Working towards an effective regulatory environment in order to stimulate investments in global energy

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Value chain and risks

Risks are related to possible failure, losses either during or at the end of an economic activity

Each unit of the chain (upstream, midstream and downstream) involves risks

Risks are proportional with the length of the project/activity

Risks are accounted as "discount rate", in energy up to 10%

Risks can engender transaction costs (not accounted)

Risks can be economic, political, legal & regulatory, technical & environmental

Economic risks

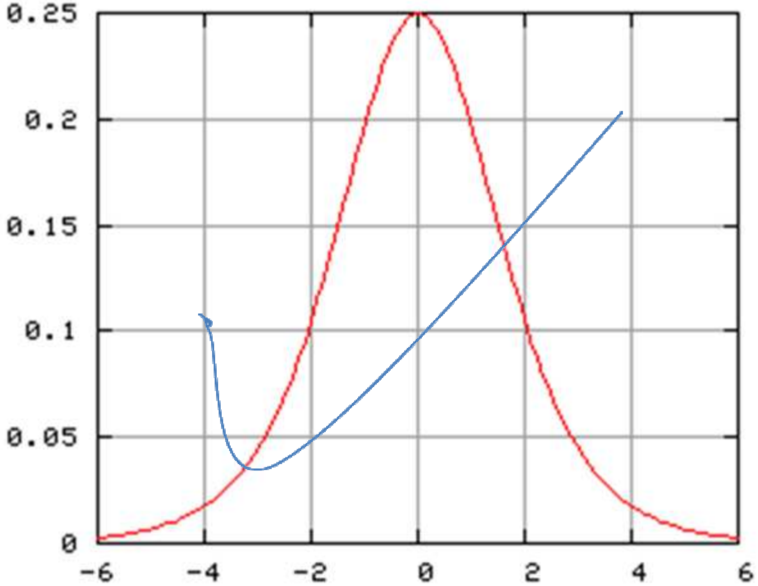
Price volatility & Changes in reserves according to price volatility

Long term investments vs short term price dynamics

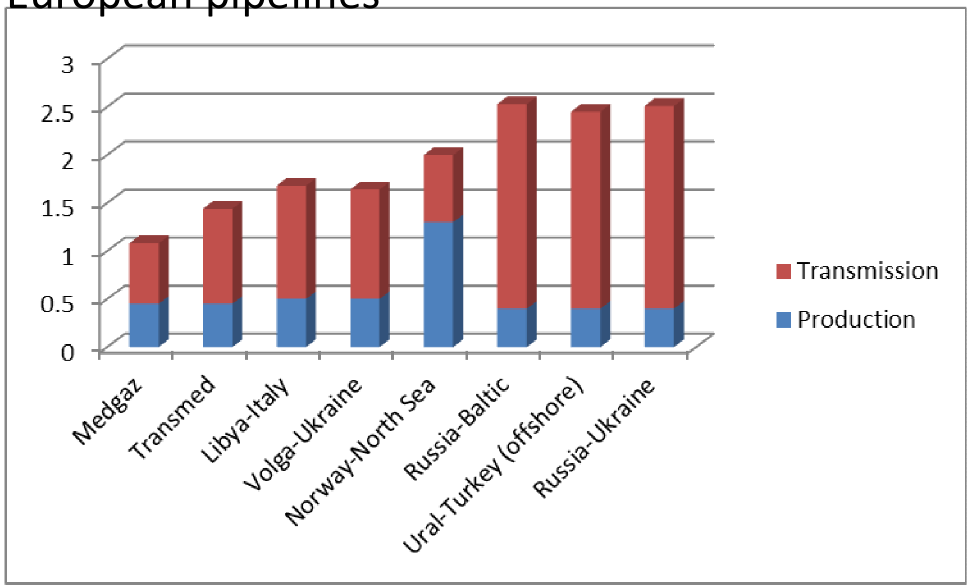
Falling or stagnating demand

In Midstream gas: economic risks for long distance pipeline pay-back

Hubbert curve and MC



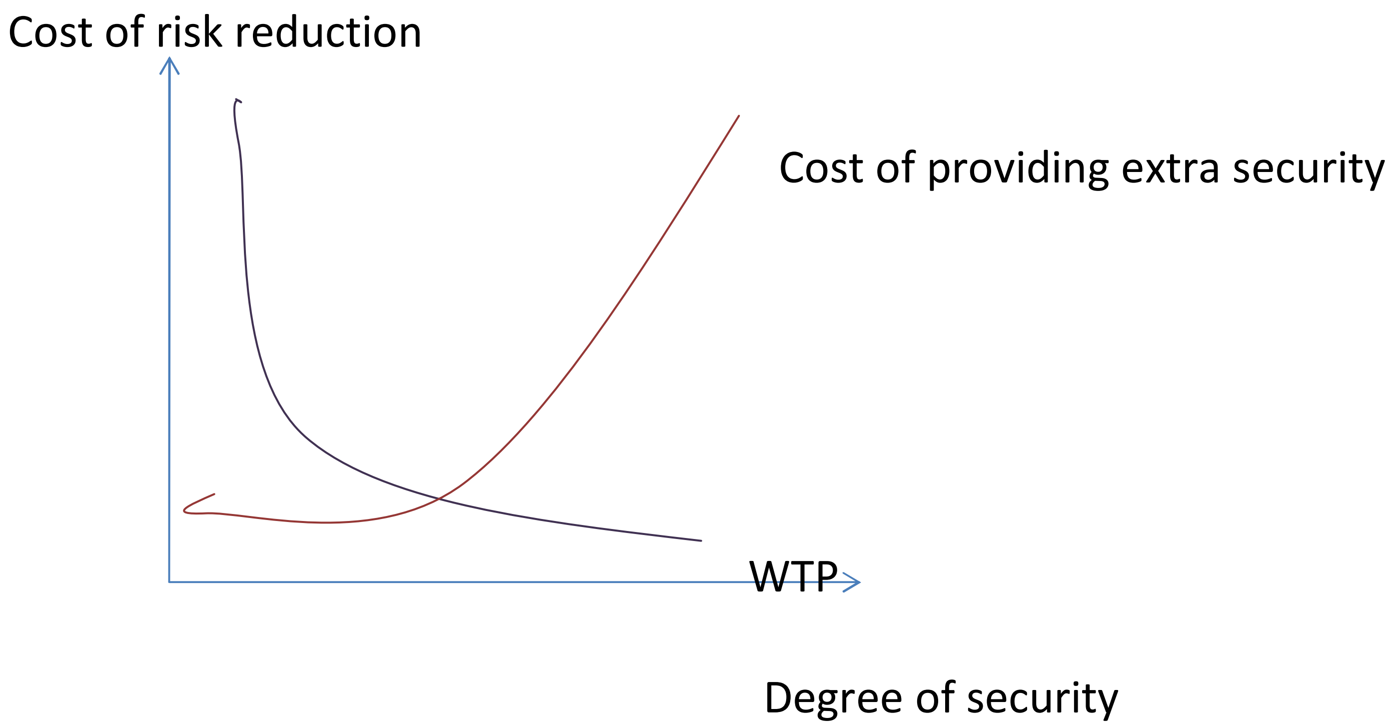
Separation of production and transmission costs European pipelines



Source: OME, 2001

Political risks

- Domestic instabilities
- Inter-State conflicts, diplomatic tensions, embargos
- Perceptions of external threat (i.e. policy of self-sufficiency)
- WTP for security vs welfare loss



For details: publications of network industries, also S. Ruester

Legal and regulatory risks

Domestic regulatory uncertainties (i.e. Russia's license system which relies on Ministry, without property right)

Legal unpredictability and rising transaction costs ,regulatory pressure on contracts and pricing (i.e. effects of the EU's energy liberalization on supply-capacity mismatch)

Expropriation of industries (i.e. Yukos affair, current case Gazprom vs Lithuania; probable similar case in Estonia)

Regulatory impact on contracts and pricing (can the competition regulator intervene into pricing mode? Still uncertain)

Environmental and technical risks

- Accidents, spills (eg oil tankers), environmental and social damages → reparations required, reputation damages (eg effect of Mexican Gulf spill)
- Smaller risks related to technical accidents and damages
- Environmental and technical risks may harden the license allocation, hence increase transaction costs (eg environmental policies in the EU)
- Politicization (securitization) of environmental threats, pressure on industries, by NGOs (new issue even gor Gazprom)

Investment protection: role of multilateral mechanisms (ECT)

- ➔ MFN principle avoids discrimination risks
- ➔ Makes predictable the issue of compensation for assets and of expected revenue loss (i.e. Estonia-Russia don’t have a clear ground for DSM as no BIT)
- ➔ Distinction between Pre-investment (*ex ante*) and post-investment (*ex post)* phases (the ECT focuses on ex post but some experts argued that ex ante could be applicable)
- ➔ DSM for cross-border pipeline transmission (transit), but difficulties remained (art 7&7 remained controversial for RF-Ukr, hence never applied)
- ➔ Can be applied for contractual changes, supply-capacity mismatch

Investment protection: non-covered areas

- ➔Political stability is a perquisite, energy interdependence <u>does not</u> create a context for political stability!
- ➔Hedging risks: involving private sector, especially in economic risks

Existence of different drivers

➔same governance mechanisms but different policy drivers! –

EU's concern:	*Russia's concern:*
security of supply	**security of demand**
To facilitate upstream resources access of energy-producers and to keep control of downstream via supply diversification to enhance competition	**To facilitate downstream markets access of energy-importers and to keep control over resources and over access to pipelines to have pay-back stability**
Governance needed to enhance competition?	**Goverance needed to provide long-term stability?**

Issues for the ECT

- ➔Number of misperceptions especially among the energy producers
- ➔Latent contradiction between "self-sufficiency strategy" and trust in interdependence (especially on consumers side)
- ➔High level of securitization of energy industry (can we imagine a Law of the Sea in XVIIIc?)