruptions within the Community, which ensures and guarantees the quality of energy security of the members and the Community itself. According to the three step approach, the first step would involve reactions of the industry to the supply disruption; if this were not sufficient, Member States should take measures to solve the problem. If the measures taken at stage one and two have failed, appropriate measures should be taken at Community level to deal with the major supply disruption⁴⁹.

The gas Security of Supply Regulation of the EU 994/2010, repealing Directive 2004/67/EC, goes further by establishing "Union emergency" and "regional emergency" frameworks (Art. 11) through the creation of coordinated preventive and emergency (joint) action plans at the regional level (Article 3(2), Article 2(2)), involving more than one Contracting Party (Article 4(3))⁵⁰. According to Article 3(1), "Security of gas supply is a shared responsibility of natural gas undertakings, Member States, notably through their competent authorities, and the Commission, within their respective areas of activities and competence. Such shared responsibility requires a high degree of cooperation between them."⁵¹

During emergency situations, in practice, such assistance is provided by the common networks/interconnections developed between the member states. Interconnectors are pipelines, which have also the role of connecting separated systems or markets. They can be reversible, if necessary, and change the direction of supply. In the case of a crisis, during temporary shortages, etc., an interconnection thus guarantees supplies to the countries that it connects. Interconnectors have an important role in facilitating the establishment of hubs, where multiple gas flows meet, trading intensity is high, and competition is stimulated⁵².

Such a transmission network cannot be technically implemented in the territory of Georgia unless it is connected to the main system of the Community network.

As was demonstrated, there are existing legal and political barriers in the gas market of Georgia, both technical and geographical, for the full implementation of the EnC Treaty. As a result, as long as the country remains isolated in terms of Security of Supply, Georgia may consider applying to the isolated market derogation in accordance with Article 49 of Directive 2009/73/EC (Third Energy Package) as mentioned above. It should also be noted that, according to Article 30 (a) of Regulation (EC) No 715/2009, this Regulation shall not apply to natural gas transmission systems situated in Member States for the duration of derogations granted un-

48 Article 3 of the Directive 2004/67/EC of April 2004 concerning measures to safeguard security of natural gas supply

49 Article 9 of the Directive 2004/67/EC of April 2004 concerning measures to safeguard security of natural gas supply

50 Security of Gas Supply, Presentation by Angus Johnston (University College, University of Oxford; ELRF, EPRG) Florence School of Regulation, 20 June 2012

51 Article 3 (1) REGULATION (EU) No 994/2010 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 20 October 2010 concerning measures to safeguard security of gas supply and repealing Council Directive 2004/67/EC

52 Gas and Oil Pipelines in Europe, Directorate General for International Policies 2009, Chapter 4.1 - Identification of Interconnectors

der Article 49 of Directive 2009/73/EC. Consequently, if Georgia receives an isolated market derogation, for the duration of this derogation Regulation (EC) No 715/2009 on conditions for access to the natural gas transmission networks will also not be applicable for Georgia.

It should be underlined that, “Article 49 of Directive 2009/73/EC (‘Emergent and isolated markets’) and subparagraph (a) of the first paragraph and the second subparagraph of Article 30 of Regulation (EC) No 715/2009 shall not be applicable” in the Energy Community Treaty according to Article 24(4) of decision 2011/02/MC of the Energy Community⁵³. ‘Divergent’ from the energy market of the European Union Energy Community does not include isolated markets. Therefore, one option for Georgia can be to make reference to EU legislation (Third Energy Package), taking into account that the Association Agreement between Georgia and the EU fully envisages implementation of the Third Energy Package of the European Union.

5.3.2 Application of Energy Community/EU competition rules to agreements between undertakings in Georgia

The existing regulatory regime applicable to the SCP, which grants an investor flexibility to own, control (100% capacity) and operate the system including the conditions of existing agreements with the SCP consortium (fixing the volume and prices of natural gas (Option SPA) and (Supplemental SPA)⁵⁴) should be also taken into consideration in relation to competition requirements.

However, the situation might be different for Georgia as it represents an isolated market and no trade with another Member State is possible in the immediate future. According to the interpretation of the terms used in EU competition policy, it is clear that a necessary condition for the application of EU antitrust rules is the effect on trade between Member States. Articles 81 and 82 of the EnC Treaty are only applicable if there may be a direct or indirect, actual or potential influence on the flow or patterns of trade between at least two Member States. An effect on trade exists, in particular, where national markets are partitioned or the structure of competition within the common market is affected. Anti-competitive agreements or actions that have no effect on trade, therefore, fall outside the scope of EU competition rules and may only be dealt with by national legislation⁵⁵.

As a result, application of the EnC competition rules in the energy market of Georgia requires a different approach from what is considered to be a general practice of the Community market. Due to the peripheral geographical position of the country, EnC/EU competition rules in Georgia can be applicable only to those agreements, decisions and practices, abuses of dominance, or aid which may affect trade of Network Energy between the Contracting Parties⁵⁶.

Georgia is part of several gas pipeline projects (AGRI, TANAP, SCPX) that would connect its territory to Europe. Nevertheless, these connections are irrelevant if there is no or only minimal cross-border trade of gas between Georgia and Energy Community Contracting Parties⁵⁷. If, for example, gas imported from Azerbaijan or Russia remains in Georgia for domestic consumption or merely transits Georgian territory, as it normally would, there would be no impact on

53 Article 24 (4) of the DECISION OF THE MINISTERIAL COUNCIL OF THE ENERGY COMMUNITY DI201102IMC-EnG: Decision on the implementation of Directive 2009/72/EC, Directive 2009/73/EC, Regulation (EC) No 714/2009 and Regulation (EC) No 715/2009 and amending Articles 11 and 59 of the Energy Community Treaty

54 See above, supply sources, chapter 2.1

55 Glossary of terms used in EU competition policy, Antitrust and control of concentrations, DG for Competition, July 2002

56 Energy Community Treaty, article 18(1)(a) and (c)

57 The Commission has previously held that there is no effect on trade where there is no or only minimal trade across the border. (Commission Decision N 258/2000 of 21 December 2000 Germany–Freizeitbad Dorsten, OJ C 172, p. 16.)

economic activity between Georgia and another Energy Community Contracting Party related to gas because there would be no such activity.

In view of that, agreements between undertakings in Georgia and undertakings in non-Energy Community Contracting Parties are likely to escape the application of Energy Community rules for the time being, as energy sector trade between the contracting parties is restricted due to Georgia's geographical isolation and lack of direct interconnection to the energy network of any Contracting Party or EU member country (including the agreements (Project Agreements) governing the implementation and operation of transit in Georgia through SCP).

5.3.3. The South Caucasus Gas Pipeline as an important component for Security of Supply (SoS)

As was mentioned above, if the energy market of Georgia is qualified as an isolated market, the access conditions of the EnC Treaty shall not apply to the natural gas transmission systems situated there for the duration of derogations granted under Article 49 of Directive 2009/73/EC. Hence, it should be demonstrated that under the EU Energy Law/EnC Treaty, new (transmission) infrastructure, which plays a significant role in ensuring Security of Supply of the community and the state itself, may also be exempted from the application of Regulation 715/2009. Below, additional aspects will be discussed that should be taken into consideration.

According to the Article 36 (Directive 2009/73/EC):

"Major new gas infrastructure, i.e. interconnectors, LNG and storage facilities, may, upon request, be exempted, for a defined period of time, from the provisions of Articles 9(unbundling), 32(third party access), 33(access to storage) and 34 (access to upstream pipeline networks) and Article 41(6)(regulatory involvement in allowing access to networks), (8) and (10) under the certain conditions:

- a) the investment must enhance competition in gas supply and enhance security of supply;
- b) the level of risk attached to the investment must be such that the investment would not take place unless an exemption was granted;
- c) the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built;
- d) charges must be levied on users of that infrastructure; and
- e) the exemption must not be detrimental to competition or the effective functioning of the internal market in natural gas, or the efficient functioning of the regulated system to which the infrastructure is connected"⁵⁸.

Accordingly, one of the central conditions for exemption in Article 36 is the condition that the investment must enhance the SoS of the Community⁵⁹. The derogation in case of new interconnectors/infrastructure, or a significant increase in the capacity of existing interconnectors/infrastructure, is because of the need to ensure the realization of such investments⁶⁰. Therefore, significant attention should be paid to the condition of whether new infrastructure or an increase of capacity in existing infrastructure enhances the Security of Supply of the Community.

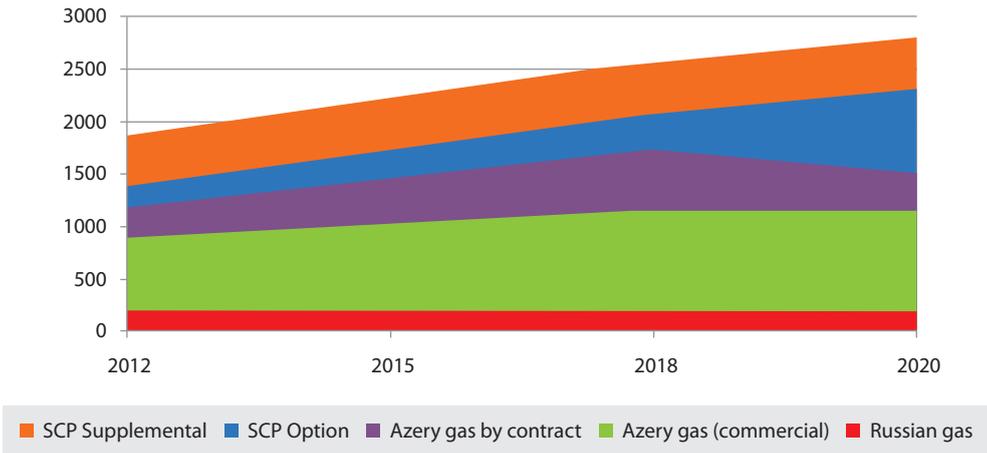
⁵⁸ Article 36 of the Directive 2009/73/EC of 13 July 2009 concerning common rules for the internal market in natural gas

⁵⁹ Security of Gas Supply - Presentation by Angus Johnston (University College, University of Oxford; ELRF, EPRG) Florence School of Regulation, 20 June 2012

⁶⁰ Angus Johnston and Guy Block, EU Energy Law (2012), Third Party Access derogation for new infrastructure paras. 4.99-4.109

As it was demonstrated above, Georgia will remain highly dependent on imported gas in the coming years, and therefore the diversification of supply routes is of utmost importance for the energy security of the country. However, diversification of supply sources in the short-term and medium-term period is not realistic due to high cost and barriers related to supply schemes. As shown above, Georgia has high reliance on a major supplier, SOCAR, who holds an extreme form of market power⁶¹ in the gas market. The situation is expected to relatively change from increasing volumes of option gas expected after the development of Shah Deniz Phase II (as projected in Figure 3).

Figure 3. Projection of natural gas supply sources



As a result, while the demand and consumption of gas in Georgia increases (from 1,6 billion m³ in 2006-2010 to about 2,5-3 billion m³ in 2020-2021, see the Figure 3, Chapter 2), outrunning supply, existing agreements will play a core role in guaranteeing SoS of the country in the coming decade.

Georgia, like other developing economies, needs to satisfy an increasing demand for cheap energy resources. The SCP Supplemental and Option Gas received under existing contracts is projected to cover demand for natural gas in the coming years. Georgia will remain energy-vulnerable (more than 75% dependant on imported gas) and existing contracts will play a major role in guaranteeing the energy security of the country. At this point it is crucial to identify the potential risks and threats affecting energy vulnerability in particular, and energy security of the country in general, while examining the possibilities of changing the legal system in the country.

The South Caucasus Pipeline may also be considered a subject of derogation related to new infrastructure, taking into note the following conditions:

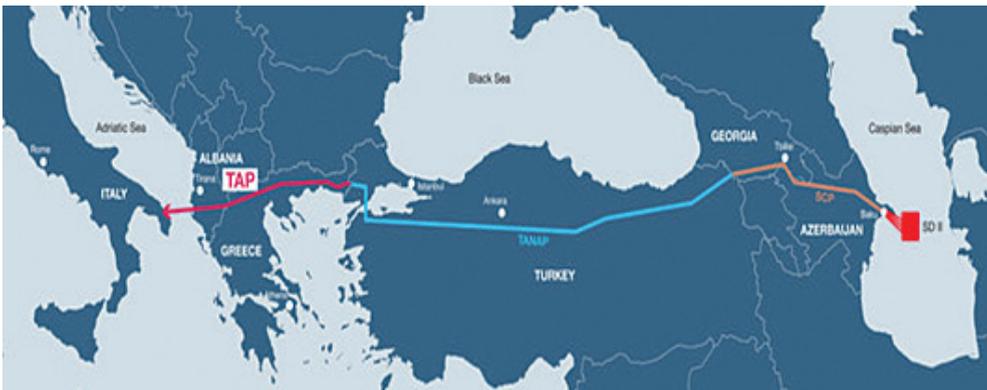
- The SCP was commissioned in 2006 and thus the Georgian government may attempt to ask for its qualification as “new infrastructure” under Article 2(33) of Directive 2009/73/EC.
- In order to receive increased supply volumes from Shah Deniz II, a new parallel pipeline will be added to the existing line across Azerbaijan and Georgia, as well as two new

⁶¹ Glossary of terms used in EU competition policy, Antitrust and control of concentrations, DG for Competition, July 2002

compressor stations, which will increase annual capacity of the pipeline from 8-9 (current capacity) to 22-24 BCM. Thus, there is a significant increase in the capacity of existing interconnector/infrastructure and accordingly of the investment cost needed for the expansion of the pipeline, just like in case of new infrastructure (TAP).

With respect to the need of ensuring the realization of such an investment, the extension of the SCP is similar to the TAP pipeline, which represents the continuation of the SCP in the west and is recognized as a high priority project for the European Union. Both pipelines (the SCP upgrade and TAP) have been granted PCI status⁶². The SCP and TAP will provide Shah Deniz gas flow from the Caspian to European markets, and ensure the quality of Security of Supply in the Community market.

Figure 4. Southern Gas Corridor



We can assume that, like TAP (a Project of Energy Community (SoS) Interest that receives the derogation related to new infrastructure), the SCP, which is an important part of the Southern Gas Corridor, should also receive such an exemption if the central necessary precondition for derogation (i.e. the need for SoS) is taken into high consideration.

For granting a derogation, the level of risk and high cost associated with an investment is decisive. In particular, if the level of risks attached to the investments mean that they would not take place unless an exemption is granted. In this respect it should be taken into consideration that the Caucasus region remains a high risk one for investors, considering the political risks related to the complex geopolitics in the region, especially for the realization of the Southern Corridor. The recognition of the high political risk and uncertainty in this region is of great necessity. With respect to the SCP, TPA may be considered for Turkmen (Central Asian) natural gas only after the implementation of the Trans-Caspian gas pipeline. The same can be said for even more theoretical (i.e. less likely) gas imports from Kazakhstan, Turkmenistan and Iran, via Russia and Armenia.

62 Projects of Common Interest (PCIs), European Commission OCT.14, 2013 (SCP-(F)X: Upgrade of the existing pipeline system between Azerbaijan and Turkey via Georgia system with throughput capacity upgrades of 16 BCM/year by 2018 (SCP-X) and 5 BCM/year by 2019 (SCP-(F)X)), Opening the Southern Corridor, presentation by Lutz Landwehr, Commercial Director.

PCI status implies that: 1. TAP represents a high priority project for the European Union and concerned member states. 2. TAP can benefit from fast-track procedures for permits. The PCI status given to TAP provides the highest political support from the European Union and a formal political recognition that TAP is a crucial part of the Southern Gas Corridor.

Taking into account the risks related to possible changes, with respect to the legal regime applicable to the SCP, including for covering political and economic risks, the above mentioned preconditions for exemptions should also be taken into high consideration.

5.3.4. Effects of Energy Charter Treaty investment protection on regulatory changes pursuant to the Energy Community membership of Georgia

As was already stated, membership in the Energy Community requires in most cases enactment of new legislation. Such legislation could change the regulatory environment of existing investors. However, as also mentioned further above, the Energy Charter contains strong provisions on investor protection. If governmental acts, including new legislation, impair established investors of their benefits, they can make claims under a procedure provided for in the Energy Charter Treaty.

The fundamental principle here is that states are sovereign to enact any policy measure in view of attaining overarching public objectives, provided that the measure is reasonable, proportional, non-discriminatory and that they refrain from taking retroactive actions. This principle simultaneously satisfies the need of states to have a maximum choice of different policy measures at their disposal, and the needs of investors to be protected against unforeseeable governmental intervention into specific investments.

Bearing in mind all the above, we can assume that, based on the terms and conditions of the Project Agreement with the SCP consortium, any effort from the state aimed at changing the elements of the Project Agreement should be done by way of legislation respecting the above principles in order to avoid any kind of dispute and investor-state arbitration between the state and investor.

Chapter 6. Indicative guidelines for handling MFN and national treatment under the Energy Community regime

Chapter 6. Indicative guidelines for handling MFN and national treatment under the Energy Community regime

When considering access conditions to the cross-border system, the key question, which is important in respect to handling MFN and national treatment, is to determine for which individual trade measures third countries (non-EU and non-EnC) may be excluded. This section illustrates some examples of measures and suggests how to treat them.

A first example of a measure to be analysed concerns goods, namely the reciprocity of grid access of imported gas or electricity. The question is whether Georgia, once it is a member of the Energy Community, will be allowed to refuse grid access to such energy originating from WTO or ECT countries that have not opened their internal markets. The answer to this question is clearly **negative**. GATT and the ECT both provide for full national treatment as a basic principle. No FTA or customs union is needed to grant national treatment to WTO or ECT partners. In order to be WTO and ECT compatible, the reciprocity provision of the EU and Energy Community law may not be interpreted as negative reciprocity⁶³, but must be seen as positive reciprocity⁶⁴, thereby following the text of their formulation in EU directives (e.g. Directive 2009/73/EC, Art. 37).

To avoid imbalance in the opening of the gas markets:

“(a) contracts for supply with an eligible customer in the system of another Member State shall not be prohibited if the customer is eligible in both systems involved; and (b) where transactions as described in point (a) are refused because the customer is eligible in only one of the two systems, the Commission may, taking into account the situation in the market and the common interest, oblige the refusing party to execute the requested supply, at the request of one of the Member States of the two systems.”⁶⁵

The above implies that no favour shall be made in this regard towards EU or Energy Community countries. The Commission would also oblige the refusing party to execute the requested supply if a WTO panel ordered it to do so, in respect of national treatment obligations. Note that granting access to foreign energy on the basis of national treatment naturally increases Georgian security of energy supply and is therefore in Georgian interest.

A second example concerns services. The question here is whether Georgia, once it is member of the Energy Community Treaty, will be allowed to refuse access to a foreign energy service provider wishing to offer any energy related services on Georgian territory. Examples of such services are TSO or DSO ownerships or operations, energy wholesale or retail sales, ancillary services such as metering or billing, or employment of foreign nationals in enterprises of these areas, and also participation in any of the institutions or bodies created by virtue of Energy Community law to manage domestic energy markets. The answer to this question is most probably **affirmative**. Contrary to GATT, the General Agreement on Trade in Services (GATS) does not provide for a general national treatment obligation in services. The precise answer depends, however, on specific commitments made by Georgia in the area of WTO GATS Art. XVI, XVII and XVIII, and also on whether any bilateral FTAs provide for specific provisions in the energy sector with the partner country.

63 Example of negative reciprocity: “I refuse to give you what you refuse to give me.”

64 Example of positive reciprocity: “I grant to you what you grant to me.”

65 Article 37 of the Directive 2009/73/EC of 13 July 2009 concerning common rules for the internal market in natural gas

Note, however, that GATS still requires MFN. If Georgia allows for participation of foreign enterprises in any of these services, this should either be on national treatment basis, or, if this is not the case, be clearly laid out in an FTA with that respective country. In the absence of such a provision in an FTA, a third country whose service providers are excluded from the market while those of another country are allowed to operate might file a claim in the WTO for non-respect of MFN status.

The subsidiary question is whether Georgian membership in the Energy Community Treaty would change that situation, in the sense that it would oblige Georgia to give any favours in the energy services area to members of the EU or the Energy Community Treaty. The answer to this question is most probably **negative**. The Energy Community Treaty is not an FTA. It sets rules on organisation of domestic markets (e.g. regulated TPA, non-discrimination between transmission and transit) and obliges countries to cooperate in cross-border energy matters, but it does not fundamentally alter the access conditions of foreign energy service providers. Such access conditions are convened in GATS or in FTAs. The numerous exemptions from national treatment mentioned in the EU-Georgia DCFTA, including those in the energy area, would not disappear simply due to Georgian membership in the Energy Community. This would only change if the DCFTA is amended when Georgia enters the Energy Community.

This section cannot claim completeness, as a complete answer would require detailed analysis of GATS energy commitments under Art. XVI, XVII and XVIII as well as a detailed analysis of bilateral FTAs concluded between Georgia and all its energy-relevant partners, a task which would go beyond the scope of this report.

Summary of main findings

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- Georgia applied for membership in the Energy Community, expecting to get certain benefits. Energy Community membership and rules are advantageous because they enhance competition in the market and attract investments for stable and continuous energy supply, creating an integrated energy market with the common energy market of the European Union and increasing the quality of Security of Supply.
- Georgia is limited in its access to the benefits derived from the common energy market of the Energy Community/EU due to the peripheral geographical location of the country. The analysis of this report shows that the obvious barrier for the full implementation of the EnC Treaty is, on the one hand, Georgia's isolation from the Community market in terms of geography, technical considerations, and security, and on the other hand, the lack of a common approach at the regional level.
- It is evident that the region lacks institutional mechanisms which could bring together disparate national interests into a coherent set of harmonized rules for efficient cross-border trade capable of increasing the Security of Supply at the regional level.
- None of the states bordering Georgia apply harmonized rules with regard to cross-border trade. The Energy Charter draft Transit Protocol aimed at deepening cooperation on transit issues as an important element for cross-border trade in view of the common legal framework of which 'Common Principles' are shared by all South Caucasus states, including Turkey, but could not provide stimulus to move the energy cooperation of the member states into a more integrated direction. In addition, the EU-inspired Eastern Partnership platform for cooperation aimed at providing a political umbrella for regional cooperation through the reinforcement of bilateral and multilateral energy cooperation schemes, building upon the achievements of the Energy Community Treaty and of the Energy Charter Treaty⁶⁶, but could also not succeed in the approximation of the regulatory framework of the member states.
- In fact the different trading blocks (the 'free trade' agreements among the CIS countries; the Eurasian Customs Union of Russia, Belarus, and Kazakhstan; the Customs Union of Turkey and the EU; and the DCFTA Agreement of Georgia and the EU) being formed in the region highlight the different approaches of the countries in both legal and political perceptions, and a lack of collaboration to converge the legislative energy frameworks at the regional level for efficient cross-border trade. As a consequence, the limited access to new alternative suppliers is not the result of legal restrictions, but mainly of the existing political and diplomatic obstacles causing the absence of potential alternative suppliers in the region (for example transportation of Central Asian natural gas (in particular, from Turkmenistan) through a sub-sea pipeline across the Caspian).
- The South Caucasus Pipeline remains an important international supply route and a vital part of the Southern Corridor. It is therefore also logical that if the SCP consortium were not granted full flexibility and independence and if all purely cross-border infrastructure in Georgia were subject to the same regulations as domestic transmission, there might probably be no such cross-border project at all.
- The implementation of Energy Community/EU Energy rules in Georgia without additional measures might be a threat to the strategic relationship with the SCP consortium/investor,

66 EU Energy Law, Edited by Christopher Jones, Volume I, The Internal Energy Market, The Third Liberalization Package, Chapter 16 - The Internal Energy Market and Neighboring Countries

as the change of regulatory environment for existing investors might become a subject of renegotiation between the state and the investor.

- Georgia is likely to escape the full application of EnC Treaty/EU rules for the time being, since, due to Georgia's peripheral geographical position, the specifics of the energy markets and the nature of the goods traded are not capable of influencing economic activity between Georgia and another Energy Community Contracting Party, and are not implemented within the territory of the Common energy market.
- The full application of the EnC Treaty to Georgia can only be effective after the gas market of Georgia is physically connected to the main Energy Community network. In the contrary case, if the country cannot participate in the wider internal market of the EnC, competition cannot be effective and full liberalization may produce negative effects for the country in terms of Security of Supply. However, since the interconnectedness will, at some point, be improved, (dependent on the progress of Turkey's energy market integration in the EU, as a main land corridor for Georgia), the effects on trade between Georgia and other Energy Community Contracting Parties cannot be completely excluded in the distant future.



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