The Regulation of European Investments in the Russian Electricity Production Sector and *vice versa*: Towards Sustainable and Secure Electricity Markets?

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Climate change and security of supply are generally considered as the two major challenges characterising the ‘new energy landscape of the 21st century’. As regards electricity markets, massive investments are needed to reorganise this sector around more climate-friendly patterns. At the same time, major international institutions stress the urgent need for investments to replace ageing plants and to meet increasing demand.

At the level of the European Union, several legislative actions have been undertaken to tackle these ‘twin energy-related challenges’. On the one hand, directives have been enacted in order to reduce the emissions of greenhouse gases of the power generation sector. On the other hand, Directive 2003/54/EC of 26 June 2003 concerning Common Rules for the Internal Market in Electricity and Directive 2005/89/EC of 18 January 2006 concerning Measures to Safeguard Security of Electricity Supply and Infrastructure Investment integrate the concern of an adequate electricity production level to meet electricity demand.

The efforts of the European Union are not limited to the territory of its current 27 Member States. Initiatives directed at the transition towards sustainable and secure energy markets can also be identified in its external relations. Improved energy efficiency is increasingly advocated as a political priority on the international scene. Russia, being of strategic importance for energy supply to Europe, is a particular partner in this view. It can indeed be considered that the promotion of energy efficient investments in Russia contributes to the security of energy supply of the European Union. In this respect, more efficient electricity production would reduce (or stabilise) Russia’s domestic energy consumption and thus safeguard the amount of energy to be exported. Moreover, the promotion of energy efficient investments would, to a certain extent, avoid nullifying the European efforts to reduce its domestic emissions of greenhouse gases by an increase of energy consumption in Russia.

The challenge of sustainable and secure electricity production in Russia appears to be especially acute. The Russian power generation sector is indeed characterised by a high energy- and thus carbon-intensity. The potential of greenhouse gas reduction in this sector appears thus to be huge. Besides, recent black-outs have highlighted the urgent need of additional investments to maintain the balance between the demand and supply of electricity.

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European private investments are expected to play an important role to meet these challenges by transferring efficient technologies and capital to the Russian power generation sector. In order to facilitate such private investments, major legislative reforms have been undertaken. Indeed, Russia has launched a privatisation and liberalisation process of its electricity market. It promotes within this liberalisation process the production of electricity on the basis of renewable energy sources. Moreover, it has created a regulatory framework enabling the implementation of so-called Joint Implementation projects in accordance with the provisions of the Kyoto Protocol.

It can, however, be considered that the readiness of European investors to participate to the financing of this transition will depend on the ability of Russia to provide the right incentives and to guarantee a stable, secure and predictable investment climate. Given the high capital-intensity and long-lived nature of electricity investments, market players are reluctant to regulatory changes and uncertainty that may affect the profitability of their investments. Recent developments have highlighted the exposure of foreign investments in the energy sector to such risks.

Initiatives to stabilise the investment climate in the Russian energy sector have already been launched at the international level. In 1994 the Energy Charter Treaty (ECT) was signed together with the Energy Charter Treaty Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA). Both texts entered into legal force in 1998. The ECT contains among others important investment protection clauses in favour of foreign investors, whereas the PEEREA refers to policies and programmes aimed at improved energy efficiency. Although being a signatory party, Russia refrained until now to ratify these instruments and limited itself to a provisional application of their provisions.

Following this failure, the European efforts to stimulate energy (efficient) investments in Russia now primarily take place within the 1994 Partnership and Cooperation Agreement (PCA) between the European Union and Russian. In this context, the EU-Russian Energy Dialogue, and

5 Russian president V. Putin recently stated that “[w]e expect foreign investors to take part in a large-scale modernization programme for the Russian power industry. Generating capacity is to be increased here by more than 50 percent within 10 years.” Interfax Press Release of 13 June 2007 published on www.ies-holding.com (consulted on 14 June 2007).
6 According to Enogian “[t]he reform’s main goal, as stated by its proponents, is to attract massive foreign investment in aging and obsolete electricity industry in order to modernise it and to ensure its efficient operation.” Enogian, A, “Industrial and Institutional Restructuring of the Russian Electricity Sector: Status and Issues”, Energy Policy, 2006, 34, p. 3236. This view has recently be confirmed by the Russian President, providing that “a clear power market liberalization schedule has been established to make the environment comprehensible to investors.” Interfax Press Release of 13 June 2007, op cit.
8 See Resolution No. 332 approving the Regulation on the approval and review of the project implementation process under Article 6 of the Kyoto Protocol.
9 More generally, it can be considered that the electricity systems with the highest financing needs and the highest potential for emissions reductions tend to be in countries with the worst investment climates, the efficient development and financing of these systems having been hindered by these risky environments. Fankhauser and Lavric, The Investment Climate for Climate Investments: Joint Implementation in Transition Countries 2003, p. 22.
in particular the Thematic Group on Energy Efficiency, tries to reactivate the discussion and to propose political and legal instruments to tackle this issue. Based on the recognition of long-term energy interdependency, the creation of a regulatory system to stimulate energy efficient investments lies at the heart of the political debate.

The proposed research project takes place within this ongoing institutionalisation process of the EU-Russian relationship in the field of energy. It proposes a legal analysis of the promotion of energy efficient electricity production in Russia as a cooperative tool to tackle the common challenges of climate change and energy security and to formalise the EU-Russian energy interdependency.

The debate on what form the EU-Russian cooperation in the field of energy efficiency should take place is nowadays particularly relevant. Indeed, the PCA ends in November of this year. Its future, and in particular the role of energy and energy efficiency, is thus actively debated at the moment. Moreover, the prospect of Russia’s accession to the World Trade Organisation (WTO), its ratification of the Kyoto Protocol and the reform of its electricity sector are recent developments that will determine the legal shape of future actions in this field.

The central question of the proposed research project is:

“What is the regulatory environment for European investments in the Russian electricity production sector and how could it be improved to stimulate the energy efficiency of this sector?”

In the context of this research, the notion of energy efficient power generation refers to the use of efficient combustion engines of fossil-fuels, including combined heat and power as well as renewable energy sources.

From a first lecture of the existing literature in this field, it appears that in order to answer this question three sub-questions have to be raised:

1) To what extent do European investors have access, or will have access, to the Russian electricity production sector and under what conditions will they have to operate? This question requires an analysis of the reform of the Russian electricity market.

2) To what extent are energy efficient investments in the Russian electricity production sector entitled to benefit from the flexible mechanisms of the Kyoto Protocol? Are there other incentives to stimulate energy efficient investments in Russia? This second question thus deals with investment promotion.

3) To what extent are European investors protected against changes of the legal and regulatory regime governing their investments? How could the security, stability and predictability of the investment climate be improved for energy efficient investments? This question thus concerns investment protection.

It can be considered that the first two questions refer to pre-investment issues, whereas the third question concerns post-investment issues. On the one hand, pre-investment issues relate to the question whether an investor can enter a given market and under what conditions its investment will have to be operated. These conditions will generally determine the profitability of a given investment. Pre-investment issues thus concern the legal and regulatory regime forming the basis of the original investment decision. On the other hand, post-investment issues relate to changes of
these conditions once the investment has been made.

1. As regards the Russian electricity production sector, it will first have to be analysed whether the privatisation and liberalisation process as well as the Russian legislation on foreign investment allow European investors to enter the electricity market and build and operate power plants. Besides the question of authorisation or licensing of power plants, issues such as the connection and access of these plants to the grid appear to be crucial. An analysis of the status of Independent Power Producer and the conditions under which electricity can be sold on the wholesale market appear also to be relevant.

2. In addition, it will have to be analysed to what extent, and in accordance with what conditions, European investors in the Russian electricity market could base their business-case on support schemes for energy efficient investments. In particular, it appears relevant to analyse whether the refurbishment of existing power plants and the construction of new energy-efficient installations could be qualified as Joint Implementation projects in the sense of Article 6 of the Kyoto Protocol. Joint Implementation projects could be analysed as a potential EU-Russian cooperative support mechanism. In this view, both the applicable international provisions and the national implementation scheme should be examined. Such an analysis should take into consideration the compatibility of the support scheme with the reform of the electricity market. Besides, the domestic regulation on the promotion of renewable energy and energy efficiency and its relevance for the power generation sector shall be analysed.

3. The third sub-question requires an analysis of the investment protection granted to foreign investors in Russia. Domestic\textsuperscript{10} and international investment protection law applicable to foreign direct investments in the Russian electricity production sector shall be analysed in parallel with the question of the legal enforcement or ‘Rule of Law’. Attention shall be paid to the experience gathered with the previous implementation of similar projects in Russia. Besides, an analysis of international power generation projects shall highlight the risks and protection that can be offered against them. In this context, the potential application and interpretation of the principles of international investment protection law shall be analysed within the context of the Russian system. In parallel with this analysis, the provisions of the ECT and the PEEREA, and their relevance in the current context, will be examined. This analysis completes the overview of international investment protection law. It focuses on the case law developed by the ECT arbitral tribunals.\textsuperscript{11} Moreover, the reasons advanced by Russia to refuse ratifying these treaties will have to be assessed. Given the fact that Russia has opted for a ‘provisional’ application of these instruments, it appears interesting to examine to what extent it has already implemented the provisions related to the protection and promotion of energy efficient investments.

Based on the lessons drawn from the ‘failure’ of the ECT, the initiatives launched within the EU-Russian Energy Dialogue will be analysed. Attention will be paid to the specificity of the Russian energy sector and to the increasing willingness of Russia to be treated as an equal interlocutor and partner of the European Union. In this view, the Russian demand to benefit from the opening of the energy markets in Europe by securing control of downstream energy assets appears to be essential. Therefore, the importance of reciprocal investments in the electricity field will be examined. Such an analysis will have to take into account the current uncertainties characterising the liberalisation process of the electricity markets both in Russia and in the European Union, in view of the creation of a stable investment climate.

\textsuperscript{10} See the Federal Law on Foreign Investments in the Russian Federation of 9 July 1999, as amended.
\textsuperscript{11} Special attention will be given to the Nykomb Synergetics Technology Holding AB vs. the Republic of Latvia case of 16 December 2003.
In this view, an analysis of the creation of a level playing field (or common principles) between the European Union and Russia to enable energy efficient investments in the power generation sector appears to be essential. The convergence or harmonisation/approximation of their respective regulations of the electricity market, in particular as regards energy efficiency, will be examined. Regulatory convergence is indeed expected to contribute to a secure investment climate\(^\text{12}\) and to facilitate support for reciprocal investments in this field. The ultimate aim would be to propose an alternative to the unilateral imposition of terms\(^\text{13}\) (or ‘juridical imperialism’\(^\text{14}\)) by the European Union on Russia and to work towards an increased mutual trust in their energy relationship.

Such an analysis requires a certain familiarisation with harmonisation techniques. It can, at least to a certain extent, be inspired by the harmonisation of the legislation of the ‘new’ Member States to the *acquis communautaire*, but will have to depart from its unilateral perspective. It also requires defining the core principles underlying the European and Russian electricity sectors, in particular those relevant for energy efficiency investments in the power generation sector. A study of the European legal history as regards the development of energy efficiency within the liberalisation process appears to be relevant in this view. Moreover, it has to be recalled that this analysis will have to take into account the specificity of the Russian energy sector, in particular the strategic importance it represents for Russia.

Current state of the research:

- “Improving the Climate for European Investments in the Russian Electricity Production Sector: (I) The Role of Investment Protection Law”, *Journal of Energy and Natural Resources Law*, 2008, (accepted for publication, forthcoming);

- “Improving the Climate for European Investments in the Russian Electricity Production Sector: (II) The Role of Regulatory Convergence”, *Journal of Energy and Natural Resources Law*, 2008, (accepted for publication, forthcoming);


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\(^{13}\) See Article 55 of the Partnership and Cooperation Agreement providing that “[t]he Parties recognize that an important condition for strengthening the economic links between Russia and the Community is the approximation of legislation. Russia shall endeavour to ensure that its legislation will be gradually made compatible with that of the Community.”