ENERGY CHARTER SECRETARIAT
СЕКРЕТАРИАТ ЭНЕРГЕТИЧЕСКОЙ ХАРТИИ

MEGAS CONFERENCE

ENERGY INVESTMENTS IN AZERBAIJAN

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Tuesday, 25 October 2011

Mr. Chairman, Ladies and Gentlemen,

It is a great pleasure to participate in this important conference. I do so on behalf of the Energy Charter Secretariat. I will of course focus on Azerbaijan given that this session is devoted to that country. By a timely coincidence the Azeri authorities and the Energy Charter Secretariat have just prepared an important review which is called "*Investment Climate and Market Structure in the energy sector of Azerbaijan*". As I speak this review is being presented today at the Investment Group of the Energy Charter in Brussels. Based on outcomes of that review and on the long and constructive participation of Azerbaijan in the Energy Charter Process, I can speak about some key issues related to Azerbaijan and the Caspian region.

I would first of all like to briefly explain what is meant by the Energy Charter Treaty.

The Energy Charter political declaration was signed in December 1991; between what is now the EU and what was then the USSR. However the Charter now involves more than 50 states including as I have said, Azerbaijan, but also other CIS countries, the EU, Japan, Turkey, Australia and others.

The Energy Charter Treaty was developed on the basis of the 1991 Energy Charter. Whereas the latter document was drawn up as a declaration of political intent to promote energy cooperation, the Energy Charter Treaty is a legally-binding multilateral instrument.

The fundamental aim of the Energy Charter Treaty is to strengthen the rule of law on energy issues, by creating rules for a level playing field to be observed by all participating governments, thereby mitigating risks associated with energy-related investment and trade.

The Treaty provides for investment protection and security of transit, both of particular relevance for Azerbaijan. The Treaty also provides for dispute resolution mechanisms, including international arbitration.

I should now like to reiterate some observations on the critical importance of Azerbaijan in terms of current geo political, or if you like, geo energy issues;

1. Within the Eurasian continent, which of course includes Azerbaijan, the Russian Federation and the European Union are the important players. The European Union is currently examining opportunities in the Caspian region generally, and in Azerbaijan in particular. The European Union has other suppliers, such as, Norway and Algeria, perhaps Iraq in time. Russia on the other hand also has export markets than other than the EU, such as China, Turkey and others.

2. China is also of increasing relevance in the Caspian region. China is rapidly industrialising. Gas is already flowing in along the new pipeline from Turkmenistan. China is a new comer to the region and its involvement is still quite small compared with that of the EU. The fact that China is buying Caspian gas should not threaten EU energy security since diversity of supply is in everyone's interest. Moreover greater Chinese interest in the Caspian region might enable the countries of the region to have a better opportunity to act with independence and in their own best interests.

3. Azerbaijan is key in this ongoing competition for Caspian gas between Russia, China and Europe, and then within Europe between competing pipelines such as Nabucco, ITGI (Italy Turkey Greece interconnector) and TAP (Trans Adriatic Pipeline). Azerbaijan has

considerable gas reserves and wants of course to get them to an open commercial market. The biggest challenge for Azerbaijan is transforming these energy resources into actual output, and then finding a way of delivering it.

4. In 1994 Azerbaijan signed the so called Contract of the Century which allowed foreign companies to develop oil and gas reserves from the Azeri-Chirag-Guneshli fields. The first oil came on stream in 1997 and was exported to Russia and then to Georgia.

5. The commercial attractiveness of Azerbaijani oil and the successful policies of BP, Azerbaijan and the United States led to the implementation of the Baku-Tbilisi-Ceyhan pipeline which was inaugurated in 2006. It has been shipping 900,000 barrels per day since. The volumes that flow through this pipeline come not only from Azerbaijan but also from Kazakhstan and Turkmenistan.

6. In addition to the BTC (Baku-Tblisi-Ceyhan) pipeline, Baku ships oil towards Russia, through the Baku-Novorossiysk pipeline, and to Georgia, through the Baku-Supsa pipeline and the Baku-Batumi railroad. The next step regarding Azerbaijani oil transportation is the implementation of the Euro-Asian Oil Transportation Corridor. Thanks to this project, Azerbaijani crude could reach Eastern and Central European markets.

7. Oil production is however slowly decreasing in Azerbaijan. But the country is now about to become renowned for its gas reserves. The Shah Deniz gas field was discovered in 1999. So far, its production has been shipped to Georgia and Turkey. The much discussed second phase of development of this field will bring another 16 bcm annually to the 6 bcm annually being produced since 2007. There will be investment of over Euro 20 billion to date in the second phase by foreign companies such as BP and also by SOCAR (State Oil Company of the Republic of Azerbaijan) which will contribute to the gas production boom in Azerbaijan. Apart from the resources of Shah Deniz there is the complex political question of whether gas from Turkmenistan and Northern Iraq might join gas from Azerbaijan in supplying the Southern gas corridor pipelines.

8. In September of this year, Total and SOCAR announced that they had discovered “significant volumes of gas” in the Absheron deposit. Prior to this SOCAR had also discovered new gas resources in Babek and Umid fields. Further good news is anticipated from explorations under way on the Caspian Sea. SOCAR states that by 2020 Azerbaijan will produce more than 54 bcm annually.

9. Given this potential for reserves of gas, the challenge is, as I have mentioned, how Azerbaijan can access commercial markets. This is why Azerbaijan issued a submission proposal to buy and ship Shah Deniz phase 2 gas. This tender closed on October 1st and the results are awaited. As is well known four projects are now being considered:

   (i) Interconnection Turkey-Italy-Greece (ITGI)

   (ii) Nabucco

   (iii) South-Eastern European Pipeline (SEEP) (a newcomer carried by BP)

   (iv) Trans-Adriatic Pipeline (TAP)

10. While they all involve different routes each one is aimed at transporting up to 10 bcm of Azerbaijani gas to Europe annually. The decision on this is expected to be announced by Azerbaijan and the Shah Deniz consortium by the end of the year.

11. Azerbaijan might be considered as a principle target market by those seeking supplies because of its gas reserves, but the country itself intends to diversify its exports. Since 2007 gas has been delivered to Georgia and Turkey. In 2010, SOCAR commenced shipment of small volumes of gas to Russia in order to supply the North Caucasus. Azerbaijan also exports gas to Iran. This multivectoral gas policy is similar to that which has been encouraged for oil. Azerbaijan does not want to rely on one single consumer and intends to diversify its hydro carbon exports as much as possible. As Former Azerbaijani President Heydar Aliyev famously said "*happiness is multiple pipelines*".

12. Finally, Azerbaijan is not only a producing country; it is a transit country. It already ships oil from Kazakhstan and Turkmenistan to the Black Sea and the Mediterranean markets. In the future it is possible that Kazakhstani and Turkmen gas may also transit Azerbaijani territory. Recently the Council of the European Union gave the European Commission a mandate to negotiate with Ashgabat and Baku the export of Turkmen gas to Europe through a subsea Trans-Caspian pipeline. More recently, this month, EU Energy Commissioner Gunther Oettinger invited Astana to join these negotiations.

The Caspian region is therefore one of the most exciting regions in the world of energy. There is an enormous potential, and the successful exploitation of these abundant energy resources has become inevitable over the last two decades. Such development is not only linked to local factors but perhaps even more importantly, is the result of the changing position of the region within the fast evolving global energy markets. The management of the hydrocarbon resources is a profound question for the governments of the Caspian region, Azerbaijan in particular. With the stakes so high, it is imperative that governments get their approach right. Governments must balance the need to entice companies to spend vast sums on exploration and development with that of the public interest in maximising benefits from national resources.

As you may be aware, the Energy Charter Treaty, uniquely among international energy organisations, can count all of the countries of the region as participants in the Energy Charter Process. This means that the Energy Charter has a special role in bringing together the producer and transit countries of this region and linking them to the main consumer markets for their energy products.

Pipeline projects, particularly cross-border pipelines, require substantial investments. There are various factors which determine where and how investments are made. Energy investments can only be decided if they make sense economically; that a legitimate return can be anticipated. One of the conditions for this is obviously a reliable stream of energy from production to consumption. Confirmed availability of volumes and confirmed demand is clearly a determining issue. Project financing can only go ahead if there is a clear demand for the pipeline's proposed capacity. This is clearly at the centre of the issue over the development of the Shah-Deniz Phase 2.

The need for massive investment to meet future energy demand is well documented and set to remain for the decades to come. Cancellation or even postponement would endanger the security of supply and in consequence the economy as a whole. Energy investments are among the most complex and capital-intensive in the world. They therefore require a high level of protection against political risk.

The Energy Charter Treaty

The Energy Charter Treaty is legally binding. The Treaty, once signed and ratified by a country, is a powerful signal to the international community. It testifies to the willingness of that country to act according to international rules that are already shared by more than fifty members, including the European Union and its member states, many countries of Eurasia, as well as Japan, Turkey and others. And of course Azerbaijan is a signatory of the Energy Charter Treaty and a valued member of the Energy Charter Process.

I would like now to focus on three particular issues where I believe that the multilateral approach – as embodied in the Energy Charter Treaty – can make a vital contribution to the energy future of Azerbaijan and the Caspian region; *investment protection*; *secure and reliable transit*, and; *building confidence and promoting cooperation through dialogue.*

1) Investment Protection

If the full energy potential of Azerbaijan is to be achieved, large scale foreign investment will be required. Experience has shown that in relatively opaque investment markets, where the issue of rule of law is far from determined, and where there are real risks of expropriation; foreign investors have been reluctant to invest.

One way to improve the climate for investment is to reduce the risk premium. This is exactly what the Energy Charter Treaty does through its investment promotion and protection provisions, including the legally binding commitment made by parties to the Treaty to abide by international arbitration in cases of dispute.

Beyond the immediate resolution of particular disputes, these provisions have the secondary effect of helping to strengthen the rule of law and transparency, thereby contributing to an improvement in the general investment climate.

2) Secure and reliable transit

Transit is a major issue. It is so for China and the EU. But is particularly so for the Caspian region (Turkmenistan and Azerbaijan).

Azerbaijan has taken a cautious and well-considered approach on the issue. Its leadership states that *"according to the European Energy Charter, we are an open transit state, and the infrastructure independent states want to build across their shared border is their own bilateral business […]. We have already stated our readiness to discuss this issue"*.

The Energy Charter Treaty already contains important provisions in the area of transit. Moreover, within the framework of the Treaty we have now reached an advanced stage in the negotiation of a Transit Protocol that would further strengthen the legally binding transit provisions of the ECT. Now is the right time to make every effort to conclude this Protocol which would go a long way to addressing the transit challenges of the countries of the Caspian region.

It is well recognised that consumer markets depend on reliable transit routes in order to secure and diversify their energy imports from distant producing regions. Energy transit is a valuable source of income for transit states. Thus, transit is an activity that serves the mutual interest of all states involved in the process. The fact that the Caspian region is land locked means that

the transit arrangements of the region are vital. Georgia was the first country to ratify the Energy Charter Treaty in 1995 and since then has proved to be a reliable transit partner for transporting Caspian energy resources to global markets.

3) Building confidence and promoting cooperation through dialogue

The third issue where a multilateral approach can make a contribution to addressing the energy challenges facing the countries of the Caspian region is by providing a forum for states to discuss issues of mutual interest and concern. Experience has shown that dialogue around critical energy issues can do much to promote better understanding, transparency, exchange of information and, in these ways, contribute to building confidence.

In recent years, we have already witnessed tensions rising to worrying levels over energy projects in Caspian region. Unless addressed, these tensions risk contributing to a worsening of relations between states. On the other hand, a constructive engagement in a mechanism for dialogue could do much to alleviate such tensions.

The multilateral approach of the Energy Charter can bring significant value added to addressing the energy challenges confronting the states of the Caspian region. Above all, the Treaty provides a common set of minimum legally binding rules in the energy sector; and it can serve as a means to promote transparency and confidence.

The three issues – investment protection, ensuring secure and reliable transit, and encouraging dialogue – are all positive contributions, but it is also clear that in the fast changing world of energy – and perhaps nowhere more than in the Caspian region - we need to think carefully about whether the existing arrangements for energy governance are sufficient to meet the full range of new challenges. Within the Energy Charter constituency there is already underway considerable thinking about this issue. This is as part of the modernisation of the Energy Charter Process.

A key challenge is to ensure that the Treaty includes the main new energy actors in the world. When one looks at the Caspian region, the states on the territory of the former Soviet Union are full members of the Treaty. This situation corresponds to the origins of the Treaty when the focus was on the interrelationship of European and Eurasian energy markets, where there were few connections to other markets. Today we see that the countries of Central Asia and the Caspian are increasingly tied to Asia – to China and south Asia in particular. This suggests that if there is to be genuine cooperative developments in the three areas that I have identified above, then it will be essential to build a broader geographical framework for the Treaty including, among others the countries of the Middle East (who are so well represented and discussed at this conference), India, China, Afghanistan, Iraq and Pakistan.

The Energy Charter Treaty is well placed to make a substantial contribution to ensuring that energy relations in the region operate on the basis of international law and are cooperative. The ECT can also encourage much needed investment in the energy sector and promote the secure and reliable transit of energy from the region to global markets.

In conclusion the Energy Charter Treaty is a very effective framework for addressing the large scale financing of major infrastructural projects to enable effective gas production in the Caspian region.