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Oil, Gas & Energy Law Intelligence

Energy Security: The Role of Business, Governments, International Organisations and International Legal Framework by A. Konoplianiuk

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“Energy Security: The Role of Business, Governments, International Organisations and International Legal Framework”¹

**Dr. A. Konoplyanik,
Deputy Secretary General,
The Energy Charter Secretariat**

The discussions on energy security, being intensified during the 2006 Russian G-8 Presidency, have once more underlined that investment is a key to international energy security.

Energy projects: why the risks are high

World demand for energy has been and would be continuously growing in absolute terms, at least until the time when the totally new generations of energy technologies will break the existing almost linear correlation between economic growth and energy demand. But in the foreseeable future (within the duration of at least one-two investment cycles) the bulk of this demand will be covered by hydrocarbons. So new fields are to be developed to cover incremental demand and to compensate depletion of the fields currently in production. Due to asymmetry between energy production and consumption areas (markets vs. resources mismatch problem) major energy consumers will face growing import demand. That leads to continued growth in international energy trade with its increasing cross-border character and to a shift to more use of infrastructure-bound energy.

Major part of new energy demand and supply will come from the “new” (non-OECD) markets, where the need for creation of energy infrastructure is much higher than within existing “old” markets. According to IEA, during 2001-2030 70% of incremental demand, 95% of supply and 60% of energy investments would be originated in non-OECD area (see Figure 1). But since emerging economies and economies in transition (e.g. countries of non-OECD area) have been developing their legal systems for less time, compared to OECD states, they are associated with higher risks. This leads to higher costs of energy projects development in non-OECD states and thus worsens comparative competitive positions of their energy projects at the international capital and energy markets.

¹ The article is based on the author’s presentation at the International Conference «The Role of Governments and International Organisations in Promoting Energy Security» co-organised by the Energy Charter Secretariat, International Energy Agency and Organisation for Security and Cooperation in Europe on 25 October 2006 at Palais d’Egmont in Brussels.

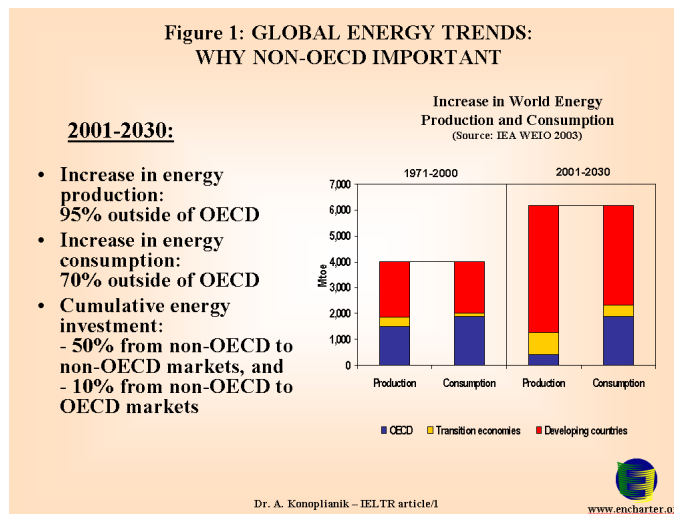


Figure 1: Global energy trends – why non-OECD important

These risks are especially high in the energy industries which, by definition, face incremental risks compared to other industries. Energy projects (especially in the upstream) are usually more long-term and capital-intensive, compared to other industries, their investment phase is more lengthy and can last for a decade (and taking into consideration the pay-back period of these investments – for two decades), and the whole project life-cycle can easily exceed 30-40 years. Taking into consideration huge influence of energy projects on the natural environment and social & economic life, one can speak about a century-long existence of the energy projects (e.g. the normative physical life-time of the dams of hydropower stations, to be considered in the feasibility studies, is to be equal to 100 years in some countries, but in practice it might last for much longer since these energy objects, like hydropower dams at the big rivers, create non-reversible changes in the natural environment).

Unit capital costs in the energy projects amounts to billions of Rubles, Dollars or Euros per project, especially in the upstream. But if in order to supply energy resource to the market one need not only to develop a field, but to create as well necessary transportation infrastructure for energy delivery to and/or distribution at the end-use market (and in case of the liquefied natural gas (LNG) – also to create capacities for natural gas liquefaction and its consequential regasification) – then these figures can easily amount to dozens of billions.

Energy investment projects are usually immobile, e.g. demand creation of stationary infrastructure. This means that after beginning investing, an investor is incapable – even theoretically – to cut down and move away his production facilities (say, on exploration and production) to another place/region/country and thus he is even more vulnerable to any non-commercial risks.

To minimize and mitigate these objectively heightened risks in energy investment projects, the latter are usually financed not from the cash-flows of the project sponsors, but from debt capital. Banks and other financial institutions, who provide loans to the “real sector”, belongs to the most conservative institutions and usually secure themselves from the non-payment of provided loans. That is especially true within such specialized financial techniques like “project financing” (though it is very frequently used in financing of large-scale energy projects) in which cases the loans provided for project development are (mostly) secured not by the asset backing but by the future revenue flows to be

generated by the future energy production from the project in question.

Diversification and balance of interests

Linking together consumers and producers by common (usually immobile) infrastructure increase their mutual interdependency. Internationalization and globalization of the energy markets put an end to the earlier existing concepts of “*energy independency*”². Though it is – in principle - technically possible to achieve “energy independency” of the individual state, this aim is not economically justifiable for any country in the current world with the generally available multiple energy supply choices (since the “energy independence” option would be the most costly choice). We are leaving in the *interdependent energy world* nowadays and all the policy decisions both on the supply and demand sides need to be developed and implemented under this approach as being not a goodwill only, but an economically-driven and justified necessity based on the “material facts of life” of the contemporary world.

As long ago as in 1911, at the time when Winston Churchill switched the Navy from coal to oil, it was recognized that “safety and certainty in oil lie in variety and variety alone”. Since then diversification is the synonym of energy security. But especially today, within the framework of the interdependent world, this is only true when the term ‘diversification’ is interpreted in the broad sense and reflects the balance of interests of the players representing all segments of the energy value chain. That involves not only diversification of energy supply routes from today’s suppliers to historically developed markets (the concept of ‘multiple pipelines’) and not only diversification of sources of energy supply for existing consumers (the concept of ‘multiple suppliers’). It also involves diversification of markets and routes to access them for suppliers (see Figure 2).

Figure 2: Energy security and diversification

Diversification:

- of supply routes ("multiple pipelines")
- of sources of supplies ("multiple suppliers")
- of markets and routes to access them

to be based on balance of interests of all players throughout whole energy value chain

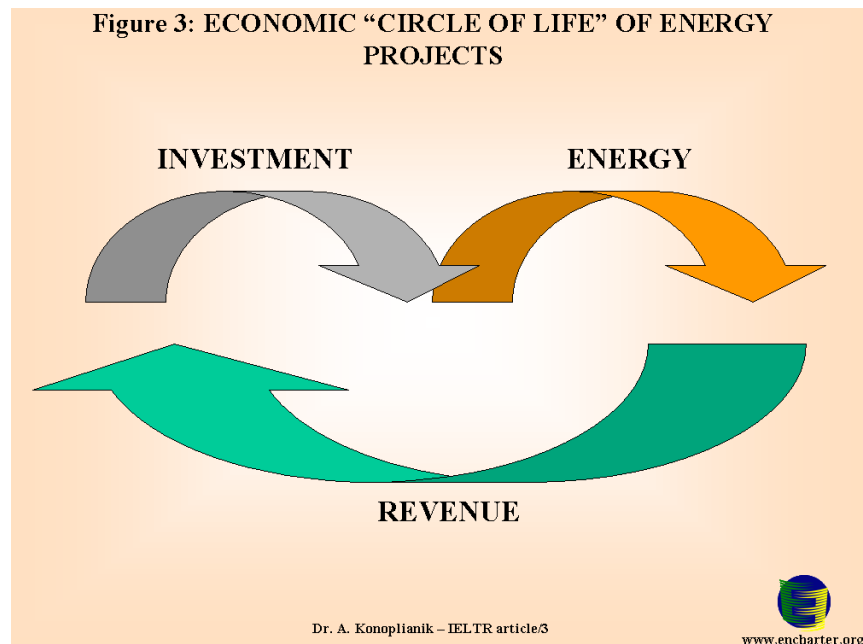
2 N.B. the 1977 US Energy Programme was officially entitled the "Energy Independence" Programme.

Demand for energy and diversification in the energy area requires creating new *energy* infrastructure, hence is related to investments, mostly the large-scale ones. And when investors are facing the necessity to develop new fields located in the totally new, unexploited, remote areas – this requires creating new *economic* infrastructure, which demands incremental investments, that usually being attributed to the costs of the energy project and makes these large-scale project investments even larger.

² Just as a reminder: the 1977 US Energy Programme was officially entitled “Energy Independence” Programme.

Any - and especially large-scale - investments are aimed at establishing stable long-term relations to the mutual benefit of suppliers and consumers, investor and host-state - relations, which are to be balanced and are to be based on clear, predictable and enforceable rules. Such rules are needed to mitigate risks, and it means stimulating not only investments as such (e.g. in energy to be produced) in all parts of the cross-border energy value chain – from exploration and development to final consumption of energy. They are needed to mitigate risks of cross-border energy flows (e.g. of the energy already produced) from suppliers to consumers. As well as to mitigate the reverse risks – related to flow of income going from consumers to suppliers for the energy delivered (e.g. from energy already produced and sold). Only in case of reduced risks and ensuring transparency, predictability and reliability of all three types of flows related to the energy business (or: to the full investment cycle in energy) – investment flows, energy flows and revenue flows – one can talk about a balanced approach to the issue of ensuring energy security (see Figure 3).

Figure 3: Economic “circle of life” regarding energy projects



It is in this context that we in the Energy Charter interpret the concept of ‘energy security’ as a triad consisting of security of supplies, security of infrastructure, security of demand, including, thereafter, the issues of access to the resources, infrastructure and markets (see Figure 4). But it is investment that is the “starting point” of the economic “circle of life” regarding energy projects. And it is transparency that is the necessary starting point to mitigate the risks related to all three types of flows.

Figure 4: Three facets of energy security

Energy Security =
Security of supply +
Security of infrastructure +
Security of demand
incl.:
access to resources +
access to transportations +
access to markets
=> Transparency is a key !

Following evolution of the markets

To pursue cross-border investments and trade one needs reliable, consistent and transparent legal frameworks irrespective of which companies in which states and under which level of current/future energy prices would undertake energy projects in any segments of cross-border energy value chains. In energy economy demands for the “quality” of such legal and regulatory framework are among the highest compared to other industries - due to longest lead-times, highest unit capital value of energy projects, together with broadest nomenclature of risks and immobile character of energy infrastructure (see Figure 5).

Figure 5: Energy Economy: demand for quality of regulatory framework

Energy projects (compared to other industries):

- Highest capital intensity (absolute & unit CAPEX per project),
- Longest project life-cycles,
- Longest pay-back periods,
- Geology risks (+ immobile infrastructure, etc.),
- Highest demand for legal & tax stability,
- Role of risk management.

=> Higher demand for "quality" of legal and regulatory framework compared to other industries.

Within the time-frame the character of and demand for investment protection and stimulation in energy has been changing due to increasing number of energy resources involved in economic circulation, expanding number and more sophisticated character of applied energy technologies, movement of energy-producing areas into more remote locations with more difficult geologic and climatic conditions, and further increasing internationalization of the energy value-chains. At the previous stages of development of the mankind, within the earlier social and economic formations the major instruments of such protection of the investors (mainly from the then “developed” countries in the then “developing” countries) and providing for the security of raw materials supplies to their mother countries were coercive instruments such as seizure of the colonies and developing them into the raw materials producing appendages of the centers of empires, deployment in these colonies of the military forces to protect, inter alia, production facilities and transportation routes of the major raw materials flows to the centers of empires.

As time goes by, a combination of military, diplomatic and legal instruments has been coming to take the place of purely coercive instruments. The role of legal protection of investors and their rights has grown significantly first at their internal markets. As the state institutions (and later democratic institutions) have been developing and strengthening in the society, and as the “rule of law” has been increasing its role in the everyday life, including everyday commercial life, implementation of the instruments of legal protection became more efficient and their comparative role in the above-mentioned triad has been steadily increasing.

With the evolution of energy markets from national to international and global level there is a parallel development of the spectrum of legal instruments of investment protection and stimulation, aimed to diminish investment risks related to the more internationalized type of interactions in energy. Such development took place within the business community (between the business actors), as well as between the individual states and business actors, as well as within the community of sovereign states (between the states). But each one next instrument of investment protection is generally not to substitute or to cancel the previously existing ones, but to add to their sum-total, thus providing both to states and investors broader spectrum of competitive choices on how to reach their aims. So one of the principles of the evolutionary development of the system of the legal instruments of investment protection can be identified as the following: posterior instruments are not instead of, but in addition to the preceding ones.

On business level, evolution of contractual structures– those that are aimed at minimization of business risks at the level and by the means in disposal of business entities - can be taken as an example (see Figure 6).

Figure 6: Energy markets: evolution of contractual structures

"Physical energy" markets =
Long-term contracts
+ Short-term contracts
+ Spot
+ Forward
+ "Paper energy" markets =
+ Forward
+ Futures
+ Options
+ ...

At initial stages of energy markets development long-term transactions/contracts dominated absolutely and for rather long time had no alternatives. Initially they were a trade-arm of concessions and production-sharing agreements (PSAs); they reflected de facto internal transactions and transfer operations within vertically-integrated structures of the major international oil companies (and were not the contracts in contemporary meaning as if concluded between two independent entities); their duration was equal to the duration of the investment agreements itself and for long was measured in decades. The first concessions has a 60-70-years duration³, later on some concessions (in the Middle

³ The first petroleum agreement to be signed in the Middle East was between the British Baron Julius de Reuter (the founder of the Reuter information agency) and the Persian Shah Nasr-ed-Din on 25 July 1872.³ It granted de Reuter a seventy year exclusive concession to explore for and to produce oil, gas and other mineral resources (it was later annulled). Perhaps the best-known concession historically is the D'Arcy concession in Persia (which gave eventual birth to British Petroleum). On 28 May 1901, His Imperial

East) were to last up to 99 years well into the XXI-st century (but were nationalized in the 1970s much before their expiration dates⁴), but then duration of investment agreements in oil and gas has shortened to 15-20 years reflecting the general trends in the evolution of petroleum arrangements between host states and foreign investors⁵. After nationalization of the upstream assets of the major international oil companies (IOCs) by the producer states and creation of their own national oil companies (NOCs) on the basis of these assets, the former transfer operations within the vertically integrated structures of IOCs were substituted by the long-term supply contracts between NOCs and IOCs.

Later on, due to diversification and development of infrastructure which provided competitive choices both for producers and consumers in selecting their counterparts, the new contractual structures have appeared first on “physical energy” markets: short-term contracts, then spot and forward deals. Later-on “paper energy” markets have been evolved first with forward deals (due to transition in forward deals from real good, available in the today’s stock, to fictitious good, not available physically in the stock as of today, but expected to be available at some future time due to availability of established stable flows of this good from its producers), then with futures and options (due to their rocket-style growth both for hedging price risks of physical deliveries as well as for pure speculation). But within their increasing diversity, each type of contractual structures, including long-term contracts (LTCs), has its “competitive niche” (even within commodities markets) dependent on the particular economic conditions and particular energy markets. That is why posterior contractual structures, which came to birth by the new developments and challenges of the energy markets, do not (and can not) “kill” the preceding contractual structures, but they change the economic balance between the “old” and “new” ones. As a result, the contractual composition (structure) of the market can (but not necessarily will, especially significantly) change to a new one under new developments.

For instance, as of today, LTCs with the pricing formula based on replacement value of the basket of energies, which are competitive/alternative to gas in end-use (usually petroleum products produced from importer oil), has an absolute dominance in gas supplies both to and within Continental Europe, reflecting the fact, that:

- Initial model of gas export contract that has been the core element of the development of gas industry in Continental Europe was the so-called “Groningen model” of long-term gas export contract that reflects the model created by the Dutch Government (initially presented in the so-called Nota de Pous⁶) for development of its national gas resources after discovery of the super-giant Groningen field;

Majesty Muzaffar al-Din Shah signed a concession granting William Knox D’Arcy ‘a special and exclusive privilege to search for, obtain, exploit, develop, render suitable for trade, carry away and sell natural gas, petroleum, asphalt and ozokerite... for a term of sixty years’. (A.Konoplyanik. Energy Security and the Development of International Energy Markets (pp. 47-84). - in : *Energy security: Managing Risk in a Dynamic Legal and Regulatory Environment*. /Ed. by B.Barton, C.Redgwell, A.Ronne, D.N.Zillman. – International Bar Association/Oxford University Press, 2004, 490 pp.).

⁴ Here are approximate expiry dates of former concessions in some OPEC countries, had they not been nationalized in the 1970s: Abu-Dhabi – 2014/2018, Iran – 1994, Iraq – 2000/2013, Kuwait – 2003/2026, Qatar – 2010/2027, Saudi Arabia – 1999/2000, Libya - 2011/2016, Nigeria - 1989/1999 (Ibid.).

⁵ See: А.Конопляник. Основные виды и условия соглашений, действующих в нефтяной промышленности капиталистических государств между ТНК и принимающими странами. - “Бюллетень иностранной коммерческой информации” (БИКИ), 1989, Приложение # 10, с. 3-23.

⁶ The Note presented to the Dutch Parliament in 1962 by the then Minister of Economic Affairs of the Netherlands, de Pous, establishing the main principles of the Dutch gas policy.

- European import gas supplies depends on development of a dozen super-giant fields located mostly far away from Europe (except for Netherlands and to some extent for Norway) and in the countries outside of EU jurisdiction such as Russia, Algeria, Qatar, Nigeria (and for future possible supplies - plus in Iran, Azerbaijan and Central Asian states);
- Development of these fields would not have been possible without LTCs since only LTCs could have guaranteed to the financial institutions (in the form of stable and predictable flows of export revenues) the pay-back of the debt capital that they have provided for the development of these fields;
- Current stage of development of the energy markets along the cross-border energy value chains (especially in their upstream segments), that link Europe with major gas producers that export their gas to Europe, did not reach yet such a stage of infrastructure development and its diversity/density that would enable to create more liquid internal gas markets with economically justifiable stimuli for increasing role of shorter-term contracts⁷;
- Administrative measures to cut/diminish the role of LTCs where their application is economically justifiable will come (are coming) in contradiction with the economic stimuli for business drivers (e.g. for long-term and capital-intensive investments in supply projects) and thus will destroy (are destroying) economic balance between all the players in the cross-border energy value chain and thus will be (are) contra-productive for improvement of energy security.

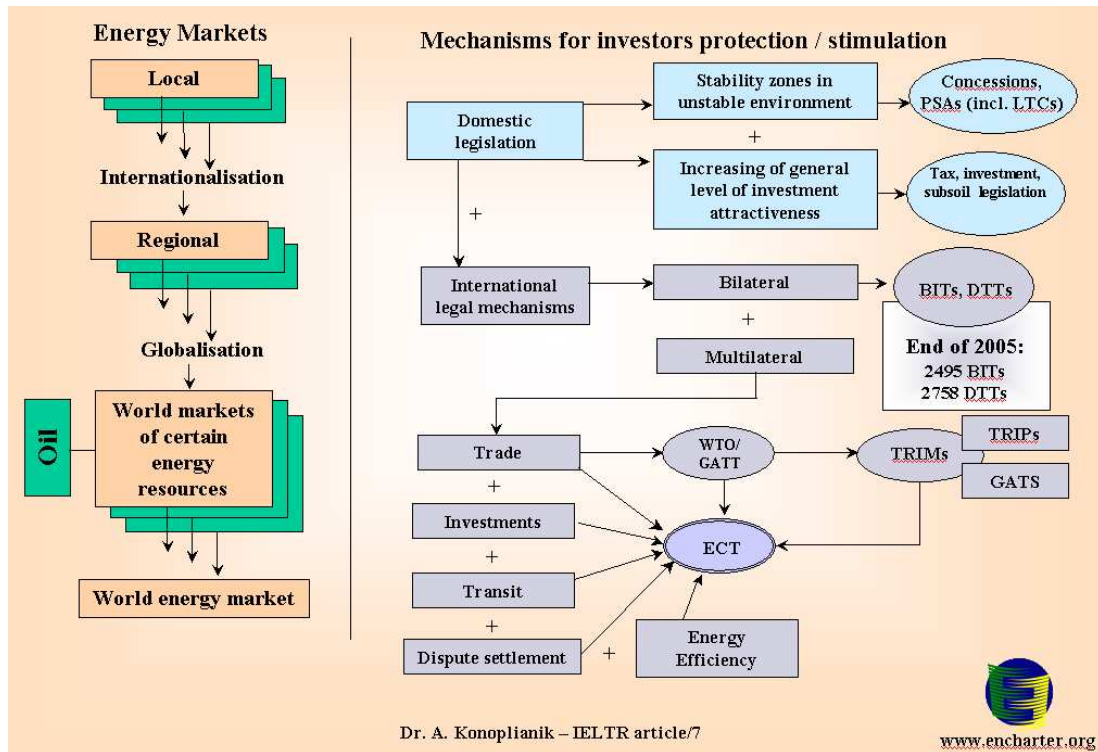
And thus LTCs will continue to play their role, especially as generally accepted by financial and energy community instrument to develop capital-intensive and long-life-cycle investment projects in energy, especially Greenfields in upstream. So contractual structures of the energy markets has been evolving following the same rule (see above): posterior contractual structures - not instead of, but in addition to the preceding ones.

From BITs to the ECT

The states as resource-owners started to develop investment protection mechanisms – to address fair and justifiable economic interests of domestic and/or foreign investors –first at the national level and first within project-oriented legal structures (see Figure 7).

⁷ The role of long-term contracts in the global energy supplies is in depths analyzed, inter alia, in the most recent study of the Energy Charter “Putting a Price on Energy: International Pricing mechanisms for Oil and Gas” (Energy Charter Secretariat, 2007, www.encharter.org).

Figure 7: Development of Energy Markets and Mechanisms of Investor Protection/Stimulation



In unstable (or in the absence of) adequate legal environment the states created “enclaves of stability”, such as PSAs and concessions for the individual projects, which were usually given the power of the law. Lack of adequate internal legal environment can be a result either of initial stage of evolutionary development of domestic legislation (like in developing countries) or of the radical change in the political and social development patterns which predetermines refusal from the previous and creation of the new domestic legal system (like in economies in transition).

Next steps were aimed to create and to improve the general “quality level” of national legislation (by implementing not only project-oriented individual legal structures, but putting together and into a system general principles of investment treatment). This is to be achieved by further, more balanced approach to particular segments of legislation, directly and indirectly influencing on investment activity: subsoil, tax legislation, etc. Besides, project-oriented legal protection can be further being developed, even expanded, in parallel with the “general improvement” of the legislation in general (based on the same, as was already mentioned above, principle: “not instead of, but together with”). This project-oriented approach can cover the whole groups of projects (both homogenous, and not), to be developed within the detached territories, where they will face special and more favourable investment regime. Such approach usually underlines legislation on free economic zones (territories).

Within the globalizing energy world with growing interdependence of the players, their challenges soon become common, and common challenges require common approaches and rules. That is why later-on the above-mentioned legal development is expanded to international level: through development of network of bilateral undertakings (Bilateral Investment Treaties (BITs), Double Taxation Treaties (DTTs) – now about 2500 and 2800

worldwide respectfully, according to UNCTAD⁸) to creation of a number of multilateral agreements. Energy Charter is one of those (Figure 7).

Before World War II foreign investments were largely a concern of national law. Shortly after WWII countries attempted to establish multilateral rules governing the protection of foreign investments, and numerous efforts have been made since (the first such attempt was the Havana Charter of 1948), though largely unsuccessful. Given the difficulty in concluding binding multilateral agreements, states concentrated on developing bilateral agreements, initially as a means for developed countries to protect their capital flows into developing countries. However, this trend has changed, and now there are numerous BITs and other bilateral agreements between developing countries and, in a few cases, between developed countries as well. That is why modern bilateral investment treaties (BITs) are a fairly recent phenomenon – the first one BIT dates back to 1959 only, but it was really in the 1990s that the number of BITs increased dramatically: among current 2500+ BITs only 72 were concluded in the 1960s, 93 – in the 1970s, 220 – in the 1980s, but 1471 – in the 1990s⁹. This not only reflects the increasing role of the cross-border investment flows in just recent decades, followed by structural changes in the investment flows, but also radical changes in the political map of the world in the 1990s and thus different structural demand for new BITs. This pace of developments in bilateral instruments of investment protection created the problem of their incoherence, which is the issue raised in every recent UNCTAD World Investment Report¹⁰.

There is a number of reasons for this. Different states have negotiated and concluded bilateral deals between them at different time. Each state, especially more economically strong, tried in its negotiations on bilateral treaties to rest upon its own model of such documents thus aiming to achieve some further benefits in the “cooperation” with weaker “partner”. Sometimes these models are approved by the national law. That is why the aggregate of BITs might not be highly homogenous, nor highly balanced. At some stage that demanded development of model bilateral agreements, which were produced both by business associations and/or international organizations. But even when based on model approaches, such bilateral agreements are still not drafted in the unified manner and, what is more important, uniformly interpreted (which has been regularly mentioned in the UNCTAD reports). So the development of bilateral instruments of investment protection has created once again the objective need for development of corresponding multilateral instruments, which will keep all the values of the bilateral instruments, but will lack – if possible - their weaknesses. The first priority were the areas where the investment risks are among the biggest, e.g. energy economy.

Need for common political fundament

There is an increasing need for a common framework – agreed by all states along the energy value chain – to provide a necessary degree of legal security for investment and reliable cross-border flows and to promote the efficient production and use of energy. There is also a continuous need for a dialogue with partners all along this chain. The balance of interest provides the basis for stable international cooperation. And this is the

⁸ www.unctad.org

⁹ H.Perezcano. Investment Protection Agreements: Should a Multilateral Approach Be Reconsidered? –

“The Geneva Post Quarterly. The Journal of World Affairs”, Vol. 0-N 0, July-September 2005, p. 33-43.

¹⁰ See, for example: Box I.7. Incoherence between IIAs. – UNCTAD World Investment Report 2006, p. 29.

philosophy that lies at the heart of the Energy Charter process based on the shared belief of its member-states that long-term international energy security can best be served by a binding multilateral framework for energy cooperation. That is the substance of the legally-binding Energy Charter Treaty (ECT) which establishes common obligations to which all member countries subscribe in the areas of energy investment, trade, transit, energy efficiency and dispute settlement (Figure 7).

It is clear that for negotiating and signing of multilateral, especially legally binding, international treaty some particular political prerequisites are needed, and in particular the open “window of opportunities”. That is especially true in regard to the treaties that covers such a wide and basic spheres of economic activities as energy economy, which provide for the fundamentals of economic development and export potential of many countries and include such politically sensitive issues like, inter alia, sovereignty on natural resources. Such treaties need to rest upon adequate political fundament.

Political foundation of the Energy Charter was first laid in 1975 due to signing at All-European Conference in Helsinki the Agreement on Security and Cooperation in “Transatlantic” Europe. Two years later, in 1977, at the Vth Congress of the Polish United Labor Party the then Secretary General of the USSR Communist Party Leonid Brezhnev has proposed the initiative on convening a All-European Conference on Energy. However, this initiative of the USSR can found out its follow-up only 13 years later – and in slightly different format. In June 1990 the then Prime Minister of Netherlands Ruud Lubbers (of the then EU Presidency) has put forward an idea of creating All-European Energy Community. In the new political environment – after the fall of Berlin Wall and the end of “Cold War” period – formation of the common All-European energy space might become a symbol of unification tendencies for two recently confronting military powers – NATO and Warsaw Pact, similar to how it had happened earlier, after the WWII, when the former war enemies – France and Germany - had laid down in 1956 the fundament of the future European Union by establishing European Coal and Steel Union¹¹.

Energy was the most economically preferable sphere for creation of “common level playing field” due to objective tendencies in energy markets development. The latter have already reached the high level of diversification and interdependency and demanded “common rules”. In the period of split of Europe (both of geographical Europe, and especially of Transatlantic one) in two camps, creation of such common rules was impossible just because capitalist and socialist systems were leaving on the basis of totally different economic laws and rules. And only after elimination of political division of Europe it became possible to start creating common economic fundament of Europe and to form common legally-binding mechanisms in the key for all the states energy area.

Of course, in the course of multilateral negotiations on the Treaty on some issues the countries has managed to agree with the higher level of mutually-binding and enforceable obligations (“hard law” language like “the parties should”), on some provisions – with the less binding level of mutual obligations (“soft law” language like “the parties shall endeavor”). But as was stated by the Russian Foreign Ministry in their note on ECT placed at the Ministry’s web-site: “the ECT and related documents represent the result of mutual compromises and ‘gives and takes’ reflecting negotiating parties endeavour to find a

¹¹ For more about history and pre-history of the Energy Charter Treaty, see: Centre for Petroleum & Mineral Law & Policy, University of Dundee. T.Waelde (ed.), *European Energy Charter Treaty: An East-West Gateway for Investment & Trade*. (International Energy and Resources Law & Policy Series), London - The Hague - Boston: Kluwer Law International, 1996, 700 p., and in particular Chapter 6 "The Energy Charter Treaty: A Russian Perspective" (p.156-178).

balance of their interests”¹².

ECT – legal protection of investment

Today the Energy Charter Treaty is the first and only multilateral investment treaty, which is energy-specific (covering the group of sub-sectors where investment risks are especially high) and provides broadest geographical coverage with the high standard of investment protection.

No one other investment-related multilateral intergovernmental treaty can present such combination of multi-facet scope of activities (ECT covers investment, trade, transit, energy efficiency, dispute settlement), types of products (it covers energy materials & products + energy-related equipment) with high standard of legal obligations (see Figure 8).

Figure 8: Selected international investment-related agreements

Organisation (member-states/CPs)	Legal Status	Scope	Investment	Trade	Transit	Energy Efficiency	Dispute Settlement
ECT (51/52)	LB	Energy	Yes	Yes	Yes	Yes	Yes
WTO (149)	LB	General	(Yes?) (Services)	Yes	Yes/No *	No	Yes
NAFTA (3)	LB	General	Yes	Yes	No	No	Yes
MERCOSUR (4)	LB	General	Yes	Yes	No	No	Yes
OECD (30)	LB	General	Yes	No	No	No	No
APEC (21)	Non-LB	General	Yes	Yes	No	No	No

* application of GATT Art.V to grid-bound transportation systems is under debate

Plus particularized energy-related organisations: OPEC, IEA, IEF, UN ECE (covers broader set of issues than just energy), IAEA, ...

Plus particularized “regional” organisations: BSEC, BASREC, ...

Dr. A. Konoplianiuk – IELTR article 8



www.encharter.org

One need to define Energy Charter Treaty (legal instrument) and Energy Charter process (political framework for this process). The latter is a specialized forum for “advanced” discussion of the issues related to energy markets evolution that might create new risks for development of energy projects in ECT member-states, and is a platform for preparation, should ECT members decide so, of new legally binding instruments to diminish such risks within ECT member-states.

ECT presents a complex set of instruments of legal protection of investment¹³, it contribute to legal security of productive activities, and this promote investment in energy. That is especially true and important for large-scale energy projects in cross-border oil and

¹² Договор к Энергетической Хартии (справочная информация), 25.11.2005, from www.mid.ru/ / Международные отраслевые и межведомственные связи

¹³ The full text of the ECT and related documents is available at www.encharter.org.

gas infrastructure, which at once affect the interests of many countries. The fundamental objective of the ECT provisions on investment issues is to ensure the creation of a “level playing field” for energy sector investments throughout the Charter’s constituency, with the aim of reducing to a minimum the non-commercial risks associated with energy-sector investments.

Investment provisions of ECT are based on¹⁴:

- well-established practice of BITs (at the beginning of negotiations on ECT already about 400 BITs were in place),
- investment chapter XI of NAFTA (US, Canada, Mexico),
- some interaction with then proposed “Multilateral Agreement for Investment” (MAI, though aborted in 1998).

The Treaty thus carries the equivalent legal force of a unified network of BITs: within its 51 member-states ECT is equivalent to 1275 BITs which is equal to 50% of all the BITs concluded in the world since the first BIT was signed in 1959 (e.g. within almost 50-years period). It took almost 35 years to conclude first 1275 BITs (or amount equal to the equivalent legal force of the ECT). Slightly more than this amount (1471 BITs) were concluded during the whole decade of the 1990s. During the first half of the current decade half of this “ECT-equivalent” amount (639 BITs) was concluded. That means that ECT does not only “substitute” a substantial amounts of BITs that would have to be concluded, but save a lot of time that would have been needed for their negotiations and conclusions and as well provide the “level playing field” with the really common rules of the game, that would not have been provided in full by the network of BITs concluded within the decade period.

The ECT ensures the protection of foreign energy investments based on the principle of non-discrimination. It provide for most favoured nation treatment (MFN) and National Treatment for investors (whichever is more favourable):

- binding guarantee of non-discriminatory treatment for *post*-establishment phase,
- soft-law obligations for *pre*-establishment phase (stage of making investment).

ECT provide for protection against key political/regulatory risk: expropriation and nationalisation, breach of individual investment contracts, unjustified restrictions on transfer of funds. It is reinforced by access to binding international arbitration in case of dispute - state-to-state, and (novelty!) investor-to-state, in which latter case ECT provide for direct dispute settlement at investor’s choice at ICSID, UNCITRAL or ICC Stockholm. The awards of arbitration institutions would be final and enforceable under New York (1965) convention, thus serve as entitlement to payment (no risk of vicious circle for retaliating measures), retroactive to start of dispute, and may include interest (no incentive for defendant to delay dispute settlement process).

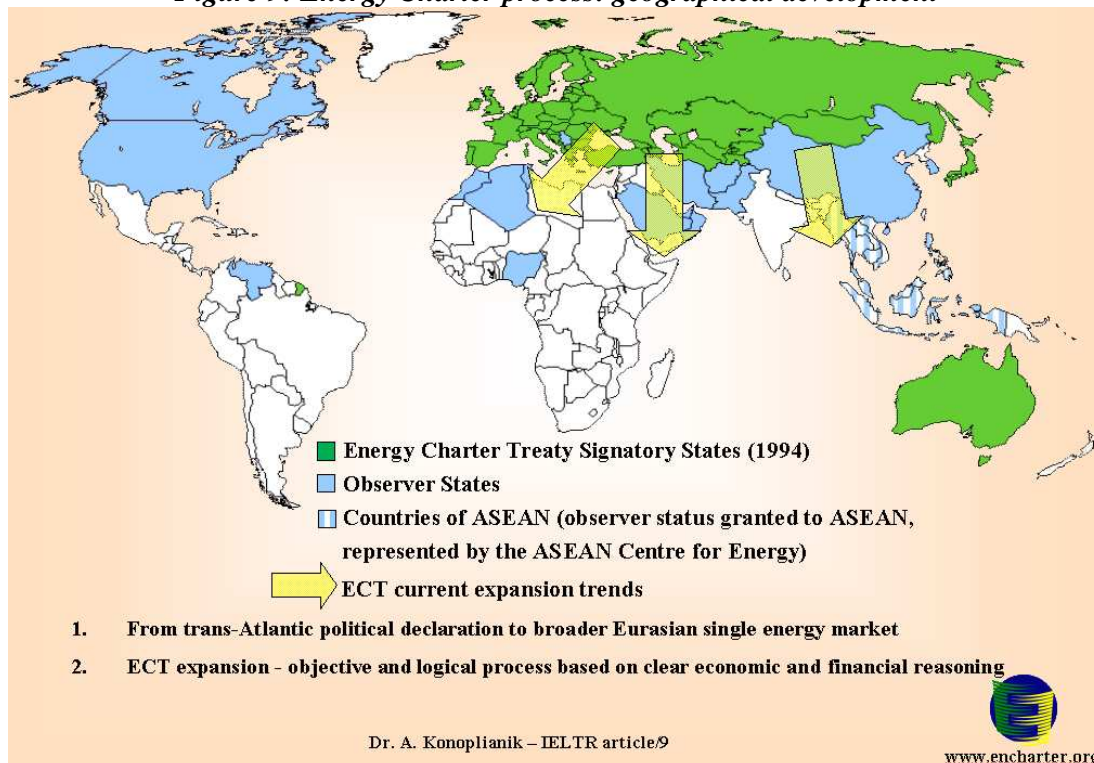
ECT – a common denominator

To date the ECT has been signed or acceded to by 51 states plus the European

¹⁴ More detailed description of the ECT can be read in the most recent publication: A.Konoplyanik, T.Waelde. Energy Charter Treaty and its Role in International Energy. – “*Journal of Energy and Natural Resources Law*”, November 2006, vol. 24, No 4, p. 523-558

Communities (the total number of members is therefore 52). Five states (Australia, Belarus, Iceland, Norway and Russia) has not yet ratified the Treaty, though Belarus and Russia apply ECT on a provisional basis. 19 states and 10 international organizations are Energy Charter observers (see Figure 9)¹⁵. After ECT came into force in 1998, geographical expansion of the Charter was dominated by its Asian dimension which reflect the current objectivities of the evolving Eurasian energy market: Mongolia became new ECT member in 1999, new ECT observers are China (2001), Republic of Korea and Iran (2002), Nigeria and ASEAN states as a single organization (2003), Pakistan (2005), Afghanistan (2006). At its meeting in November 2006, the Energy Charter Conference unanimously invited the Islamic Republic of Pakistan to become the 53rd member of the Energy Charter, opening the way to Pakistan to accede to the 1994 Energy Charter Treaty.

Figure 9: Energy Charter process: geographical development



As international energy investment and trade increases across Eurasia, the strategic value of the Charter framework will increase both for consumers and for producers seeking long-term access to the main international markets. Starting with political declaration for Trans-Atlantic Europe (in post-Helsinki-1975 OSCE terms), today Energy Charter process has been developing to cover evolving Eurasian energy market. Energy Charter represents objective and logical process based on clear economic and financial reasoning for its member-states. Our role - as an instrument of international law setting a reliable framework with effective dispute settlement procedures - is to protect long-term capital-intensive cross-border investment decisions.

Energy Charter (both in its political and legal dimensions) support and help to develop policies that remove barriers to the flow of international energy investment and promote

¹⁵ For more details see latest Energy Charter “Annual Report 2006” at www.encharter.org.

fair access to the markets. This became more and more relevant, inter alia, for Russian companies, which have passed through the difficult and not always straightforward period of their formation and strengthening and now are more actively cope with international markets and thus demand for legal protection, including from unfair competition and subjective barriers raised in front of them. Indeed, to implement ECT instruments in order to protect domestic investors abroad, their mother state need not only to sign, but to ratify ECT as well.

ECT and its instruments provide a legal framework for investments, reducing risk by lowering technical and financing costs and maximizing the economic potential of projects. And energy projects, through their direct and multiplier effects, bring economic development into corresponding areas and add to economic growth – which is especially important for developing nations and economies in transition.

Energy Charter unites both energy producers, consumers and transit states representing developed, developing and transition economies. Moreover, Energy Charter political declaration (the so-called “European Energy Charter”) is the only document establishing common approaches to providing energy security that was signed (in December 1991) by all member-states of the G-8. So common denominator to promote international energy security was established already 15 years ago – and we are glad that at July’s 2006 Summit G-8 member-states has reconfirmed their support to Energy Charter principles.

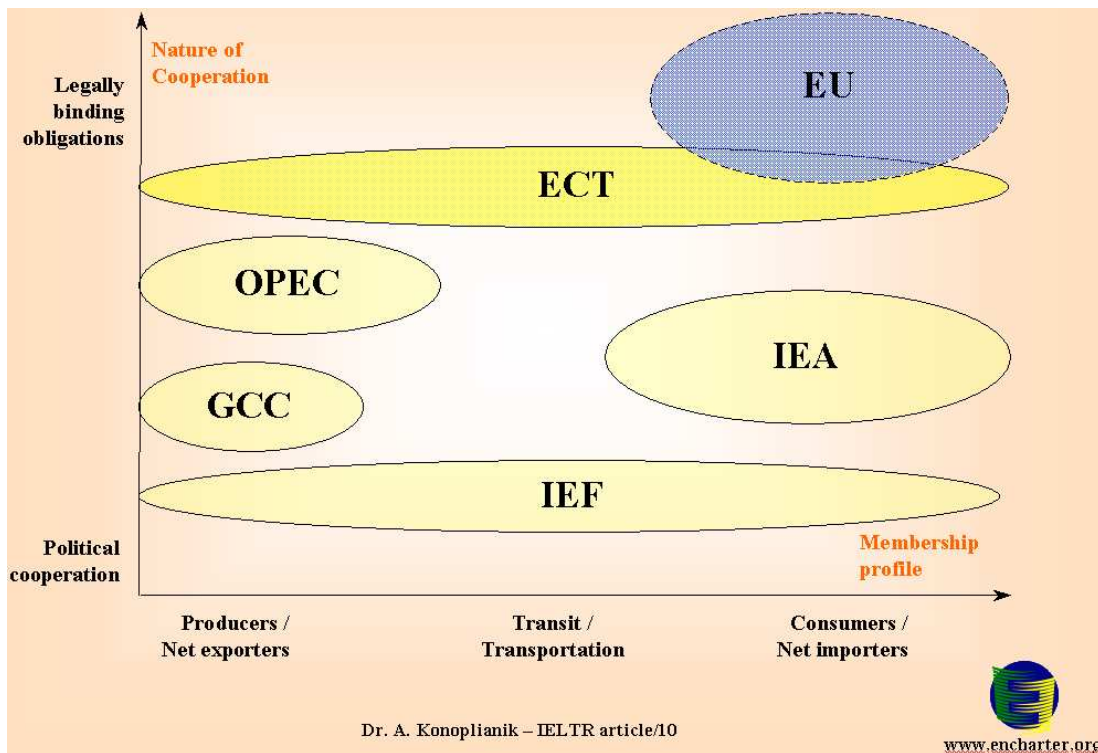
Moreover, the G-8 Summit went even further in implementing within its documents the ECT principles, though without direct mentioning ECT as such. If one would undertake a comparative reading of both ECT and G-8 documents he will see with evidence that G-8 Action Plan and Chairman’s Statement, Final Document of G8 Summit, not only refer to the spirit of the Charter, but also use the same approaches and even same wording, as in the Energy Charter Treaty, on a number of key institutional issues such as development of open and competitive energy markets, investment protection, energy efficiency, transparency, etc.

On the way to international consensus

Finding an international consensus on issues of energy is not always an easy task, especially when the objective is to conclude a binding instrument of international law. And the task became much more difficult when this binding instrument need to be a multilateral one. The Energy Charter Treaty is therefore a unique achievement in international cooperation. And if it will not exist today – it need to be invented. Indeed, it looks that nowadays it would have been much more difficult to bring ECT to signature.

But Energy Charter is not the only one energy-related multilateral international organization in the current world (see Figure 10). These organizations present different composition of energy producers, consumers and transit states, energy exporters and importers, some of them are more policy-oriented, others have more legally-binding character. However, none is comparable with the Energy Charter in terms of legally binding nature of its provisions.

Figure 10: Some energy-related international organisations

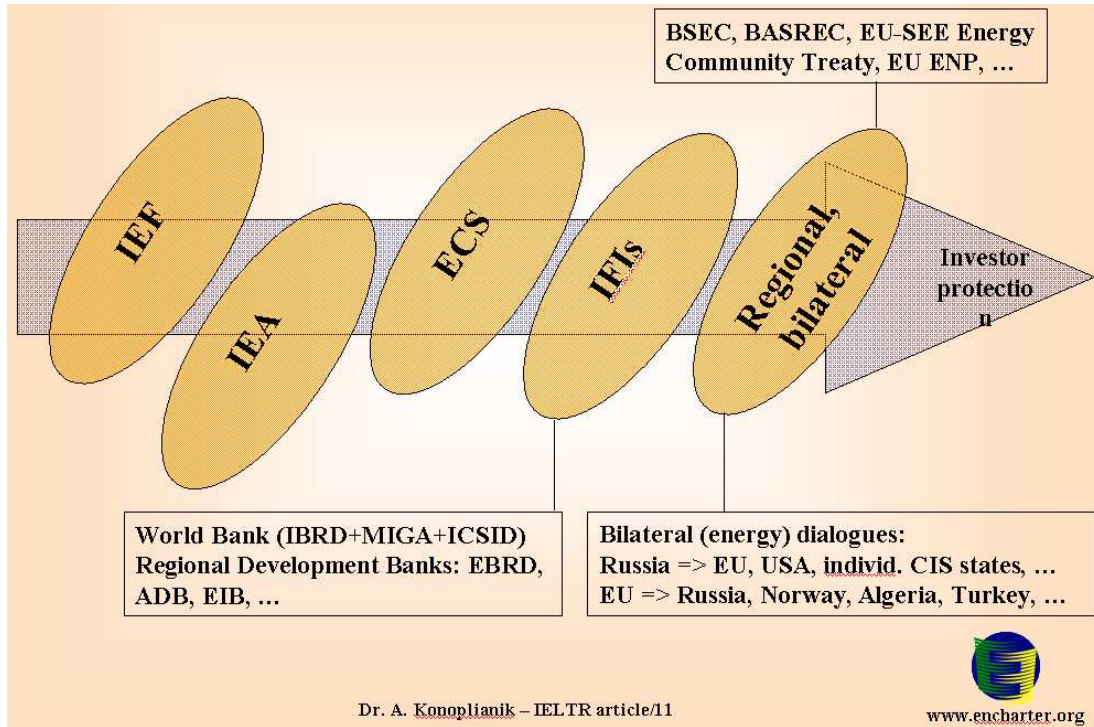


In the sphere of *investment protection*, the Energy Charter process forms part of a chain of energy-related international organizations, whose activities are mutually complimentary and which can and already collaborate to improve international energy security (see Figure 11):

- **International Energy Forum** – the logical starting point in this chain - provides the Energy Ministers of both energy-producing and consuming states with twice-a-year opportunity to outline their long-term vision of national and international energy developments and prospects;
- **International Energy Agency** – the second element in this chain - most effectively quantifies those visions in terms of global energy demand and supply projections and since 2003 – also of investments needed to implement these projections;
- **Energy Charter** – the third element in this chain – provides a forum for discussion on common approaches within its multilateral community to risks linked to/generated by the future developments in energy markets. Energy Charter creates corresponding multilateral legal instruments that will mitigate risks related to international energy investments (as quantified by IEA and/or by member-states), ultimately promoting cross-border energy flows within Eurasia;
- **International financial institutions** (the World Bank and regional development banks such as EBRD, ADB) – the fourth element in the chain – assist in attracting private capital to finance capital-intensive energy projects in the economies in transition and Greenfield areas;

- **Bilateral** organizations (including “energy dialogues”, such as Russia-EU, Russia-USA) and organizations for **regional** economic cooperation (such as BSEC or BASREC) provide additional support, including political and financial support, to the projects of mutual interest to their members.

Figure 11: Complimentarity of energy-related international organizations (in protecting energy investments)



A structured approach to the international energy cooperation along these lines, reducing international energy-related investment risks, would create positive multiplier effects for all the states within the energy value chain. Without international energy cooperation it is not possible to improve international energy security.