

**Caspian oil and gas, Russian gas reforms and
Energy Charter process
(with particular reference to transit issues)**

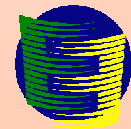
Pre-meeting presentation

Dr. Andrei Konopliank
Deputy Secretary General
The Energy Charter Secretariat

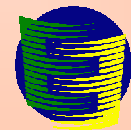
Royal Dutch Shell Senior Management meeting - Caspian Region
6 March 2003, Hague

CONTENTS

- 1. Energy markets development, energy security and its legal instruments, including ECT**
- 2. Energy Charter Process and its business aim**
- 3. Energy Charter Transit Protocol**
- 4. Russian position on ECT and transit**
- 5. Other Caspian states position on transit**
- 6. Caspian states transit problems dependant on Russian gas reforms**



1. Energy markets development, energy security and its legal instruments, including ECT



ENERGY SECURITY

***ENERGY SECURITY* = stable, cheap & environmentally friendly energy cycle (primary supplies + transportation + refining + transformation + final consumption)**

***ENERGY SECURITY* =**

- (1) minimum volume risk +**
- (2) minimum price risk**

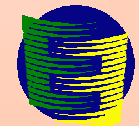
EVOLUTION OF *ENERGY SECURITY* INSTRUMENTS:

- (1) colonies + traditional concessions,**
- (2) military instruments + modernized concessions, PSAs, RSCs,**
- (3) strategic reserves + stocks,**
- (4) international law instruments**

EFFECTIVE *ENERGY SECURITY* INSTRUMENTS are different at different stages of energy markets development:

- from monopoly to competition as a driving force of energy markets development,**
- from energy independence to energy interdependence,**
- from local markets of individual energy resources to global energy market**

Further to growth of energy interdependence, international law becomes more and more effective (relatively cheap per unit of supplies/final consumption) instrument of providing *energy security*



DEVELOPMENT OF ENERGY MARKETS AND MECHANISMS FOR INVESTORS PROTECTION / STIMULATION

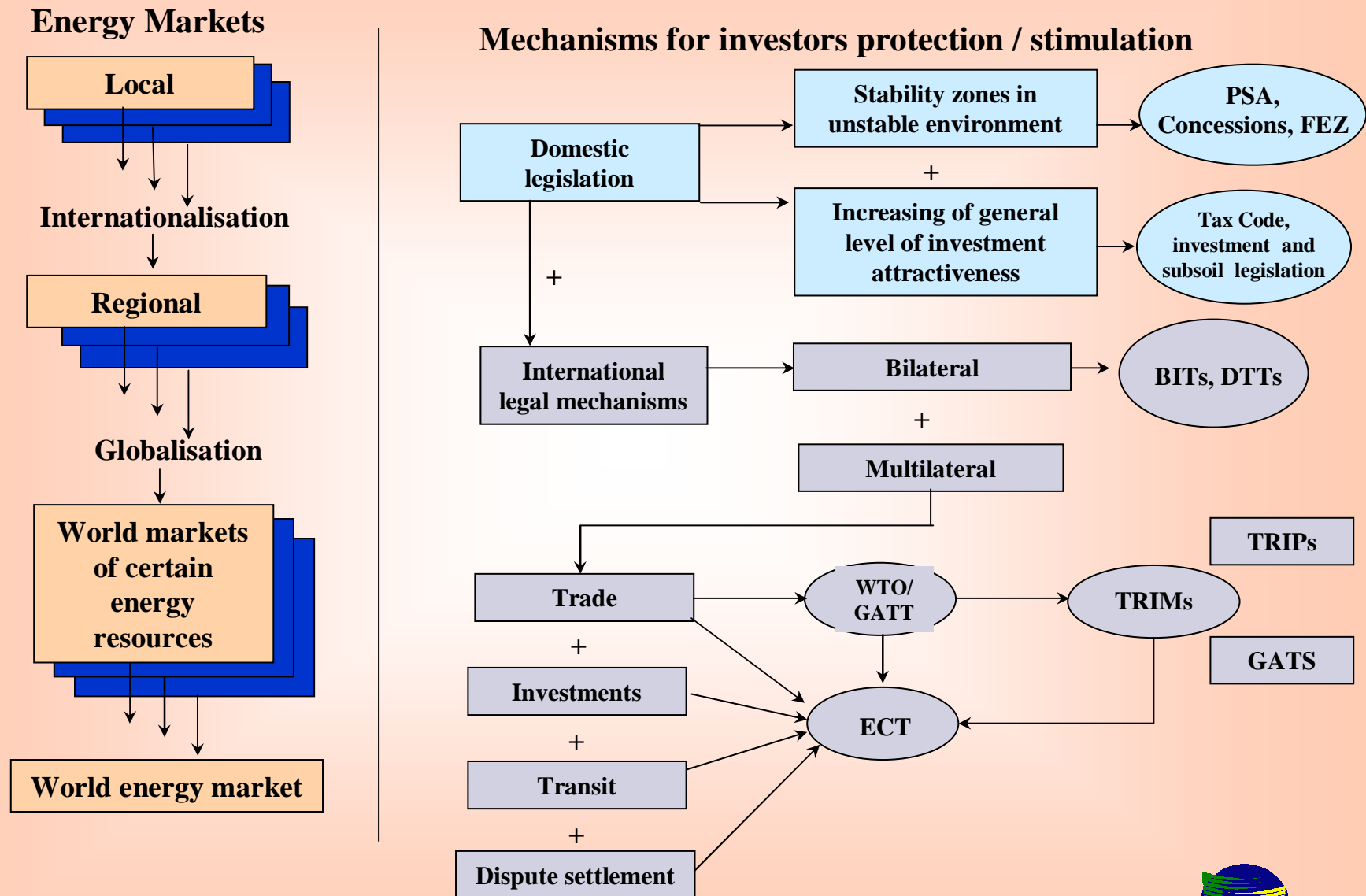
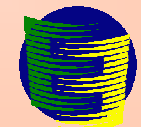


Figure 2



ENERGY CHARTER WORLD AND MAJOR ENERGY FLOWS IN THE EASTERN HEMISPHERE

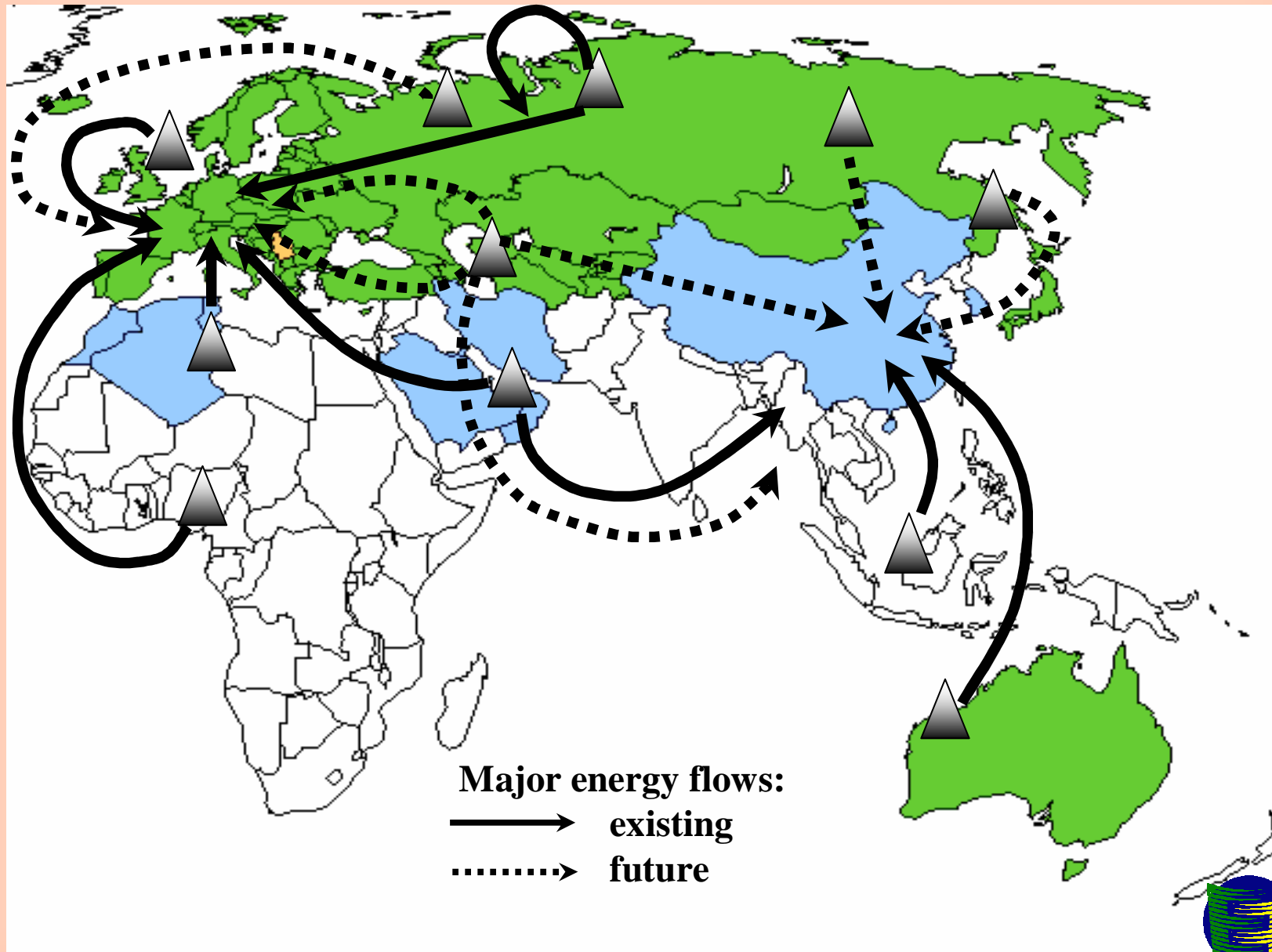
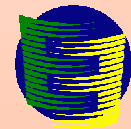


Figure 3

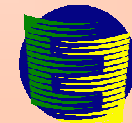
2. Energy Charter Process and its business aim



ENERGY CHARTER HISTORY

June 25, 1990	Lubbers' initiative presented to the European Council
December 17, 1991	European Energy Charter signed
December 17, 1994	Energy Charter Treaty (ECT) and Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) signed
June, 1996	Russia started ECT ratification process for the first time (unsuccessfully).
16 April, 1998	ECT enters into force
January, 2001	Russia restarted ratification process. RF State Duma: Russia will ratify ECT, but not yet (depending on Transit Protocol)
As of January 1, 2003	<ul style="list-style-type: none"> • ECT signed by 51 states + European Communities = 52 ECT signatories • ECT ratified by 46 states + EC (excl. 5 countries: Russia, Belarus, Iceland, Australia, Norway) • Russia: provisional application, together with Belarus

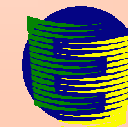
Figure 4



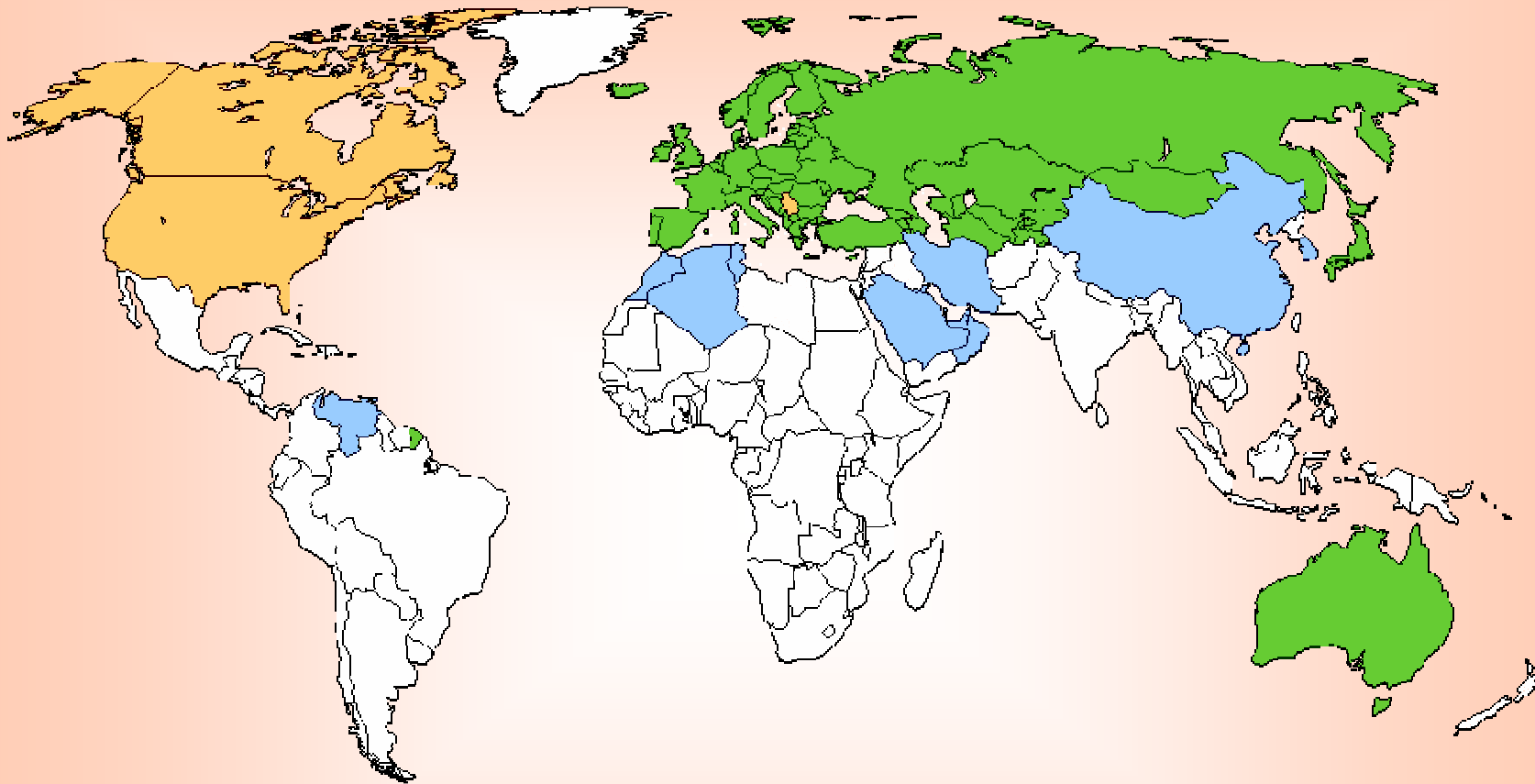
ECT PROCESS: THEN & NOW

	INITIALLY	CURRENTLY
Driving force	Motivated & dominated by interests of consumers	Consumer-producer balance of interests
Policy vs. economy dominance	Politically initiated	Economically driven
Approach to energy security	Physical security of supplies from economies in transition	Security of supplies + security of demand (by economic, not administrative means)
Geography	<p>(1) “Trans-Atlantic” Europe (i.e. in political / OSCE terms)</p> <p>(2) OECD+CIS+EE</p>	<p>(1) Broader Eurasia, incl. North Africa, Australasia (i.e. in energy & economic terms)</p> <p>(2) OECD+CIS+EE+others</p>
Competitiveness	To decrease final energy prices to consumers even by diminishing producer’s ROR	To decrease full investment-cycle risks → to diminish both technical & financial costs → to increase competitiveness and protect adequate ROR at each step of energy & investment cycle

Figure 5

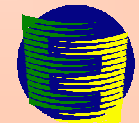


ENERGY CHARTER TREATY: GEOGRAPHY



- Energy Charter Treaty Signatory States (1994)
- Observer States that have signed the European Energy Charter (1991)
- Other Observer States

Figure 6



ENERGY CHARTER AND RELATED DOCUMENTS

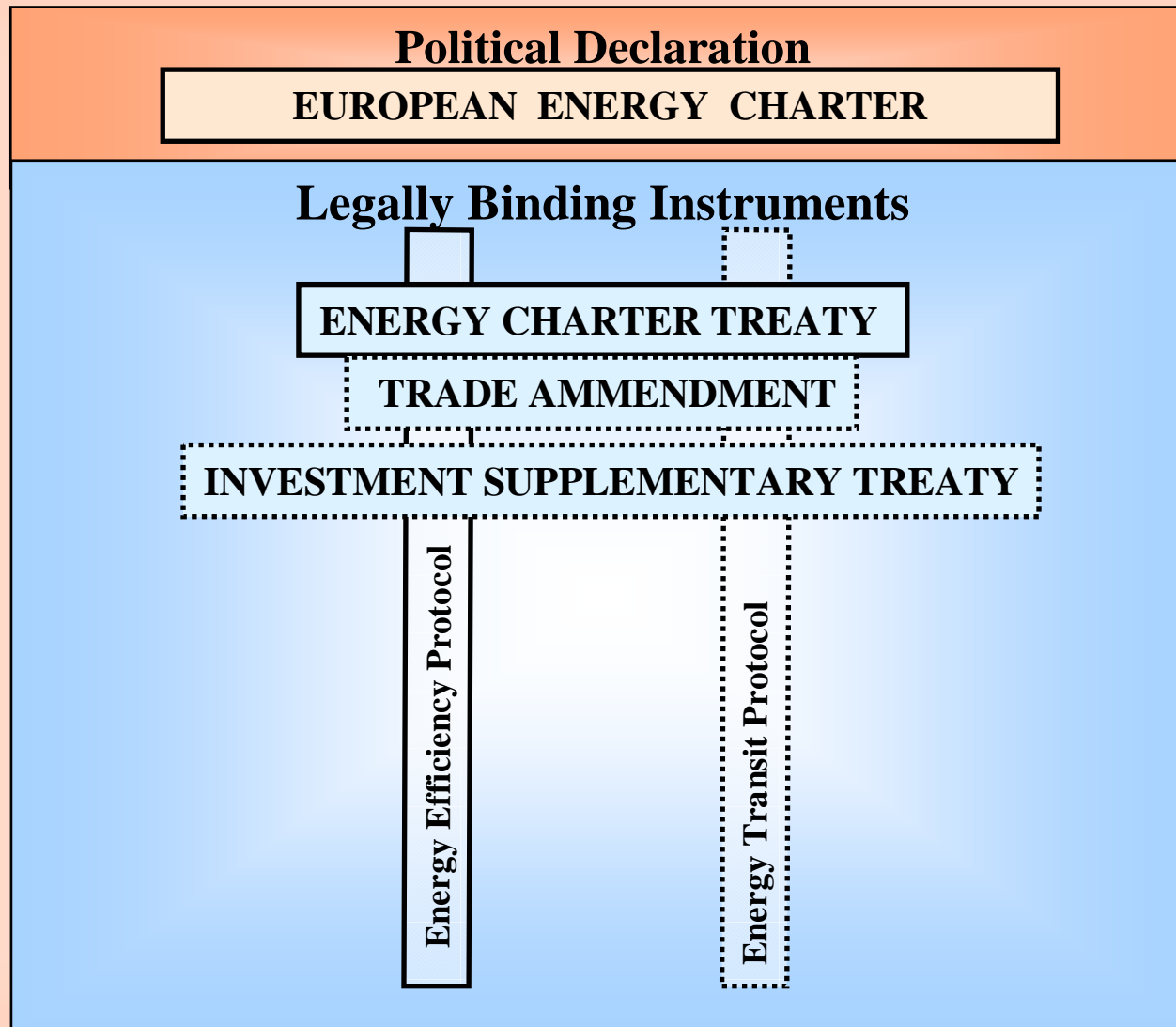
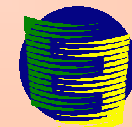
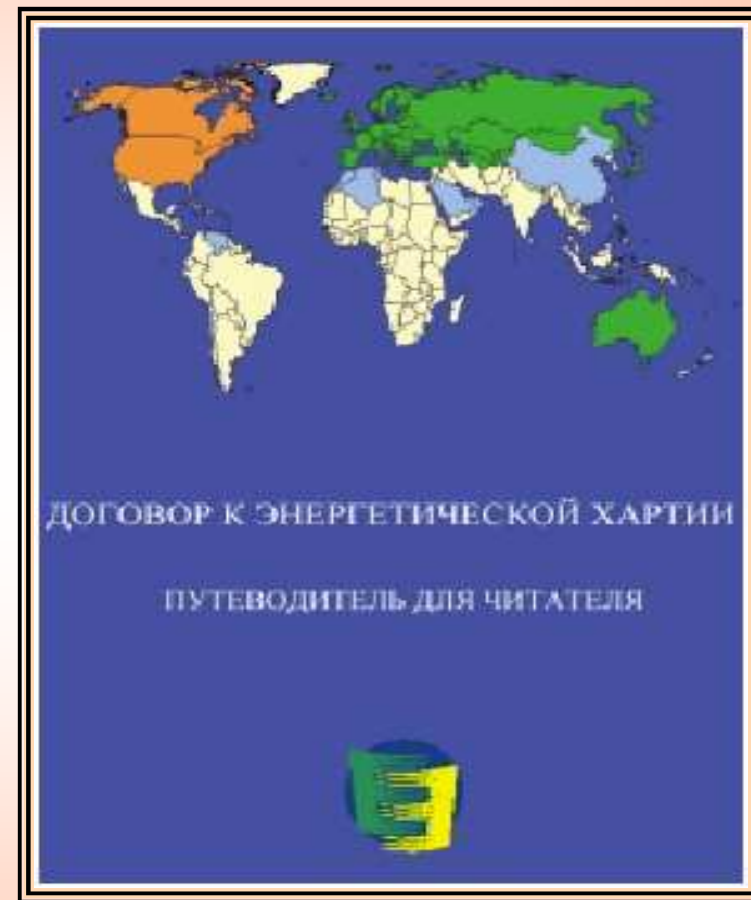


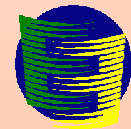
Figure 7



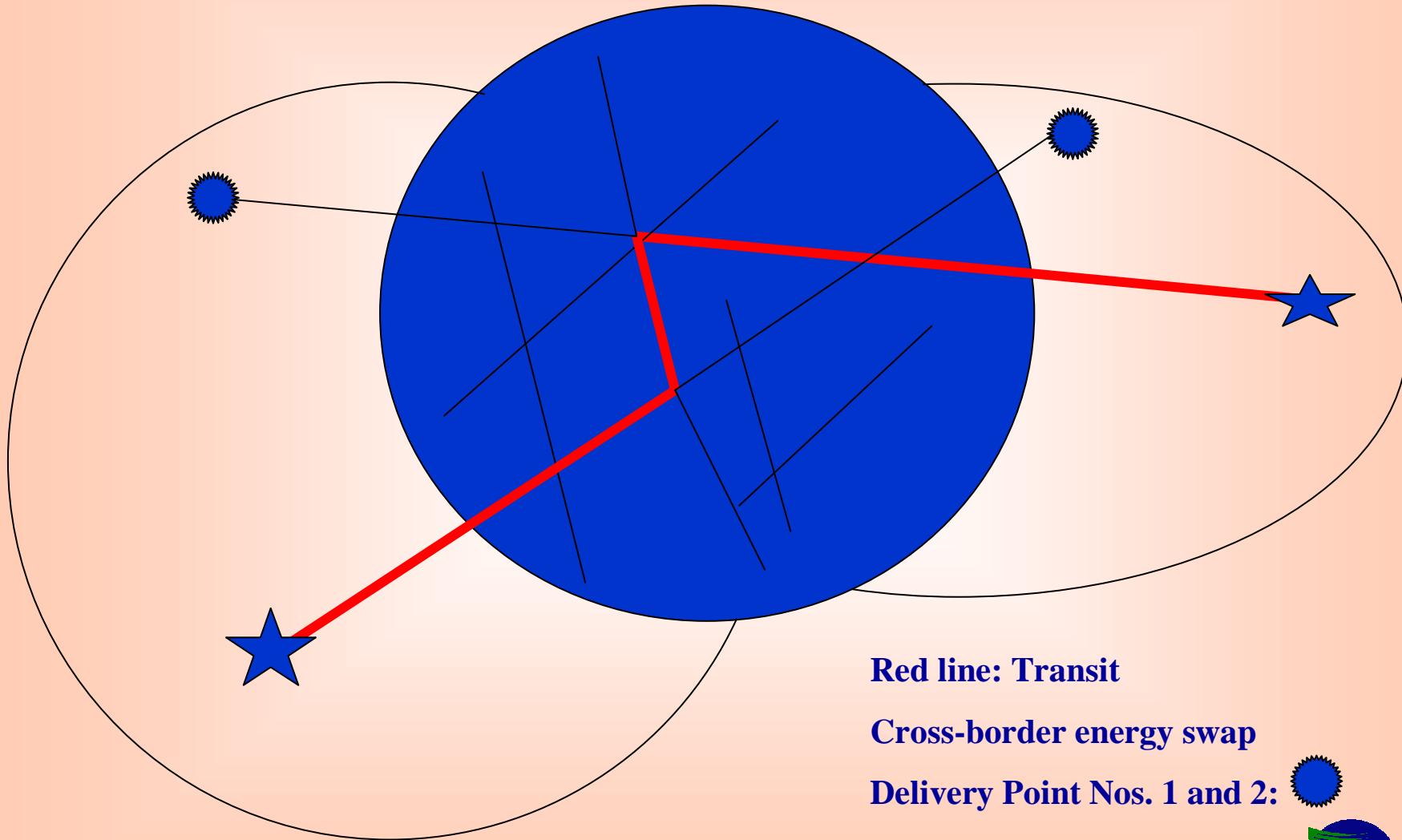
MOST RECENT PUBLICATIONS ON ECT:



3. Energy Charter Transit Protocol



TRANSIT DEFINITION



Red line: Transit

Cross-border energy swap

Delivery Point Nos. 1 and 2:

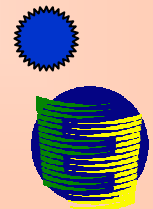


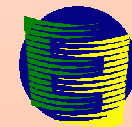
Figure 9

ENERGY CHARTER AND RELATED DOCUMENTS:

TRANSIT PROTOCOL

The Transit Protocol deals with the following issues:

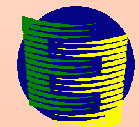
- 1. The obligation to observe Transit Agreements**
- 2. Prohibition of unauthorized taking of Energy Materials and Products in Transit**
- 3. Negotiated access of third parties to Available Capacity in Energy Transport Facilities used for Transit (mandatory access is excluded)**
- 4. Facilitation of construction, expansion or operation of Energy Transport Facilities used for Transit**
- 5. Transit Tariffs shall be non-discriminating, objective, reasonable and transparent, not affected by market distortions, and cost-based**
- 6. Technical and accounting standards harmonized by use of internationally accepted standards**
- 7. Energy metering and measuring strengthened at international borders**
- 8. Co-ordination in the event of accidental interruption, reduction or stoppage of Transit**
- 9. Protection of International Energy Swap Agreements**
- 10. Implementation and compliance**
- 11. Dispute settlement**



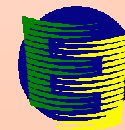
TRANSIT PROTOCOL - FINALISATION

December 2002 meeting of the Energy Charter Conference agreed that, in view of the very wide measure of agreement reached on the Protocol on Transit, its text, in order to facilitate a rapid conclusion of the negotiations, should not be open for further negotiations with the exception of the following three interrelated issues:

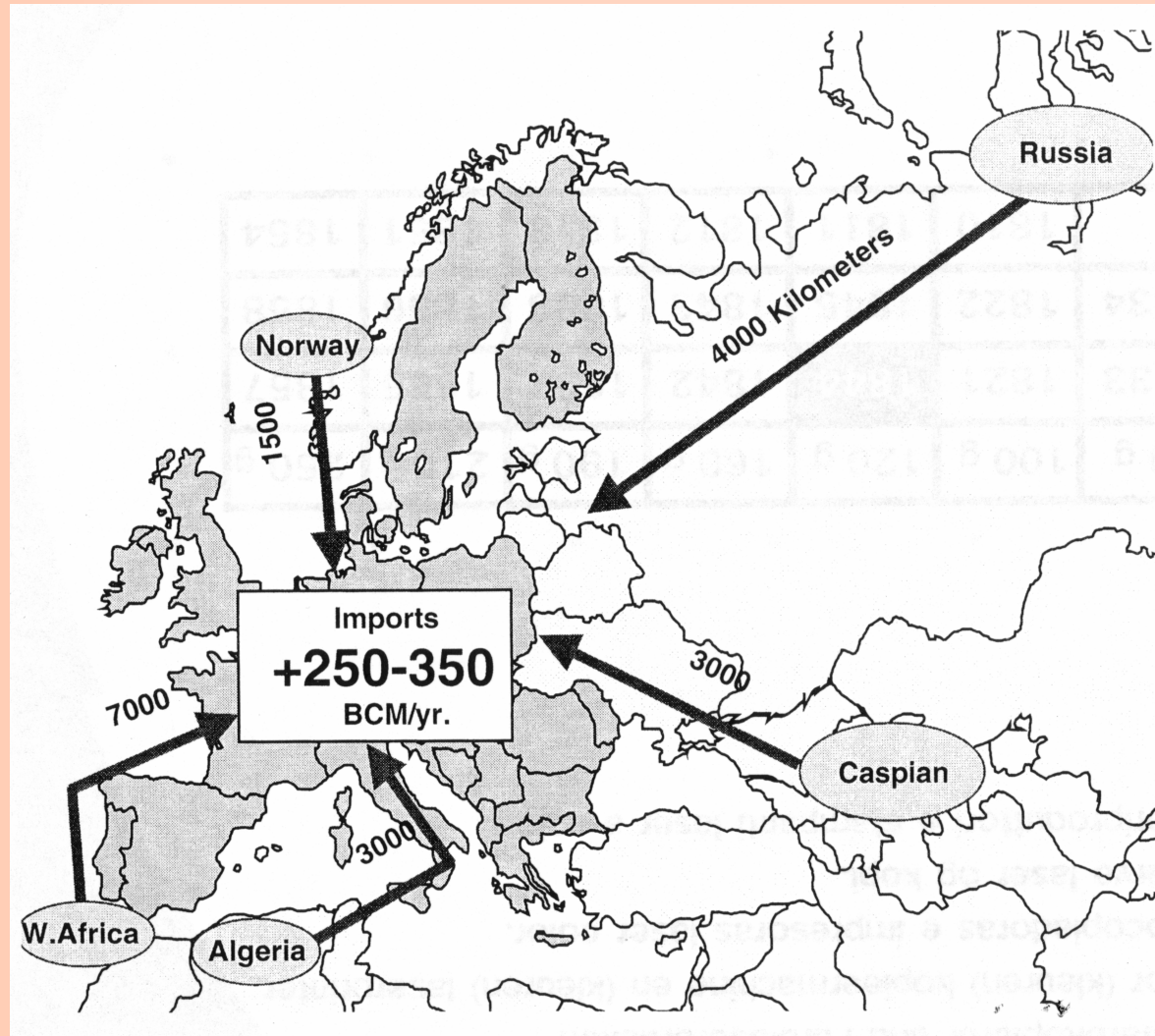
- Right of First Refusal;**
- Application of REIO clause; and**
- Transit Tariffs (the text of which was provisionally agreed, subject to reserve).**



4. Russian position on ECT transit



EUROPEAN GAS MARKET OUTLOOK

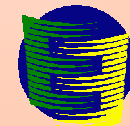


By 2020:

- Demand up 200-300 BCM/yr
- Imports up 250-350 BCM/yr
- New investments 250-300 billion \$

Source: J.V.Genova/Exxon Mobil

Figure 12



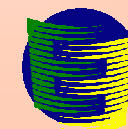
GAS TRANSIT ROLE FOR MAIN EXPORTERS TO EUROPE IN 1999

Country-exporter	Direct supplies, % of volume of exports	Transit through the territory of: % of volume of exports			
		one country	two countries	three countries	four countries
Netherlands	76,2	13,8	10,0	-	-
Norway	67,7	7,5	21,4	3,4	-
Algeria	44,9	14,8	9,6	24,3	6,4
Russia	39,5	9,4	11,4	28,1	11,6

Russian gas supplies (% of export volume):

To FSU
40,8%

Beyond FSU
59,2%



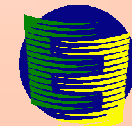
ECT MAJOR OPPONENTS IN RUSSIA AND THEIR ARGUMENTS

Arguments against ECT ratification	Comments
<p><u>Gazprom:</u></p> <ol style="list-style-type: none"> 1) ECT demands mandatory TPA to Gazprom’s pipelines for cheap gas from Central Asia 2) Obligation to transit Central Asian gas at low (subsidised) domestic transportation tariffs 3) ECT will “kill” LTCs 	<p>No such obligation. ECT excludes mandatory TPA (ECT Understanding IV.1(b)(i)).</p> <p>No such obligations (ECT Article 7(3)). Transit and transportation are different in non-EU.</p> <p>Not true. ECT documents do not deal with LTC at all. Economic niche for LTCs will become more narrow due to objective reasons, but they will continue to exist as a major instrument of financing greenfield gas projects.</p>
<p><u>Ministry of Nuclear:</u></p> <ol style="list-style-type: none"> 1) Bilateral RF-EU trade in nuclear materials is not regulated by ECT 	<p>Prior to ECT signing in 1994, RF and EU has agreed to regulate nuclear trade bilaterally (P&CA).</p>

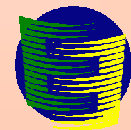
Major Russia’s concern regarding ECT ratification relates to gas transit issues

Other debate – see publications

Figure 14



5. Other Caspian states position on transit



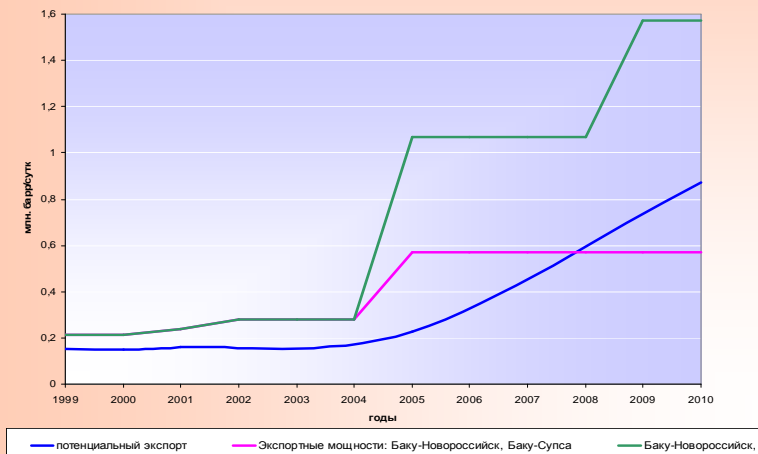
SPLIT OF THE UNIFIED CONCEPT OF CASPIAN O&G DEVELOPMENT (TRANSPORTATION ROUTES)

SOUTHERN CASPIAN		NOTHERN CASPIAN	
ROUTE	STATUS	ROUTE	STATUS
1. Baku- Novorossiysk	Active pipeline	1. CPC	Active pipeline
2. Baku-Supsa	Active pipeline	2. Tengiz-Atyrau- Samara	Acting pipeline
3. Baku-Ceyhan	Pipeline in project	3. Tengiz-China	Railway
4. Baku-Batumi	Railway	4. Tengiz-Russia	Railway+inland water transport
5. Swaps		5. Tengiz-Aktau- Baku-Ceyhan	Pipeline, stage of agreement
		6. Swaps	
Decrease of potential supply volumes – no need for new options for transportation (lack of resources)		Increase of potential supply volumes – possibility for increase of existing routes transportation capacities	

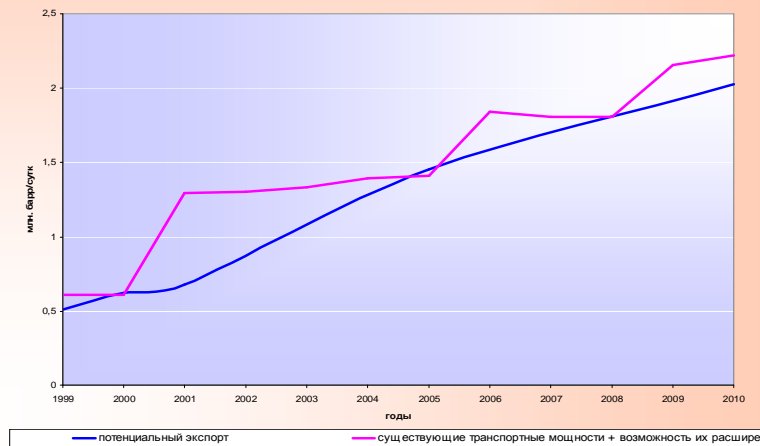
DEMAND OF CASPIAN REGION FOR NEW EXPORT ROUTES

Correlation between export potential and transportation routes:

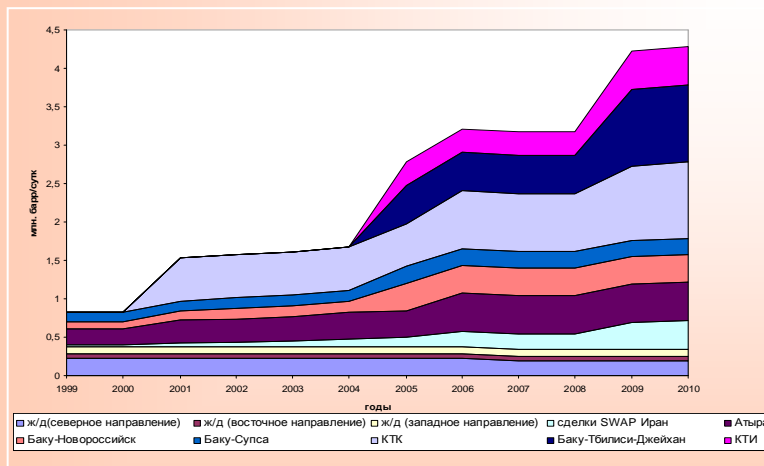
AZERI OIL



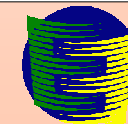
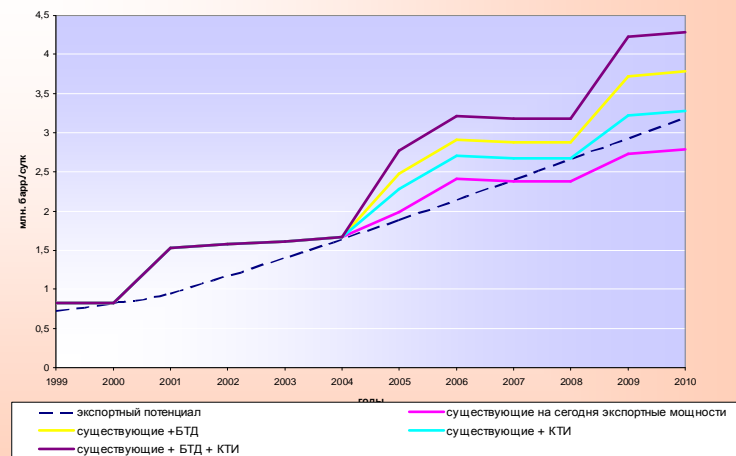
KAZAKH OIL



Caspian oil pipeline export capacity

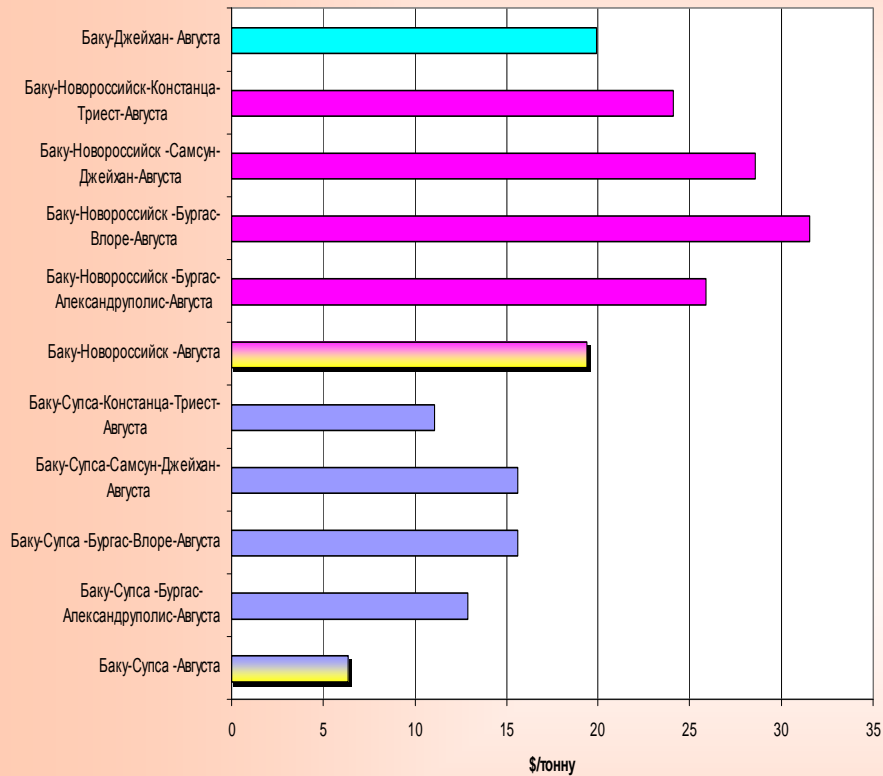


Surplus deficit of capacities under different scenarios

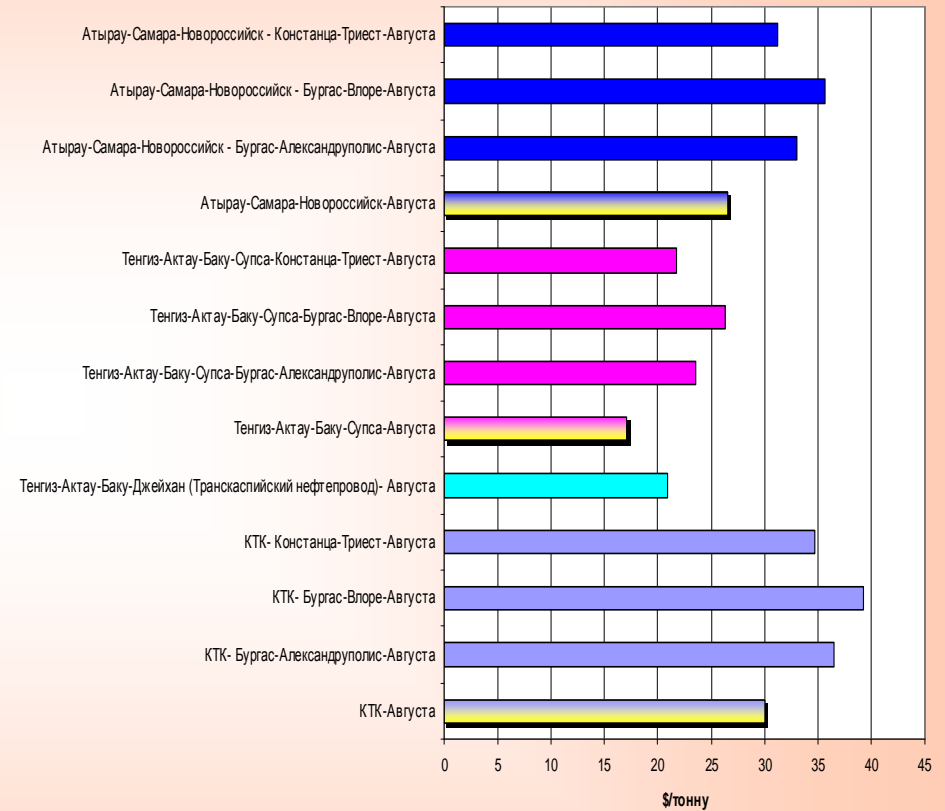


COSTS OF CASPIAN OIL TRANSPORTATION DEPENDING OF SUPPLY DIRECTION

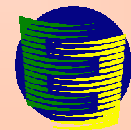
Нефть Азербайджана



Нефть Казахстана



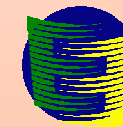
6. Caspian states transit problems dependant on Russian gas reforms



RUSSIA'S PRIORITIES FOR INSTITUTIONAL REFORMS IN GAS

PRIORITY	LEVEL	INSTRUMENTS
1.	Internal	<p>Reform of domestic gas industry and Gazprom</p> <p>But:</p> <ul style="list-style-type: none"> - 6 competing programmes - Putin (to Miller's letter): do not split Gazprom - Duma and Presidential elections (2003-2004)
2.	Bilateral	<p>i.e.:</p> <ul style="list-style-type: none"> - Russia-Kazakhstan (KazRosGaz) - Russia-Ukraine (+Germany/Ruhrgas) - Russia-Belarus - RF-EU Energy Dialogue
3.	Multilateral with neighbour countries (CIS)	<p>EurAsEC</p> <p>But: on what basis? Cartel of gas producers (Gas OPEC) or common principles based on balance of interests of all the participants of gas value chain?</p>
4.	Multilateral within a broader community	<p>WTO, ECT</p>

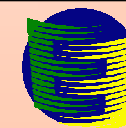
Figure 18

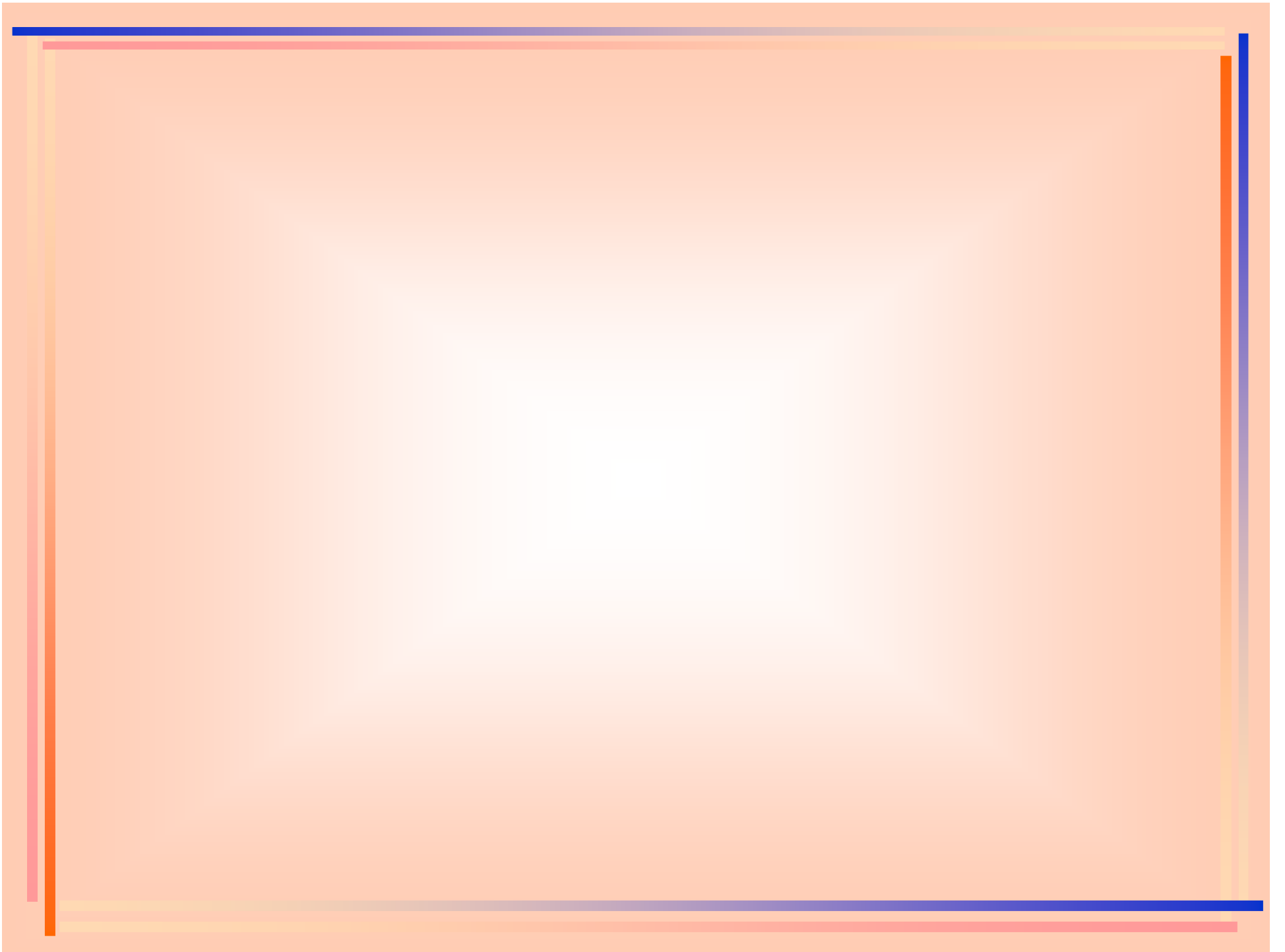


ACCESS TO AVAILABLE CAPACITIES ON TRANSIT: KAZROSGAS VS. ECT APPROACH

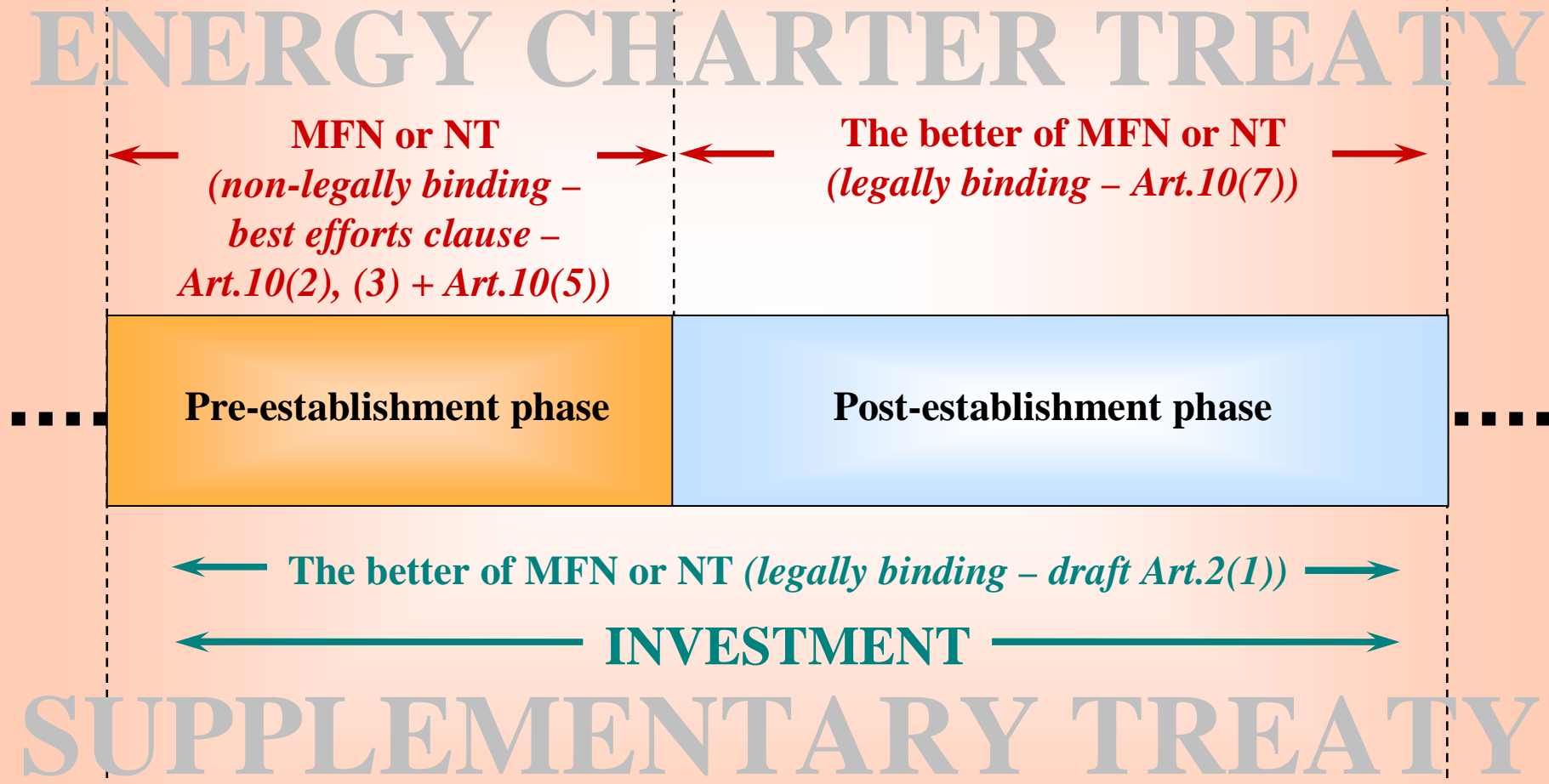
KAZROSGAS RULES	ECT RULES
<p>KRG = JV: production+transportation=ownership+operation</p> <p>KRG = JV between two natural monopolies+one state company=JV with strong state participation</p> <p>KRG = preferential treatment for the participants of JV (for few)+discriminatory treatment for others</p> <p>Aim: not to create new assets, but to exclude part of existing assets from competition</p>	<p>ECT = contractual law</p> <p>ECT = negotiated TPA (non-mandatory) = non-discriminatory treatment for all</p> <p>Aim: transparent, competitive, open market that will stimulate inflow of investments in creation of new assets</p>

Figure 19



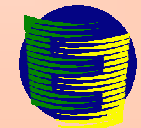


ECT ARTICLE 10(1): Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area.

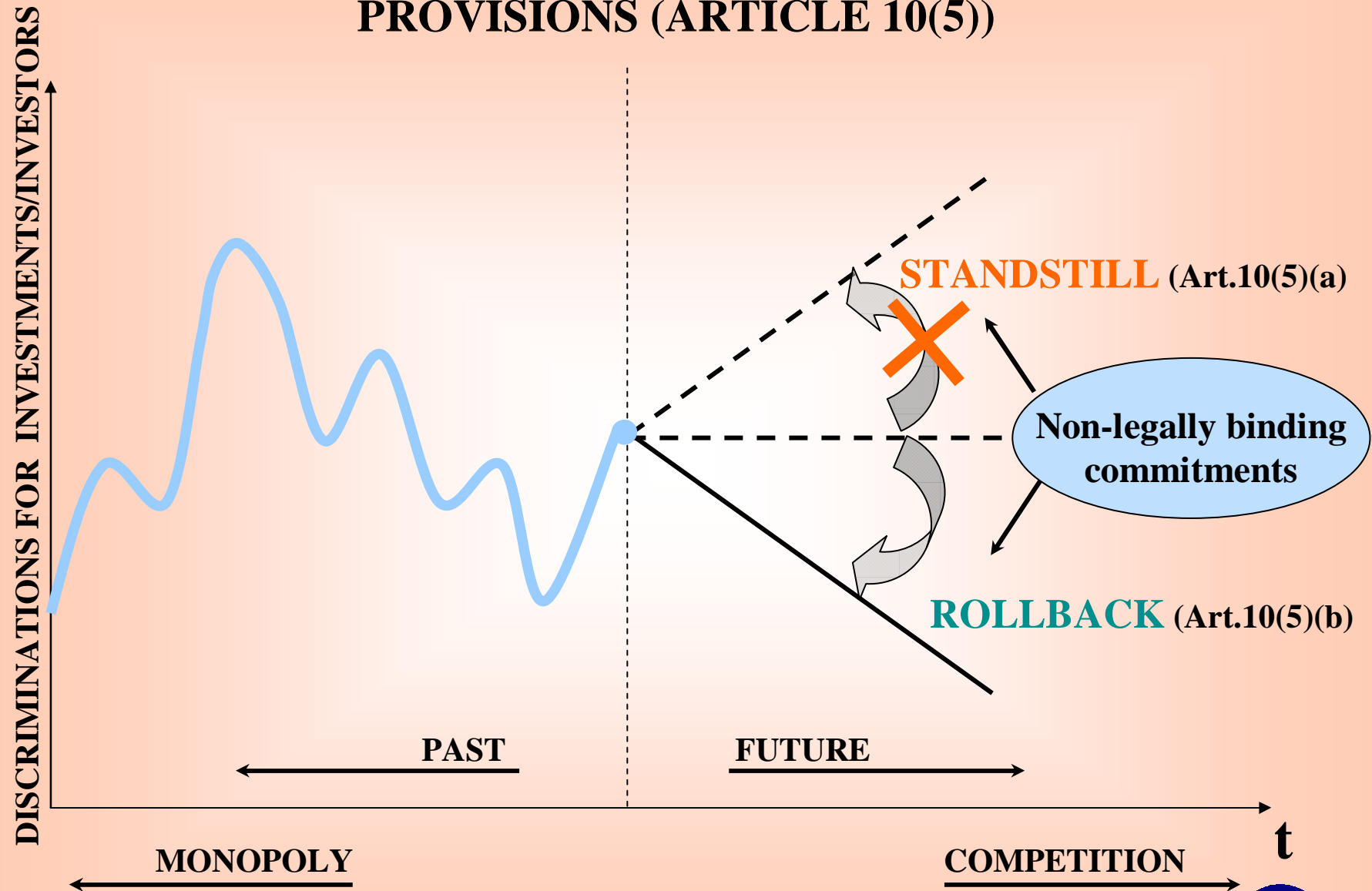


MFN = Most favored nation treatment
NT = National treatment

Figure



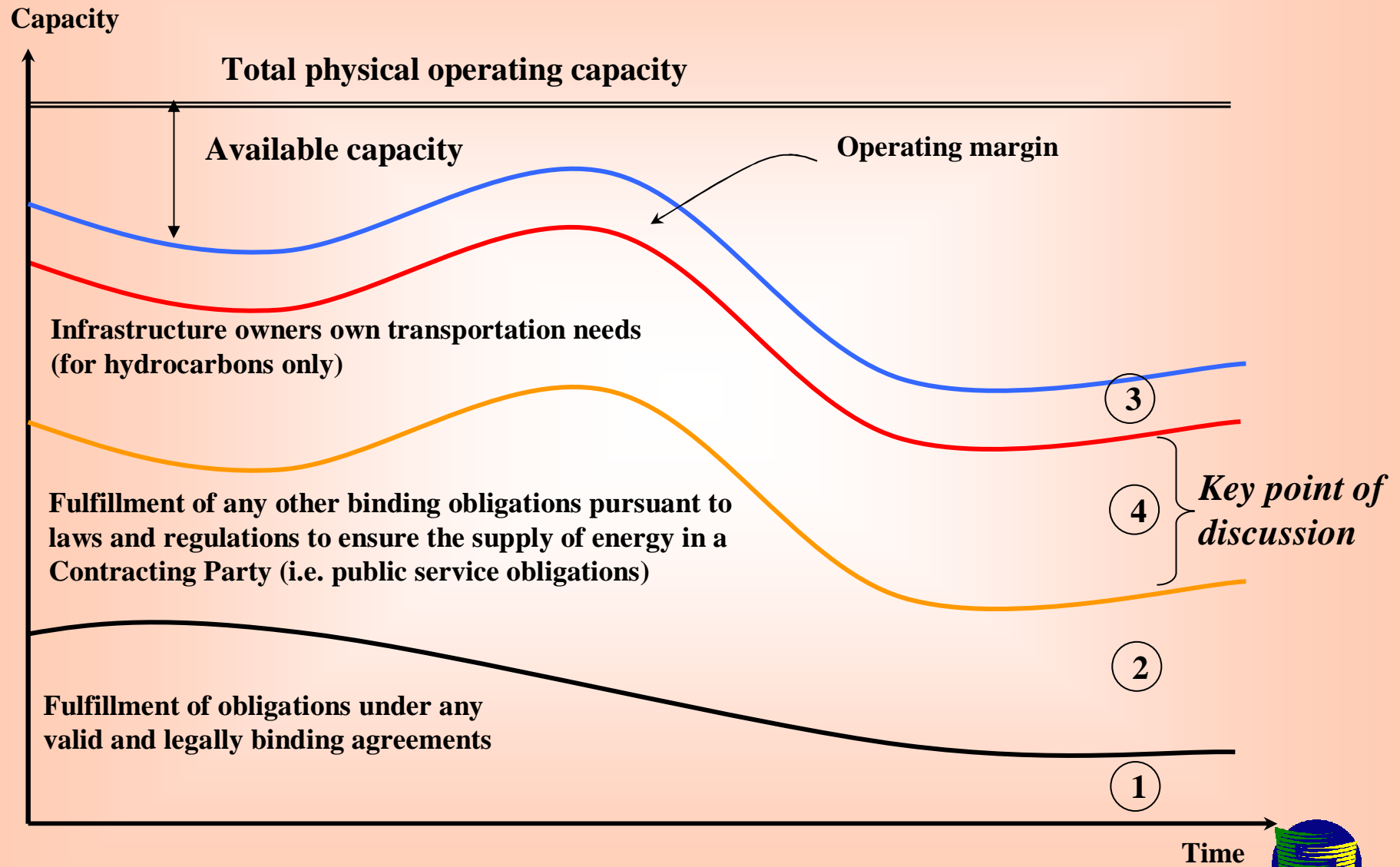
ECT INVESTMENT REGIME: STANDSTILL & ROLLBACK PROVISIONS (ARTICLE 10(5))



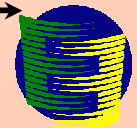
Figure



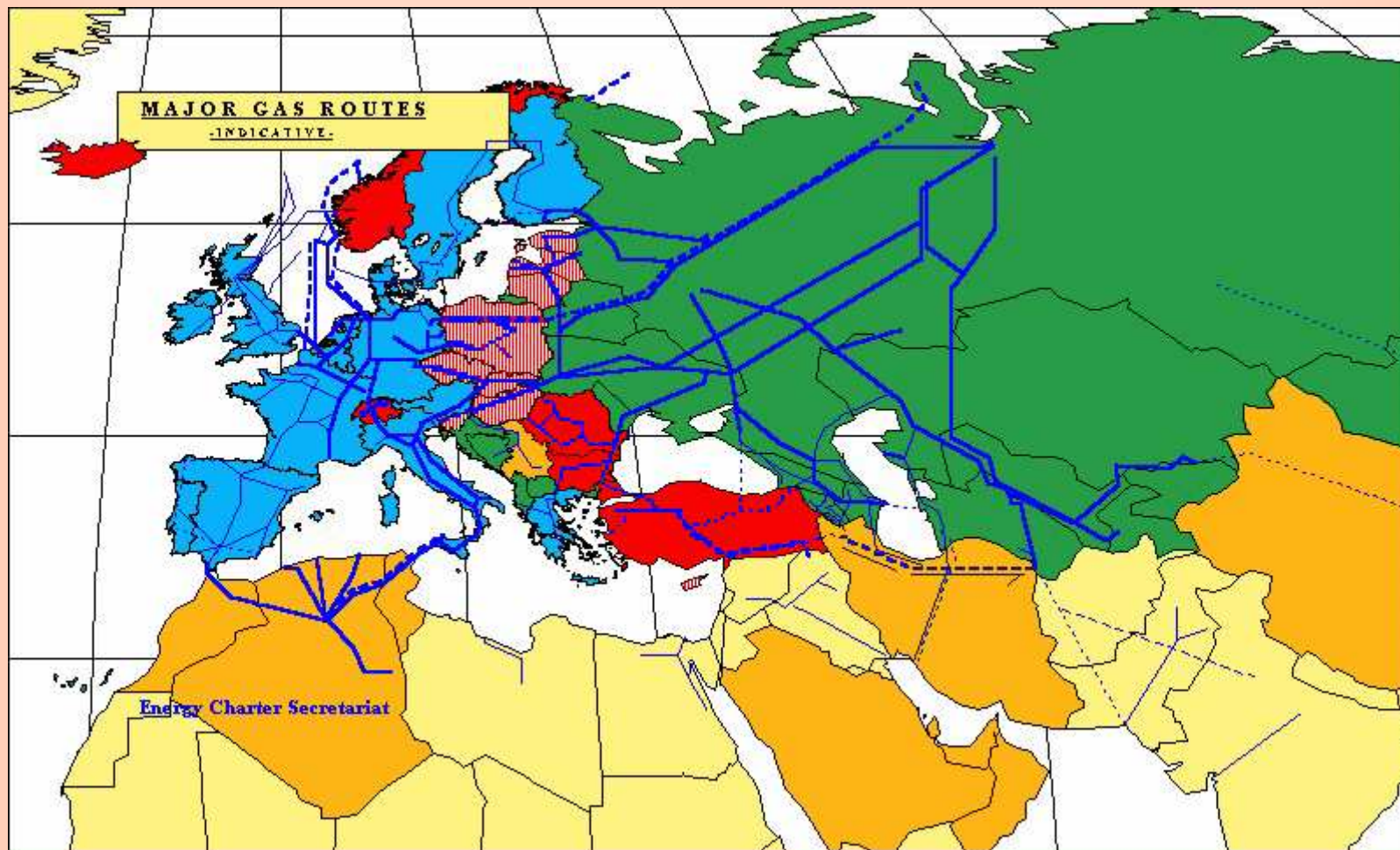
1. AVAILABLE CAPACITY



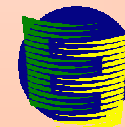
Figure



REIO CLAUSE: GEOGRAPHICAL ASPECTS

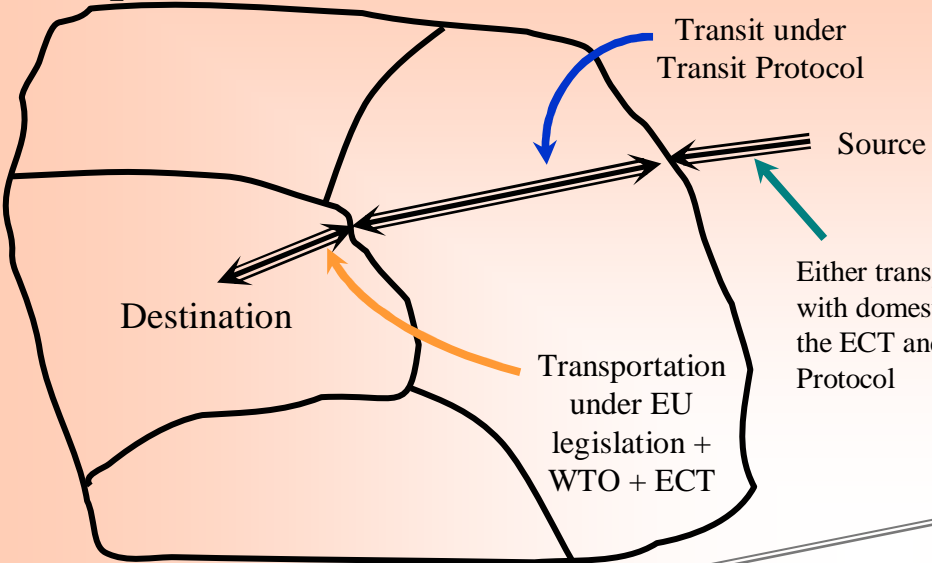


Figure



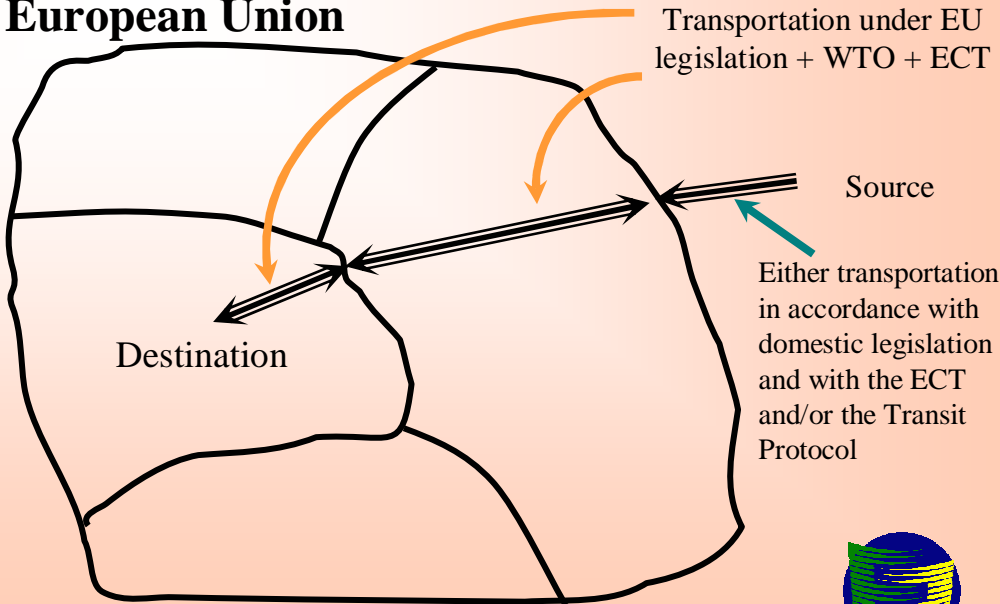
REIO CLAUSE: LEGAL ASPECTS

European Union



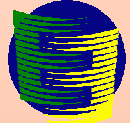
(a) Before REIO:

European Union



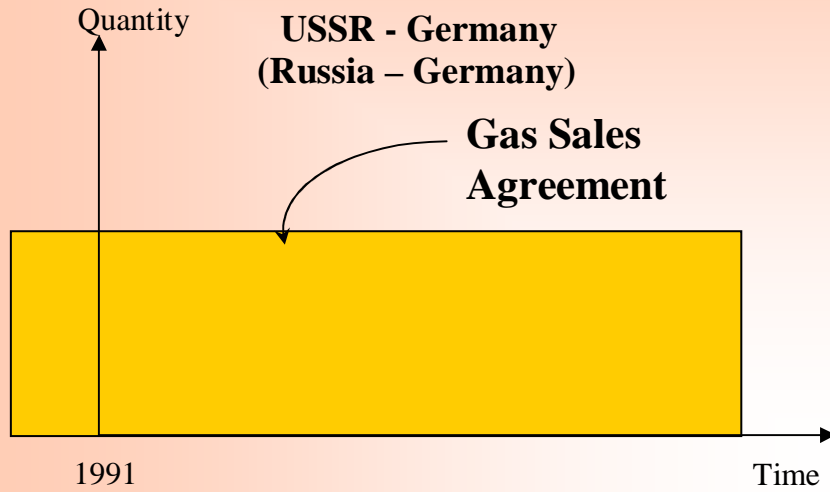
(b) After REIO:

Figure

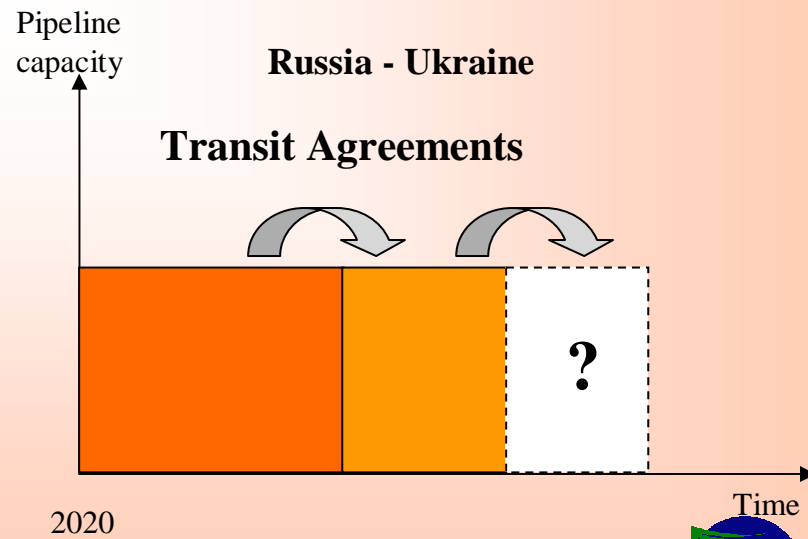
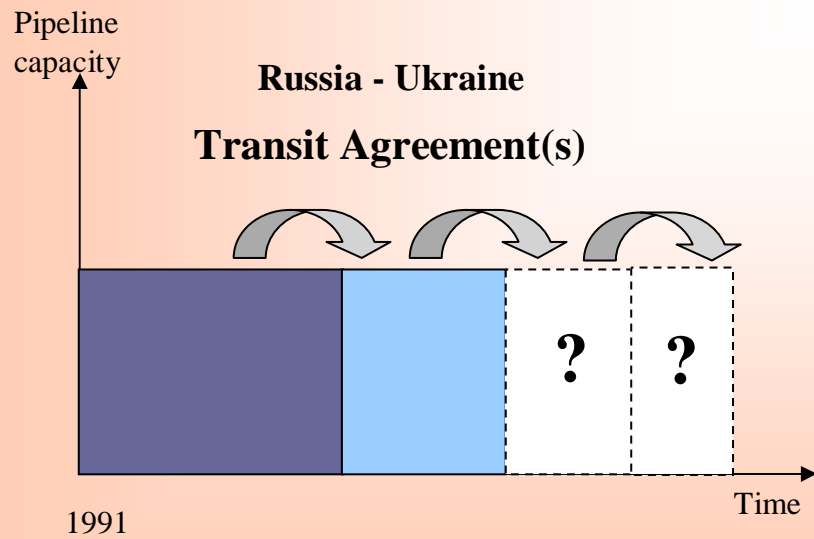
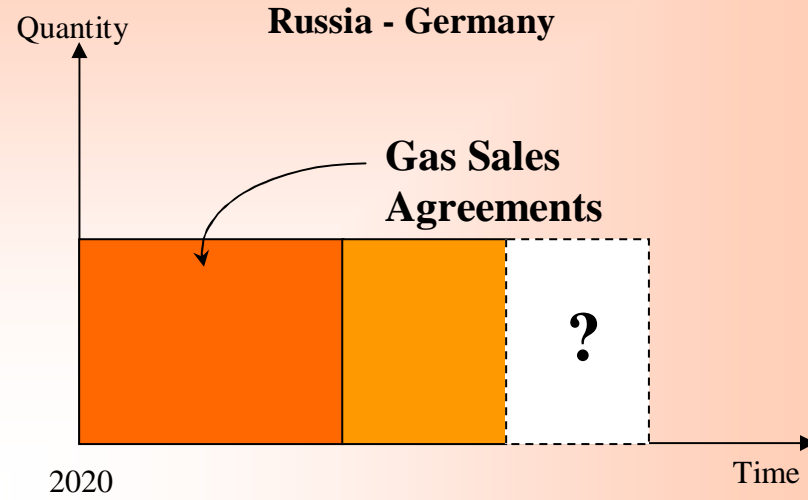


RIGHT OF FIRST REFUSAL: TWO ASPECTS

Currently

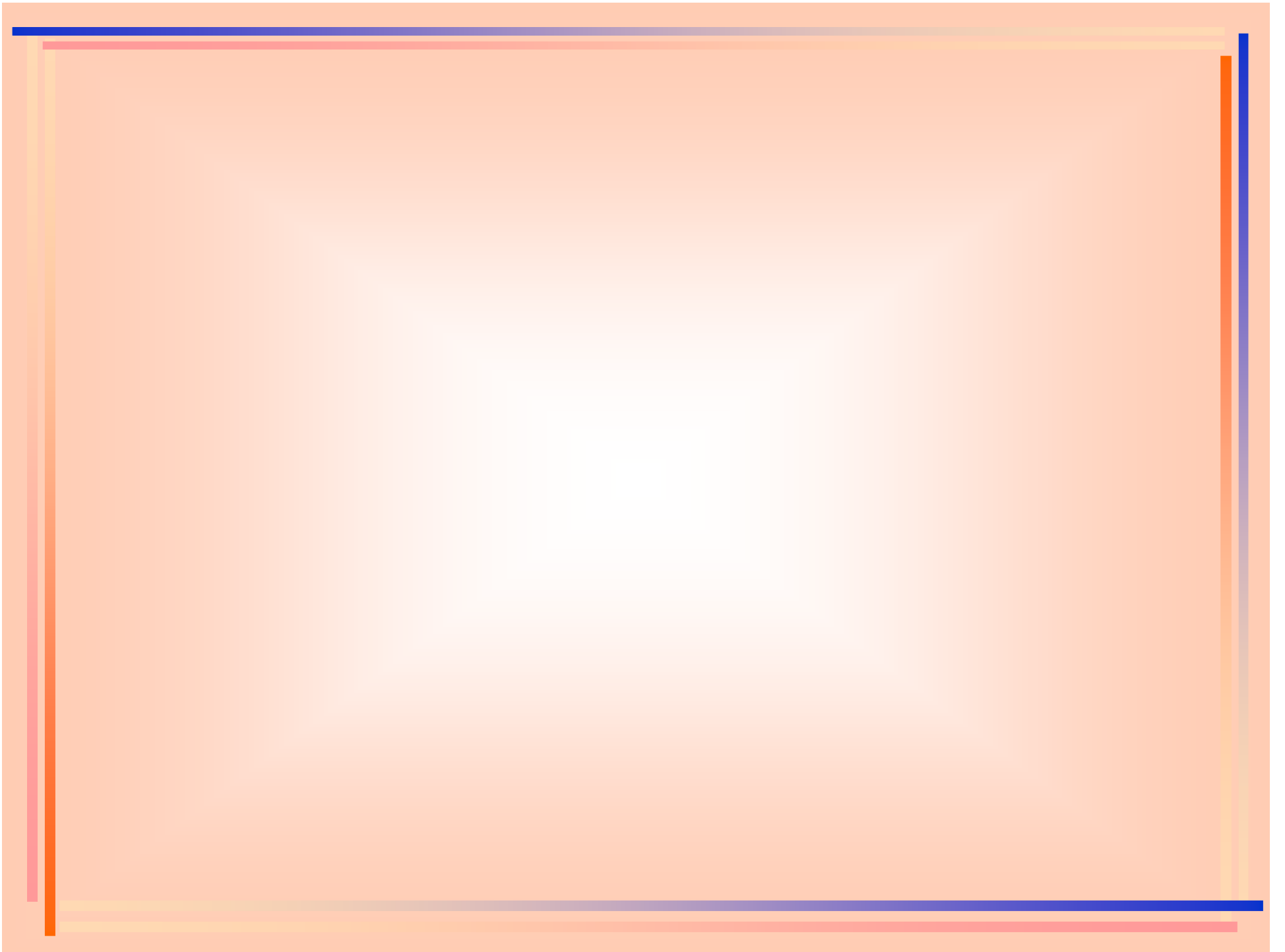


In the future



Figure





ROLE OF THE LONG TERM CONTRACTS

At initial stages of market development LTCs plays role of (the then almost absent) legislation, i.e. LTC secure investor from common & specific risks:

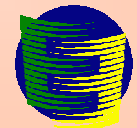
- (a) common risks = due to low state of development of legal environment,**
- (b) specific risks = related to particular energy supply projects**

LTC = analog to PSA = anclave of stability = effective way to diminish project financing risks

Two ways of further development:

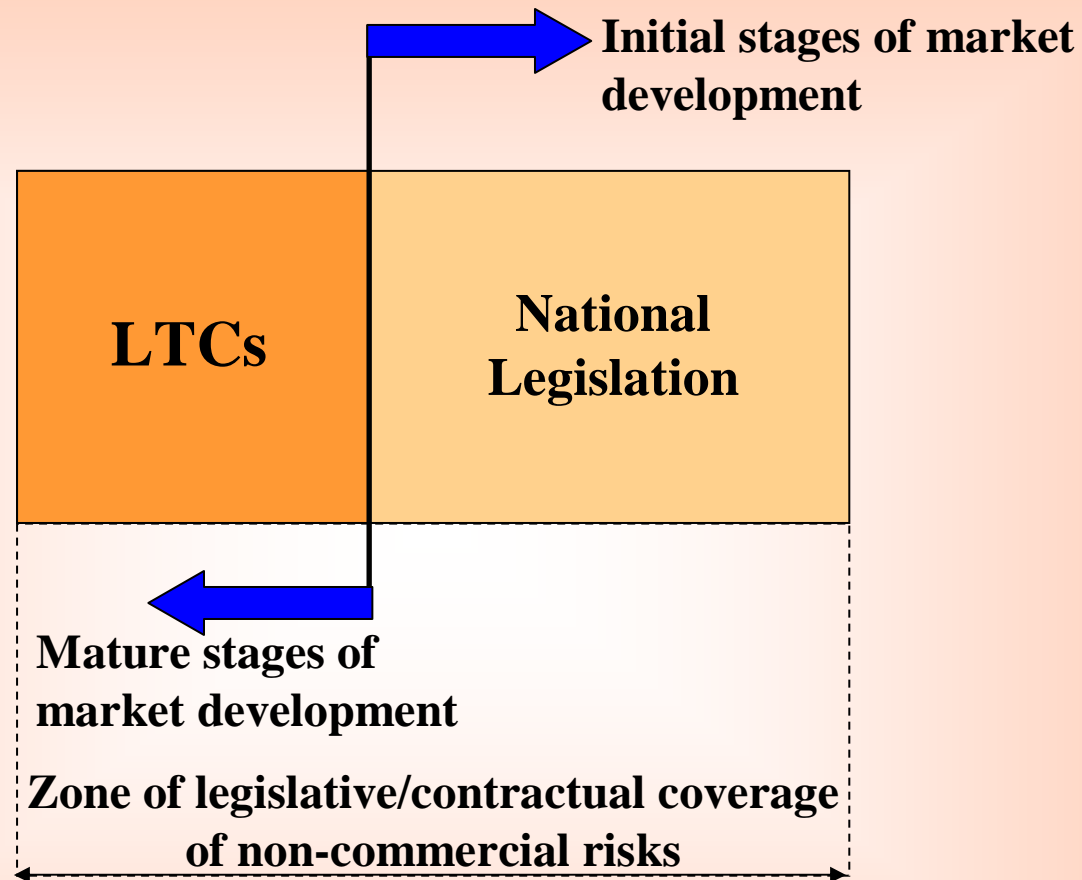
- (1) framework of LTCs (analogy to BITs), but:
high probability that due to confidentiality clauses conditions of different LTCs will differ => model LTC (?)**
- (2) development of legislation that will cover major common risks, previously covered by LTCs**

Figure



www.encharter.org

Energy markets development: LTCs vs. national legislation



Further to development of national legislation, LTC-zone will diminish due to objective reasons, but some effective niche for LTCs will be left anyhow

GAS: DIFFERENT PROJECTS – DIFFERENT CONTRACTS

(1) New projects in mature regions with existing infrastructure, with available transportation capacities (usually less capital-intensive projects, relatively small to the existing market) =

(a) short-term contracts (“take and/or pay”) – for the duration of payback period (?)

(b) spot deals – when payback period is over (?):

- dated
- forward
- futures

Regions: Western, Central & Eastern Europe

(2) New projects in new regions with no/lack-of infrastructure for both production and transportation (usually more capital-intensive projects, relatively big to the existing market) =

(a) long-term “take and/or pay” contracts

Regions: Russia, CIS, Asia

GAS: LONG-TERM TAKE AND/OR PAY CONTRACTS (LTC TOP) AND PROJECT FINANCING RISKS

$$\text{Financing} = f(\text{revenue}) = f(\text{volume} \times \text{price})$$

(1) LTC TOP = mechanism of supply risks («volume» risks) reduction

(2) LTC TOP + adequate pricing mechanism = mechanism of “price” risks reduction:

- prior to exchange pricing: escalation formulas
- exchange pricing: futures + hedging

(1) + (2) = mechanism of project financing risks reduction (long-term capital-intensive Greenfield projects, i.e. in new regions with no/lack-of production & transportation infrastructure)

LTC TOP as a mechanism of risks reduction related to investments into new (Greenfield) gas projects yet has no alternatives at the emerging energy markets

LONG-TERM CONTRACTS

Item 22: “Long-term contracts will continue to be an important part of the gas supply of Member States and should be maintained as an option for gas supply undertakings in so far as they do not undermine the objectives of this Directive and are compatible with the Treaty, including competition rules.”

Source:

Amended proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directives 96/92/EC and 98/30/EC concerning rules for the internal markets in electricity and natural gas