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

Cost of risk reduction

Cost of providing extra security

WTP

Degree of security

For details: publications of network industries, also S. Ruster
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 (e.g., oil tankers), environmental and social damages ➔ reparations required, reputation damages (e.g., 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 (e.g., environmental policies in the EU)
- Politicization (securitization) of environmental threats, pressure on industries, by NGOs (new issue even for 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 **does not** 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:
security of supply

To facilitate upstream resources access of energy-producers and to keep control of downstream via supply diversification to enhance competition

Governance needed to enhance competition?

Russia’s concern:
security of demand

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 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?)