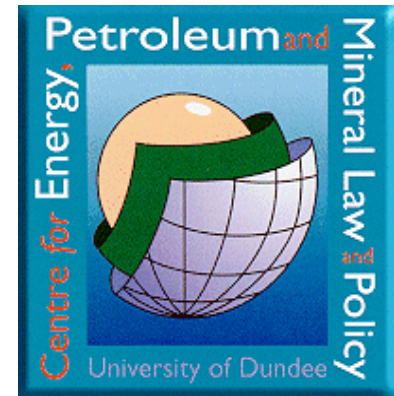


Cross-Border Energy Investment Issues... and Energy Transit

Stephen Dow

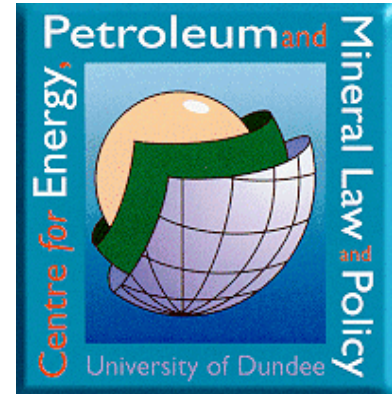
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Mineral Law and Policy

Context



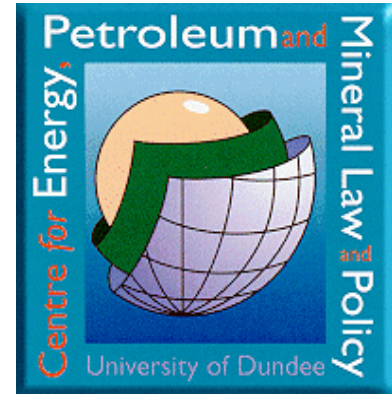
- Main focus on gas; oil issues similar
- Assumption is that more gas is needed
- Consequent need for new gas fields
- Consequent need for more pipeline capacity
- Investment mostly by private companies
- Transit is regulated / controlled by governments

Investment in New Fields



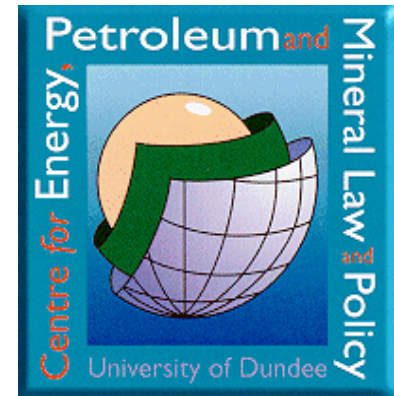
- Traditional gas model breaking down
- Traditional model based on long term contracts backed through from field to wholesale supplier
- High take or pay levels and (relatively) rigid price formula guarantees market for producers – and guarantees income
- Problem – model not readily compatible with liberalised supply markets
- Oil spot market more established than gas

Traditional Model is Breaking Down



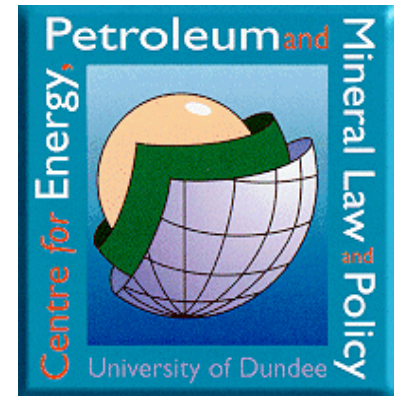
- European buyers have a problem as consumption market is becoming more liberalised
- Wholesale suppliers in competition
- Reluctance to commit to long term contract with producer – can't guarantee consumers
- European Commission not completely convinced long term contracts are compatible with (competitive) single market
- Traditional comforts for investors no longer reliable

Problem for Producer



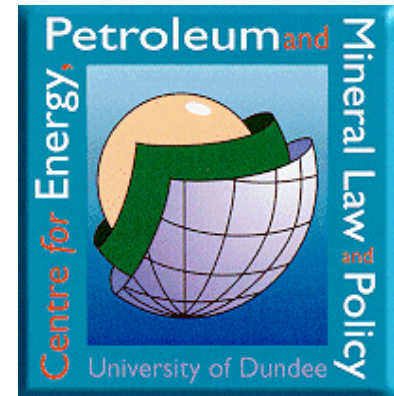
- Liberalisation of the consumption market is pushing the volume risk towards producer
- Producer (and lender!!) not happy – and difficult for him to manage gas volume risk
- Vertical integration becomes tempting as a way to help manage risk
- Does producer want to be a supplier?
- Gazprom...

Encouraging investment



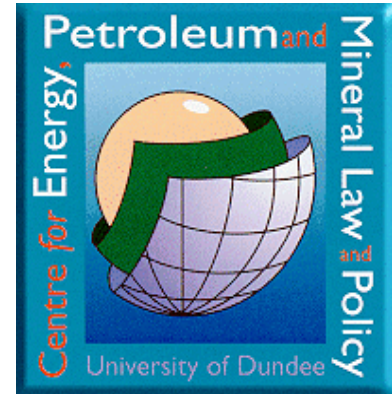
- Various measures try to encourage investment
- General measures which just happen to be relevant to energy (!)
- Key in energy is to follow links (contracts) from producer to consumer
- Traditional problem for gas is the position of the pipeline monopolist

Pipeline monopoly



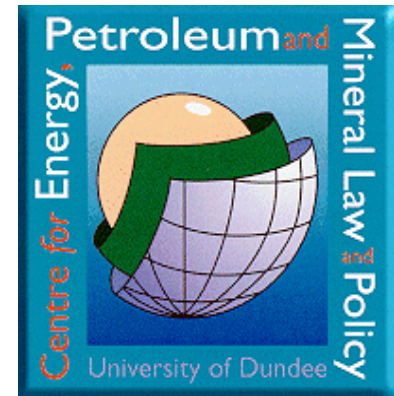
- National (and nationalised) gas systems do not have a problem with pipe monopoly
- The history of gas systems starts with national systems
- Cross-border gas is relatively recent
- Liberalisation gets round pipe monopoly by breaking (controlling?) link between pipe and supply
- Pipe can abuse position to appropriate rent; or deny new producers access to existing markets

Cross-Border issues and liberalisation



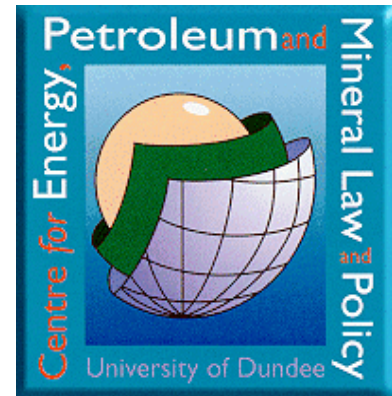
- Liberalisation is an issue for individual jurisdictions – there is a conceptual disconnection with cross-border issues
- Europe cannot insist on Russian liberalisation of either transit or production
- Investment measures indirectly support (domestic) liberalisation schemes
- Investment measures designed to address market risks associated with liberalisation

Energy Charter Treaty



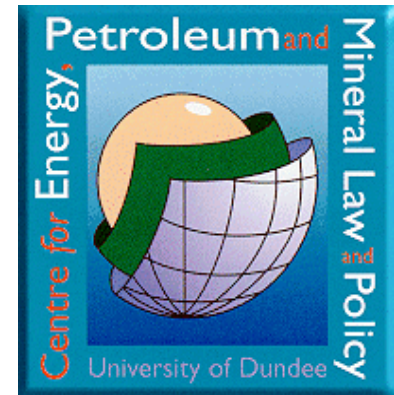
- Brilliantly simple concept, but has found practical limitations
- Remember access to pipelines is a different issue from third country consent to pipeline construction
- ECT attempts to create an international access regime
- Limitation for Russia-Europe gas is membership, ratification... currently cannot get started
- Transit article an early attempt to internationalise the problems of cross-border pipes

World Trade Organisation



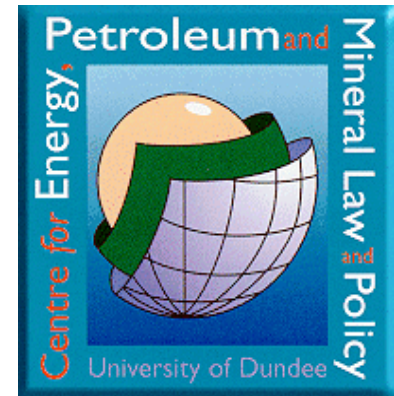
- Is there a right of access to pipelines in terms of trade law?
- UNCLOS Art 125 provides for third party access to means of transport
- Art 124 however excludes pipelines from definition of means of transport
- Tends to make application of GATT art V problematic in extreme

WTO in gas



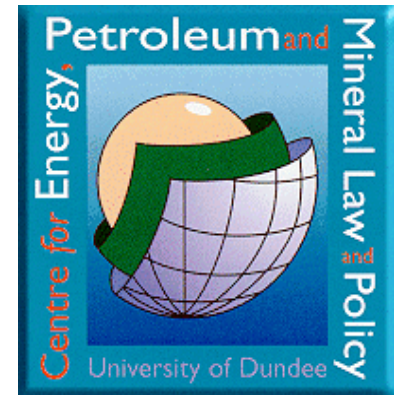
- Fundamental problem... Russia is not a member of WTO (yet?)
- Fundamental problem – trade law only applies to states (state trading enterprises) not private entities
- It is not a settled issue that Gazprom as pipeline owner would qualify as a state trading enterprise
- And even if everything else is in place, Art V currently does not cover pipelines

Future trade law



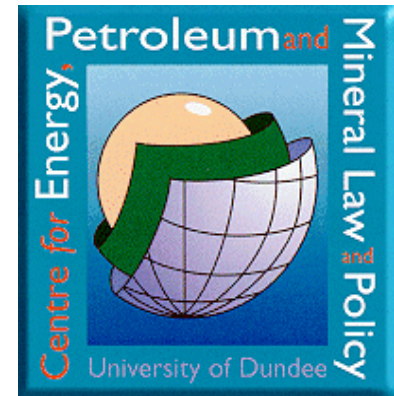
- General WTO mechanism is an exceptionally powerful influence on states
- Modifications necessary to bring pipelines within jurisdiction
- Alternatively, creation of international competition law would provide a mechanism to use against monopoly abuse

Russia – Ukraine fallout



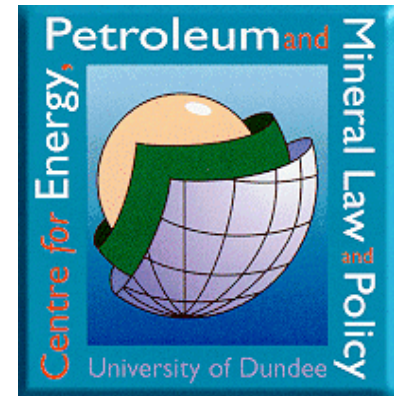
- Investment climate has changed after disruption in supplies to Ukraine
- Not an isolated incident - long history of disputes over payment; difference this time is EU noticed
- Allegations of theft of gas (inviting treatment as a local issue); nonpayment; price differences
- Problem now for Russia is that European buyers are increasingly concerned about security of supply – never previously a serious concern

Trade and the deal



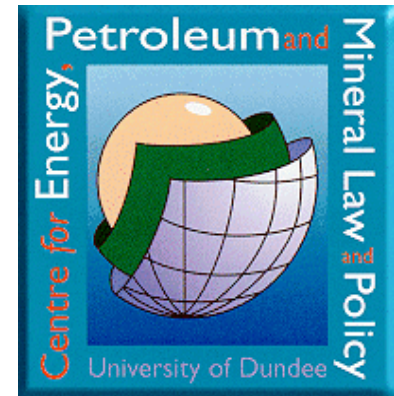
- “Temporary” deal to end the dispute
- Underlying issue will come back again
- Price in Ukraine lower than European prices
- Hangover from arrangements in FSU
- Deal requires a gas swap with alternate producer
- Only works if Gazprom can control allocation of volumes via its control of the pipelines
- Alternate producer being denied access to market

Security of Supply



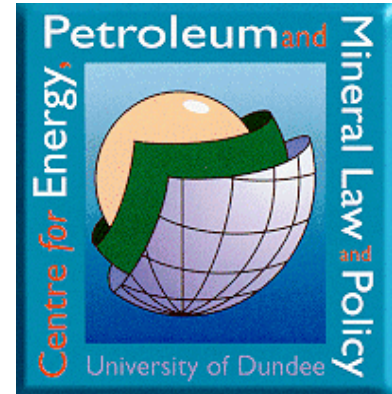
- Views on security of supply evolving
- Formerly based on domestic production and control of that production
- Cross-border gas now an important part of consumption pattern in Europe
- Infant spot markets tend not to provide high levels of security of supply
- Sales contracts are dependent on transit contracts (and transit rights)

Cross-Border issues



- There is a disconnection between traditional demands of investors and the needs of a competitive market
- Access etc can always be agreed – key point is effectively Russian government consent (Gazprom agreement)
- Non-standardised / unpredictable / unique agreements not really good enough for investors in long term
- No present over-reaching legal framework to build investor confidence in gas industries
- No current over-reaching legal mechanisms to control potential abuses by pipeline monopolists
- Key question – why would Gazprom give up pipe control?

Conclusions



- Three elements to future gas investment
- Production capacity
 - Future long term sales contracts?
- Transit capacity
 - Future rights under ECT, WTO or competition law?
- Confidence in security of supply
 - Reliability of spot markets
 - Enforcement of transit rights