РЕГИОНАЛЬНОЕ ЭНЕРГЕТИЧЕСКОЕ СОТРУДНИЧЕСТВО В СЕВЕРО-ВОСТОЧНОЙ АЗИИ: ГЛОБАЛЬНЫЕ ТЕНДЕНЦИИ, ЗНАЧЕНИЕ РОССИЙСКОГО ПРИРОДНОГО ГАЗА И РОЛЬ ЭНЕРГЕТИЧЕСКОЙ ХАРТИИ

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REGIONAL ENERGY COOPERATION IN NORTHEAST ASIA: GLOBAL TRENDS, THE IMPORTANCE OF RUSSIAN NATURAL GAS AND THE ROLE OF THE ENERGY CHARTER

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1. Globalisation effect: from energy independence to energy interdependence

The world economy is in the process of growing globalisation. Energy markets follow suit, evolving from local to regional and on to world markets of individual energy resources. Today a world oil market is only in existence. Pipeline gas markets are regional. Going forward, an emerging LNG market will bring them together into a world gas market. In the longer term, a single world energy market will take shape.

Internalisation of energy processes brings together producers and consumers, exporters and importers through an interconnected (usually fixed, immovable) infrastructure including pipelines, power transmission lines, port terminals, and liquefaction/LNG regasification plants. This strengthens the interdependence of nations and energy companies located in the various links of the energy value chain. Energy infrastructure and energy projects are becoming increasingly international and cross-border-based.

Energy market internalisation and globalisation are putting an end to the previous philosophy of "energy independence". All of us, representatives of various states, live in an interdependent energy world now. Short-sighted or populist-minded politicians may call on to strengthen the "energy independence". But such calls more likely belong to the realm of political speculations. Professionals see that the "energy independence" game is over. This means that one of the keys to a reliable and sustainable energy supply lies in the need to balance the interests of all players (countries and companies) involved in such cross-border and international energy supply at every link of the energy value chain.

2. World energy sector growth and investment risks

Worldwide demand for energy will continue to grow in absolute terms (Fig. 1). In the foreseeable future (i.e. during at least one or two investment cycles), hydrocarbons will bear the brunt of such demand (Fig. 2-3). The nations of North East Asia, firstly China, account for a considerable part of the world's growing demand for energy, *inter alia*, oil and gas (Fig. 4). Therefore, on the one hand, there is a need for developing new fields to meet incremental demand and make up for the depletion of reserves under development. Major energy consumers, including in North East Asia (NEA), facing necessity to increase energy imports (Fig. 5). International energy trade is growing, the share of cross-border transactions is on the rise, and a largely fixed and very capital intensive infrastructure is taking shape at an increasingly faster pace. On the other hand, there is a need for improving the efficiency of energy use (to reduce adverse impacts on the environment) in all links of the energy value chain – from production to end use. All such measures are impossible without massive and mostly cross-border investment (Fig. 6-7). Such investment is associated with enormous risks.

Investment risks in the energy sector are greater than in other sectors of the economy. Energy projects are usually longer and more capital intensive than in other sectors. The investment phase may take about a decade (or even two decades taking into account the payback period) while the total project life may exceed 30-40 and more years (Fig. 8).

Unit investments in energy projects amount to billions of roubles, dollars or euros especially in extractive industries. Considering that delivery of production to the market not only calls for field development but also requires the requisite transport infrastructure (liquefaction/regasification capacity is to be also included in the case of LNG), tens of billions may be at stake. This problem is particularly acute for the nations of NEA where vast space separates hydrocarbon fields in Russia and Central Asian states from the key markets in NEA (Fig. 9).

Energy investment ventures are usually immobile, relating to fixed infrastructure formation. This means that having started investing, the investor cannot in principle disinvest or move to another country or region the energy resource production and evacuation facilities, i.e. the investor will be most vulnerable to any non-commercial risk.

To minimise and allocate risks, energy investment ventures are financed with debt rather than equity (Fig. 10). Banks and other financial institutions lending to the real economy are the die-hards of the industry hedging themselves against any potential failure to repay debt. Especially, this is true of "project financing" where new construction loans are secured with future cash flows to be generated by the new capacity rather than existing tangibles. Therefore, the cost of borrowing will depend on country risks, directly affecting project competitiveness (Fig. 11).

3. "Transition risks" and "liberalisation risks"

The preponderance of new energy demand and supply will fall on "new" markets, i.e. non-OECD countries. The "new" markets require by far more new infrastructure than the existing ones. According to the International Energy Agency (IEA), emerging non-OECD market economies will account for 70% of incremental demand, 95% of additional supply and 60% of energy investment in 2001-2030 (Fig. 12). Such countries have less time to establish their national legal frameworks than industrialised powers. In this connection, investment activities in such economies are prone to certain additional non-commercial risks which are typical of all early market economies. Such risks may be called "transition risks" (Fig. 13).

However, investment risks including political ones (i.e. those depending on the political choice of an economic model) are typical of every single market, OECD markets inclusive – they are just of a different description or nature than the "transition risks". For example, the continuing liberalisation of energy markets in Continental Europe has led to new investment risks which may be dubbed as "liberalisation risks" (resulting from vertically integrated company unbundling, mandatory TPA, rejection of "destination clauses", opposition to long-term contract, forced promotion of short-term contract, etc.) (Fig. 14).

"Transition risks" – these are the risks related to transition from one economic model to another, risks related to construction of new model of economic development. "Liberalisation risks" – these are the risks related to perfection of earlier chosen model of economic development, when its internal proportions based on demand to obey balance of interests of different market players are violated, e.g. demand for competition (in the interests of consumers) and investment demands (in the interests of producers, who provide for competitive supply).

Summing up, there is a common problem relating to energy investment activities irrespective of the phase of national energy market institutional advancement, whether "transition" or "liberalization" phase. The problem is how to mitigate non-commercial risks of energy investment. Before common energy investment problems may be resolved and balance of interests achieved a common arsenal of harmonised international law instruments should be put in place for all countries to use. The need for such instruments is evolving.

4. Evolution of energy markets and investor/investment protection instruments

The development of legal instruments to protect and promote investment parallels the evolution of energy markets from national to international and global ones. The set of instruments of a "higher" (supranational) level does not usually supersede (or replace) the national legal instruments designed to protect investment but complements them, providing states and investors with broader, more reliable and, consequently, more competitive opportunities for implementing energy projects. One of the principles of evolutionary development of legal instrument system has it that newer instruments work together with older ones rather than instead of them (Fig. 15).

At the time of energy internalisation and globalisation and increasingly greater interdependence of individual players, their problems first overlap and then become common, calling for uniform approaches and rules. This is why the evolution of investor protection instruments has inevitably come into the international domain. In the beginning, this occurred in the form of a fast-track expansion of bilateral relations. The first bilateral investment treaty (BIT) was entered into in 1959. At the present time, the number of BITs executed worldwide exceeds 2,500 and that of double taxation treaties (DTT) stands at 2800.

Bilateral treaties are not characterised by a high degree of homogeneity or harmonisation of their terms and conditions. For this reason, at a certain stage there is a need for developing relevant multilateral instruments of international law that would retain all the merits of bilateral arrangements but at the same time be free, as much as possible, from their demerits, thus establishing level playfield.

Before a multilateral and – the more so – legally binding international agreement can be executed, certain political prerequisites are required – an open "window of opportunities", so to speak. This is particularly relevant to agreements spanning broad and basic areas of economic activity such as energy which lays the groundwork for economic development and export capability of many countries and includes politically sensitive matters such as national sovereignty over natural resources.

The political foundation of the Energy Charter was laid in 1975 by the signing of the Helsinki Agreements on Security and Cooperation in (Transatlantic) Europe. In 1977, the Soviet Union was the first to suggest convening an All-European Energy Conference. However, the USSR's proposal only came to fruition 13 years later and in a slightly different format – that of the Energy Charter when the then Dutch Premier Ruud Lubbers put forward the idea of creating a European Energy Community.

In the late 1980's and early 1990's, Europe and Asia saw drastic political changes resulting in a sharp increase in the number of sovereign states with economies in transition. This development objectively stepped up international investment and trade risks. At that time, the concern for security of investment and cross-border energy flows became particularly relevant. But it is the dramatic changes in world politics in the 1990's when the political division in Europe was gone that paved the way for establishing legally binding mechanisms in the energy sector, the key one for all European and Asian nations. It was only then that it became possible to resolve the inconsistency (and sometimes controversy) of bilateral investor and investment protection instruments and start developing uniform "rules of the game" for investment and trade in the high-risk energy sector.

5. Common concerns – common rules of the game

The philosophy that it is only the balance of interests of all players that forms the basis for sustainable energy cooperation is fundamental to the Energy Charter process. Its member-states are confident that achieving long-term international energy security calls for a legal framework based precisely on a multilateral balance of interests – otherwise this mechanism will be inoperable. The Energy Charter Treaty (ECT) is just the one to set forth common obligations assumed by its member-states in the fields of investment, trade (there, the ECT fully incorporates GATT/WTO rules), transit, energy efficiency and dispute resolution (Fig. 16).

The ECT covers the entire investment (reproduction) cycle in the energy sector. In doing so, the ECT embraces the energy sector in the broadest sense of the word: in terms of the product line (energy materials and products and energy-related equipment); and operational phases – the entire energy value chain from energy exploration and production to end-use (Fig. 17). No other multilateral interstate agreement relating one way or another to investment matters has such a diverse scope coupled with such a high decree of legally binding force.

The ECT is the first and only multilateral interstate legally binding energy agreement and the only multilateral investment treaty with stringent investment protection requirements. This is its strongest point and advantage versus other international multilateral or bilateral agreements (Fig. 18). The ECT streamlines access to international arbitration whose awards are binding on the parties. In the event of investor-state disputes the former has direct access to international arbitration of its choice – the International Center for the Settlement of Investment Disputes (ICSID), the United Nations

Commission on International Trade Law (UNCITRAL), or the Arbitration Institute of the Stockholm International Chamber of Commerce. This is precisely where the legal innovation of the ECT lies. Awards of such institutions will be final and enforceable under the 1965 New York Convention (Fig. 19).

The ECT brings together 51 nations and would supersede almost 1,300 bilateral investment agreements (1,275 to be more precise) that would have to be concluded in its absence. Since 1959, more than 2,500 BITs have been signed worldwide, involving 170 countries. That means that the ECT is worth a half of all existing BITs which took decades to sign. In such a way, the ECT shortens the way to the establishment of a mutually advantageous international economic and legal order in the most capital-intensive and high-risk energy sector (Fig. 20).

The ECT reaffirms state sovereignty over, and sovereign rights to, energy resources. It protects energy flows based on contract inviolability, thus protecting the existing system of long-term oil and gas supply contracts.

The objective of the Treaty is to facilitate transparency and efficiency of energy markets. But it is the governments themselves that should determine the structure of the energy sector. There is no obligation to privatise government-owned energy companies or unbundle vertically integrated energy companies. Nor is there the obligation to introduce mandatory third party access. The Draft Transit Protocol protects the interests of vertically integrated companies that own the oil and gas transportation infrastructure. However, each ECT member-state may adopt a more liberalised energy market pattern within its territory than the one provided for in the ECT as a level playfield for its entire constituency.

Naturally, in some cases the ECT member-states managed to achieve a higher degree of mutual covenants (the language of “firm” law – such as “the Parties shall…”) while others are worded in the terms of “soft” law (such as “the Parties shall endeavour…”). The proportions of “firm” and “soft” law language reflect the level of understanding, balance of interests and mutual covenants that the parties managed to achieve as a result of multilateral negotiations in the early 1990’s and enshrine in the text of the Treaty. It is not by accident that the Russian Foreign Ministry states that “…the ECT and related documents are the product of mutual compromise and concessions reflecting the intent of negotiators to balance their interests”. This means that with time as new mutual agreements are achieved, the ratio between “firm” and “soft” law obligations may change – but only towards an increase in the level of “firm” law obligations (as provided for in the ECT’s unique “screens” such as stand-still and roll-back arrangements).

Although the Energy Charter was called “European” at the time of its inception, it has effectively been a Eurasian organisation all along because it has always included many Asian nations (in particular, all the Asian republics of the FSU). With years, it has been growing into an increasingly Eurasian entity, with all its new accessions coming form the Eastern part of the Continent: Mongolia acceded in 1999; Japan ratified the Treaty in 2002; Pakistan (who has been an observer since 2005) is in the process of accession. The following states and organisation obtained an observer status: China (2001), the Korean Republic and Iran (2002), Nigeria and the ASEAN as a single entity (2003), Afghanistan (2006), and Philippines (2007) (Fig. 21).

5. The ECT and Russia

Russia is seeking to diversify its energy exports. Its agenda includes major projects requiring billions worth of investment in production, processing and infrastructure. In the first instance, reference is made to the country’s East – for export to the booming Asian market and the formation of, say, a

unitary gas supply infrastructure to North East Asian nations based on the development of Russian gas fields (Fig. 22). At an estimate of the Petroleum Geology Institute of the Russian Academy of Sciences, investment requirements for a gas transmission system in Eastern Siberia and the Russian Far East alone exceed US $25 billion until 2020 (Fig. 23). By mitigating risks, the ECT reduces the cost of debt financing and energy project implementation costs both within an ECT member-state and for its companies. Such cost reduction is particularly important for projects in Russia with locations in a relatively worse natural environment and farther from markets in comparison with competing countries.

It is obvious that the development of energy resources in the Russian East should not and will not be focused on export only. The implementation of large-scale energy projects is needed for the economic advancement of Eastern Siberia and the Russian Far East. Energy and especially infrastructure projects have high multiplier effects, being in effect regional "development projects". Tapping the energy potential of undeveloped areas may provide an impetus to the development of other sectors of the economy.

The intent of the ECT is to promote foreign investment in the energy sector. Therefore, as Russian business gains ground, the ECT, when ratified by Russia, will progressively become an instrument to promote Russian company operations outside Russia. It is precisely for this reason that Russia needs to ratify the Treaty for the purpose of improving the competitiveness of Russian energy projects and companies. Both inside and outside Russia. The ratification will straighten up all ambiguities in regard of Russia's rights and obligations under the ECT. However, pushing Russia to ratify is counterproductive.

Russia's well-founded concerns about the Treaty should be taken into account and resolved by the entire ECT constituency, using the existing legal procedures. Since 2001, Russia has been repeating its requirement that certain provisions of ECT Article 7 (Transit) be clarified as the key prerequisite for its ratification, with such provisions admitting of various interpretations fraught with huge economic losses for the nation. The idea was to adjust such provisions taking into account the Russian interests as part of the development of the Energy Charter Transit Protocol such that Russia could ratify both the ECT and the Transit Protocol at a time. However, final TP negotiations eventually stalled – primarily because the EU internal institutional issues having no bearing on transit had not been resolved. Thus, it would not be an exaggeration to say that the key to the Russian ratification is in the hands of the EU.

However, the ECT member-states should be confident that Russia has voiced and substantiated all concerns that really stand in the way of ratifying the multilateral ECT and are not just a negotiating tool in its bilateral relations with the EU. It is important that ratification be not indefinitely delayed as Russia takes new exceptions as was the case in 2006 in connection with trade in nuclear materials between Russia and the EU, the Supplementary (investment) Treaty, etc. It is essential that the multilateral ECT be not held hostage to unresolved bilateral matters between Russia and the EU.

In their documents, the G8 Summit in St. Petersburg in 2006 stated that they 'support the principles of the Energy Charter and the efforts of participating countries to improve international energy cooperation'. And it came as no surprise: the 1991 Charter (political declaration) is the only political document addressing energy security whose parties include all of the G8 members. Moreover, in a number of key matters such as open and competitive energy market formation, investment protection and promotion, energy efficiency and greater transparency of energy business and policies, the 2006 G8 Summit documents even use the same wordings as the 1994 Energy Charter Treaty.

However, any medal has a downside: the Treaty has become subject to wrong interpretations – and undue expectations – both in the West and Russia. As a result, the Russian President's aide S. Yastrzhembsky stated late last year that Russia "will not ratify the document without amendment of the language of the Transit Protocol and the Charter proper".

At the 20 November 2006 Energy Charter Conference, the Russian delegation 'called on other Contracting Parties to discuss a reform of the Energy Charter Treaty'. At the same time, the RF representatives confirmed that 'the Energy Charter Treaty retains importance for Russia as the only document establishing international rules of the game for the energy sector'. Let me emphasize: the *balanced* rules of the game. Because the ECT aims to reduce risks in the entire energy value chain including producers, transit countries and consumers.

Let me remind you that Russia signed off on the ECT in 1994 and, like Belarus, applies it on a provisional basis, i.e. 'to the extent that such provisional application is not inconsistent with its constitution, laws or regulations' (ECT Article 45). Absence of the ratification is not a barrier to practical and technical work as part of the Energy Charter process in which Russia is an active and valuable player. But it does not help remove the ambiguity in regard of Russia' rights and obligations under the Treaty.

6. Two dimensions of the Energy Charter

The dual role of the Energy Charter in the world energy sector and international law is that it, firstly, spans, at a legally binding level, a unique and open-ended combination of countries, activities and product lines. Secondly, the Charter is a specialised and depoliticised forum for the discussion of present-day challenges relating to energy markets for timely identification of new risks and ways to minimise them. Subject to a harmonised position of the ECT constituency, the Energy Charter may serve as groundwork for the development of new instruments or improvement of existing ones to ensure legal protection in international energy relationships (Fig. 17). From this perspective, Russia's call 'to discuss a reform of the ECT' was taken by the ECT member-states as a call for a constructive discussion of the need for adjusting the Charter process to the new realities of energy markets, new opportunities and new risks relating to their development – primarily, in the context of skyrocketing prices for energy in the beginning of the decade.

This year, an *ad hoc* Charter strategy group meets to discuss, *inter alia*, the changing priorities of the Energy Charter process (one such meeting was held in April and another one will take place in November). Whereas, in the early 1990's when the ECT negotiations were underway the Charter process priorities included certain mutually advantageous "trade-offs": Western investments for energy from the East, in subsequent years such priorities were adjusted to focus on risk mitigation throughout the entire energy value chain, energy security of energy producer, consumer and transit countries, and efficient allocation of the resource rent. In the near term, no doubt, a further adjustment (expansion) of Energy Charter priorities will occur towards improved energy efficiency and abated adverse impacts on the environment. All such matters are extremely relevant to the nations of NEA (Fig. 26).

In the past two or three years – just before energy pricing started to be transferred to market-based principles for energy trade within the post-Soviet space – the Energy Charter made a number of studies on pricing and transit tariff-setting in international energy trade (Fig. 27-29). The Secretariat is currently conducting a series of presentation seminars on such studies in ECT member-states (already held in Russia and Turkey and slated to be conducted before yearend in Austria, Belarus, Kazakhstan, Ukraine and Uzbekistan). Such studies are an Energy Charter contribution to the provision of a common basis for understanding of the general pattern of oil and gas pricing in international trade and

transparency of oil and gas transit tariff-setting and levels. This, in its turn, should facilitate more efficient agreements to be reached by new energy project participants, including those in NEA, on pricing and tariff-setting, a *sine qua non* for such project implementation. For example, if used as part of long-term gas supply contracts in Europe and Asia, a single pricing pattern based on gas replacement value in the consumer country will have different price levels for one and the same exporter supplying to Europe and Asia due to the different set of, and prices for, gas substitutes in the importing country.

A pragmatic, project-oriented approach to investment risk mitigation when implementing infrastructure projects called for such priority Energy Charter areas as the development of model agreements on transit pipeline construction and clarification of the depoliticised dispute settlement arrangements under the ECT. A second revision of the model agreement package enabling a neutral starting point for negotiation of specific transit pipeline projects will be submitted to the Energy Charter for review this coming December.

The high investment protection standard is ensured in the ECT through the appropriate dispute resolution mechanisms. To date, the Secretariat is aware of 18 arbitration proceedings under the ECT between the investor and the host country (Fig. 30). In cooperation with the Arbitration Institute of the Stockholm Chamber of Commerce and the International Centre for the Settlement of Investment Disputes (ICSID), international conferences were held in 2005 and 2007 to review the existing arbitration practices, which proved the efficacy of the investment dispute resolution procedures based on the ECT.

The energy sector has the largest potential to demonstrate the advantages of international cooperation. If properly managed, the energy sector may consolidate long-term regional cooperation in NEA, ensure efficient social and economic development of the countries in the region, including Eastern Siberia and the Russian Far East. For this to become a reality, the regional countries need to have the same understanding of the principles on which such cooperation should be based. A long way has been travelled in this direction: all of the NEA countries are either ECT members or ECT process observers. We expect that the relevant NEA countries involved in the Energy Charter process can implement the requisite policy actions to take the next logical step: the observers towards the signing of the political declaration (European Energy Charter) and the ECT members towards ratification of the Treaty. The ECT is the mutually advantageous, alternative-free legal basis for multilateral energy cooperation in North East Asia (Fig. 21).