Regional Energy Cooperation and the Energy Charter Process: 
the increasing role of Russia, gas and transit issues

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Promoting Regional Cooperation
The diagram illustrates the evolution of gas markets development over time. It is divided into three phases: initial growth, intensive growth, and mature market. Key developments include:

1. Initial Growth: China, Thailand, India etc. (LNG)
2. Intensive Growth: Russia, Middle & Far East, Latin America, Africa, rest of CIS
3. Mature Market: Japan (LNG), USA, Continental Europe, Gas price

The diagram also highlights long-term contracts and short-term contracts, with spot deals. Pricing mechanism development stages:

1. Cost increase
2. Escalation formulas (based on alternative fuels prices)
3. Based on futures prices

Figure 1
By 2020:

- Demand up 200-300 BCM/yr
- Imports up 250-350 BCM/yr
- New investments 250-300 billion $
RUSSIAN GAS IN EUROPE

(a) Share of Russia in gas consumption:
- All Europe >25%
- Central & Eastern Europe 40%
- Eastern Europe >90%

(b) European importers of Russian gas
- Austria
- Belarus
- Bulgaria
- Bosnia
- Hungary
- Germany
- Greece
- Italy
- Latvia
- Lithuania
- Macedonia
- Moldova
- Poland
- Romania
- Slovakia
- Slovenia
- Turkey
- Ukraine
- Finland
- France
- Croatia
- Czech Republic
- Switzerland
- Estonia
- Yugoslavia

(c) Gazprom sales in Europe

Source: OAO Gazprom
Figure 3

Total: 25
LONG-TERM CONTRACTS AND COMPETITION IN GAS MARKETS IN EUROPE

(A) Existing organisation of the market

Gas (monopoly) producers

- LTC “take and/or pay”

Gas monopsony + network

- Regulated prices based on pipeline transmission capacity

Monopoly customers without switching

Supply-based consumer prices defined by monopoly producers and suppliers (pricing mechanism: cost-plus; escalation formulas)

(B) Future organisation of the market

Competing gas producers

- Spot market

Competing supply companies

- Network

Customers with switching

Demand-based producer prices defined by consumers (pricing mechanism: spot + forward + futures)

Based on: D.Helm / OXERA

Figure 4

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GAS: DIFFERENT PROJECTS – DIFFERENT CONTRACTS

(1) New projects in mature regions with existing infrastructure, with available transportation capacities (usually less capital-intensive projects, relatively small to the existing market) =
(a) short-term contracts ("take and/or pay") – for the duration of payback period (?)
(b) spot deals – when payback period is over (?):
   - dated
   - forward
   - futures
Regions: Western, Central & Eastern Europe

(2) New projects in new regions with no/lack-of infrastructure for both production and transportation (usually more capital-intensive projects, relatively big to the existing market) =
(a) long-term "take and/or pay" contracts
Regions: Russia, CIS, Asia
GAS: LONG-TERM TAKE AND/OR PAY CONTRACTS (LTC TOP) AND PROJECT FINANCING RISKS

Financing = f (revenue) = f (volume x price)

(1) LTC TOP = mechanism of supply risks («volume» risks) reduction

(2) LTC TOP + adequate pricing mechanism = mechanism of “price” risks reduction:
- prior to exchange pricing: escalation formulas
- exchange pricing: futures + hedging

(1) + (2) = mechanism of project financing risks reduction (long-term capital-intensive Greenfield projects, i.e. in new regions with no/lack-of production & transportation infrastructure)

LTC TOP as a mechanism of risks reduction related to investments into new (Greenfield) gas projects yet has no alternatives at the emerging energy markets

Figure 6
LONG-TERM CONTRACTS

Item 22: “Long-term contracts will continue to be an important part of the gas supply of Member States and should be maintained as an option for gas supply undertakings in so far as they do not undermine the objectives of this Directive and are compatible with the Treaty, including competition rules.”

Source:
Amended proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
amending Directives 96/92/EC and 98/30/EC concerning rules for the internal markets in electricity and natural gas
# GAS TRANSIT ROLE FOR MAIN EXPORTERS TO EUROPE IN 1999

<table>
<thead>
<tr>
<th>Country-exporter</th>
<th>Direct supplies, % of volume of exports</th>
<th>Transit through the territory of: % of volume of exports</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>one country</td>
</tr>
<tr>
<td>Netherlands</td>
<td>76,2</td>
<td>13,8</td>
</tr>
<tr>
<td>Norway</td>
<td>67,7</td>
<td>7,5</td>
</tr>
<tr>
<td>Algeria</td>
<td>44,9</td>
<td>14,8</td>
</tr>
<tr>
<td>Russia</td>
<td>5,4</td>
<td>-</td>
</tr>
</tbody>
</table>

*Figure 8*
DEVELOPMENT OF ENERGY MARKETS AND MECHANISMS FOR INVESTORS PROTECTION / STIMULATION

Energy Markets
- Local
- Internationalisation
- Regional
- Globalisation
- World markets of certain energy resources
- World energy market

Mechanisms for investors protection / stimulation
- Stability zones in unstable environment
- Increasing of general level of investment attractiveness
- Domestic legislation
- Tax Code, investment and subsoil legislation
- International legal mechanisms
- BITs, BDTTs
- Bilateral
- Multilateral
- Trade
- Investments
- Transit
- Dispute settlement
- WTO
- TRIMs
- ECT

Figure 9

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Observer States that have signed the European Energy Charter (1991)
Other Observer States
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 25, 1990</td>
<td>Lubbers’ initiative presented in Dublin</td>
</tr>
<tr>
<td>December 17, 1991</td>
<td>European Energy Charter signed</td>
</tr>
<tr>
<td>December 17, 1994</td>
<td>Energy Charter Treaty (ECT) and Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) signed</td>
</tr>
<tr>
<td>June, 1996</td>
<td>Russia started ECT ratification process</td>
</tr>
<tr>
<td>April, 1998</td>
<td>ECT came into full legal power</td>
</tr>
<tr>
<td>January, 2001</td>
<td>RF State Duma: Russia will ratify ECT, but not yet</td>
</tr>
<tr>
<td></td>
<td>(depending on Transit Protocol)</td>
</tr>
<tr>
<td>As of September 1, 2002</td>
<td>• ECT signed by 51 states + European Communities = 52</td>
</tr>
<tr>
<td></td>
<td>ECT Contracting Parties</td>
</tr>
<tr>
<td></td>
<td>• ECT ratified by 46 states (excl. 5 countries: Russia, Belarus,</td>
</tr>
<tr>
<td></td>
<td>Iceland, Australia, Norway ) + EC</td>
</tr>
<tr>
<td></td>
<td>• Russia: provisional application, together with Belarus</td>
</tr>
</tbody>
</table>
ENERGY CHARTER AND RELATED DOCUMENTS

Political Declaration
EUROPEAN ENERGY CHARTER

Legally Binding Documents

ENERGY CHARTER TREATY
TRADE AMMENDMENT
INVESTMENT SUPPLEMENTARY TREATY

Energy Efficiency Protocol
Energy Transit Protocol

Figure 12
CORRELATION BETWEEN GEOGRAPHICAL SCOPE AND ACTIVITY TARGET OF ECT AND WTO

**ECT:**
- 51 countries (+EC) signed the ECT, including 46 countries (+EC) which ratified the ECT (as for 1.09.2002)

**WTO:**
- 144 member-countries plus 32 observer-states

«Trade» chapter of ECT:
- WTO rules for WTO members, WTO rules by reference for non-WTO countries

Trade in goods and services – “most favourable nation” treatment (MFN)

Energy:
- goods & services (Energy Materials and Products), investments, trade, transit – “national” treatment (NT) or “most favourable nation” treatment (MFN), whichever is the most favourable

Figure 13

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MOST RECENT PUBLICATIONS ON ECT:
OUTSTANDING ISSUES RELATED TO TRANSIT OF ENERGY

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Available capacity</strong></td>
<td>Solved in substance</td>
</tr>
<tr>
<td><strong>2. Environment</strong></td>
<td></td>
</tr>
<tr>
<td><strong>3. Geographical scope</strong></td>
<td></td>
</tr>
<tr>
<td><strong>4. Conciliation of transit disputes</strong></td>
<td></td>
</tr>
<tr>
<td><strong>5. Transit tariffs</strong></td>
<td>Russia – EU trade-off is possible</td>
</tr>
<tr>
<td><strong>6. Right of first refusal</strong></td>
<td></td>
</tr>
<tr>
<td><strong>7. REIO clause</strong></td>
<td>Major unsolved issue. Subject for bilateral consultations, in particular Russia – EU</td>
</tr>
</tbody>
</table>

Negotiations on Transit Protocol: under way since 2000, to be finished (successfully or not) at December 2002 Energy Charter Conference
TRANSIT TARIFFS

- Total physical operating pipeline capacity
- Demand for the capacity
- Investments
- Available capacity is less than demand for the capacity
- Increase in capacity
- Excessive Profits?
- Reasonable profits
- OPEX
- CAPEX

Figure 16
Figure 17

TRANSLIT TARIFFS (continued)

Time

Available capacity is less then demand for the capacity

Commercial negotiations or auction

Total physical operating pipeline capacity

Demand for the capacity

Investments

Increase in capacity

Excessive Profits?

Reasonable profits

OPEX

CAPEX

Investments

Increase in capacity

Excessive Profits?

Reasonable profits

OPEX

CAPEX

Commercial negotiations or auction
Figure 18

TRANSLATION TARIFFS (continued)

- Excessive Profits?
- Reasonable profits

Commercial negotiations or auction

No need in auction

Available capacity is less than demand for the capacity

Demand for the capacity

Influence of pipeline operating capacity

Increase in capacity

Influence of commercial negotiations or auction

Increase in capacity

Time
TRANSIT TARIFFS AND AUCTIONS:
“EXCESSIVE PROFITS RECYCLING” MACHINERY

Deficit of pipeline capacity

Auctions for access to pipeline

Transit tariffs with excessive profits

Further increase in demand for pipeline capacities

Further increase in oil and gas production

Regulatory or negotiatory access to pipeline

No need in auctions

No pipeline capacity deficit

Transit tariff consists of 2 elements:
(1) payment for transportation services;
(2) if deficit of pipeline capacities – payment for access to the pipe (TPA)

Excessive profits are obligatory to be invested into pipeline capacity increase

Increased pipeline capacity

Key element of the “excessive profits recycling” machinery

Figure 19

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RIGHT OF FIRST REFUSAL

Currently

- USSR - Germany (Russia – Germany)
  - Gas Sales Agreement
  - Quantity
    - 1991

Russia - Ukraine
  - Transit Agreement(s)
  - Pipeline capacity
    - 1991

In the future

- Russia - Germany
  - Gas Sales Agreements
  - Quantity
    - Time
      - 2020

Russia - Ukraine
  - Transit Agreements
  - Pipeline capacity
    - 2020

Figure 20
REIO CLAUSE: GEOGRAPHICAL SCOPE (EC - 15)
REIO CLAUSE: GEOGRAPHICAL SCOPE (EC - 30)
REIO CLAUSE: GEOGRAPHICAL ASPECTS

Figure 23
**REIO CLAUSE: LEGAL ASPECTS**

(a) Before REIO:
- Either transportation in accordance with domestic legislation and with the ECT and/or the Transit Protocol.

(b) After REIO:
- Either transportation in accordance with domestic legislation and with the ECT and/or the Transit Protocol.

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**Figure 24**

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EVOLUTION OF GAS MARKETS DEVELOPMENT – 2
(With whom is Mr Putin?)

Pricing mechanism development stages:
1. cost +
2. escalation formulas (based on alternative fuels prices)
3. based on futures prices
ECT & LEGISLATIVE PRIORITIES OF PRESIDENT PUTIN

3 legislative priorities of President Putin for 2002
(Message to the Federal Assembly)

Privatisation of farmland

Reform of natural monopolies

Accession to WTO

ECT

Reform of gas industry to be discussed by the RF Government in Dec.2002

ECT = legal background for electricity and natural gas industry reform

WTO rules = integral part of the ECT (trade section)

To take place before 2004?