

FDI in International Energy, Russia-EU relations & Energy Charter (Seminar at Prof. Bressand's class)

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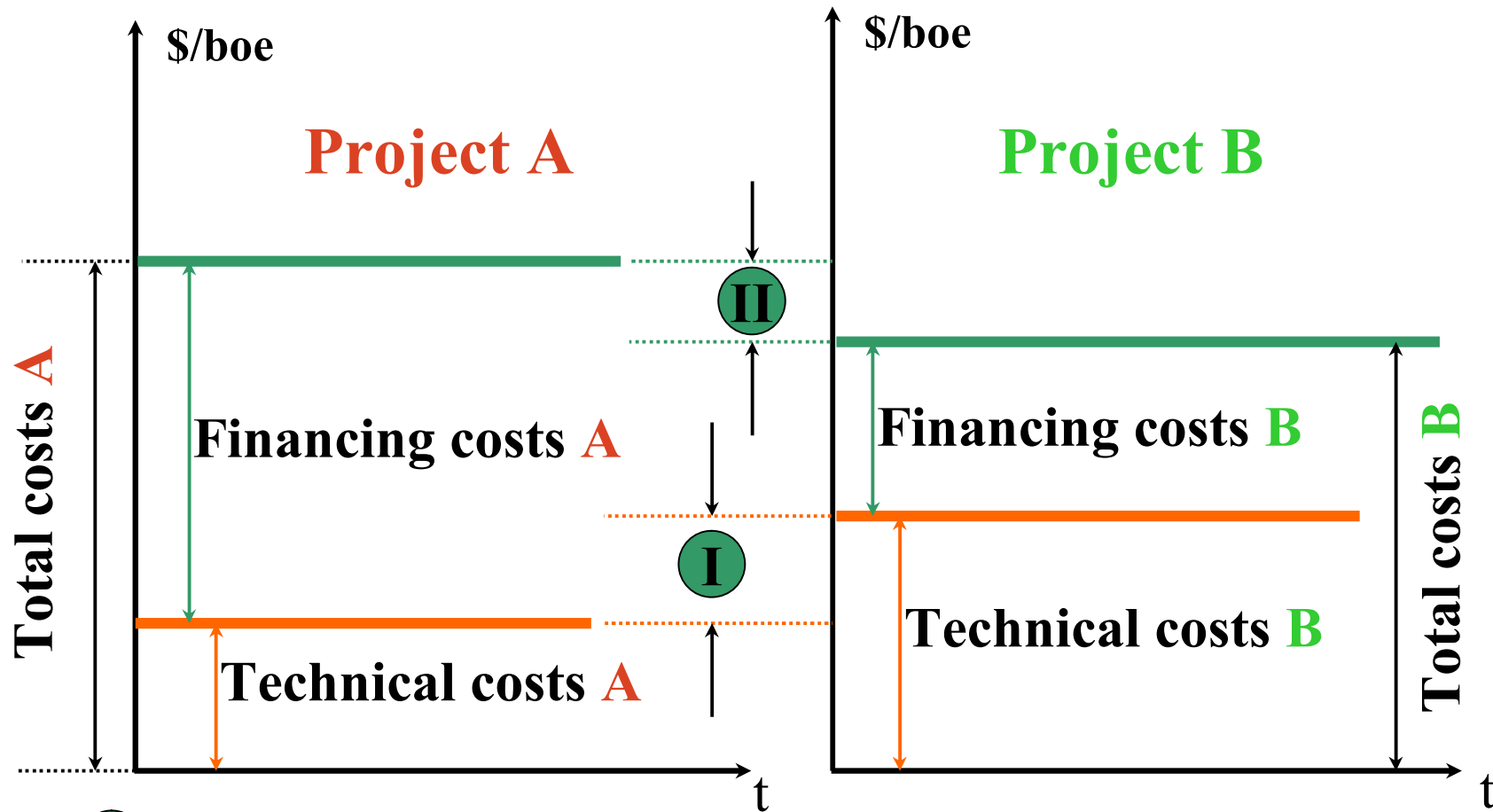
ENERGY ECONOMY: DEMAND FOR QUALITY OF REGULATORY FRAMEWORK

Energy projects (compared to other industries):

- Highest capital intensity (absolute & unit CAPEX per project),
- Longest project life-cycles,
- Longest pay-back periods,
- Geology risks (+ immobile infrastructure, etc.),
- Highest demand for legal & tax stability,
- Role of risk management

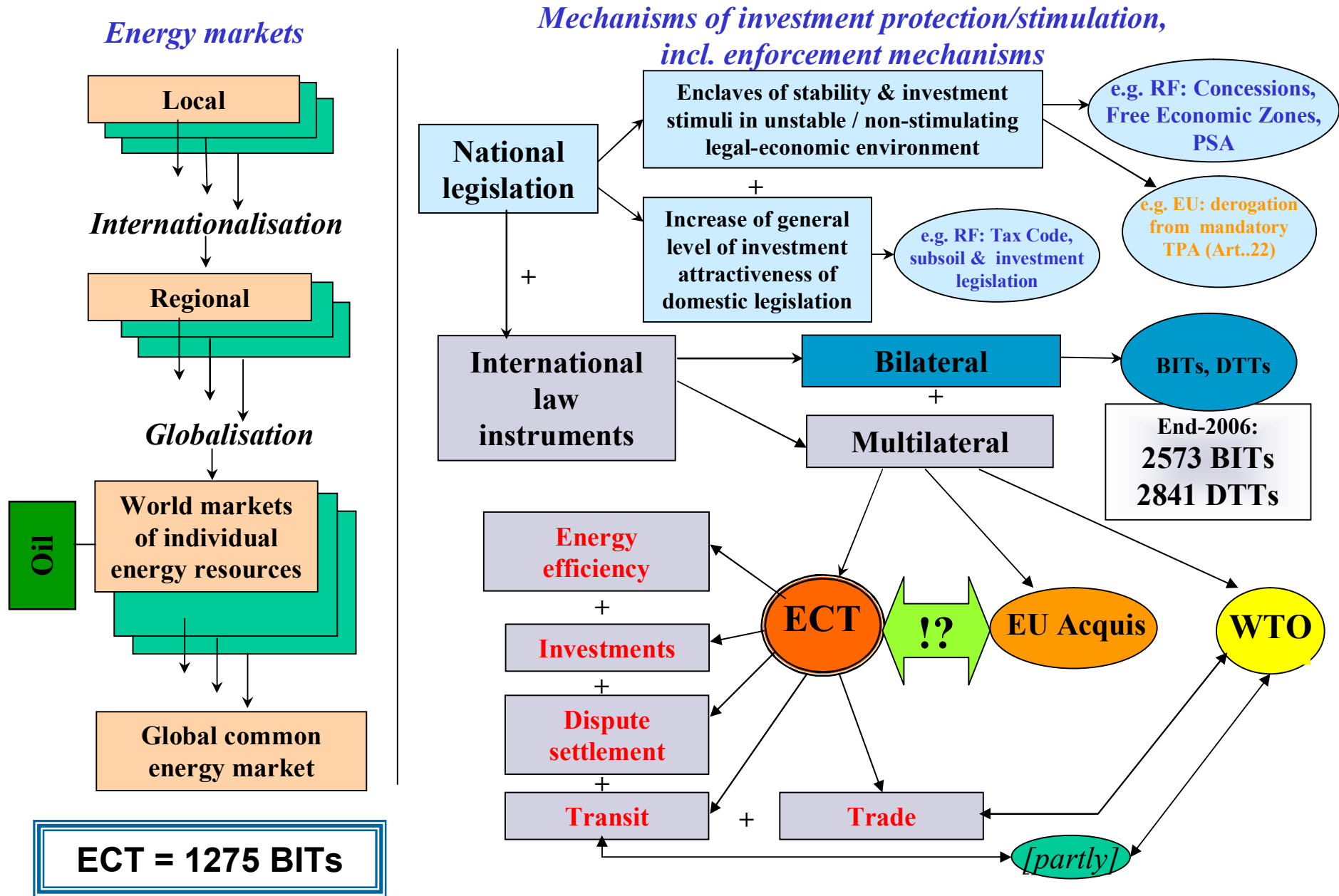
=> Higher demand for “quality” of legal and regulatory framework compared to other industries

"NATURAL" VS. "FINAL" COMPETITIVE ADVANTAGES OF ENERGY PROJECTS



- I** "Natural advantage" of project A over project B ($A < B$)
- II** Final competitive *dis*advantage of project A over project B ($A > B$)

DEVELOPMENT OF INTERNATIONAL ENERGY MARKETS & MECHANISMS OF INVESTMENT PROTECTION/STIMULATION



SELECTED INTERNATIONAL INVESTMENT-RELATED AGREEMENTS

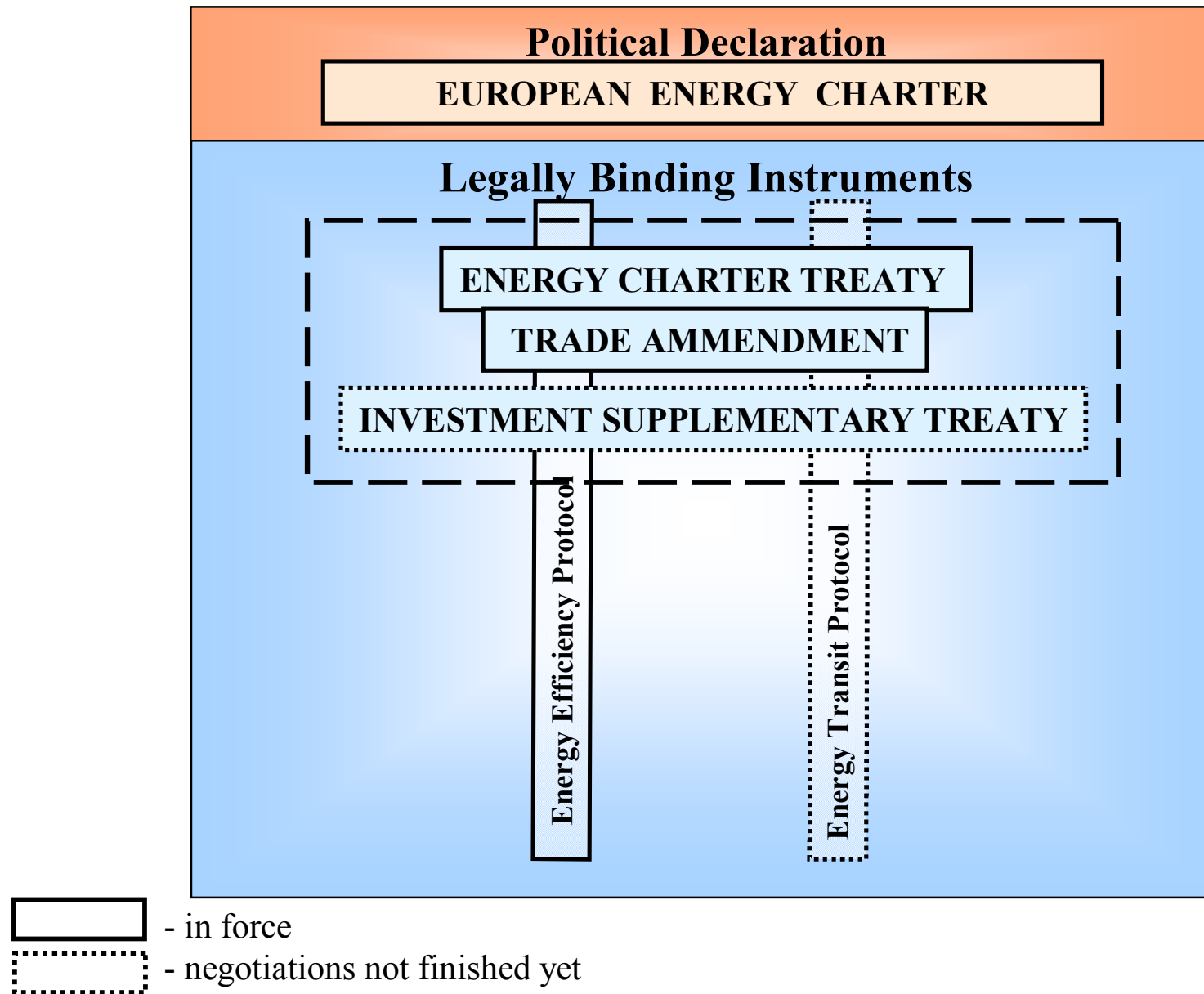
Organisation (member-states/CPs)	Legal Status	Scope	Investment	Trade	Transit	Energy Efficiency	Dispute Settlement
ECT (51/52)	LB	Energy	Yes	Yes	Yes	Yes	Yes
WTO (149)	LB	General	(Yes?) (Services)	Yes	Yes/No*	No	Yes
NAFTA (3)	LB	General	Yes	Yes	No	No	Yes
MERCOSUR (4)	LB	General	Yes	Yes	No	No	Yes
OECD (30)	LB	General	Yes	No	No	No	No
APEC (21)	<i>Non-LB</i>	General	Yes	Yes	No	No	No

* application of GATT Art.V to grid-bound transportation systems is under debate

Plus specialised energy-related organisations: OPEC, IEA, IEF, UN ECE (partly), IAEA, ...

Plus specialised “regional” organisations: BSEC, BASREC, ...

ENERGY CHARTER AND RELATED DOCUMENTS



ENERGY CHARTER SPECIFIC ROLE

- **Energy Charter *Treaty***

- Unique coverage of different areas for *energy* cooperation:

- investment, trade, transit, energy efficiency, dispute settlement,
- energy materials & products + energy-related equipment,
- 51 member-states (52 CPs) + 20 observer-states + 10 observer international organisations

- First and only one multilateral investment agreement with high standard of investment protection, incl. dispute settlement

- **Energy Charter *process***

- *Implementation* of ECT,

- Specialized forum for “*advanced*” *discussion* of the issues of energy markets evolution that *might create new risks* for development of energy projects in ECT member-states,

- Platform for *preparation of new legally binding instruments* to diminish such risks within ECT member-states (e.g. broadening & deepening of ECT & upgrading its “*minimum standard*” of protection)

ECT = THE FIRST MULTILATERAL INVESTMENT AGREEMENT (1)

- Based on:
 - well-established practice of BITs (about 400 BITs at the beginning of the 1990's - around 2600 BITs as of today)
 - investment chapter XI of NAFTA (US, Canada, Mexico)
 - some interaction with then OECD proposed “Multilateral Agreement for Investment” (MAI – aborted in 1998)
- **Within 51 member-states ECT is equal to 1275 BITs**
- MFN and National Treatment for investors:
 - *hard-law* obligations (binding guarantee) of non-discriminatory treatment for *post*-establishment phase,
 - *soft-law* obligations for *pre*-establishment phase (stage of making investment)

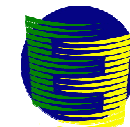
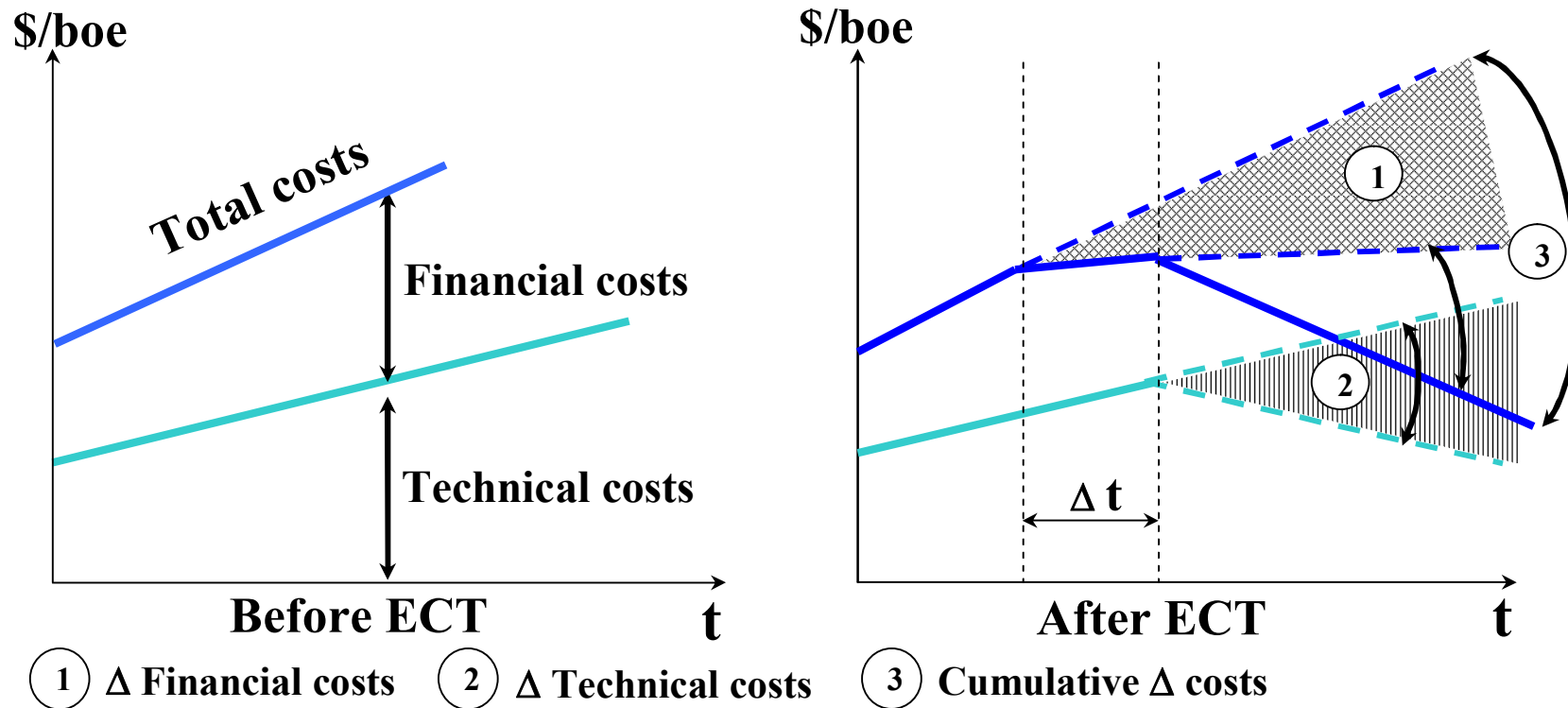
ECT = THE FIRST MULTILATERAL INVESTMENT AGREEMENT (2)

- Protection against key political/regulatory risk:
 - expropriation and nationalisation,
 - breach of individual investment contracts,
 - unjustified restrictions on transfer of funds
- Reinforced by access to binding international arbitration in case of dispute:
 - State-to-state, and **(NOVELTY!)** investor-to-state => direct dispute settlement at investor's choice at ICSID, UNCITRAL or ICC Stockholm (*competence: appr.50% of new ICSID submissions & appr.20% of ICC cases relates to energy*),
 - Awards:
 - ✓ final and enforceable under New York convention,
 - ✓ usually as entitlement to payment (no risk of vicious circle for retaliating measures),
 - ✓ retroactive to start of dispute, may include interest (no incentive to delay process)

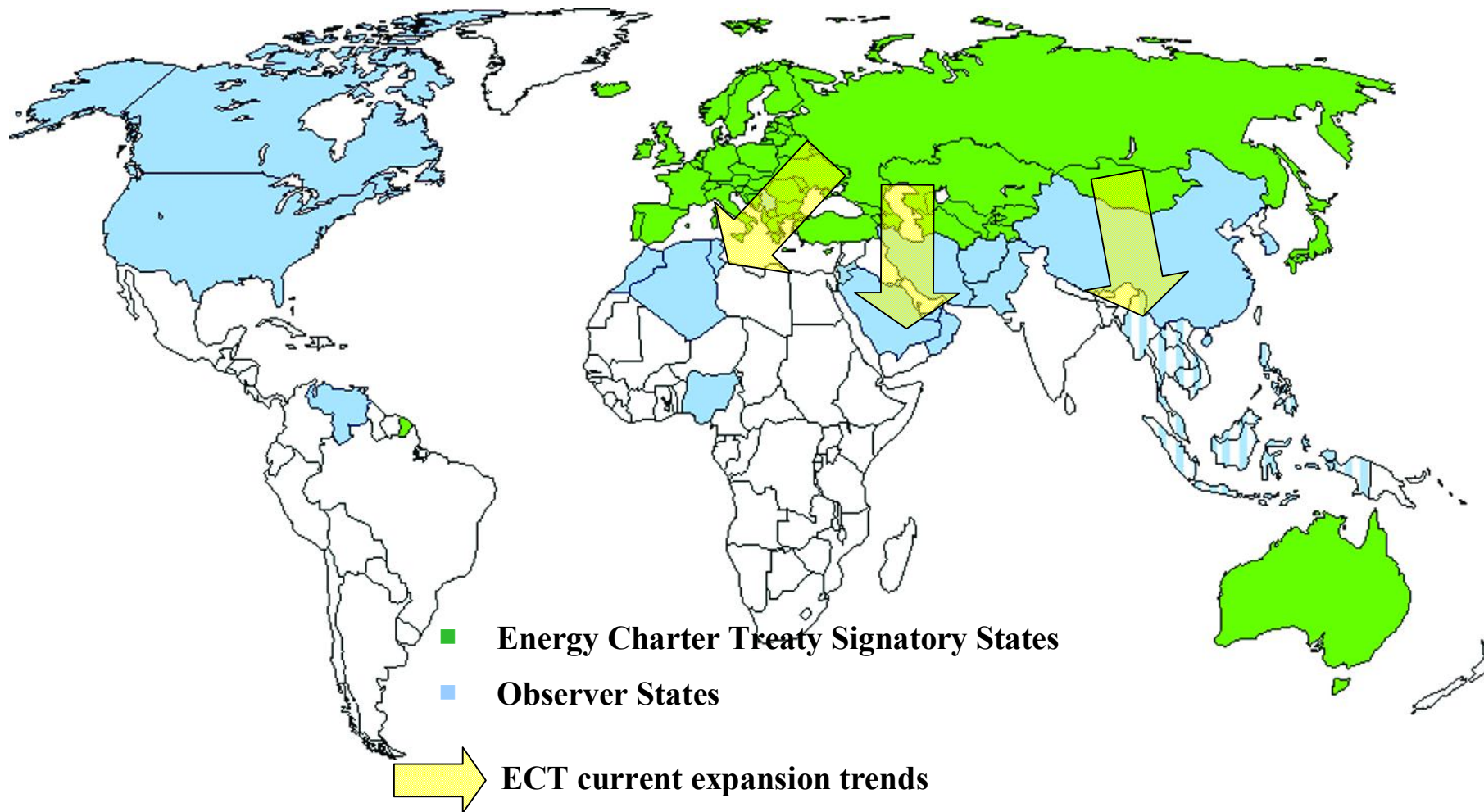
ROLE OF THE ECT FOR PROJECT FINANCING (ECT IS A BUSINESS-ORIENTED TREATY)

ECT/Legislation → ↓ risks → ↓ financial costs (cost of capital) = (1) →
 ↑ inflow of investments (i.e. ↑ FDI, ↓ capital flight) → ↑ CAPEX → ↓ technical costs = (2) →
 (1) + (2) = (3) → ↑ pre-tax profit → ↑ IRR (if adequate tax system) → ↑ competitiveness →
 ↑ market share → ↑ sales volumes → ↑ revenue volumes

ECT provides multiplier legal effect in diminishing risks with consequential economic results in cost reduction and increase of revenues and profits

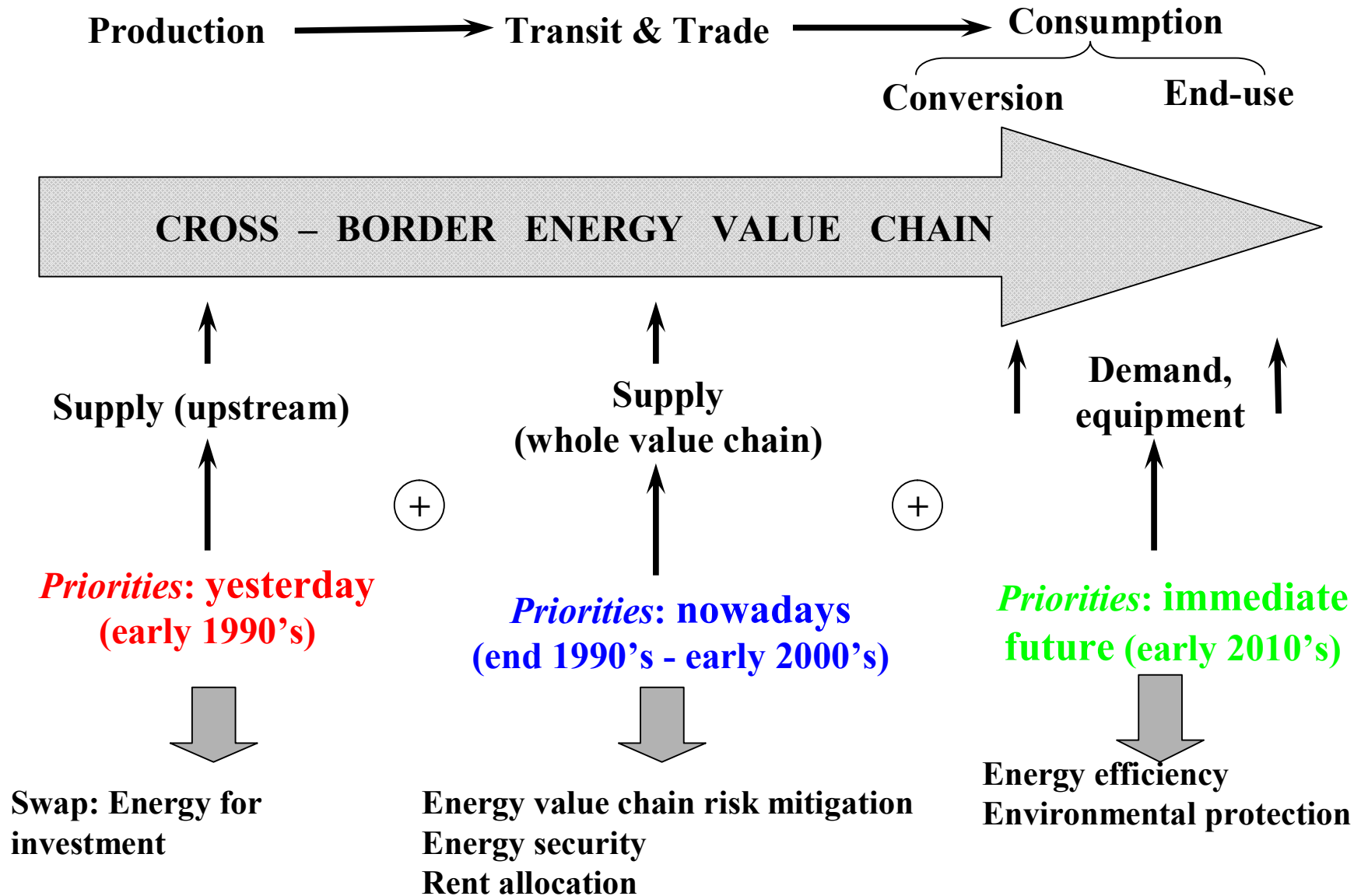


ENERGY CHARTER PROCESS: GEOGRAPHICAL DEVELOPMENT

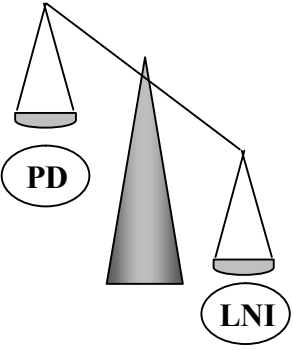
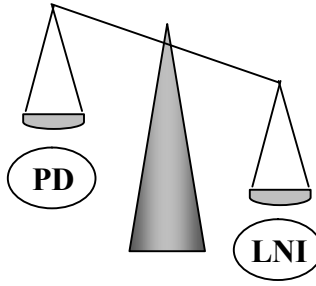
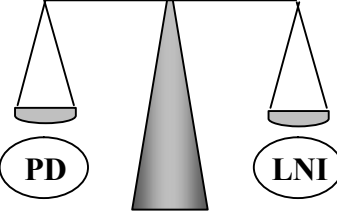
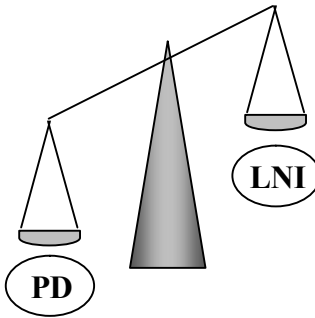


1. From trans-Atlantic political declaration to broader Eurasian single energy market
2. ECT expansion - objective and logical process based on clear economic and financial reasoning

ENERGY CHARTER: BROADENING PRIORITIES



ENERGY CHARTER: EVOLVING BALANCE OF ACTIVITIES

<p>1990 - 1994</p> 	<p>1994 - 1999</p> 	<p>1999 - 2004</p> 	<p>2004 - 2009</p> 
<ul style="list-style-type: none"> ▪ All policy debate was done in 1991 prior to/during negotiations on (European) Energy Charter political declaration ▪ Only legal negotiations (ECT+PEEREA) ▪ No implementation yet 	<ul style="list-style-type: none"> ▪ <u>ECT came into force (1998)</u> ▪ Little policy debate ▪ Legal negotiations (Supplementary Treaty, Trade Amendment) ▪ Implementation (ECT+PEEREA) <p>PD – policy debate LNI – Legal negotiations and implementation</p>	<ul style="list-style-type: none"> ▪ More focused policy debate (established as integral part of the Charter Process by 1999 ECT Policy Review) ▪ Few legal negotiations (Transit Protocol) ▪ Implementation (ECT+PEEREA) 	<ul style="list-style-type: none"> ▪ Active policy debate based on 2004 ECT Policy Review results & further to new challenges & risks of energy markets developments => preparation to 2009 Review ▪ No immediate new legal negotiations (by/multi-lateral discussion on TP) ▪ Implementation (ECT+PEEREA)

ENERGY INVESTMENT PROTECTION: COMPLIMENTARITY OF ENERGY-RELATED INTERNATIONAL ORGANISATIONS

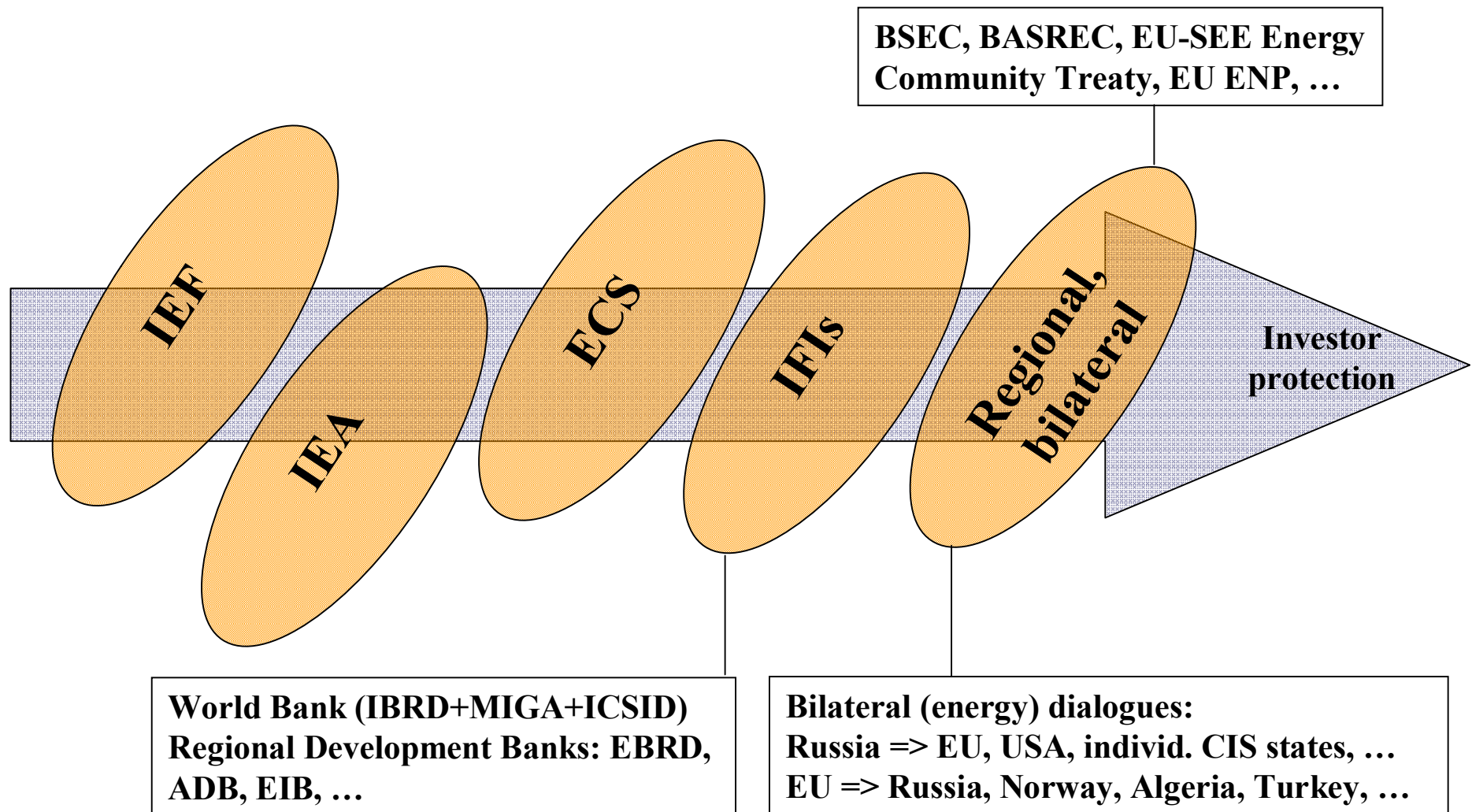
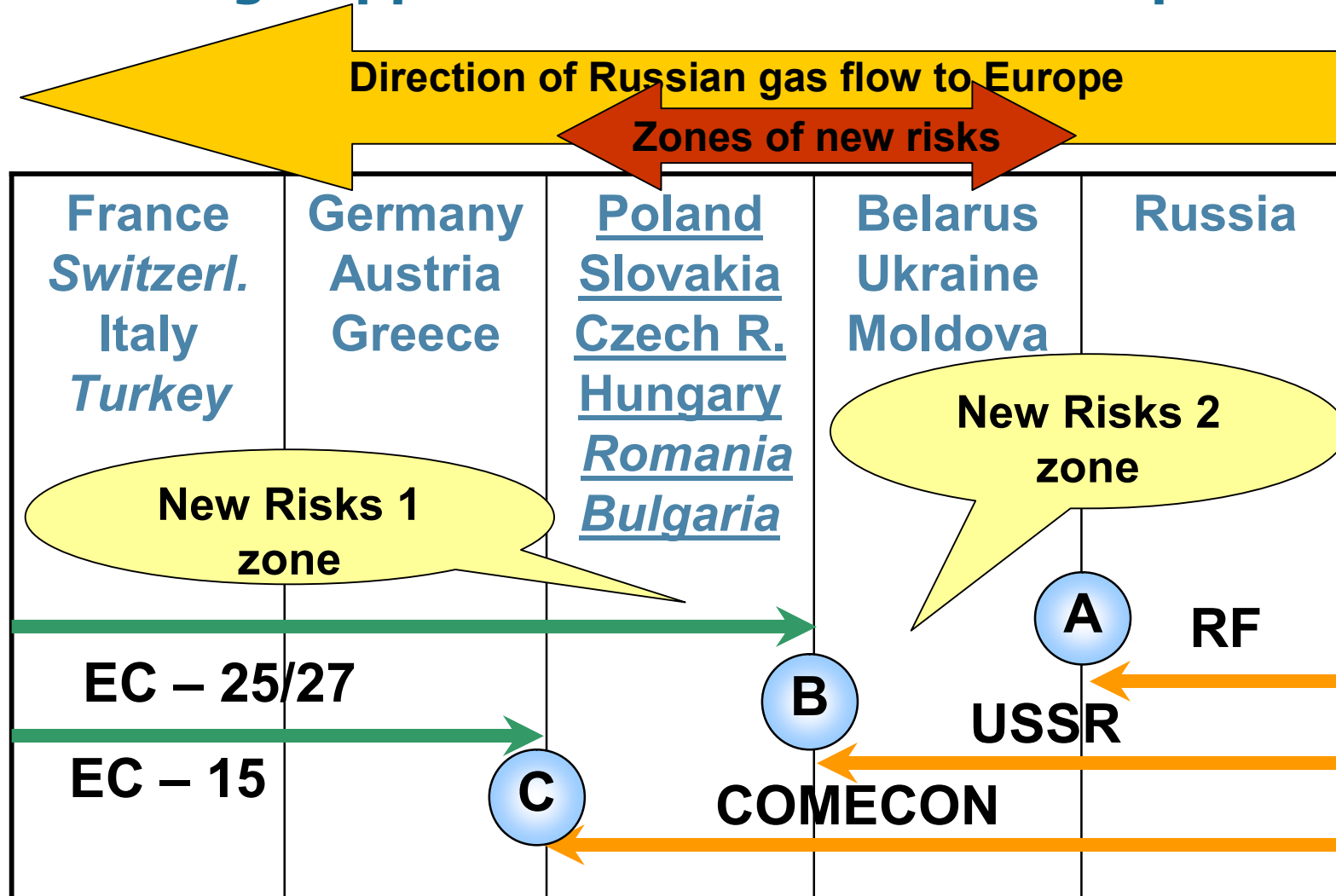


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Russian Gas Supplies to Europe: Zones of New Risks for Existing Supplies Within RF Area of Responsibility

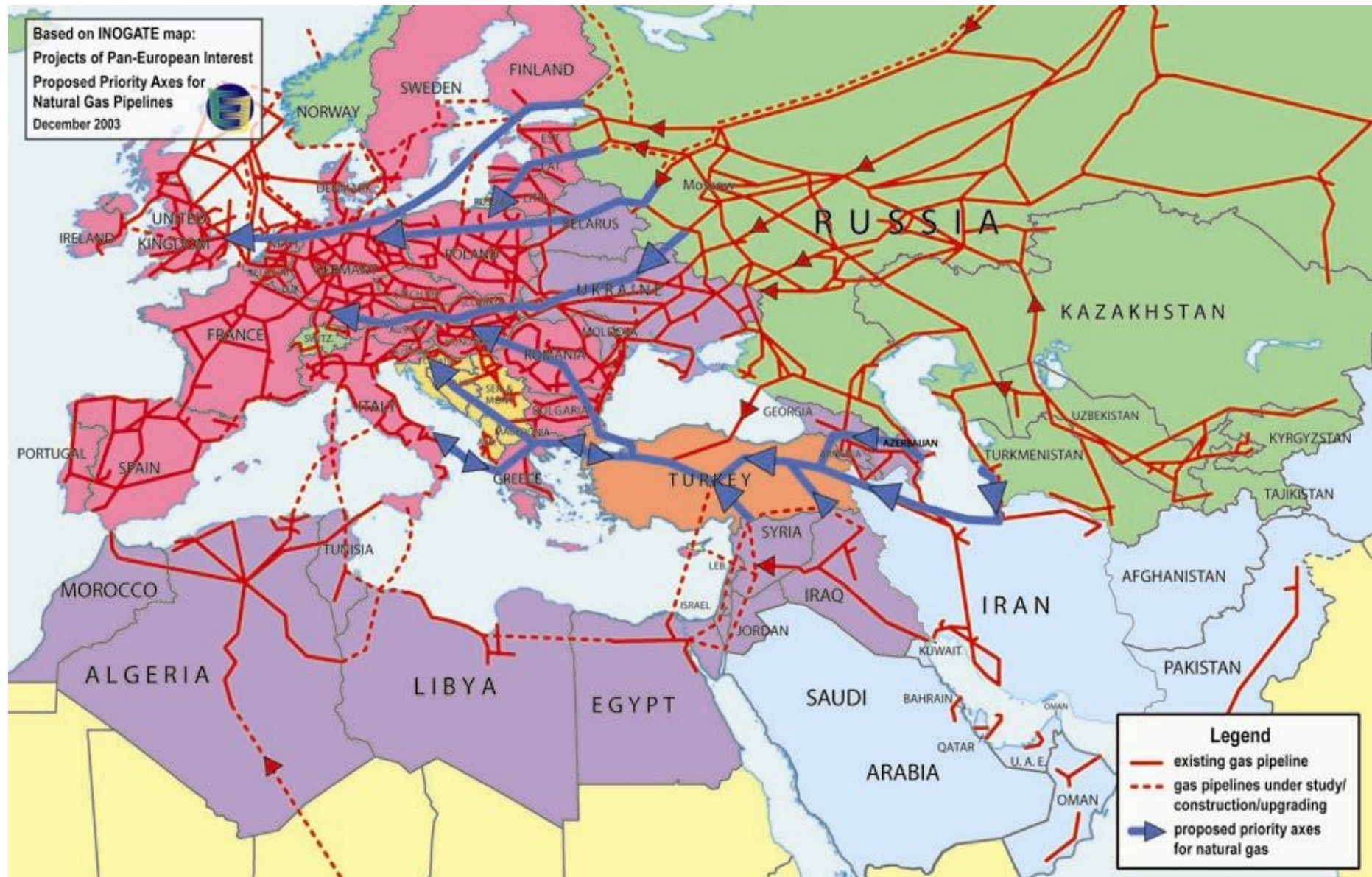


Italic – non-EU countries; New EU accession states: underlined – since 01.05.2004, underlined + italic – since 1.01.2007; A, B, C – points of change of ownership for Russian gas and/or pipeline on its way to Europe

RUSSIA'S GAS SUPPLY TO EUROPE: NEW RISKS - WHICH, WHEN & WHERE (in the zone of responsibility of Russian side)

- **Since 1991:** upstream to delivery points, within CIS/NIS
 - USSR dissolution + diversified supply routes => new transit risks
- **Since 2002/03:** + at delivery points (consequences for Russian gas at end-use EU markets?)
 - solution on destination clauses = package deal, but whether it balanced? (e.g. TAG Dec'05 auction - capacity allocation procedure)
- **Since 2004/07:** + upstream to delivery points, within enlarged EU-25/27
 - combined result of EU expansion + EU gas market liberalization => new prospective transit / transportation risks
- **Role of 3rd EU liberalization package?** (announced 19 September 2007)

Figure 1. Common rules of the game in Eurasian energy & export of EU's acquis



Common rules of the game in Eurasian energy & export of EU's acquis ? (legend to figures 1 & 2)


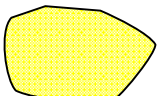
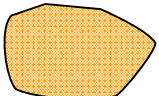
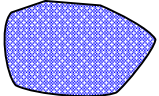
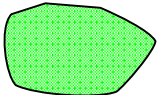
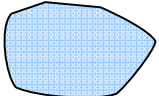
Zone	States within the zone	Description
	EU Members: 27 EU countries	EU legislation, including the energy legislation, is fully applicable
	Energy Community EU-SEE Countries: Croatia, Serbia, Montenegro, Croatia, Bosnia, FYROM (Macedonia), Albania, UNMIK (Kosova); other Energy Community members are already EU members	Only EU legislation on internal electricity and gas markets is applicable
	EU Candidate Countries: Turkey (Croatia is already an Energy Community member so applying the EU energy market acquis)	Still in the process of alignment to the EU legislation but full compliance not likely before membership
	EU Neighbourhood Policy Countries: CIS (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine) and Northern Africa (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, the Palestinian Authority, Syria, Tunisia)	Enhanced energy cooperation based on National Action Plans with Ukraine and Moldova (as well as with Israel, Jordan, Morocco, the Palestinian Authority and Tunisia); partial application of EU energy policies and legislation may be possible in the future
	EU-Russia Strategic Partnership: EU & Russia	Based on shared principles and objectives; applicability of the EU legislation in Russia is out of question
	ECT member-states: 51 states of Europe & Asia	ECT is fully applicable within the EU as minimum standard; EU went further in liberalizing its internal energy market, BUT whether EU can demand that other ECT member-states follow same model and speed of developing their domestic markets?
	ECT observer-states: 20 states of Europe, Asia (e.g. Middle East, South-, SE- & NE-Asia), Africa, North & Latin America	Shared ECT aims & principles; did not take ECT legally binding rules; not ready to take more liberal rules of EU Acquis

Figure 2. Common rules of the game in Eurasian energy & expansion of ECT

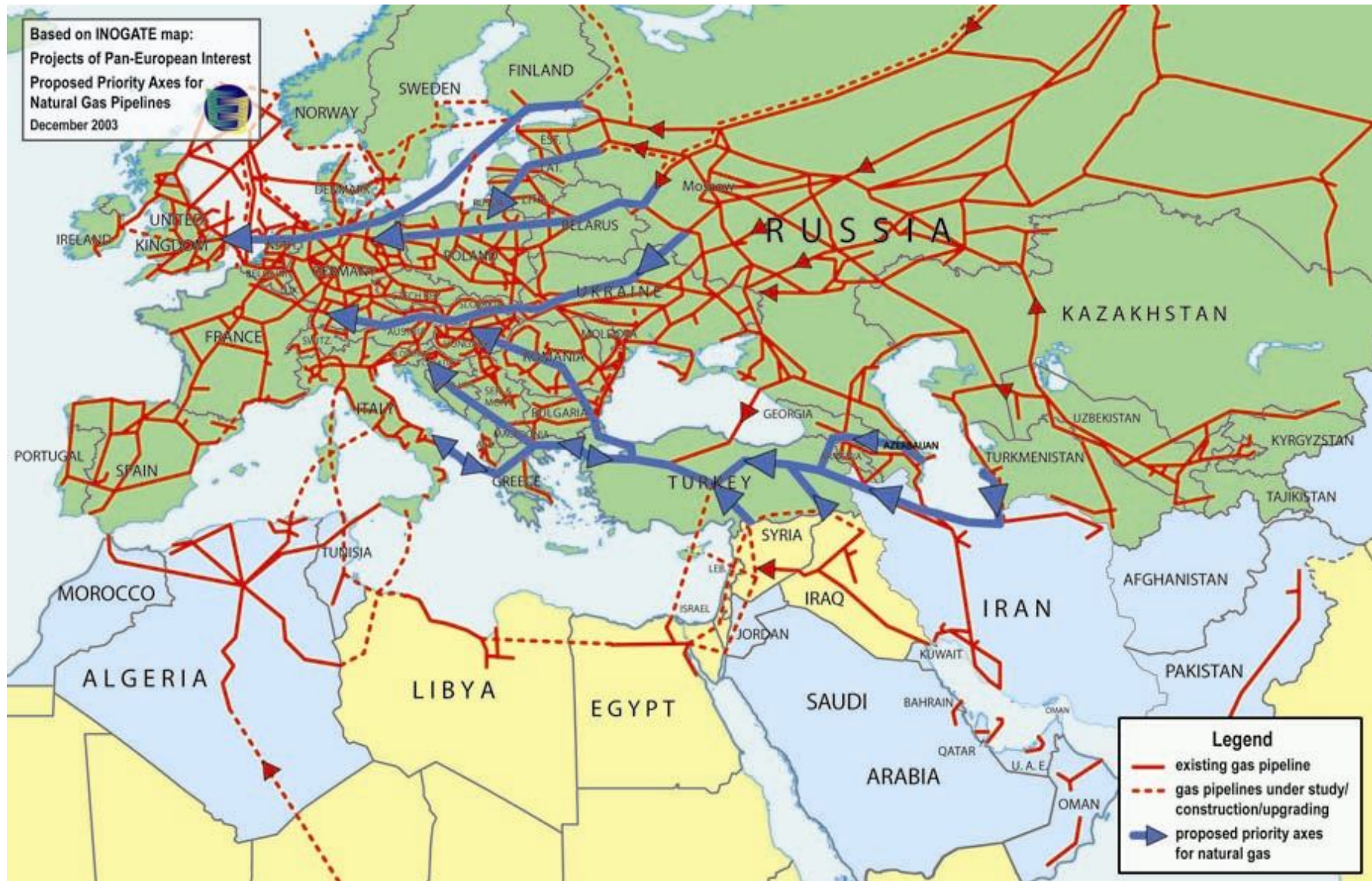
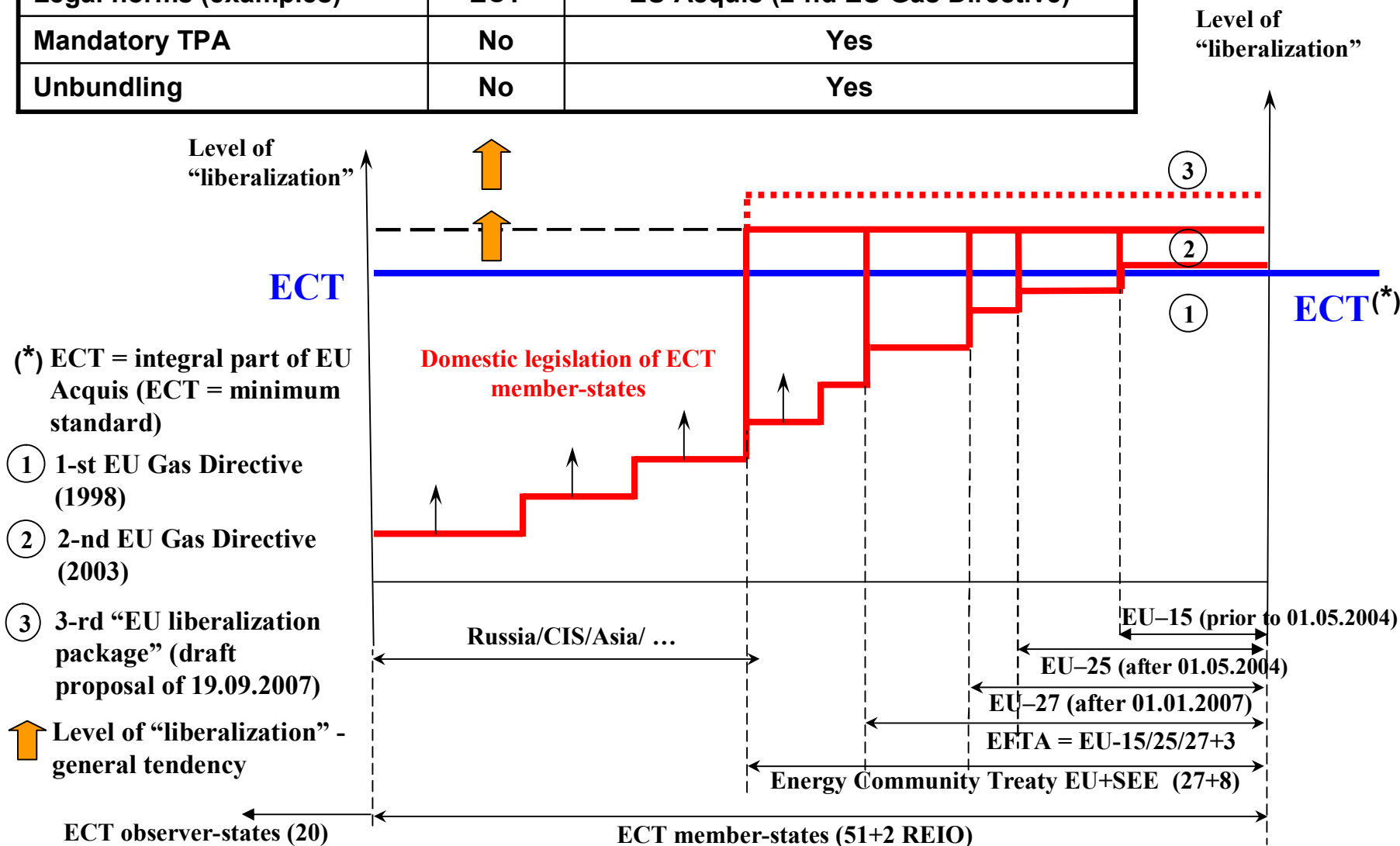
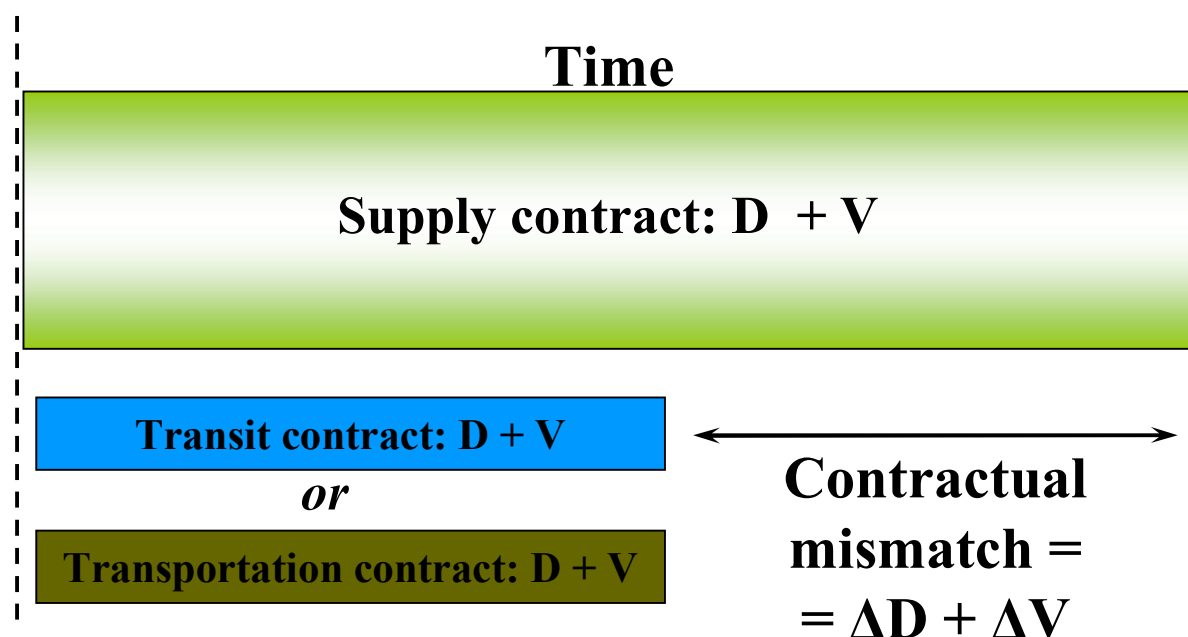


Figure 3. ECT & EU acquis: "minimum standard" within evolving Eurasian common energy space vs. more "liberalized" model

Legal norms (examples)	ECT	EU Acquis (2-nd EU Gas Directive)
Mandatory TPA	No	Yes
Unbundling	No	Yes



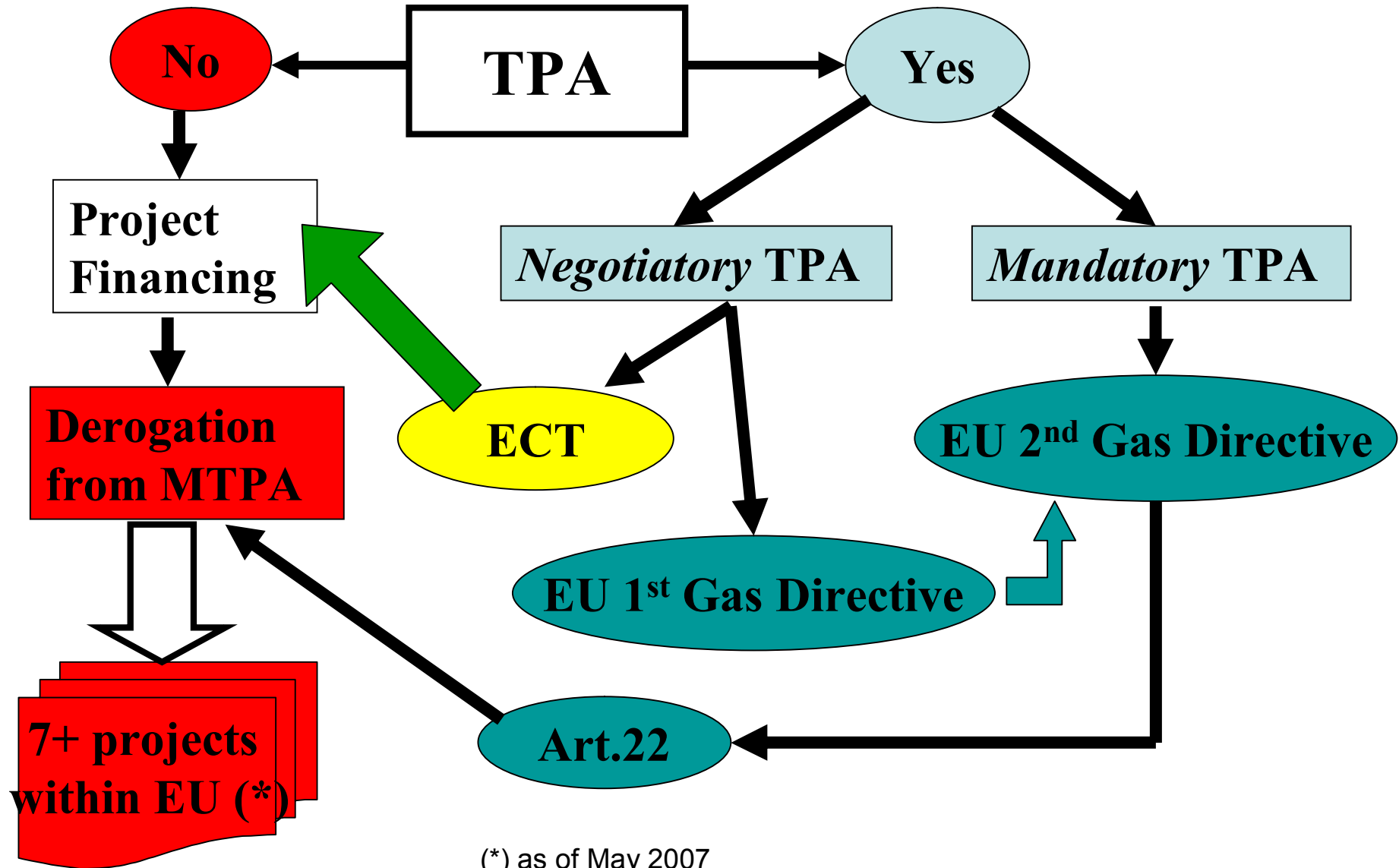
Contractual Mismatch Problem (Draft TP Art.8)



Mismatch: between duration/ volumes (D/V) of long term supply (delivery) contract and transit/transportation contract as integral part to fulfill the delivery contract => risk of non-renewal of transit / transportation contract => risk for supply contract.

Core issue: guarantee of access to / creation of adequate transportation capacity for the duration of long term contracts.

Competition & investment: Debate on Third Party Access (TPA)

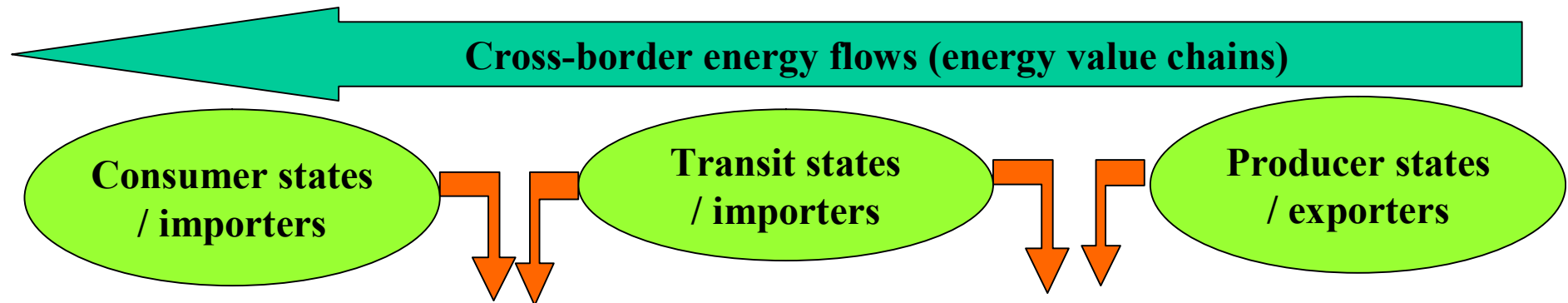


(*) as of May 2007

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INTERNATIONAL ENERGY: COMPETITION & INVESTMENTS



Aim of importers = increase import supplies of EMP => to **decrease** energy **prices** for end-users => competition is **not** the end in itself, but the **mean** to achieve major aim => competition between exporters (!?) => diversification of supply routes from existing exporters (multiple pipelines) + new exporters & supply routes (multiple supplies) => **CAPEX + time** => competition (cooperation? coordination?) between few major producers;
But: competition increases energy prices for end-users if organised as increase of number of **traders** (especially of small re-sellers) at the consumer/importer market under **limited supply** (restricted, *inter alia*, by liberalization risks for exporters) => investment stimuli (growing markets) dominates over demands for competition (mature markets)

Non-renewable energy resources: limited number of producers / exporters + national sovereignty on energy resources (UNGA Res.N1803 / 1962 + ECT Art.18);
Aim of exporters = resource rent maximization (Hotelling rent + Ricardian rent);
 Competition (for exporters) = diversification of supply routes to existing markets & access to new markets => **CAPEX + time**

Competition = f (CAPEX + time + ...) !!! => investment rules !!!

MATURE & GROWING ENERGY MARKETS ARE DIFFERENT => TO DISTINGUISH THEM

GROWING MARKETS:

- Aim: to develop markets to mature stage = to tie together different segments of energy value chain = to create new energy infrastructure => investment stimuli for domestic & foreign investors regarding creation basic infrastructure
- Basic (most costly/risky) infrastructure is being/to be developed and pay-back periods are still ahead
- Creation of basic infrastructure => aimed to develop access to resources and markets = most costly/risky (pioneering) projects with longest pay-back periods (+ macroeconomic costs usually imputed to these projects)

MATURE MARKETS:

- Aim: to improve their operational efficiency within existing infrastructure/established energy value chains => open & competitive markets, multiple choice & access to diversified infrastructure (both for producers/suppliers & consumers)
- Basic (most costly/risky) infrastructure has been already developed & pay-back periods are over
- Expansion (diversification) of existing basic infrastructure => aimed to provide multiple choice for market participants = less costly/risky projects with shorter pay-back periods

=> Demand for different legal instruments at different stages of market development

INTERNATIONAL ENERGY LAW: WHOM TO PROTECT FIRST - TRADERS/SPECULATORS *OR* INVESTORS/PRODUCERS/HEDGERS?

Competition rules – most important for **mature** markets (?), since aimed mostly on suppliers-traders (speculators) who:

- work at “**paper** energy” markets
- interested in **liquid & volatile** market (**short-term**)
- make money from providing **financial services**, not energies (money=>money)
- create bubbles & financial crises (when “paper” value exceed too much “physical” value of the market)

Investment rules – most important for **growing** markets (?), since aimed mostly on suppliers-producers (hedgers) who:

- work at “**physical** energy” markets
- interested in **stable & predictable** market (**longer-term**)
- make money from providing **goods & non-financial services** to energy consumers (money=>goods=>money)

Whom international law is aimed to protect first/more: financial speculators *or* suppliers of goods & services ?

THEN AND NOW: CHANGING ROLE OF FDI?

To develop its natural resources (projects) resource-owning state needs:

- **money/finance:** *then* – VIOC/FDI, *now* – NOC (both equity & debt + sovereign budget financing)
- **capital (technologies/innovations):** *then* – VIOC/FDI, *now* – NOC via OECD service companies
- **skilled labour:** *then* VIOC/FDI, *now* – NOC (domestic blue-collars)
- **managerial skills:** *then* VIOC/FDI, *now* – NOC (OECD-originated & domestic white-collars)
- Changing role of FDI !?

New challenges?: Diminishing role of traditional FDI in energy (OECD to non-OECD)? New FDI in energy are developing (non-OECD to OECD & to non-OECD)?

INTERNATIONAL ENERGY LAW: CHANGING PRIORITIES OVER TIME (1)?

Then:

- **Aim:** to continue develop fossil fuel energy economy =>
- access to resources of fossil fuels outside of OECD by FDI/IOC from OECD (“security of supplies”/SoS concept) =>
- international energy law reflects SoS concepts developed in OECD to protect FDI/IOC from OECD in non-OECD => dominated by “Western” priorities, *but* =>

Now (1):

- whether these FDI-supportive “Western”/OECD concepts incorporated in international law still acceptable for OECD states when they face capital-exporting intentions of non-OECD “Eastern” energy producers (NOC) to invest in OECD? =>
- protectionist measures in “open & competitive” OECD markets against FDI (NOC) from “Eastern” (non-OECD) energy producers?

Changing role of FDI? => move away from open investment rules?

INTERNATIONAL ENERGY LAW: CHANGING PRIORITIES OVER TIME (2)?

Now (2):

- **Aim:** to shift to non-fossil fuel energy economy =>
- Energy Efficiency & Climate Change =>
- new challenges & models for international energy law to reflect further transition *from* specific country/regional energy markets, united by cross-border flows of energy & investment, *to* global energy markets/market =>
- emphasis shifts from protection of individual companies of consumer states in international trade & investment (FDI) to creation of global instruments common & acceptable for all states & companies within cross-border energy value chains?

Changing role of FDI? => changing priorities for international legal instruments? => international rule-making towards supra-national governance (global energy markets) vs. sovereign prerogative (state sovereignty on natural resources)?