

THE ENERGY CHARTER'S ROLE IN ENSURING SUSTAINABLE ENERGY DEVELOPMENT

**(Unique multilateral treaty to mitigate the cross-border
energy & investment risks in Eurasia)**

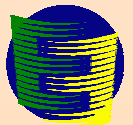
Dr. Andrei Konoplianiuk

Deputy Secretary General, Energy Charter Secretariat

**Presentation at the SMI's Conference on
"Sustainable Energy: Cleaner fossil fuels, Renewables, Energy Efficiency and Nuclear Energy»,
23-24 May 2007, The Hatton, London**

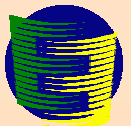
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6. The future of the Energy Charter process: towards open & competitive energy markets



TOWARDS MORE RISKY ENERGY MARKETS ?

- Markets:
 - from independent to interdependent
 - from monopolistic/monopsonic to competitive
 - more liquid (trade, short-term) not necessary means more competitive (few import supply sources, long-term) & secure (investment, long-term)
- Diversification (multi-dimensional) in:
 - energy mix, suppliers, routes, markets, contractual & business (corporate) structures, pricing mechanisms
- Pricing:
 - cost-plus (fixed prices, negotiated levels) => replacement values (flexible prices, formula-based, negotiated formulas) => exchange pricing (flexible prices, based on perceptions of two groups of players with opposite interests: hedgers & speculators)
- Price behaviour:
 - increasing volatility, more transparent – less predictable



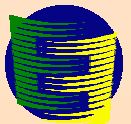
CHALLENGES OF CROSS BORDER ENERGY INVESTMENT & TRADE

During 90s:

- 1) Energy prices 15-20 \$/bbl
- 2) Fall of Berlin Wall:
 - Transition of USSR/COMECON economies => need to attract investment
- 3) Sector reform in OECD countries
- 4) Increased imports OECD
- 5) Local pollution / start GHG discussion
- 6) Emerging global oil market

Since 2000:

- 1) Energy prices 50–70 \$/bbl
- 2) Post 9 /11 and Iraq intervention
- 3) Sector reforms under high oil prices
- 4) Strong economic growth of developing countries => requiring investment into infrastructure and energy imports
- 5) GHG emissions perceived as imminent global threat
- 6) Established global oil market, gas to follow?

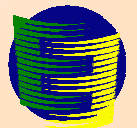


SOVIET / RUSSIAN GAS TO EUROPE: CONTRACTUAL STRUCTURE

- Long-term contracts
- On-border EU (-15) sales / delivery points
- Pricing: netted-back from replacement value at the end-market (e.g. less cost of transportation from end-market to delivery point)
- Protection against arbitrage (destination clauses)
- Multiple transit

Soviet / Russian gas export contracts to the EU (historically), former COMECON (since after USSR dissolution) and FSU (since recently) are based (& to be based) on Groningen (Dutch) concept of long-term export contract

Historically existing structure of LTC proved its validity & reliability through Cold War and post-Soviet transformation periods



RUSSIAN GAS TO EUROPE

Map source -
IEA



Russian LTC to EU:
A, B, C – points of change
of ownership for gas
and/or pipeline;
C – delivery points
to EU



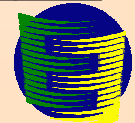
Shtokmanovskoye field: to be developed as of 2007; may require 1-3 large-diameter pipelines

Yamal peninsula fields: to be developed after 2015; may require up to 6-7 large-diameter pipelines

Zapolyarnoye field: Exploitation began late October 2001 to supply gas for "Blue Stream"

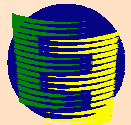
— Existing Large-Diameter Pipeline
 - - - Planned Large-Diameter Pipeline
 ■ Producing Gas Field
 ▨ Undeveloped Gas Field

Dr. A. Konoplyanik, Smi's Conference on Sustainable Energy, London, 23-24 May 2007 - Figure 5

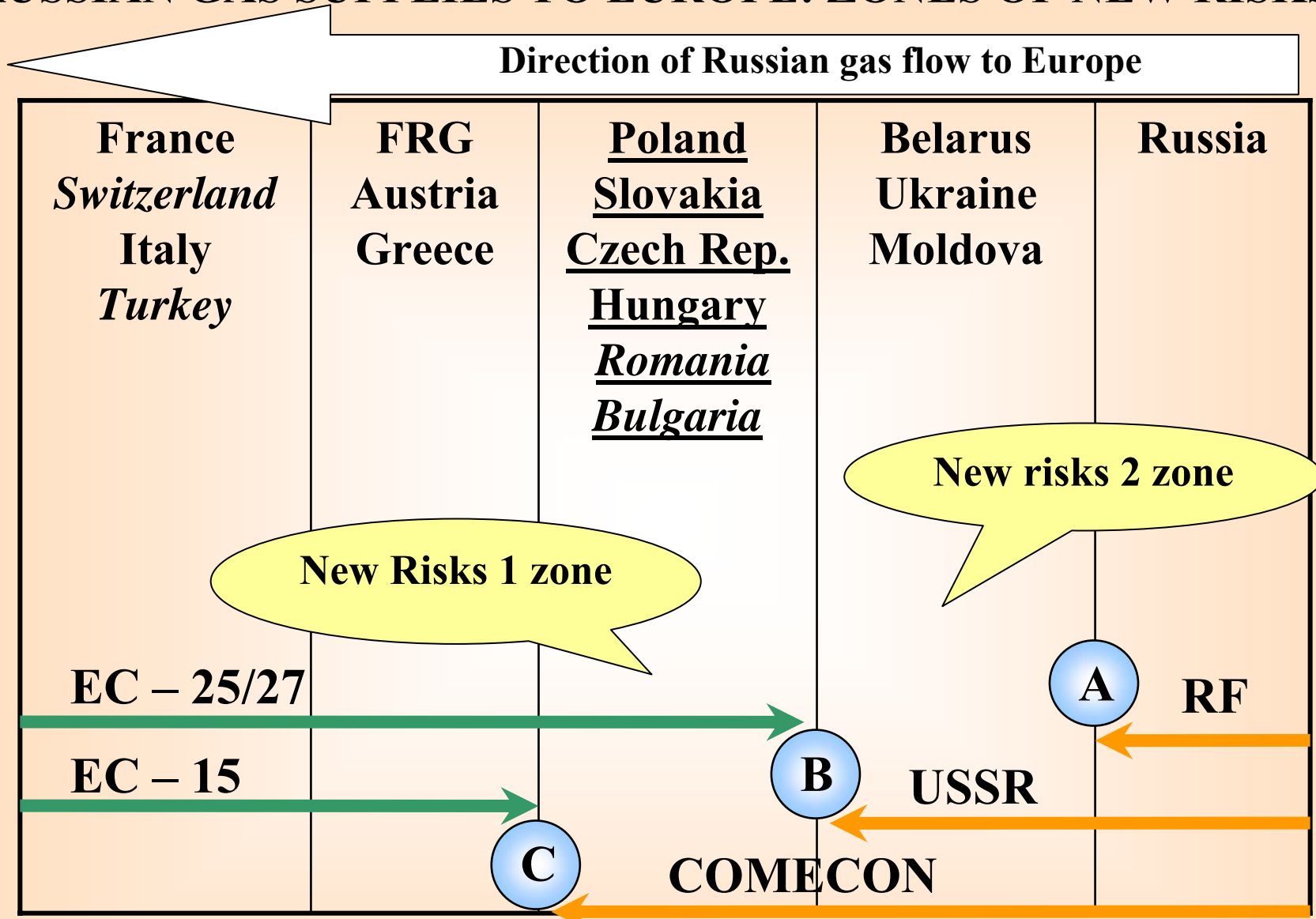


NEW RISKS FOR RUSSIA'S GAS SUPPLY TO EUROPE: WHICH, WHEN & WHERE

- **Since 1991** – *upstream* to delivery points, within CIS/NIS = result of USSR dissolution => new transit risks
- **Since 2002/03** – *at* delivery points (not at the market); solution on destination clauses = result of EU liberalization = package deal (lifting restrictions both on sales of imported gas within EU vs. access of exporters to downstream EU markets) => but: e.g. TAG Dec'05 capacity allocation
- **Since 2004/07** – *downstream* to delivery points, within enlarged EU-25/27 = combined result of EU expansion + EU gas market liberalization => new prospective transit/transportation risks

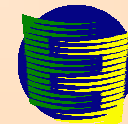


RUSSIAN GAS SUPPLIES TO EUROPE: ZONES OF NEW RISKS



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

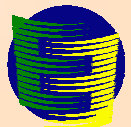


NEW RISKS 1: EU RELATED (SINCE 2004)

- No transit of Russian gas inside EU up to May'2004 (EU-15)
- Transit of Russian gas inside EU since May'2004 (EU-25) and even more since Jan'2007 (EU-27)
- Transit risks for imported Russian & other non-EU gas inside EU:
 - Major elements of liberalization: unbundling + mandatory TPA,
 - No clear transit rules for internal EU gas market (domestic transportation = free flow of goods inside EU),
 - Problem of contractual mismatch (long-term access to infrastructure for transit flows to match existing supply LTC)

Energy Charter role: ECT
Art.7 "Transit" + draft TP
+ other gas/transit related
activities ...

New risks = Combined result of creation & liberalization of EU internal energy market (e.g. unclear EU rules on gas transit through single member states) plus + EU expansion => EU transition risks (liberalization risks)



NEW RISKS 2: COMECON / CIS RELATED (SINCE 1991)

- Earlier structure :
 - Barter deals
 - Political & friendly pricing
 - Transportation system – not transit system
 - No transit within USSR
 - Supply & transit are not separated within COMECON
- Long & painful transition to :
 - Contractual separation of transit & export supplies
 - Domestic transportation vs. transit legislation
 - From barter to cash payments
 - From political to market-based pricing:
 - Transit tariffs methodology
 - Market-oriented gas export pricing & prices

Energy
Charter role:
draft TP +
gas/transit-
related
activities (e.g.
Transit tariffs
study
(Jan'06),
Pricing study
(March'07),
etc.

New risks = Result & long-term consequences of dissolution of USSR/COMECON system & transition of NIS to different (EU/non-EU) legal systems (transition risks)

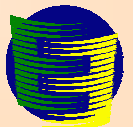
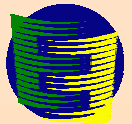


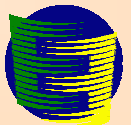
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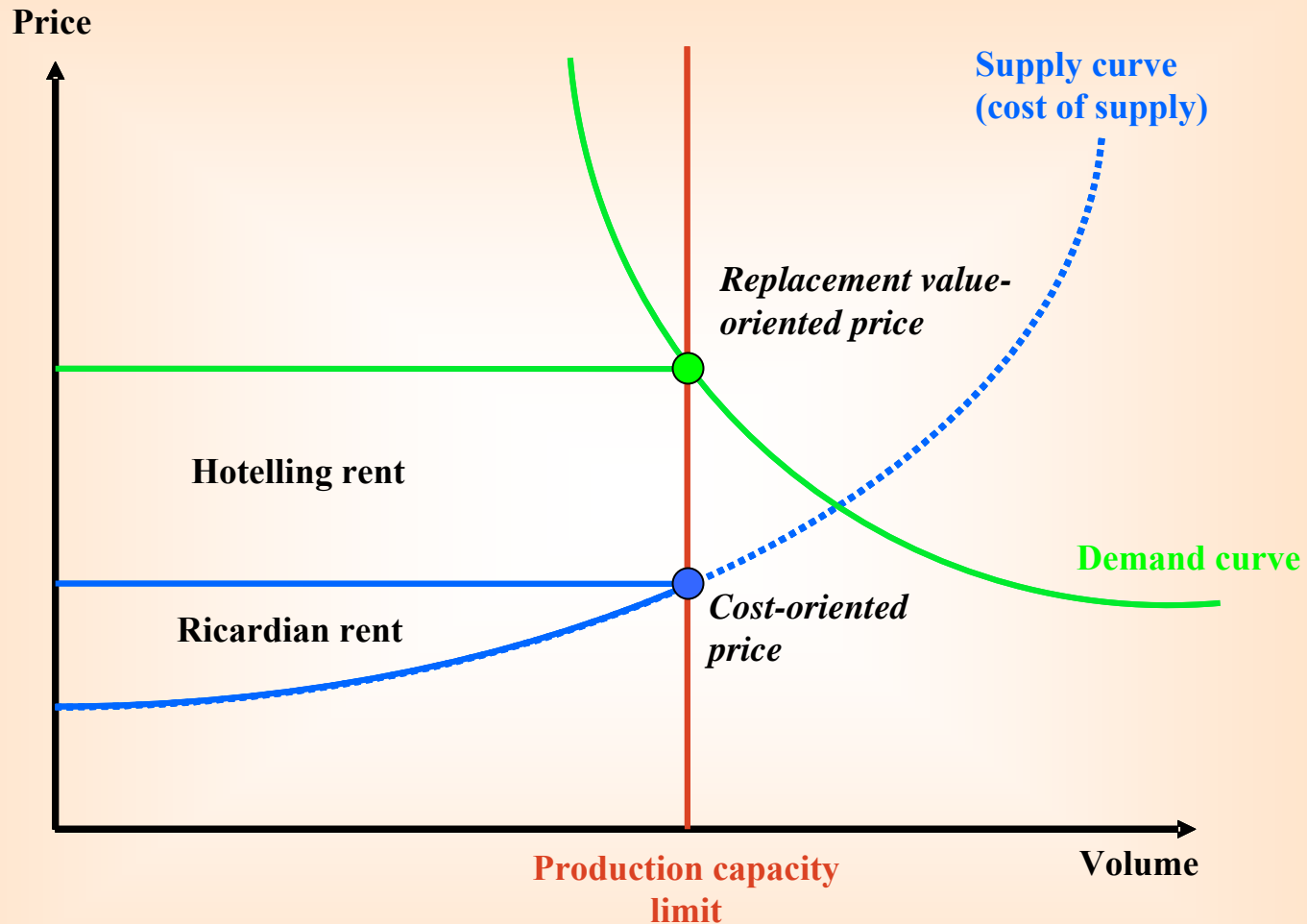


WHAT “SUSTAINABLE” MEANS?

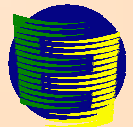
- Fair (non-discriminatory)
- Balanced (mutually beneficial within cross-border energy value chains, long-term)
- Economically proven (understandable)
- Market-based (clear market signals)
- Transparent (predictable)
- No new risks & diminish existing ones (diminish barriers for investment)
- Competitive (choice for producers/consumers)



PRICING OF NON-RENEWABLE ENERGY RESOURCES: RICARDIAN VS. HOTELLING RENT

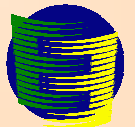


Source: “Putting a price on Energy: International Pricing Mechanisms for Oil and Gas”,
Energy Charter Secretariat, March 2007

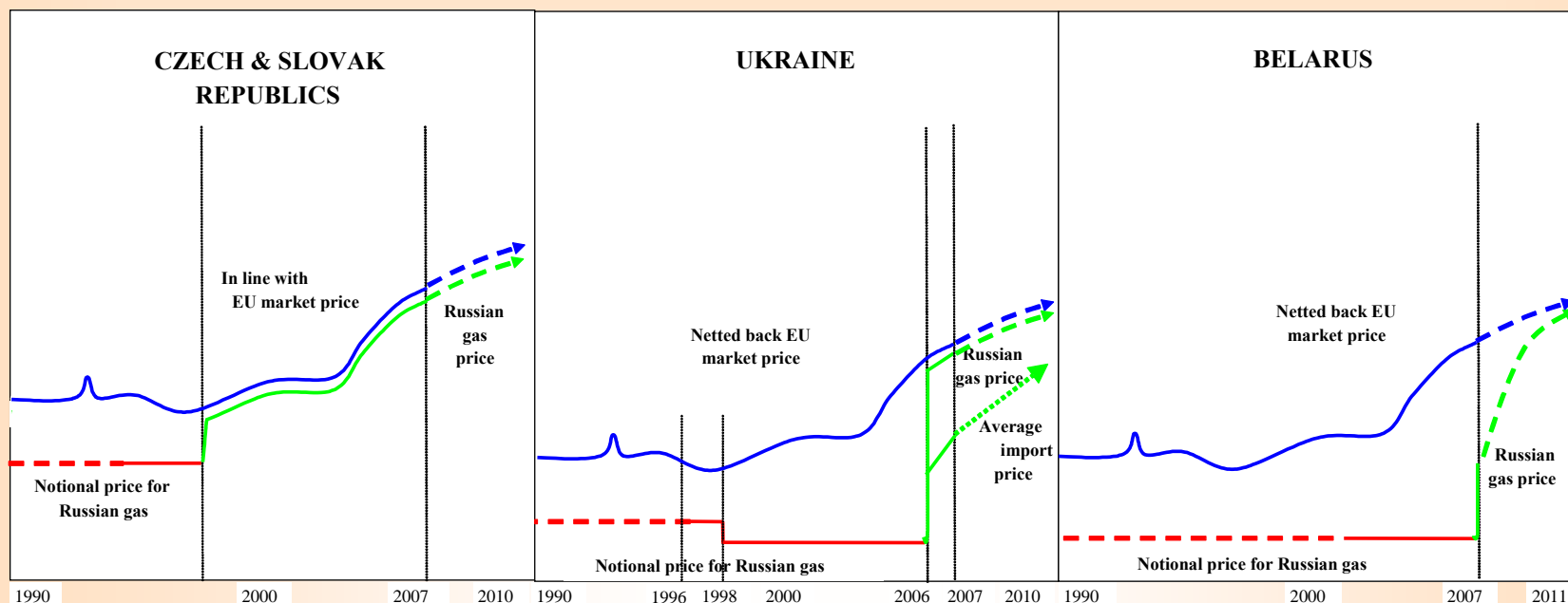


GAS EXPORT PRICING & PRICES

- Resource price and resource rent for non-renewable energy:
 - Ricardian rent: internal demand is *below* domestic production capacity limitations
 - Hotelling rent: internal demand is *above* domestic production capacity limitations
- Pricing principles:
 - Cost-plus => pricing at the internal domestic market of the producer *or* subsidized export pricing
 - Replacement value (costs of alternative energies) => in case when domestic production capacities are below internal demand for gas
 - Net-back replacement value = Replacement value netted back to an upstream point in the delivery chain (delivery point) => Dutch (Groningen) model of long-term export contract

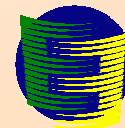


RUSSIAN GAS PRICES TO EU & COUNTRIES ALONG THE PIPE



- Remarks:**
- 1- The figures are entirely for illustration purposes and, therefore, may not fully reflect the actual price levels and movements
 - 2- The illustration for "Netted back EU market prices" are based on the IEA's World Energy Outlook, 2006
 - 3- Estimates for future gas price movements beyond 2007 are entirely illustrative.
 - 4- Recent actual price figures for Ukraine and Belarus, based on information from public sources, are as follows:
 - For Ukraine - Russian gas price: 230 \$/mcm (2006) ; Average gas price (for a mixture of Russian / Central Asian gas): 95 and 135 \$/mcm (2006 and 2007, respectively)
 - For Belarus - Russian gas price: 100 \$/mcm (2007) It will reach market price level by 2011 in agreed upon steps (67, 80, 90 and 100% from 2008 to 2011)
 - 5- Notional prices for Russian gas were used to determine volumes of gas as compensation for transit services.
 - For Ukraine: 80 \$/mcm until 1998; 50 \$/mcm from 1998 to 2006
 - For Belarus: 47 \$/mcm most recently until 2007

Source : "Putting a Price on ENERGY: International Pricing Mechanisms for Oil and Gas, Energy Charter Secretariat, March 2007

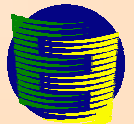
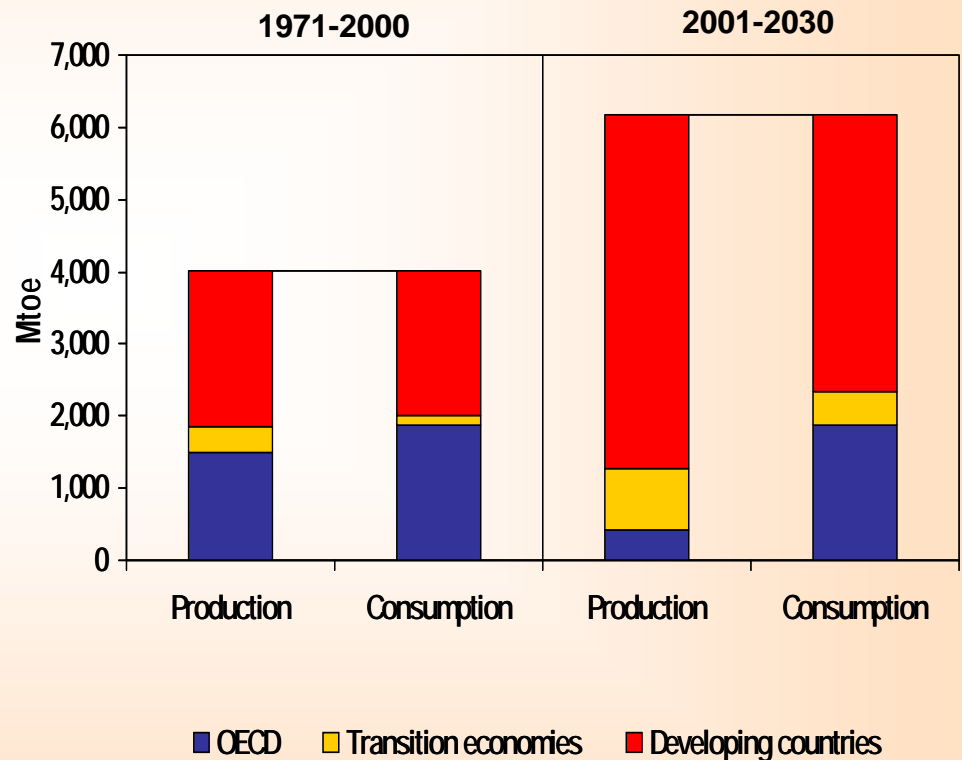


GLOBAL ENERGY TRENDS: WHY NON-OECD IMPORTANT

2001-2030:

- Increase in energy production:
95% outside of OECD
- Increase in energy consumption:
70% outside of OECD
- Cumulative energy investment:
 - 50% from non-OECD to non-OECD markets, and
 - 10% from non-OECD to OECD markets

**Increase in World Energy
Production and Consumption**
(Source: IEA WEIO 2003)



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

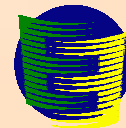
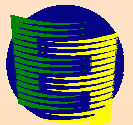
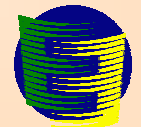
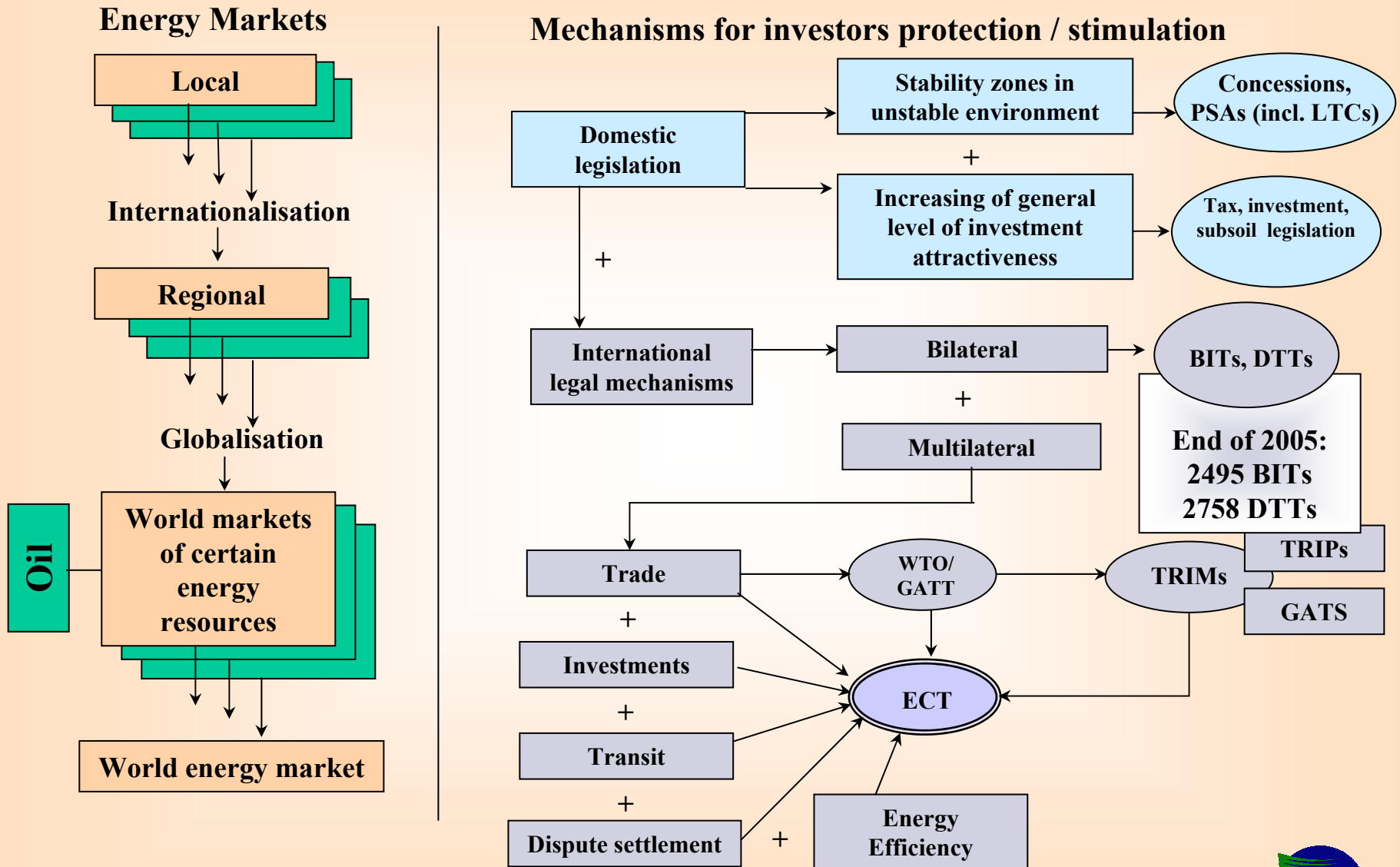


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DEVELOPMENT OF ENERGY MARKETS AND MECHANISMS FOR INVESTORS PROTECTION / STIMULATION



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)	Non-LB	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, ...

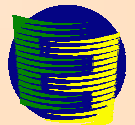
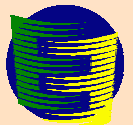
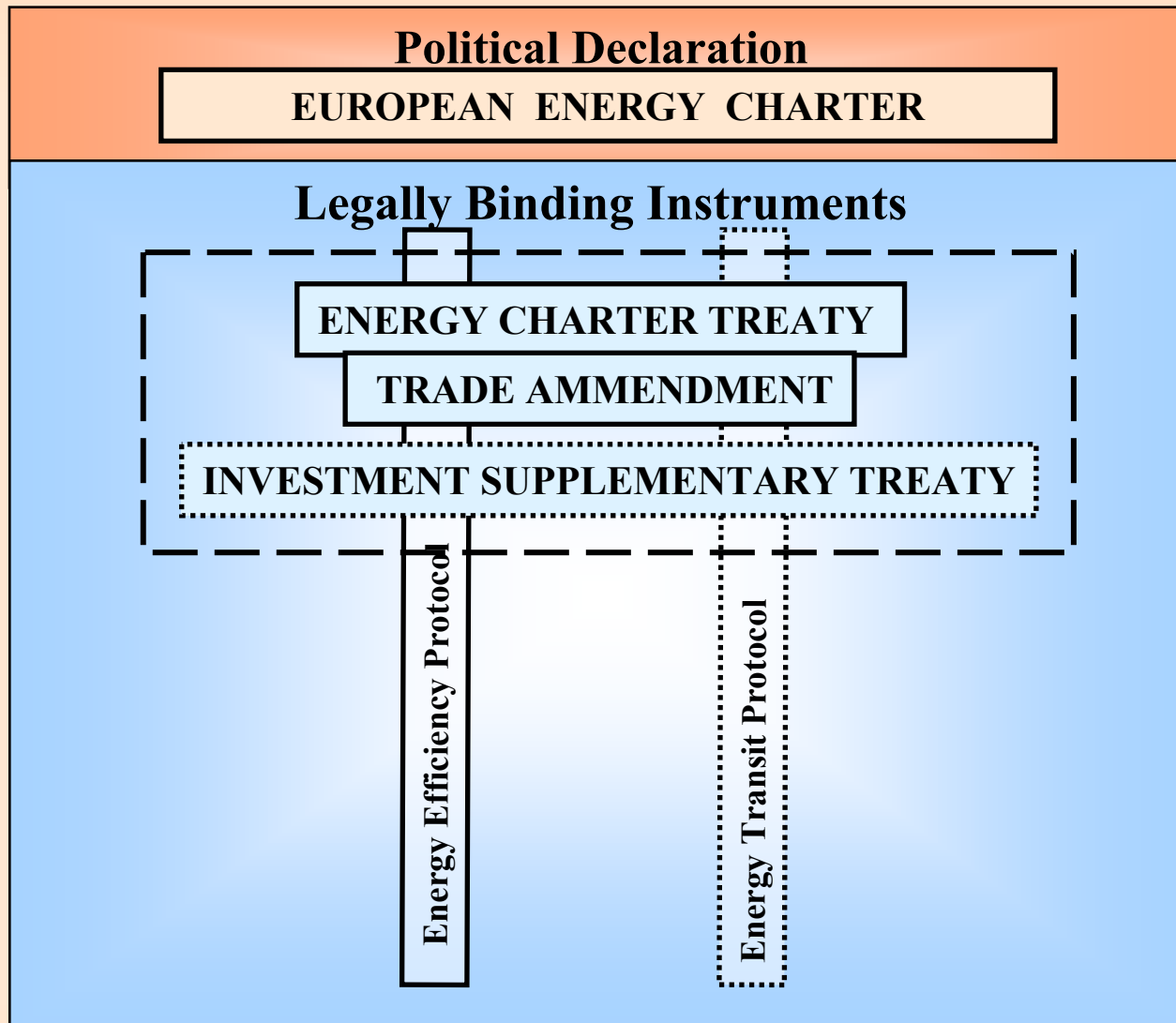


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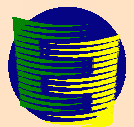


ENERGY CHARTER AND RELATED DOCUMENTS



- in force

- negotiations not finished yet



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) + 19 observer-states + 10 observer international organisations

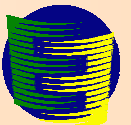
- First and only one multilateral investment agreement with high standard of investment protection, incl. dispute settlement

- **Energy Charter *process***

- *Implementation* of ECT,

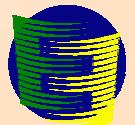
- Specialized forum for “*advanced*” *discussion* of the issues of energy markets evolution that *might create new risks* for development of energy projects in ECT member-states,

- 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*”).



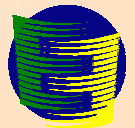
ECT = THE FIRST MULTILATERAL INVESTMENT AGREEMENT (1)

- Based on:
 - well-established practice of BITs (about 400 BITs at the beginning of the 1990's - around 2500 BITs as of today)
 - investment chapter XI of NAFTA (US, Canada, Mexico)
 - some interaction with then 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)



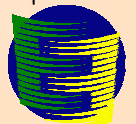
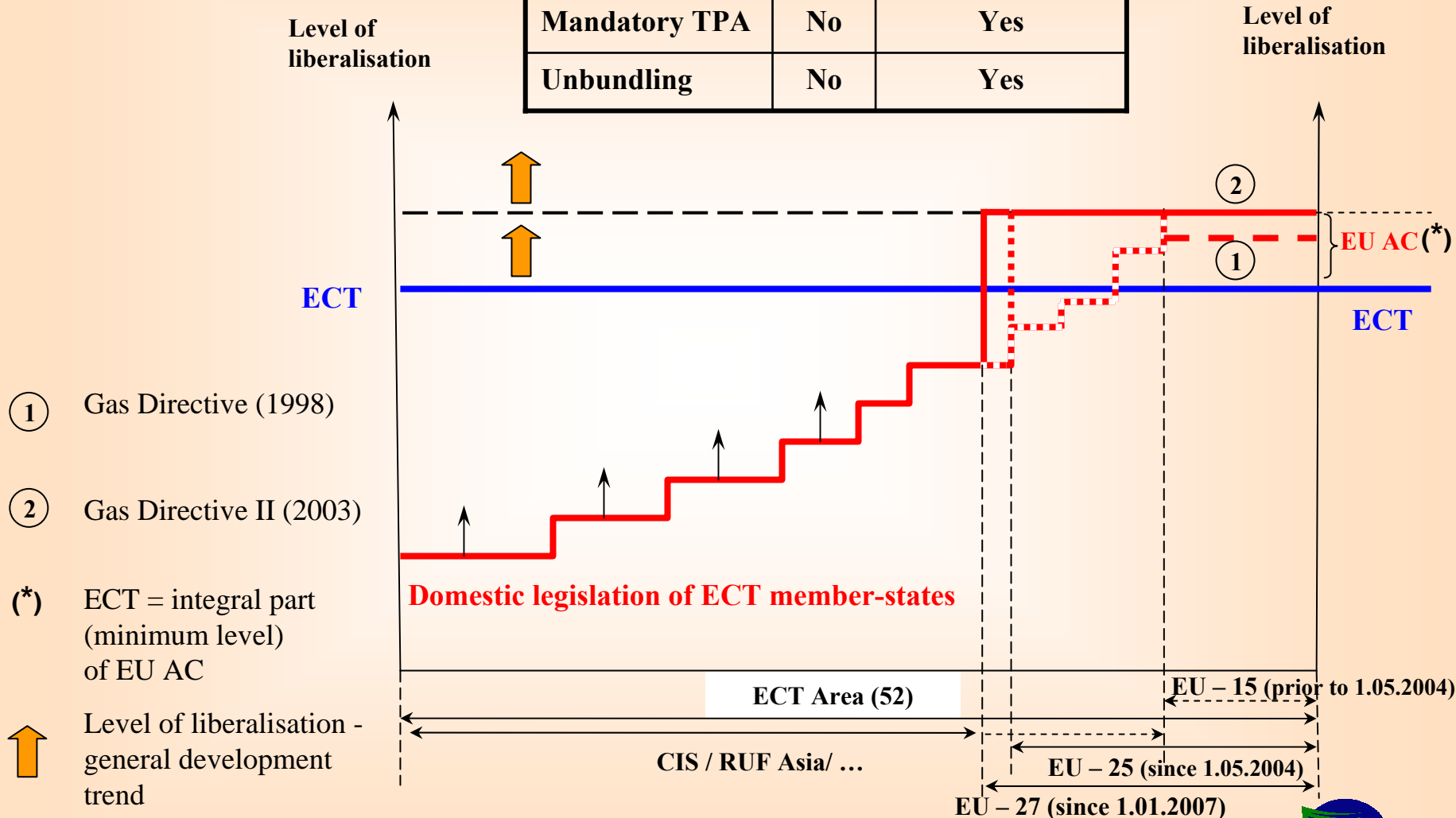
ECT = THE FIRST MULTILATERAL INVESTMENT AGREEMENT (2)

- 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,
 - Awards:
 - ✓ final and enforceable under NY 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)



Correlation between ECT and EU's *acquis communautaire*

Legal provisions (examples)	ECT	EU <i>acquis</i> (Gas Directive 2)
Mandatory TPA	No	Yes
Unbundling	No	Yes



COMPLIMENTARITY OF ENERGY-RELATED INTERNATIONAL ORGANISATIONS (IN PROTECTING ENERGY INVESTMENTS)

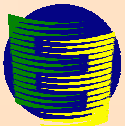
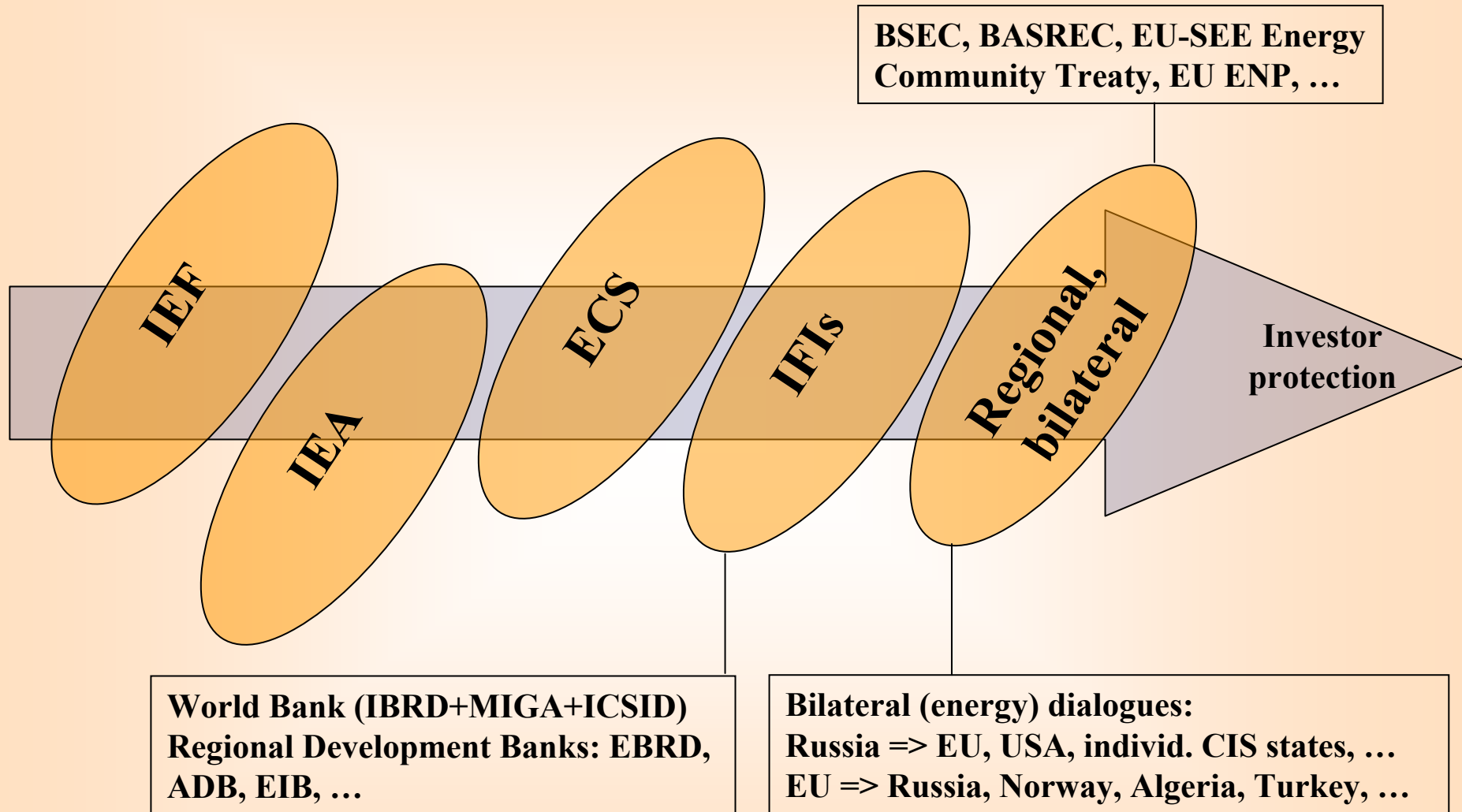
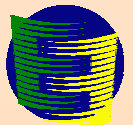


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ENERGY CHARTER EVOLVING BALANCE OF ACTIVITIES

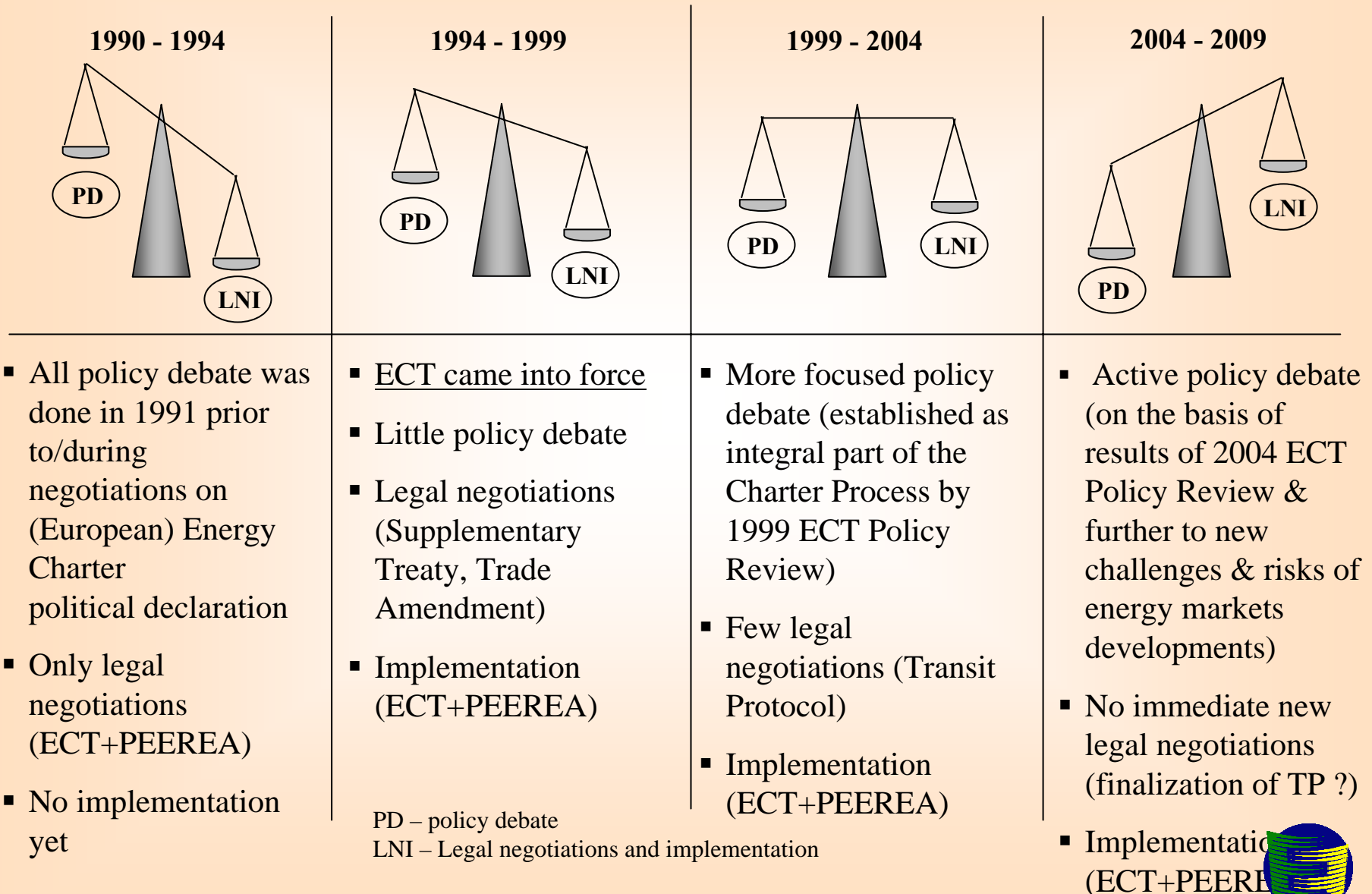
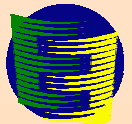
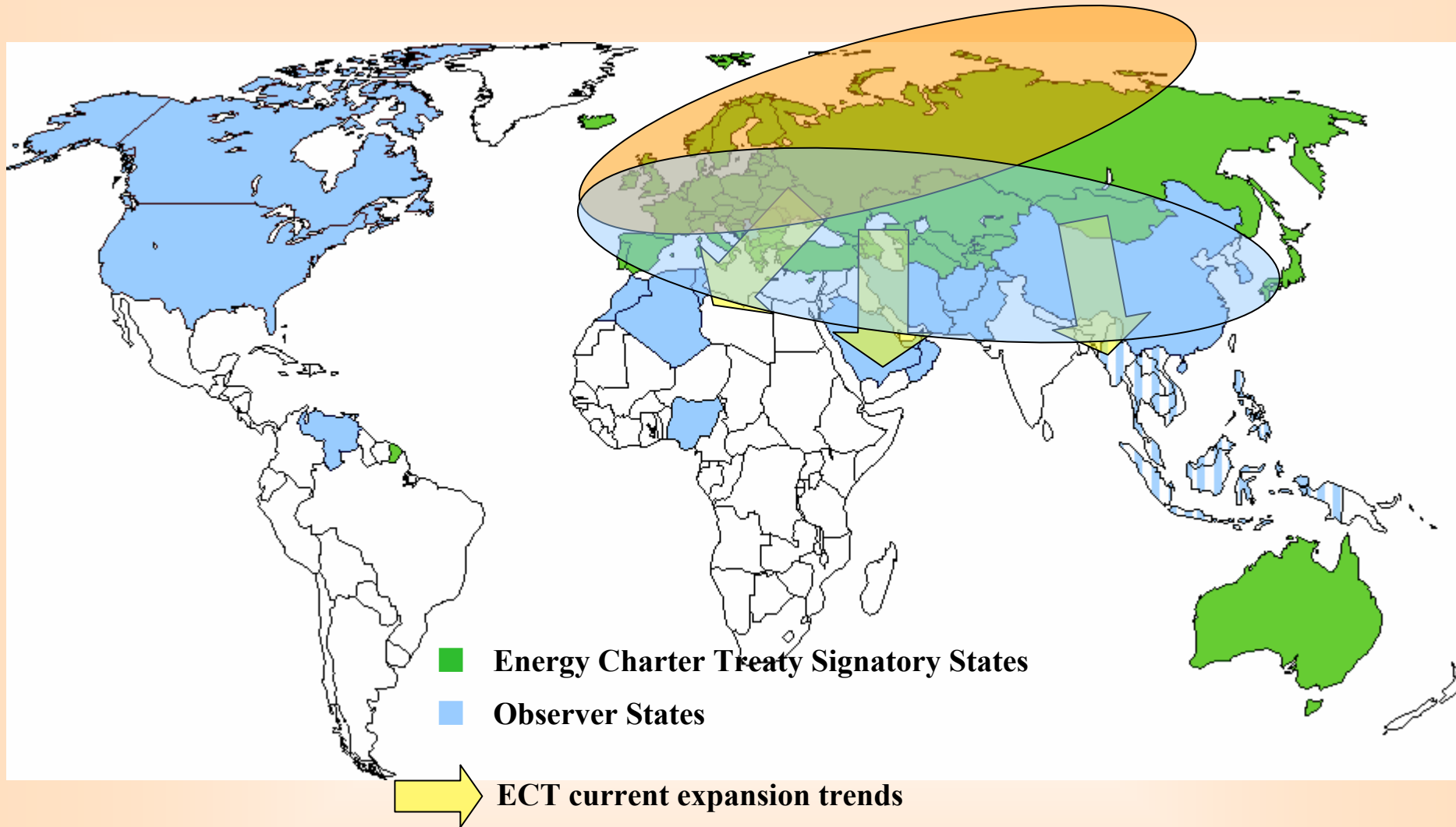


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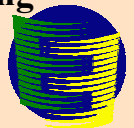
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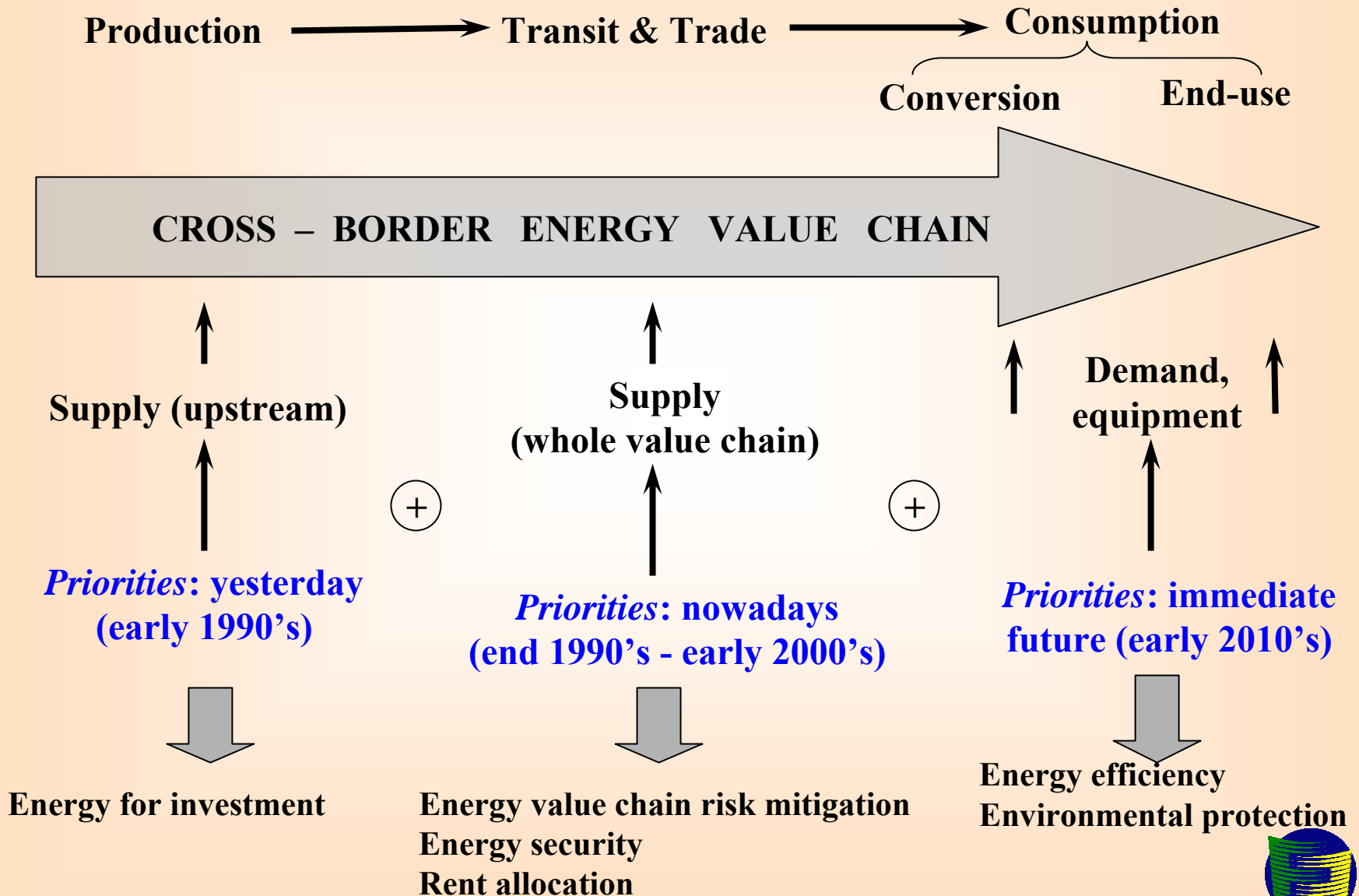
ENERGY CHARTER PROCESS: GEOGRAPHICAL DEVELOPMENT



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



BROADENING ENERGY CHARTER PRIORITIES



Thank you for your attention!

www.encharter.org

