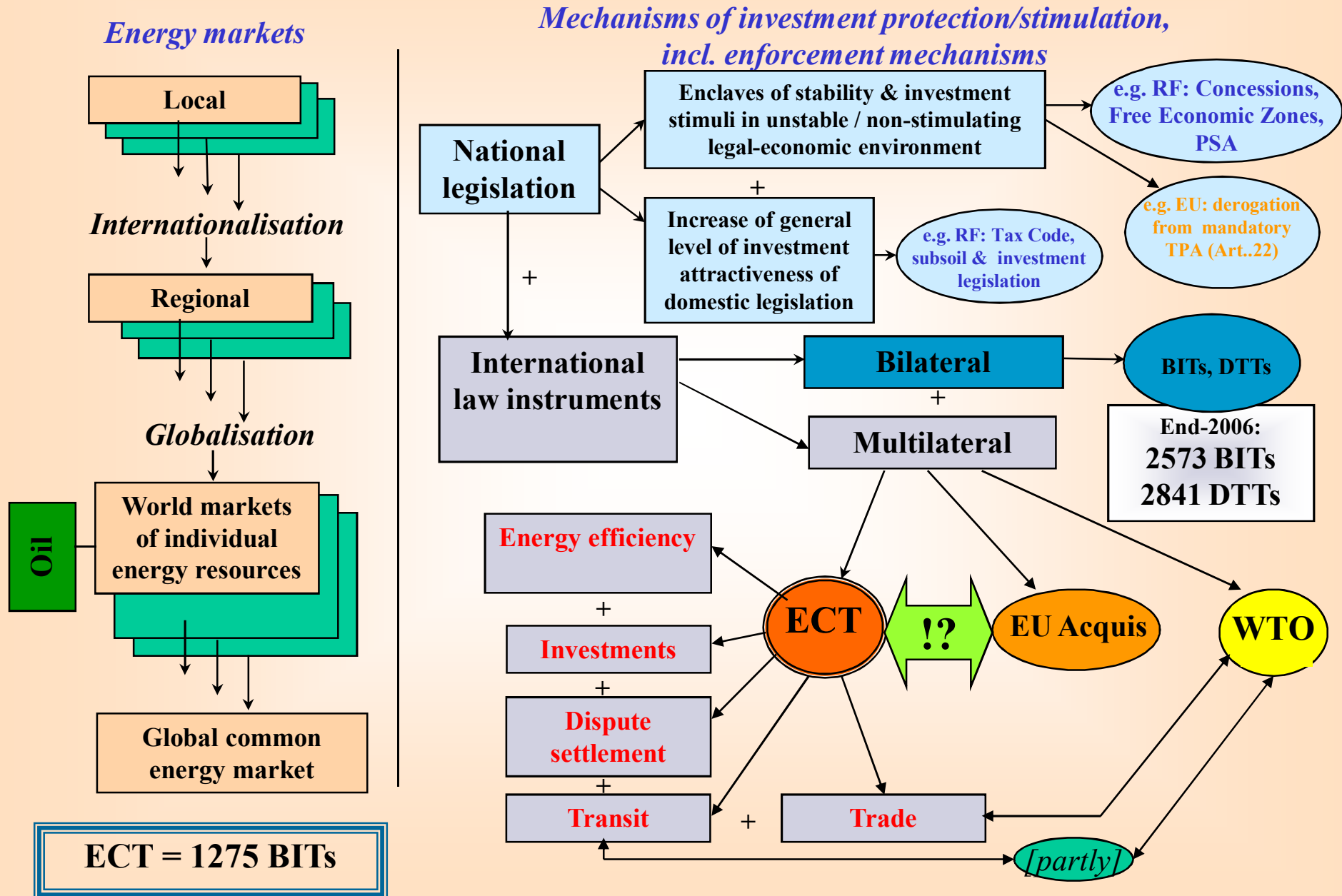


Investment in Relations: Lessons from the Energy Charter

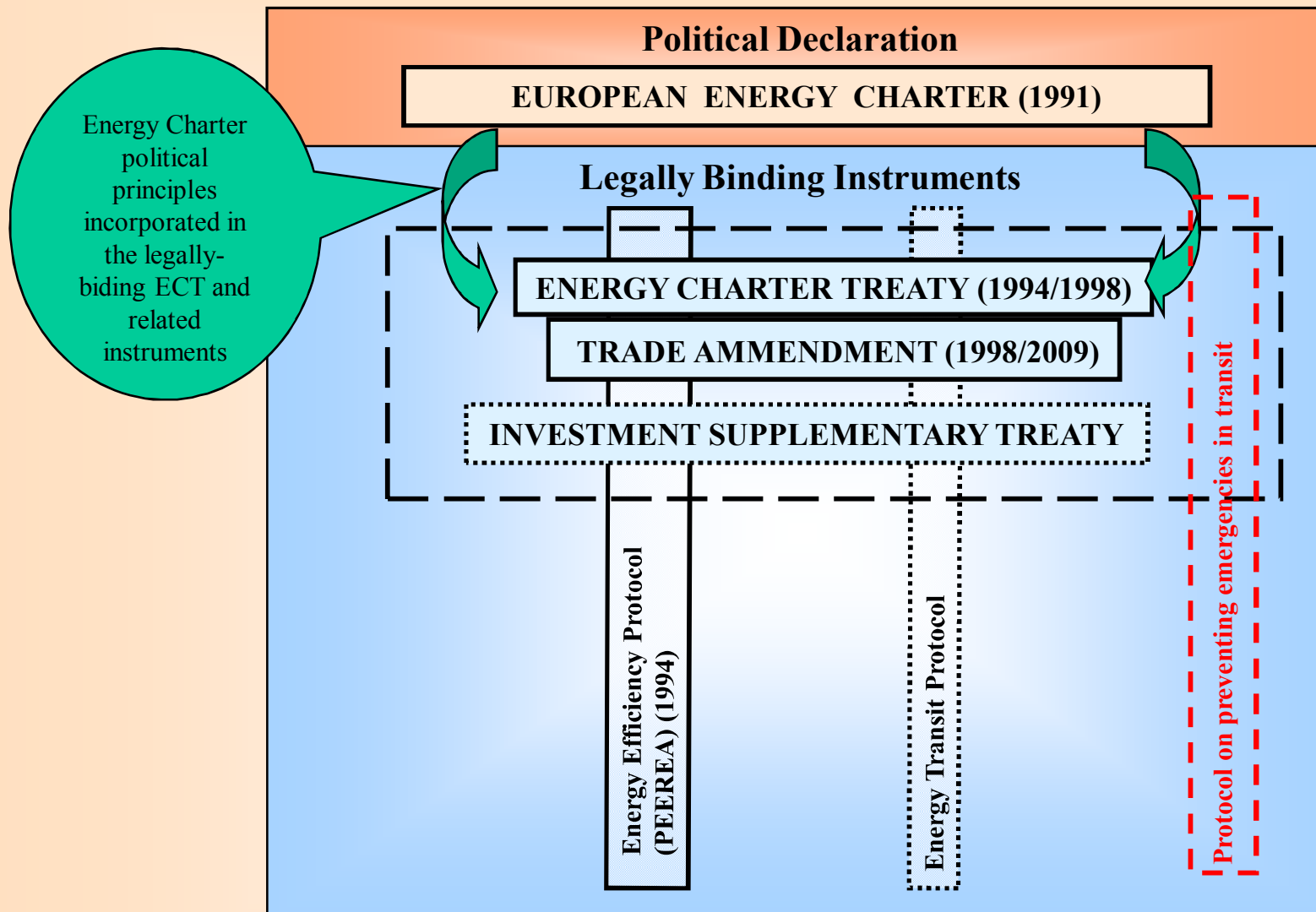
**Dr. Andrey A.Konoplyanik,
Consultant to the Board, Gazprombank, &
Professor, Russian State Oil & Gas University**

Presentation at the course “Risk and Scenario Analysis Across the Energy Value Chain”, Columbia University, New York, NY, 19 April 2010

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



ENERGY CHARTER AND RELATED DOCUMENTS



- in force
- negotiations not finished yet
- new Protocol which can be proposed by Russia

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)

National regulatory changes, 1992-2008

Table I.14. National regulatory changes, 1992-2008

Item	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Number of countries that introduced changes	43	56	49	63	66	76	60	65	70	71	72	82	103	92	91	58	55
Number of regulatory changes	77	100	110	112	114	150	145	139	150	207	246	242	270	203	177	98	110
More favourable	77	99	108	106	98	134	136	130	147	193	234	218	234	162	142	74	85
Less favourable	0	1	2	6	16	16	9	9	3	14	12	24	36	41	35	24	25

Source: UNCTAD database on national laws and regulations.

Source: World Investment Report 2009. UNCTAD, 2009, p.31

ECT ARTICLE 10(1): Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area.

ENERGY CHARTER TREATY

← **MFN or NT**
(non-legally binding – best efforts clause – Art.10(2), (3) + Art.10(5)) →

← **The better of MFN or NT**
(legally binding – Art.10(7)) →



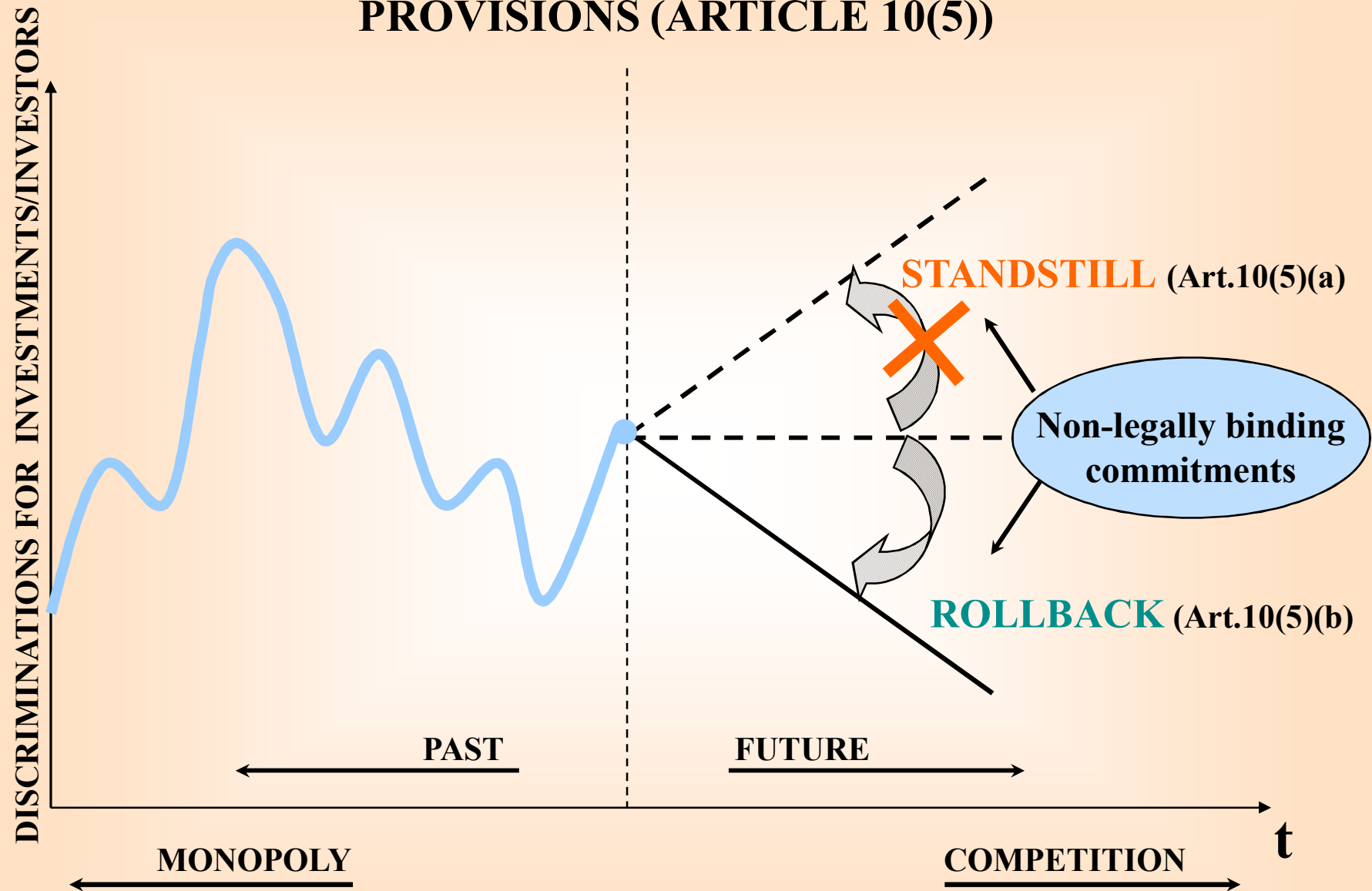
← **The better of MFN or NT** *(legally binding – draft Art.2(1))* →

← **INVESTMENT** →

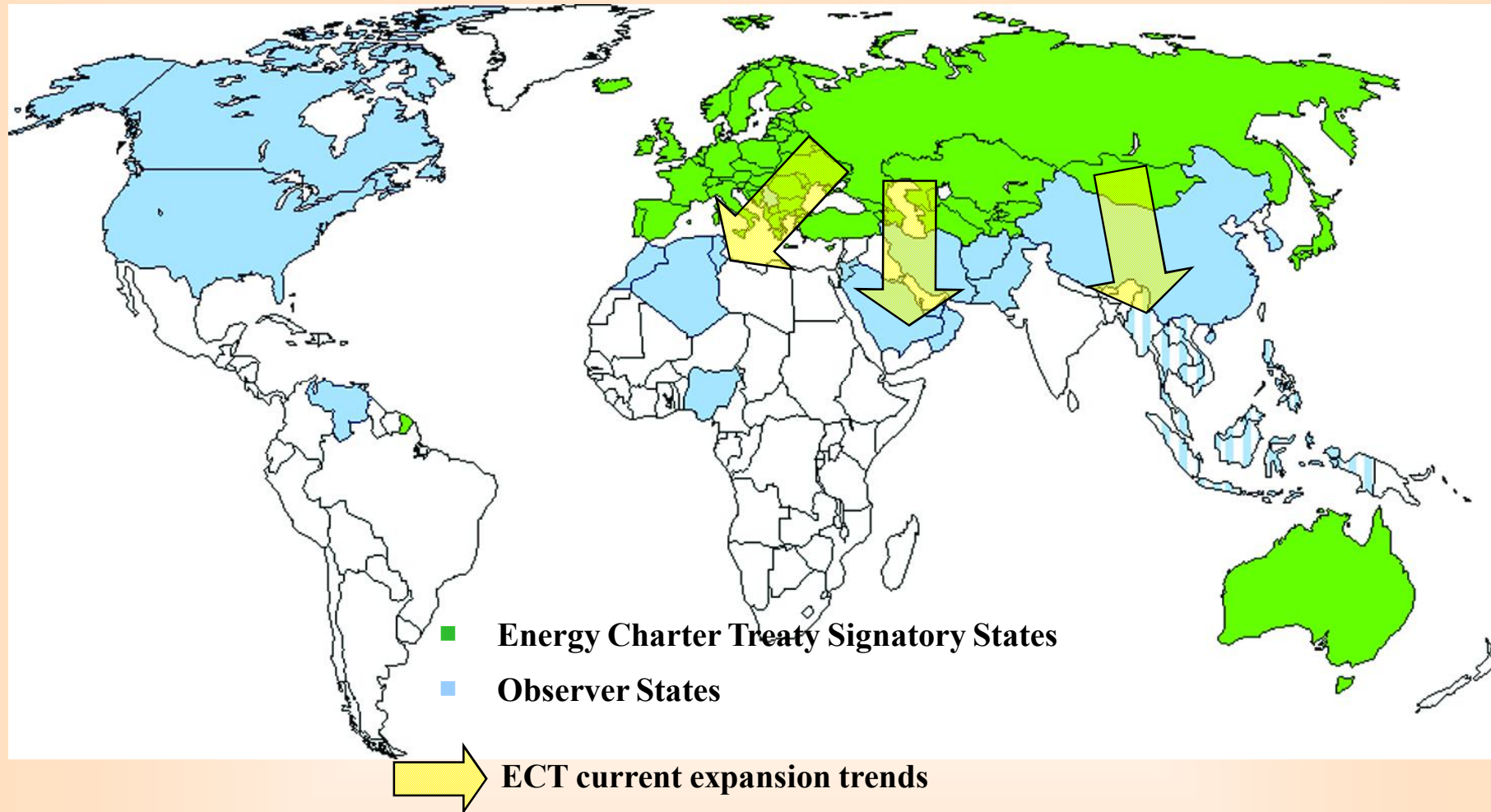
SUPPLEMENTARY TREATY

MFN = Most favored nation treatment
NT = National treatment

ECT INVESTMENT REGIME: STANDSTILL & ROLLBACK PROVISIONS (ARTICLE 10(5))



ENERGY CHARTER PROCESS: GEOGRAPHICAL DEVELOPMENT

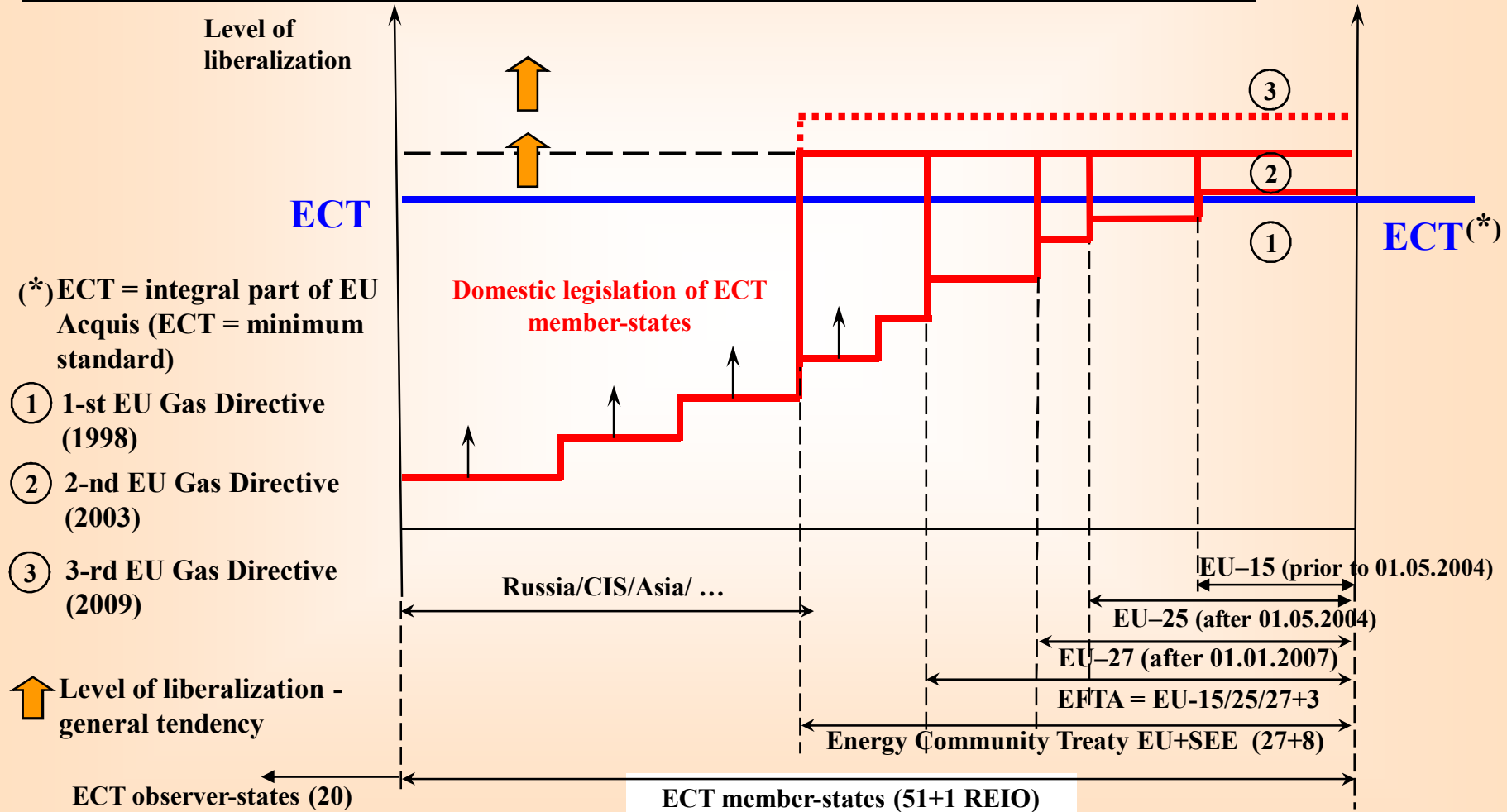


1. From trans-Atlantic political declaration to broader Eurasian single energy market
2. ECT expansion - objective and logical process based on clear economic and financial reasoning

ECT & EU ACQUIS: “MINIMUM STANDARD” WITHIN EVOLVING EURASIAN COMMON ENERGY SPACE VS. MORE LIBERALISED MODEL

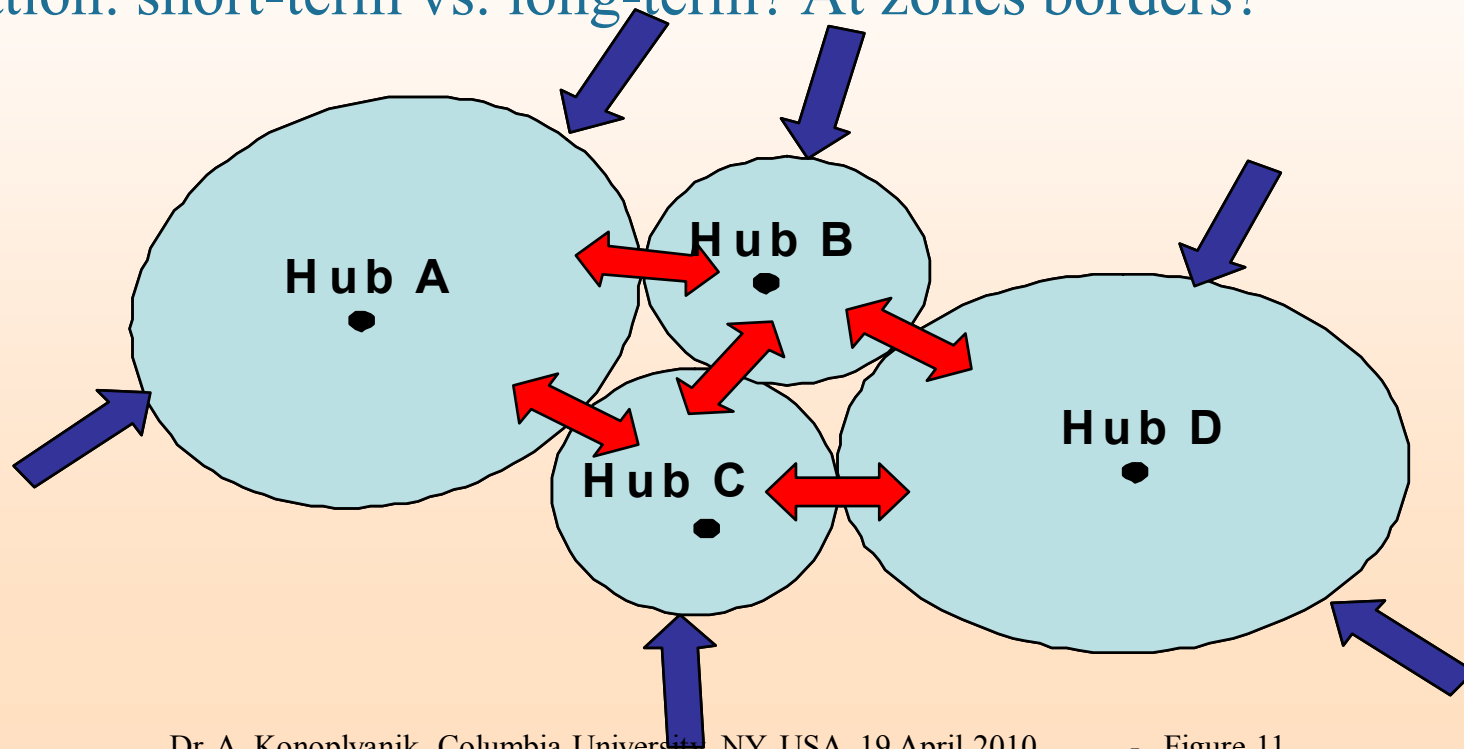
Legal norms (examples)	ECT	EU Acquis (2-nd & 3rd EU Gas Directives)
Mandatory TPA	No	Yes
Unbundling	No	Yes

Level of liberalization

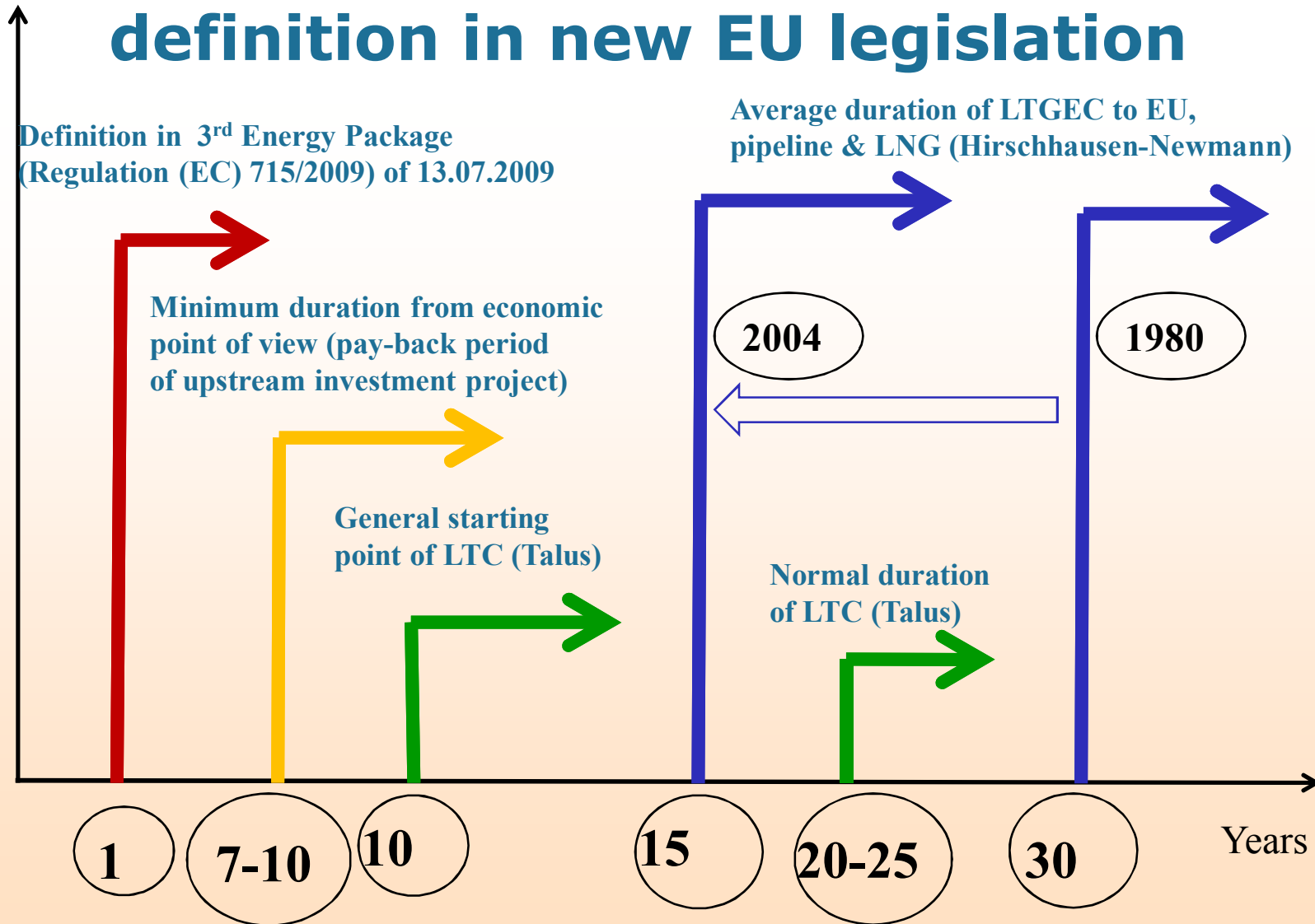


Future organization of common internal EU gas market according to 3rd EU Energy package

All market areas to be organized as **entry–exit zones** with **virtual hubs** => Towards uniform capacity allocation mechanisms & gas pricing mechanisms => Gas pricing at the hubs: on **all** gas volumes *or* just on **a portion** of gas supplies? And when? Capacity allocation: short-term vs. long-term? At zones borders?



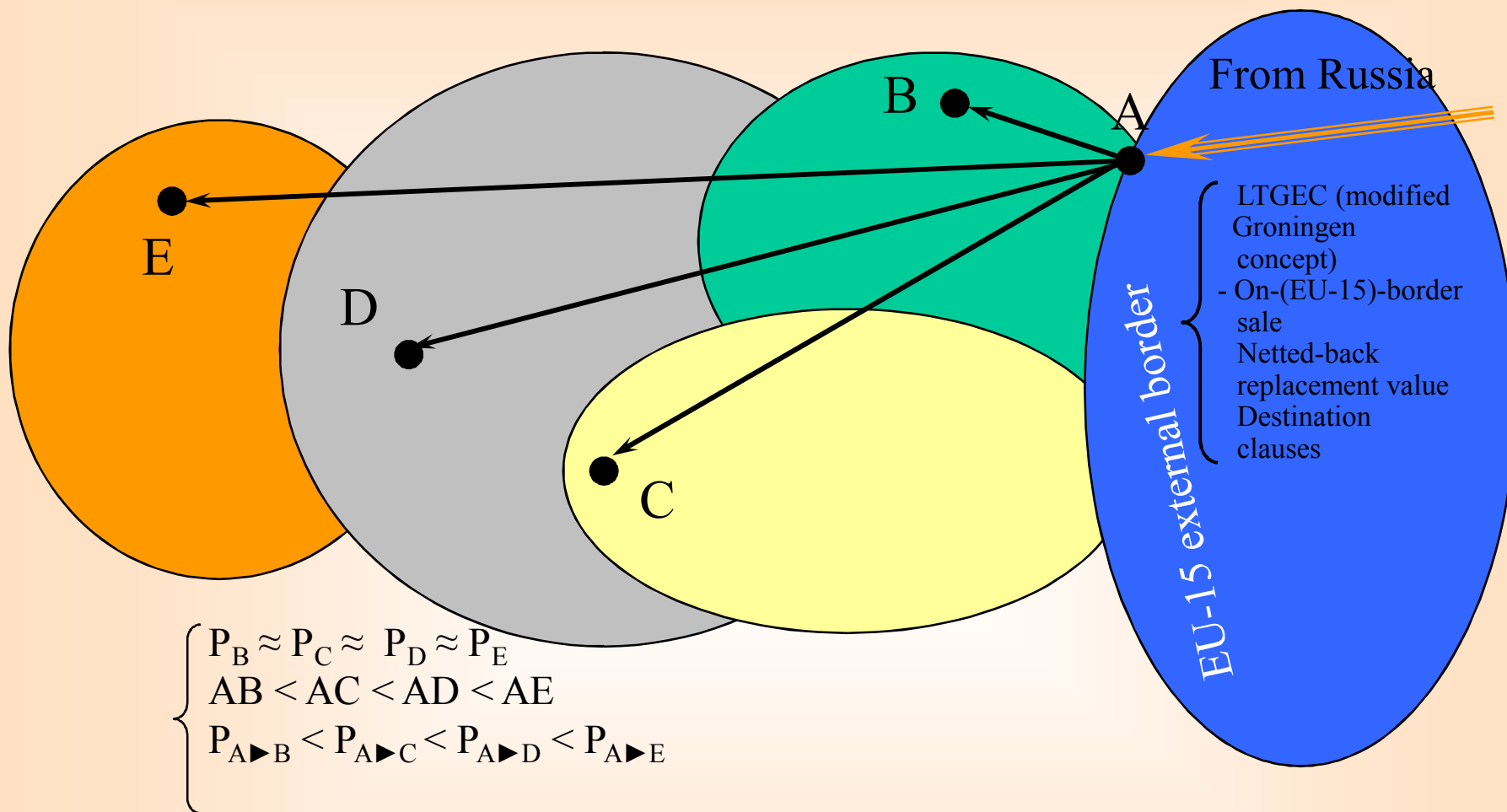
Long-term gas (export) contracts: different duration in historical European practice & definition in new EU legislation



Groningen (Dutch) & Russian/Soviet LTGEC Models: Differences & Similarities

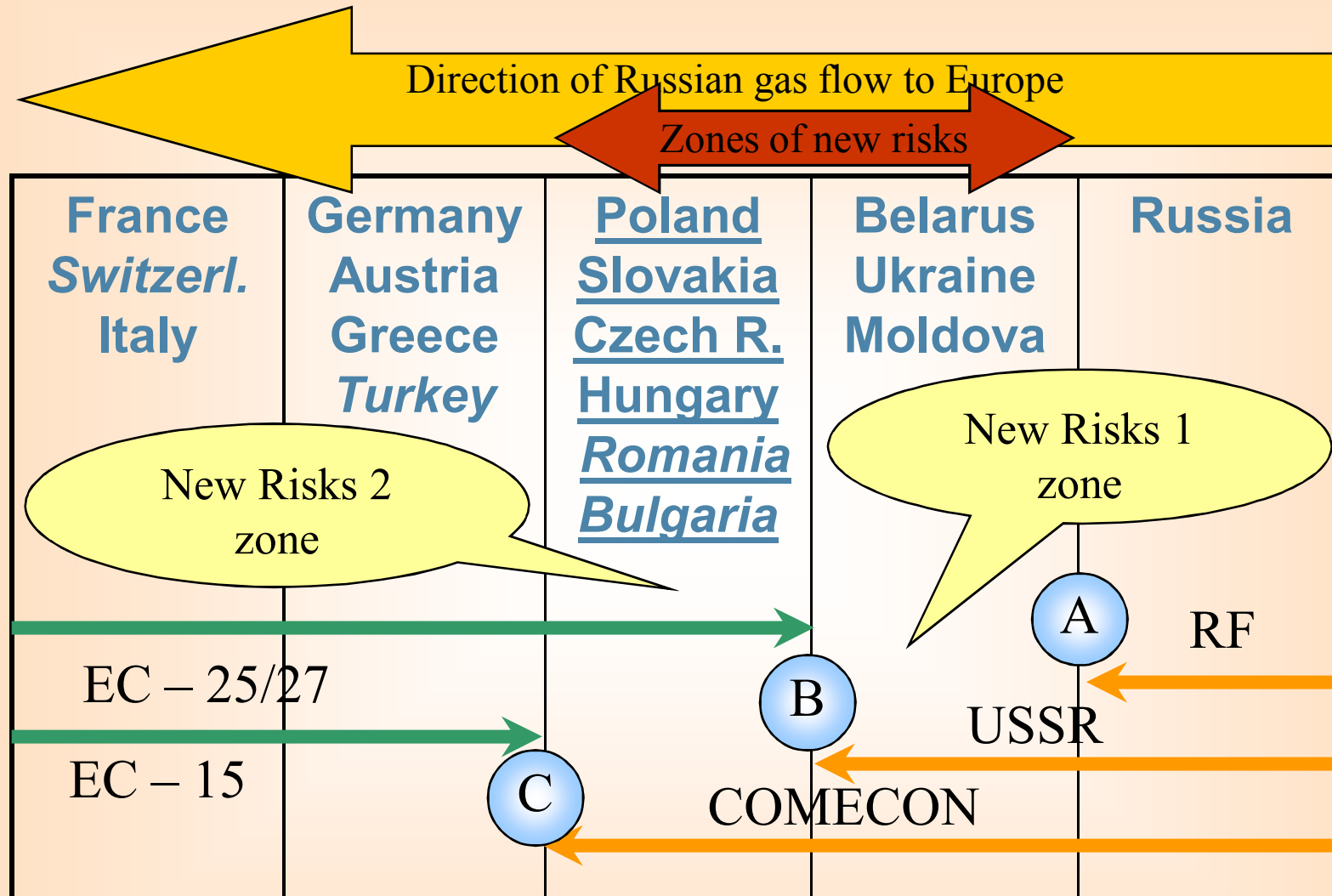
	Groningen LTGEC model (since 1962)	Russian / Soviet LTGEC model (since 1968)	Russian / Soviet specifics (why Russian /Soviet LTGEC model differs from Groningen LTGEC model)
Contract duration	Long-term	Longer-term	Larger West Siberian fields & unit CAPEX, longer transportation distances & pay-back periods
Delivery point	Upstream to end-user	Upstream to end-user - on EU-15 border; one delivery point served for few final consumers	Historically: on political border between East & West
Pricing	Replacement value (RFO + LFO) + net-back to delivery point + regular price review + minimum pay obligation (take-and/or-pay)		West: both for export & domestic sales; East: only for export sales
Protection from price arbitrage	Destination clauses		More important since in one delivery point - few contracts with much more differing export prices destined for different markets
Role of transit	None (minimal)	Significant – especially after dissolution of COMECON & USSR & after EU expansion	New sovereign states appeared upstream to historical delivery points + new rules discriminating transit

Destination Clauses: Economically Motivated Integral Part of Soviet / Russian Export Schemes to Europe



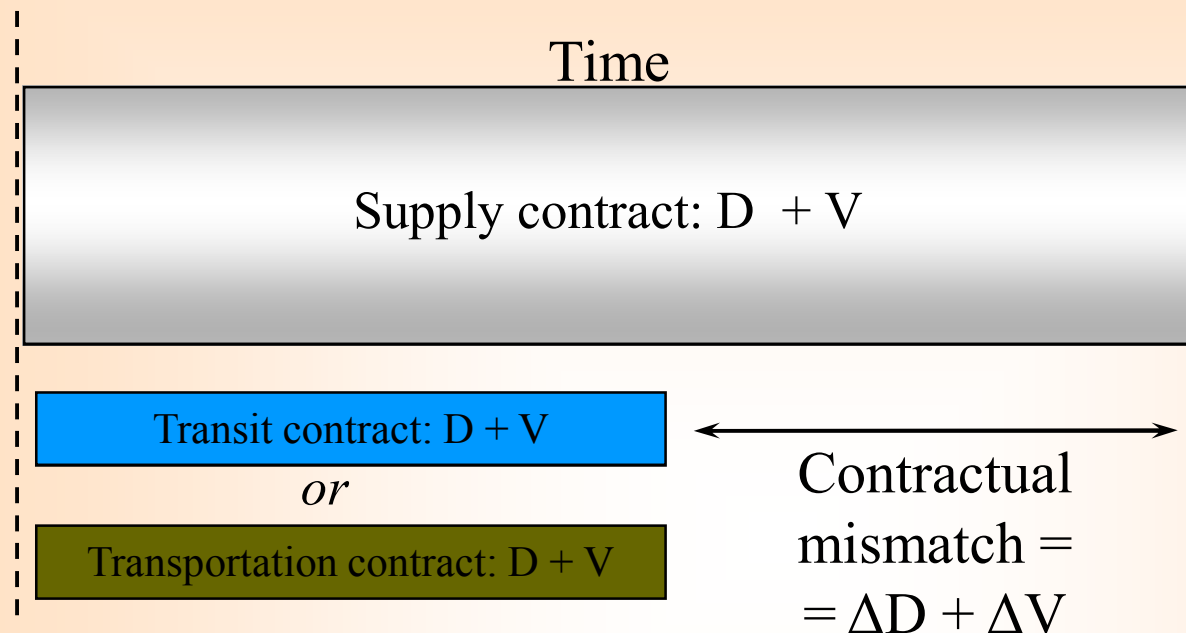
“Destination clauses” allowed gas supplier to sell gas to different buyers at different prices and other contractual terms at one and the same delivery point to protect its competitiveness at the end-use market (to prevent arbitrage by buyers)

Russian Gas Supplies to Europe: Zones of New Risks for Existing Supplies Within Russia's 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

Contractual Mismatch Problem (Draft TP Art.8)

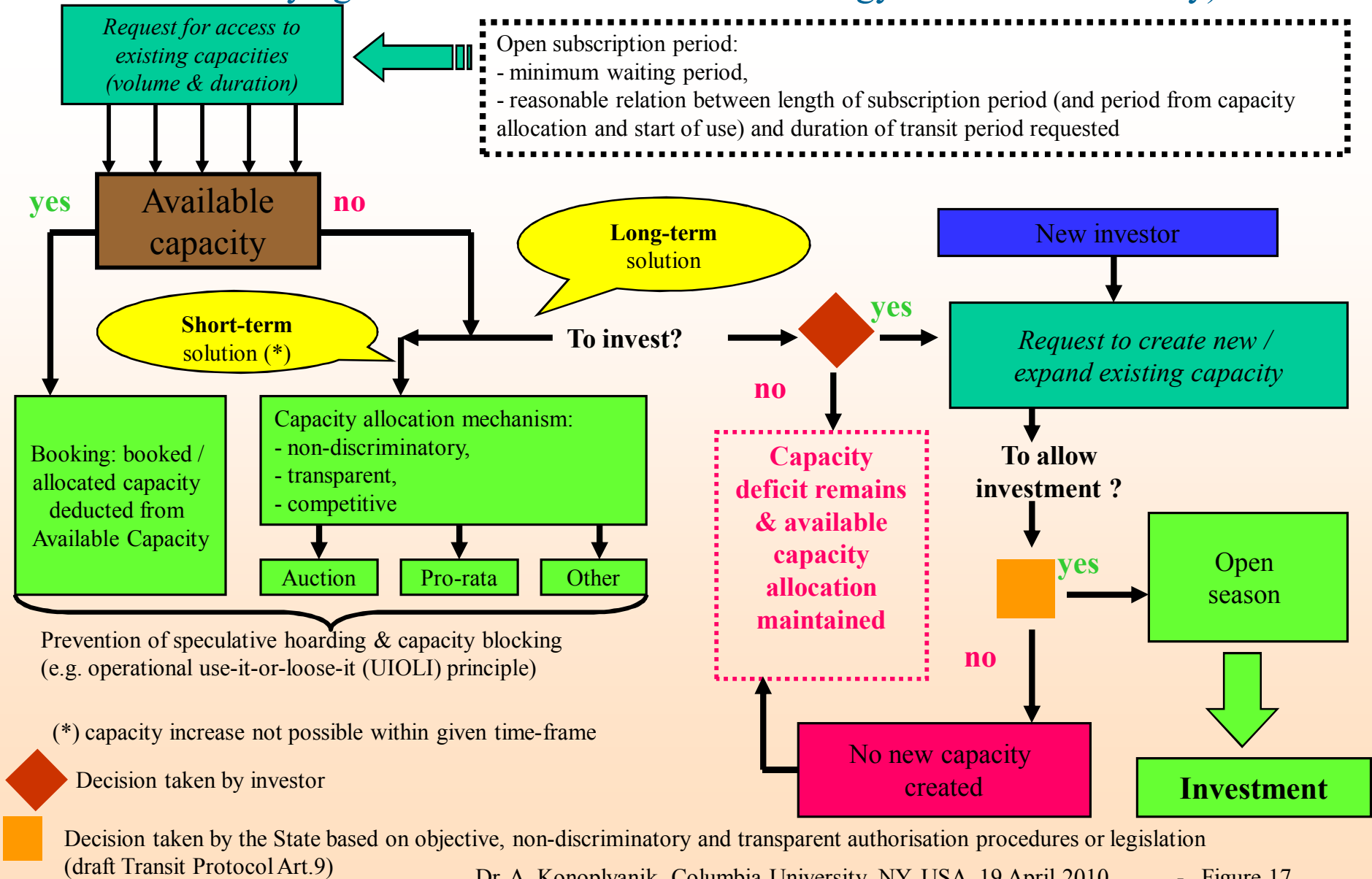


Mismatch: between duration/ volumes (D/V) of long term supply (delivery) contract and transit/transportation contract as integral part to fulfill the delivery contract => risk of non-renewal of transit / transportation contract => risk for **supply** contract.

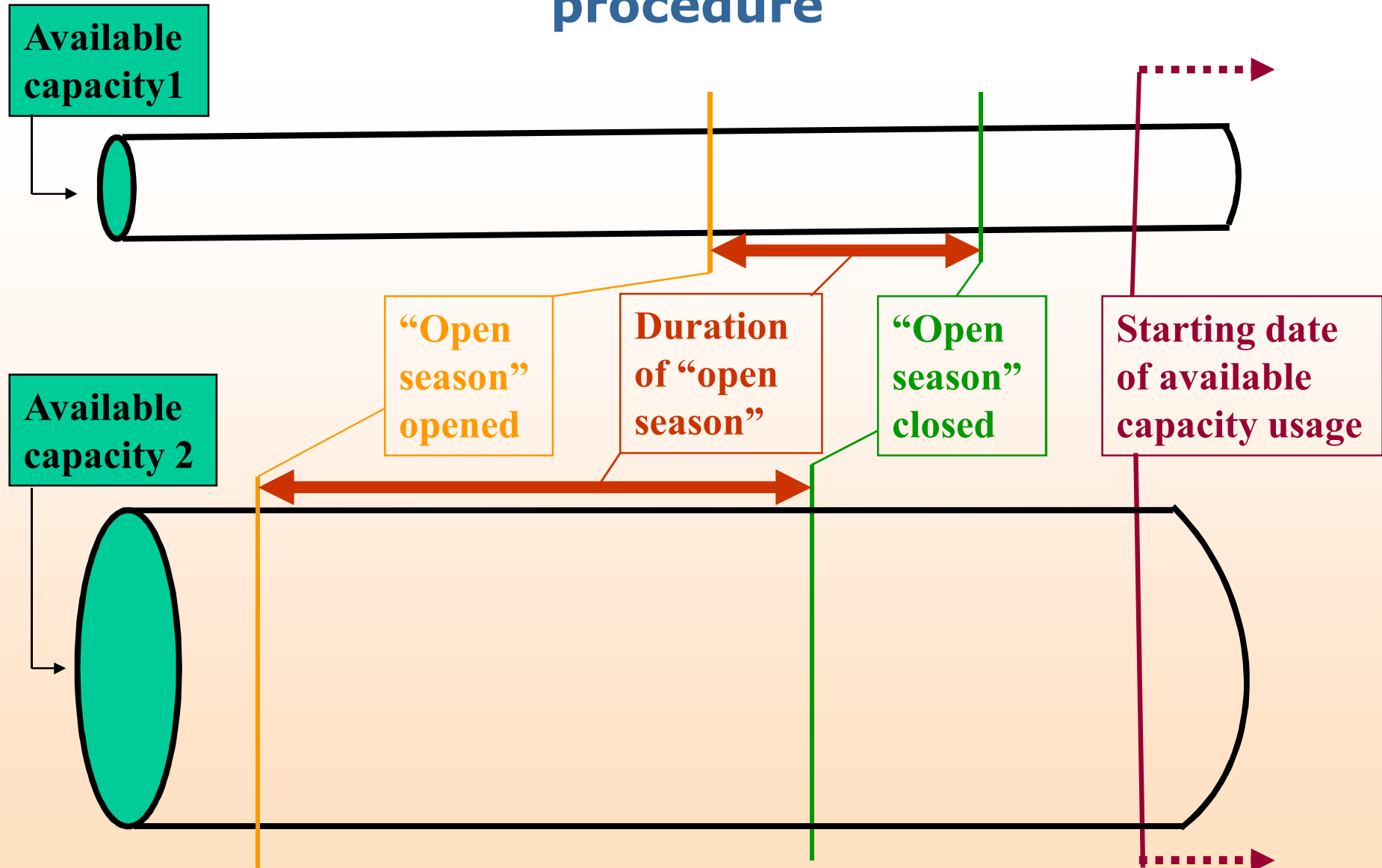
Core issue: guarantee of access to / creation of adequate transportation capacity for the duration of long term contracts.

Available Transportation Capacity Allocation & Creation

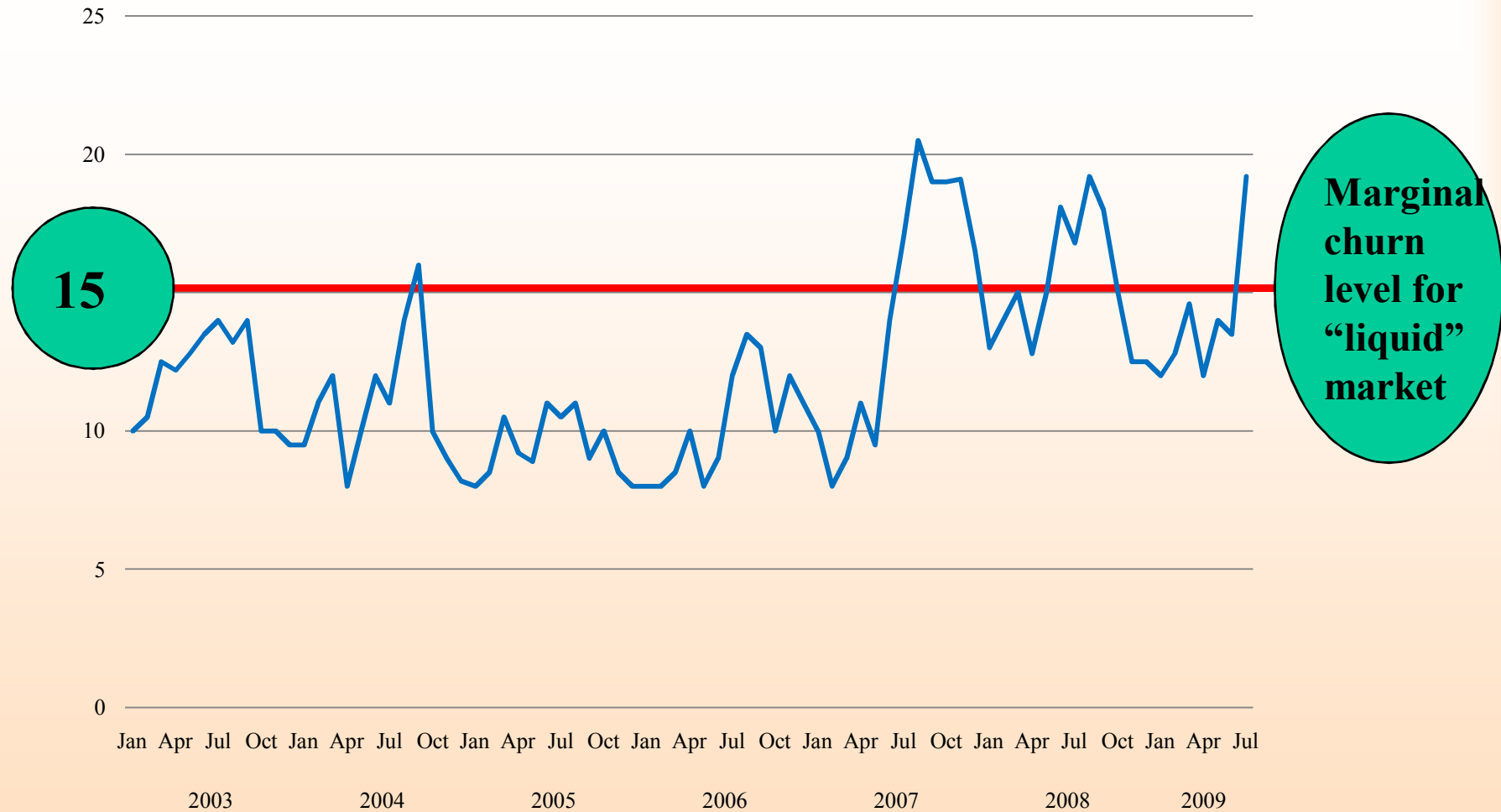
(non-discriminatory competitive procedure – a joint proposal of Russian & EU experts informally agreed at multilateral level of Energy Charter community)



Available transportation capacity allocation and creation: major criteria for “open season” procedure

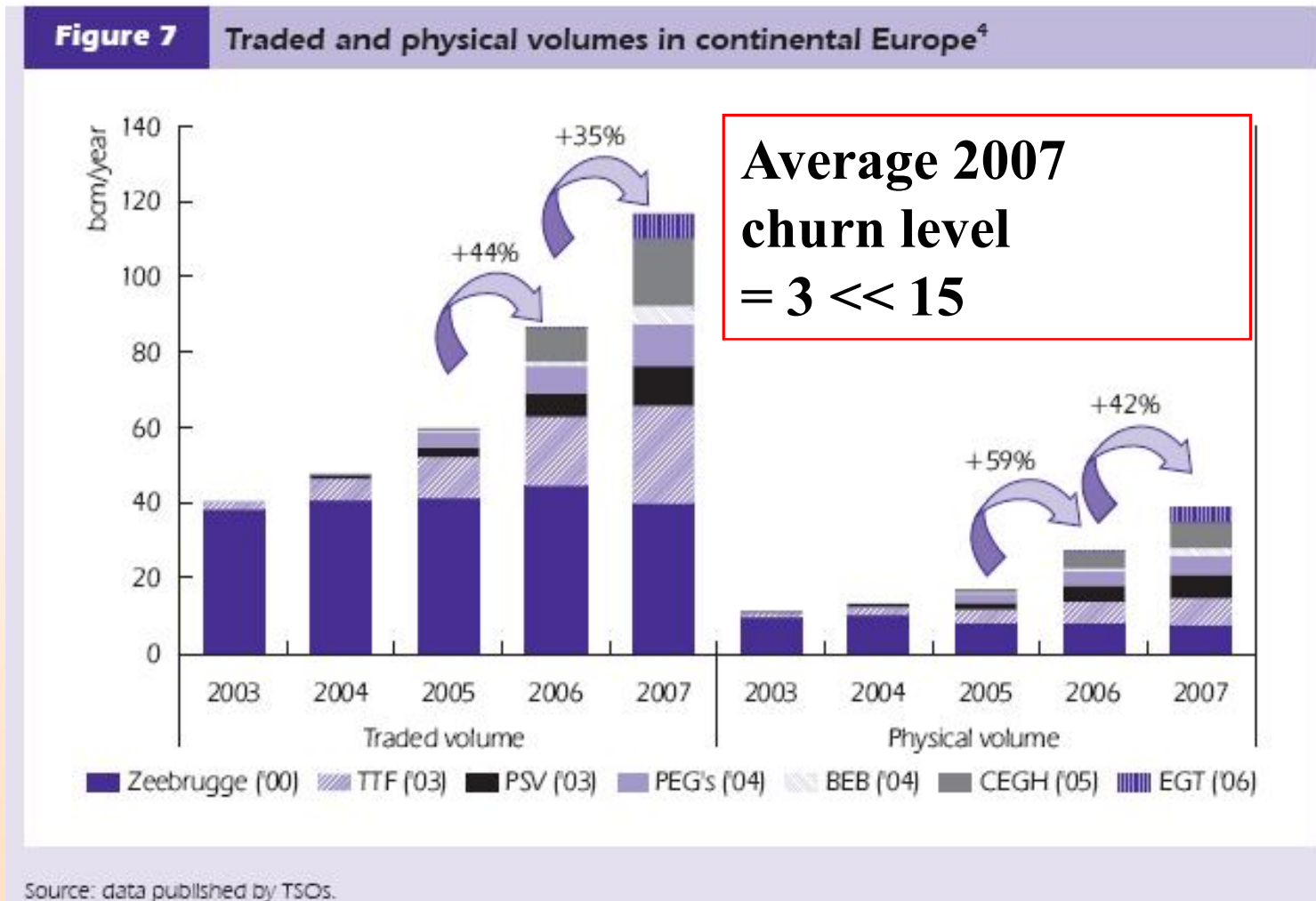


NBP churning factor, 2003-2009



Source: "Gas Matters" for corresponding years

Traded and physical gas volumes in continental Europe (w/o NBP)

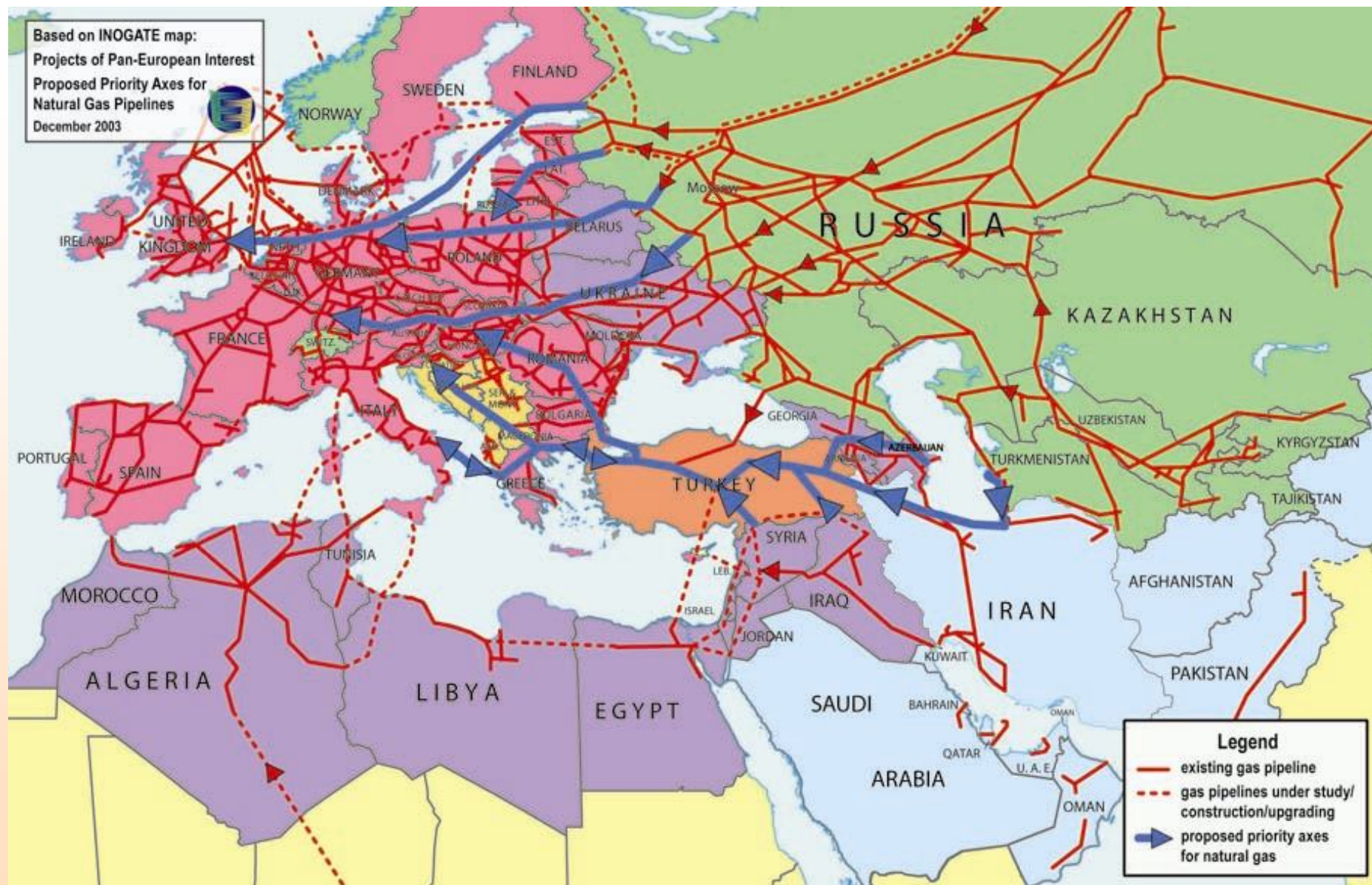


Source: IEA. Natural Gas Market Review 2008, p.32

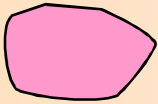
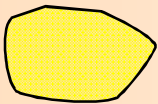
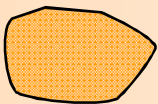
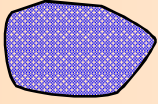
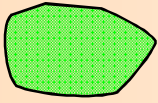
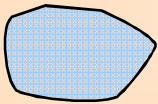
Evolution/adaptation of gas pricing mechanisms in Europe: two main options

- **Option 1:** to substitute gas price indexation in LTGECs by spot/futures quotations => **NO**
- **Option 2:** to adapt mostly oil-linked gas price indexation in LTGEC by pricing formulas linked to broader spectrum of parameters & non-oil gas replacement values => **YES** (long-term capacity allocation *must* be available to exclude contractual mismatch problems - supply vs. transportation):
 - **Long-term supplies (basic/base-load)** : more flexible LTGEC (n x 1 year) + “modified” gas replacement value formulas (price indexation *not* limited to oil-pegging);
 - **Short-term supplies (supplementary/peak- & semi-peak load)** : short-term (< 1 year)/spot contracts + futures quotations

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)

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 = EU Eastern Partnership) 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 observers: 23 states of Europe, Asia (e.g. Middle East, South-, SE- & NE-Asia), Africa, North & Latin America + 10 international organisations	Shared ECT aims & principles; did not take ECT legally binding rules; not ready to take more liberal rules of EU Acquis

Option 1: Export of “acquis communautaire”

- EU’s preference: for EU, harmonization of EU legislation with legal systems of thirds states means basically application of EU legislation within these third states, incl. in energy => “export of acquis”
- EU tries to expand geographical area of implementation of acquis in energy (umbrella policies => soft law => hard law):
 - Hard/overall: EU enlargement (EU15=>EU25=>EU27=>EU27+?)
 - Hard/sectoral: EU-SEE Energy Community Treaty (EU27+7) + new observers/members
 - Soft: EU Neighborhood Policy (EU27 + 10NA + 8FSU/CIS)
 - EU has even initially included Russia in this Policy => strong negative respond from DPM V.Khristenko to DG DGTREN F.Lamoureux,
 - Umbrella: EU Eastern Partnership (6CIS)

but

- EU acquis does not (and will not !) cover all segments of energy (gas) value chains destined for EU and originated from Russia & other key non-EU producers (Central Asia, Caucasus, Iran, etc.)

Option 2: New bilateral Russia-EU treaty

New bilateral treaty: (i) “based on Energy Charter principles” or
(ii) from the scratch

but

- Any bilateral Russia-EU Treaty (PA) does not cover transit states between Russia & EU (but major recent problems are there),
- To negotiate today new Russia-EU legally-binding Treaty (27+1+1 CPs) is much more difficult task than it was in early 1990’s with PCA & ECT negotiations
 - then – broad window of political opportunities, now – much more narrow =>
 - 3+2 open transit-related issues between Russia & EU in ECT & draft TP took 10 years already => when new broader Treaty can be finalized & ratified ? =>
 - risk of failure of new negotiations
- If it based on “Energy Charter principles”:
 - What does this mean operationally? Different wording of ECT provisions in new PA? =>
 - if so, possibility for two standards (under new PA & under ECT) of :
 - implementation of “provisions based on ECT principles” &
 - of their interpretation in different arbitrations =>
 - instead of diminishing legal risks, this would increase such risks & cost of capital for Russian and EU investors in energy projects of mutual interest

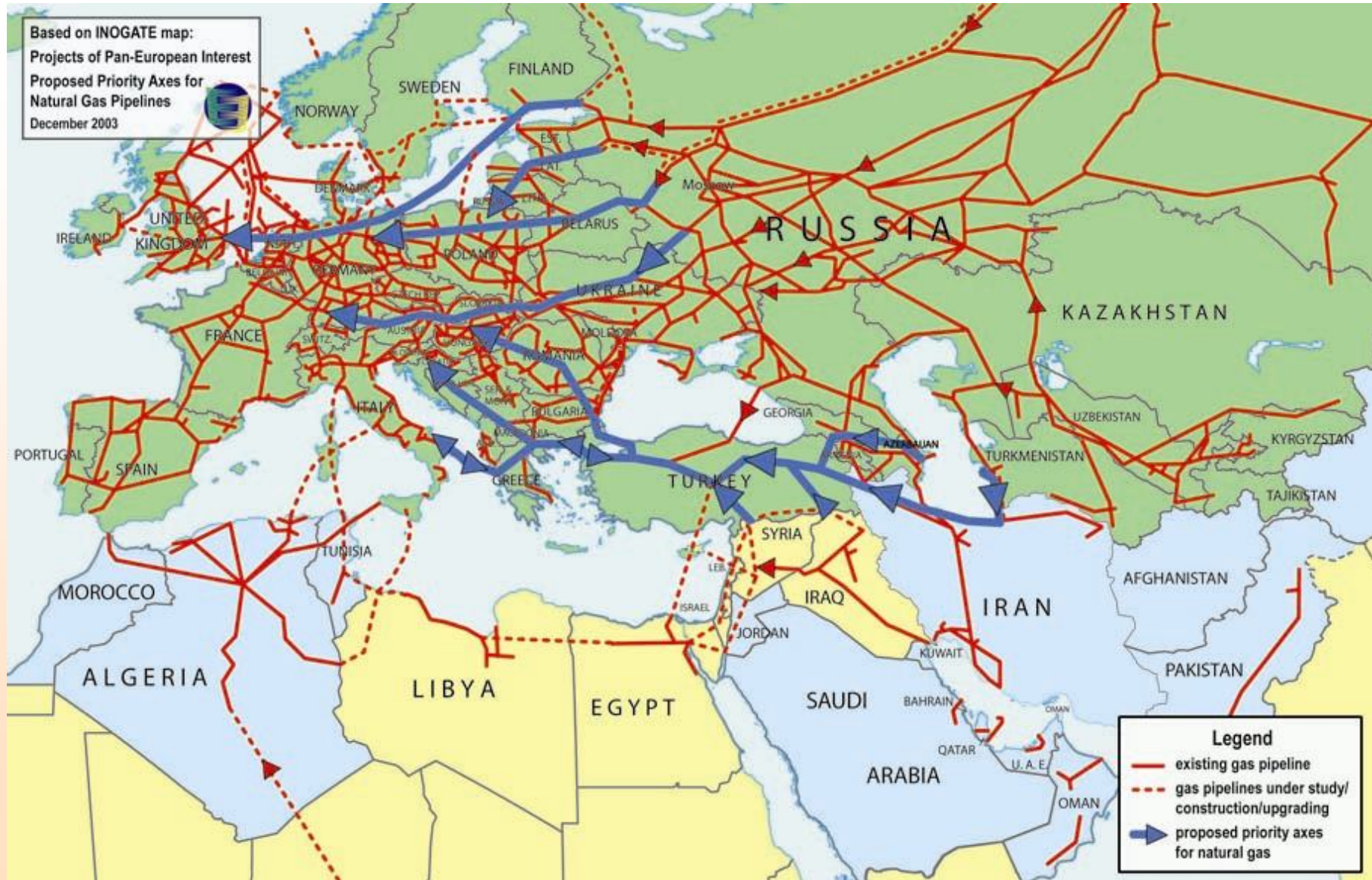
Option 3: ECT as legal background of Russia-EU common energy space

- ECT (incl. members & observers) covers all major current & future energy (gas) value chains to EU => minimum standard of common rules in a broader area than just Russia-EU space =>
- Optimal solution: Russia-EU PA energy chapter = ECT as legal background of Russia-EU common energy space
- ECT in force since 1998; already common legal background within 51 Eurasian states, incl. Russia & EU:
 - EU: ratified by all EU member-states & by EU => ECT is already integral part of EU acquis,
 - Russia: signed & applied on provisional basis (ECT Art.45) => Russia still to ratify ECT => this is crucial if ECT to become common legal background of Russia-EU common energy space

but

- on October 20, 2009, Russia has terminated of ECT provisional application

Common rules of the game in Eurasian energy & expansion of ECT



Instead of “Energy Charter” - or to improve it ?

- “Energy Charter” is a multi-facet meaning:
 - International organization with open and expanding membership - Energy Charter Conference,
 - Long-term process with repeating life-cycle (legal negotiations => monitoring of implementation => political debate on adaptation => new legal negotiations => new cycle),
 - Expanding package of documents (both legally binding & non-binding),
 - Executive body – Energy Charter Secretariat
- **Russia’s new “Conceptual Approach...” (of 21.04.2009)** can *not* be treated as alternative to Energy Charter/ECT, but it might have been accepted by international community as set of proposals on how to further improve and adapt existing Energy Charter multi-facet meaning/process:
 - ECT Art.34(7): Energy Charter Policy Review once in 5 years: 1999, 2004, 2009, ...,
 - 2004 Policy Review Conclusions (item 3) => regular adaptation of Energy Charter process,
 - **“Mail principles...”** (bullet points, mostly consist of ECT-related provisions) – to discuss at Energy Charter Strategy Group => Russia to attend the meetings
 - **Annex 1 “Elements of the Transit Agreement”** => draft Transit Agreement => Ad Hoc international commissions authorized to settle and prevent transit-related emergencies in case of risk of its occurrence (**novelty !**):
 - was prepared (by Gazprom) as complimentary to ECT mechanisms and not instead of them,
 - can be developed as new Energy Charter Protocol (“On Preventing Emergences in Transit”),
 - this novelty can be easily incorporated into ECT dispute settlement procedures as second pre-arbitration mechanism, in parallel with conciliation
 - **Annex 2 “List of EMP”**: equal to Annex EM to ECT-1994 and is more narrow than Annex EM1 to Trade Amendment-1998 (EM1 = EM + energy-related equipment)