

**The speech of the Secretary General Dr. Ria Kemper**  
**International Round Table "Optimal Models of Gas Growth"**  
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Mr Chairman, distinguished delegates, it is a great pleasure for me to be here in Tuapse, and to have the opportunity present a perspective from the Energy Charter on energy cooperation between Russian and the European Union in a multilateral context.

I would like in my presentation to focus on three issues:

- Firstly, I will examine Russia's role as a major gas supplier, in particular to the European Union, and how this role may develop in the future;
- Secondly, I would like to look at the issue of energy security, and assess some of the main risk factors affecting the energy security of Russia and the European Union. As you are aware, this topic will be at the top of the agenda during Russia's presidency of the G8 next year;
- In addition, and throughout my presentation, I will be highlighting the role of inter-governmental cooperation in reducing these long-term risks, and in promoting the development of natural gas markets in the Eurasian space.

To begin with, let us recall some fundamentals of the market for natural gas. All the indications are that, where gas is available at a reasonable price, it is the fuel of choice for all purposes except for transportation. Global demand has been growing steadily, and in recent years this has been driven not only by growth in OECD markets, but also by increased gas penetration in developing countries. Not least because of its relative environmental benefits, it is widely anticipated that the share of natural gas in the global fuel mix will increase substantially in the coming decades.

However, it is too soon to speak of a truly global market for natural gas. Transportation costs for gas are significantly higher than for competing fuels. Over half of proven reserves are found in just three countries, Russia, Qatar and Iran, which are all relatively distant from the major markets. Despite the rise and improving economics of LNG, trade in natural gas is still dominated by piped gas and for this reason, the main bulk of this trade has been with countries that are geographically close to the producing nation. These factors help to explain why only around a quarter of global gas production was traded internationally in 2004, as compared to around 60% of crude oil production.

At the same time, it is clear that if gas consumption is to continue growing at anything like current rates, then the lion's share of this increase will have to come through a growth in trade. Taking the European Union as an example, the anticipated rise in demand over the coming decades will be accompanied by a decline in indigenous production, and the EU's overall dependence upon external supply has been reinforced by the accession in 2004 of new member states in Central and Eastern Europe that also rely on imported natural gas.

In this context, the importance of the EU-Russian relationship in the area of natural gas supplies is self-evident. Russia is, and will remain for the foreseeable future, the Union's major single supplier of natural gas. Over 40% of the EU's gas imports are already sourced from Russia, and - even alongside European efforts to diversify sources of supply - this figure may well increase over the next two decades.

This growth in trade will have to be accompanied by an increase in transportation capability, and some of the projects that will serve European markets are already becoming visible. The Yamal-Europe pipeline, which runs through Belarus and Poland, is expected to become operational along its entire length by mid-2006. A second trunk line could be commissioned in a few years time. In addition, as we saw last week during the visit of President Putin to Germany, preparations are becoming more specific for the North European Gas Pipeline that will run from Russia along the Baltic seabed to Germany, which may begin carrying gas already in 2010.

However, the Russian requirement for new transportation infrastructure is not confined to its traditional export markets in Europe. In my view, one of the major developments of the past year has been the Russian programme for a unified system of gas extraction, transportation and gasification in Eastern Siberia. This will have major implications for both the social and economic development of this part of Russia, and also in opening up the possibility of exports to the countries of Northeast Asia.

There is undoubtedly a market opportunity for Russian gas in this region. Demand for natural gas in Northeast Asia continues to grow rapidly, and is expected to increase at twice the global average in the years until 2020. While LNG is likely to take up some of the incremental demand, the size and relative proximity of the East Siberian reserves suggests a rich potential for cross-border trade.

So how will the market for natural gas develop over the next decades, and what are the main risk factors that will affect its development? Our view in the Energy Charter Secretariat is that Eurasia - comprising all of Europe, Russia, the Caspian region, Central Asia, and also South and Northeast Asia - constitutes a natural cooperative space for natural gas supplies. This is due to geographical factors, the fact that on-shore natural gas transmission is grid-bound in nature, and also the fact that Eurasia ought to be more or less self-sufficient in natural gas supplies for a significant period ahead. Against this background, there is a real possibility, in our view, to establish in future an efficient, transparent and competitive environment for investment and trade in natural gas extending across the entire Eurasian continent.

This is easy to say. The challenge of translating this potential into a working reality will be far more difficult, as there are several key risks that need to be addressed.

The first of these relates to investment. Enormous long-term investments are required if a fully-fledged, competitive Eurasian gas market is to be created. Within Russia, these investments are needed both for the development of this country's vast gas reserves and also for the transportation capacity required to bring gas from remote locations, such as the Yamal Peninsula, to the main consumer markets. But - even at a time of high energy prices - such investments will only be made if there is

confidence in a stable legal and regulatory framework. Without this stability and predictability, the opportunity to forge an efficient and secure Eurasian gas market will be missed. I believe that such a scenario would be to the detriment in particular of Russia, because its gas production and export opportunities would face increasing competition in future from other global sources of supply, which might offer a lower combination of technical and financial costs in the long term.

Russia has a number of first-class gas projects at various stages of development, and these will need to be brought on stream in the near future in order to compensate for declining output from the existing giant fields in Western Siberia. Investment capital needs to be attracted to the most efficient new energy supply projects, but this flow of capital is by no means guaranteed. The cause of this uncertainty is the existence of various political and economic impediments to investment, the effect of which is magnified in the energy sector by the high capital costs associated with projects and the long-term horizon over which possible risks have to be assessed. Russia has recognized in its Energy Strategy to 2020 that an actual and potential shortage of investment funds is a threat to its national energy security.

In my view, the Energy Charter Treaty is the best available multilateral instrument to mitigate these investment risks and encourage capital flows. It operates not by imposing a single model for investment projects, or a particular structure for national energy markets. On the contrary, the Treaty is explicit in confirming that each Contracting Party has the sovereign right to decide how, and to what extent, its natural energy resources will be developed, and also the extent to which its energy sector will be opened to foreign investments. These are matters for governments to decide.

However, once a foreign investment is made in the energy sector, then the Treaty provides some specific guarantees, which are enforceable for the investor through access to international arbitration. Such guarantees are necessary because investors in the energy sector can be exposed over time to non-commercial risks such as discriminatory treatment, direct or indirect expropriation, or the breach of individual investment contracts. By mitigating these risks, the binding rules contained in the Energy Charter Treaty can foster the confidence that is necessary for major investment decisions, and also reduce the cost of investment capital on competitive international markets.

A second key risk to Eurasian energy security relates to cross-border flows of energy. Across much of Eurasia, the task of bringing natural gas from producer to consumer involves crossing multiple national borders and national legal jurisdictions. In my view, a comprehensive multilateral transit regime is a key 'missing link' for the balanced development of the Eurasian gas market.

The Energy Charter Treaty is uniquely well placed to tackle the issue of cross-border energy flows because of its broad geographical reach across Europe and Asia. It is self-evident that a reliable regime for trade and transit across such a large area must be based on common standards that are accepted by all countries on a multilateral basis.

The current Treaty provisions oblige participating states to take all necessary measures to facilitate transit of energy, as well as to co-operate in order to mitigate the effects of interruptions in energy supply. Measures to facilitate transit must be taken on a non-discriminatory basis, and without imposing any unreasonable delays, restrictions or charges.

Transit countries are also under an obligation not to interrupt or reduce existing transit flows, even if they have disputes with another country concerning this transit. In such cases, they have the possibility to invoke a special, rapid conciliation procedure, under which an independent conciliator is empowered to fix interim transit tariffs for up to twelve months if the parties to the dispute fail to reach an agreement.

These rules came into force in 1998 as part of the existing Treaty. However, experience showed that the issue of transit across Eurasia remained an area of concern. The Energy Charter's member states therefore took the decision to start negotiations on a new legal instrument, known as the Transit Protocol, which is intended to supplement the Treaty by providing more detail on specific operational issues relating to energy transit.

I would like to emphasise the large degree of consensus that has already been reached on the bulk of the draft text: in its current form, the draft Protocol would strengthen the obligations on governments to ensure that energy flows passing through their territory in transit are secure, unimpeded and not interrupted. It would define, for the first time under international law, the concept of 'available capacity for transit', and oblige network operators to negotiate in good faith on access to this capacity, without, however, imposing mandatory third party access. It would make transparent the criteria that are used for setting transit tariffs, promote the effective settlement of transit disputes, and prohibit the illegal taking of energy resources in transit.

Multilateral negotiations on the draft Protocol were concluded already in 2002, leaving only three outstanding issues to be discussed in further bilateral discussions between the Russian Federation and the European Union. I believe that it is strongly in the interest of Russia and the European Union to find a balanced resolution to the small number of open issues in the draft text, and that it is in the common interest of all the Charter's member states to see this instrument in force as soon as possible.

A third issue that affects energy security relates not to energy supply or to transportation, but rather to demand. This is not only an issue for countries that rely upon imported gas; in fact, almost half of all the natural gas produced in Eurasia is consumed in the producing countries themselves. More efficient energy use, through the introduction of market-based pricing and efforts to lessen the energy intensity of industrial production, can free up large volumes of gas for export. In the long term, therefore, the development of Russia's gas export potential has to be accompanied also by reform of the country's domestic gas market.

There are signs that within Russia, a consensus is now gradually emerging concerning at least some key elements of the process of gas-sector reforms - including the need to move, over time, to cost-reflective gas prices and to create a

more transparent regime of access to the gas transportation network for all interested parties. Important questions in this regard are the time-frame within which this process will happen, and what the implications would be for the future structure of Gazprom, as Russia's main producer company and the present operator of the transportation grid. I would not wish at this Conference to offer any detailed commentary on these questions; however, I would like to underline the importance of a resulting structure for the gas sector that is based on transparent and non-discriminatory legal rules, upon which both domestic companies and outside investors can rely. This would help to provide a sound foundation for long-term strategic investments in the Russian gas industry.

Mr Chairman, it is well known that Russia and the European Union have the political intention to create four 'common spaces' of cooperation for the future, including a 'common economic space' with an important energy component. In my view, it is axiomatic that any common space must be based on common rules - such as those of the Energy Charter Treaty - and complemented by the strategic bilateral dialogue that is already in place.

I have highlighted in this presentation some points which I believe are key to the common energy security of Russia, the European Union, and the wider Eurasian space:

- Policy-makers need to focus their attention on how to minimize the risks associated with investments in highly capital-intensive projects to develop new gas fields, and in the transportation capacity necessary to bring the gas to consumer markets, either via pipelines or in the form of LNG.
- Key elements in reducing the level of risks for investors are a secure multilateral framework for the legal protection of investments in gas projects; and the establishment of clear international rules governing the transit of gas across national boundaries.

In both of these respects, Mr Chairman, the Energy Charter Treaty and the draft Transit Protocol have an important role to play. Yet, as many of you will know, so far the potential benefits of the Energy Charter Treaty have not been fully realised, for the simple reason that Russia, which signed the Treaty back in 1994, has not ratified it.

In 2006, Russia will have the Presidency of the G8, and has indicated that energy security will be at the top of its agenda for the world's leading industrialised nations. It is worth remembering, in this context, that all the members of the G8 - including the United States and Canada - are signatories of the Energy Charter Political Declaration from 1991, which lays down the shared principles that should underpin international energy cooperation.

One could expect, therefore, that the Russian government should wish during its presidency of the G8 to demonstrate its commitment to a rule-based multilateral system for energy cooperation. In my view, the best possible demonstration of this commitment would be for Russia to push for adoption of the Energy Charter Protocol on Transit and to ratify the Energy Charter Treaty.

Thank you for your attention, Mr Chairman, and allow me to wish you and all of the participants every success for this Conference.