INVESTING IN AND FINANCING THE HYDROCARBON SECTOR TO ENHANCE GLOBAL ENERGY SECURITY: ENERGY CHARTER TREATY AND RISK MITIGATION

Dr. Andrei Konoplyanik
Deputy Secretary General, Energy Charter Secretariat

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- Towards more risky energy markets?
- Towards more project financing?
- Competition/liberalization vs. investment
- ECT as risk-mitigating instrument of international law

TOWARDS MORE RISKY ENERGY MARKETS ?

- Energy markets:
  - from ***in***dependent to ***inter***dependent & complimentary
  - from monopolistic/monopsonic towards competitive
  - to more liquid (trade, short-term) - which not necessary means more competitive (resource vs. markets asymmetry, few import supply sources, long-term) & secure (investment, long-term)
  - to more cross-border energy trade & investment
- Diversification (multi-dimensional) in energy economy:
  - energy mix, suppliers, routes, markets, contractual & business (corporate) structures, pricing mechanisms
- Energy pricing:
  - cost-plus (fixed prices, negotiated levels) => replacement values (flexible prices, formula-based, negotiated formulas) => exchange-based pricing (flexible prices, based on perceptions of two groups of players with opposite interests: hedgers & speculators with increasing role of speculators)
- Price behaviour:
  - increasing volatility, more transparent – less predictable
  - liquid markets not necessarily lead to price decrease (e.g. oil)

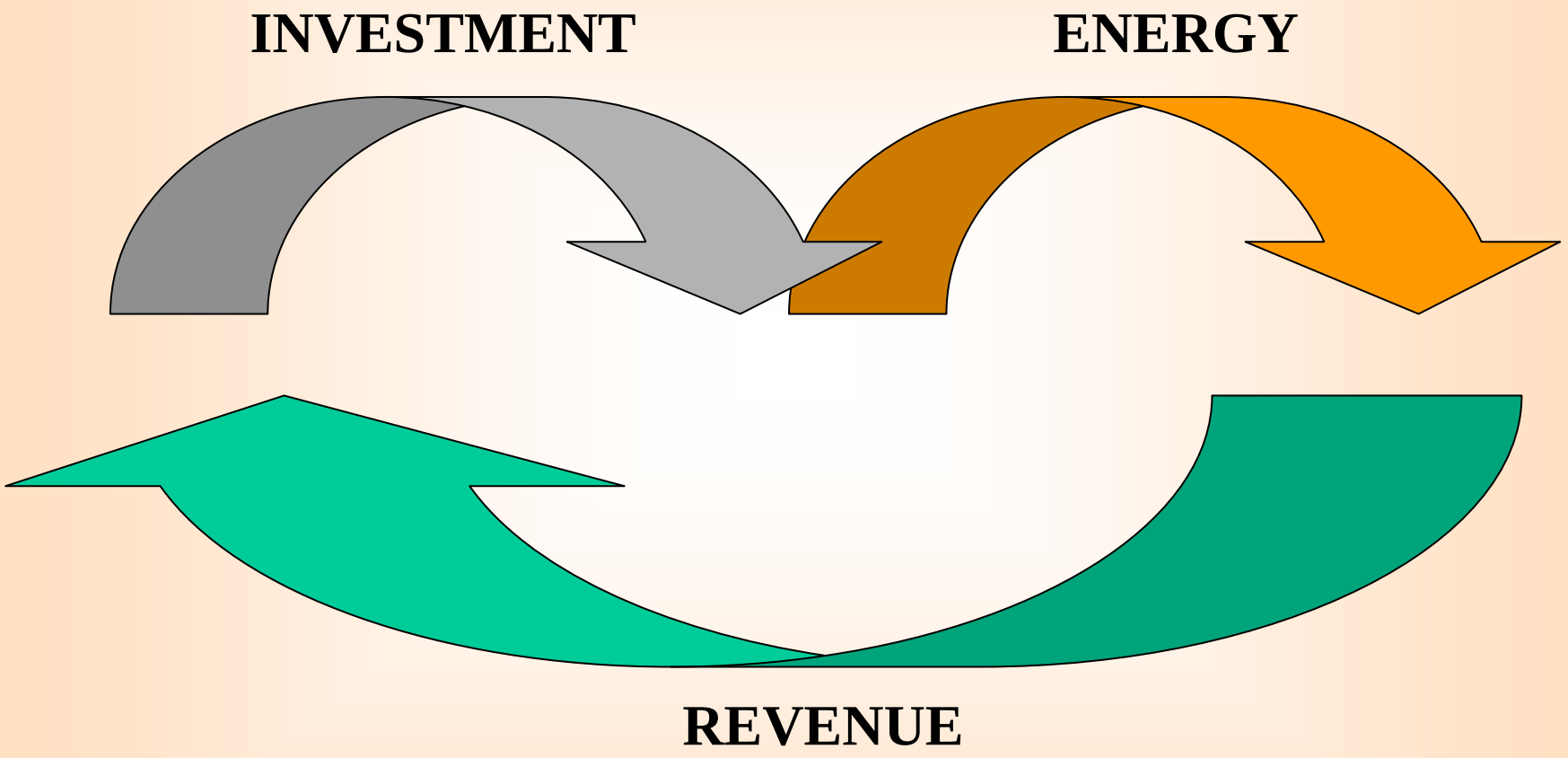
ENERGY ECONOMY: DEMAND FOR QUALITY OF REGULATORY FRAMEWORK

Energy/hydrocarbon projects (compared to other industries):

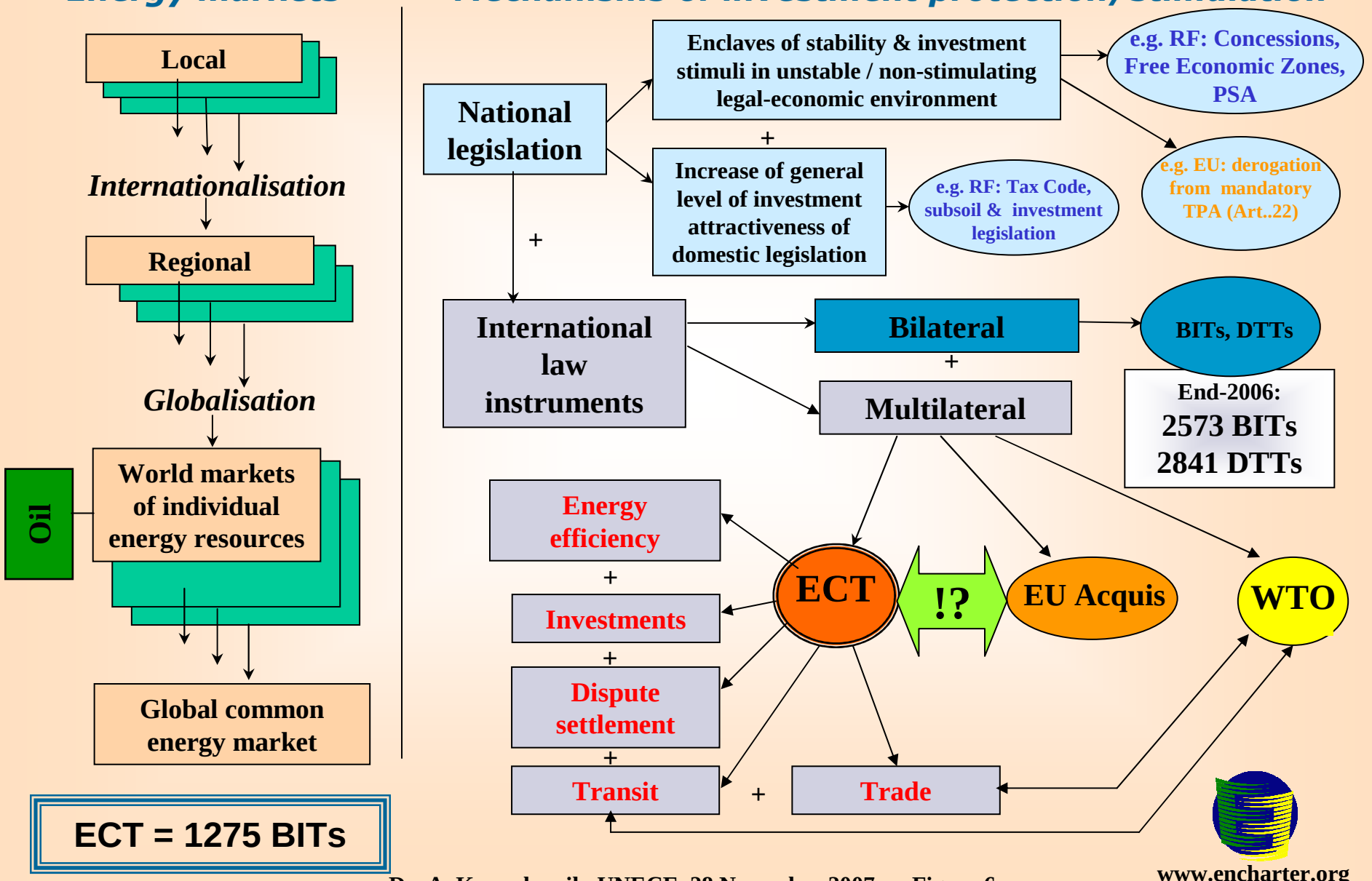
- **Highest capital intensity (absolute & unit CAPEX per project),**
- **Longest project life-cycles & pay-back periods,**
- **Geology risks + immobile infrastructure,**
- **Cross-border flows + immobile infrastructure,**
- **Worsening natural conditions of resources to be developed,**
- **Highest demand for legal & tax stability,**
- **Role of risk management**

=> Higher/highest demand for "quality" of legal and regulatory framework compared to other industries - to diminish energy projects risks

ECONOMIC “CIRCLE OF LIFE” OF ENERGY PROJECTS



DEVELOPMENT OF INTERNATIONAL ENERGY MARKETS & OF MECHANISMS OF INVESTMENT PROTECTION/STIMULATION



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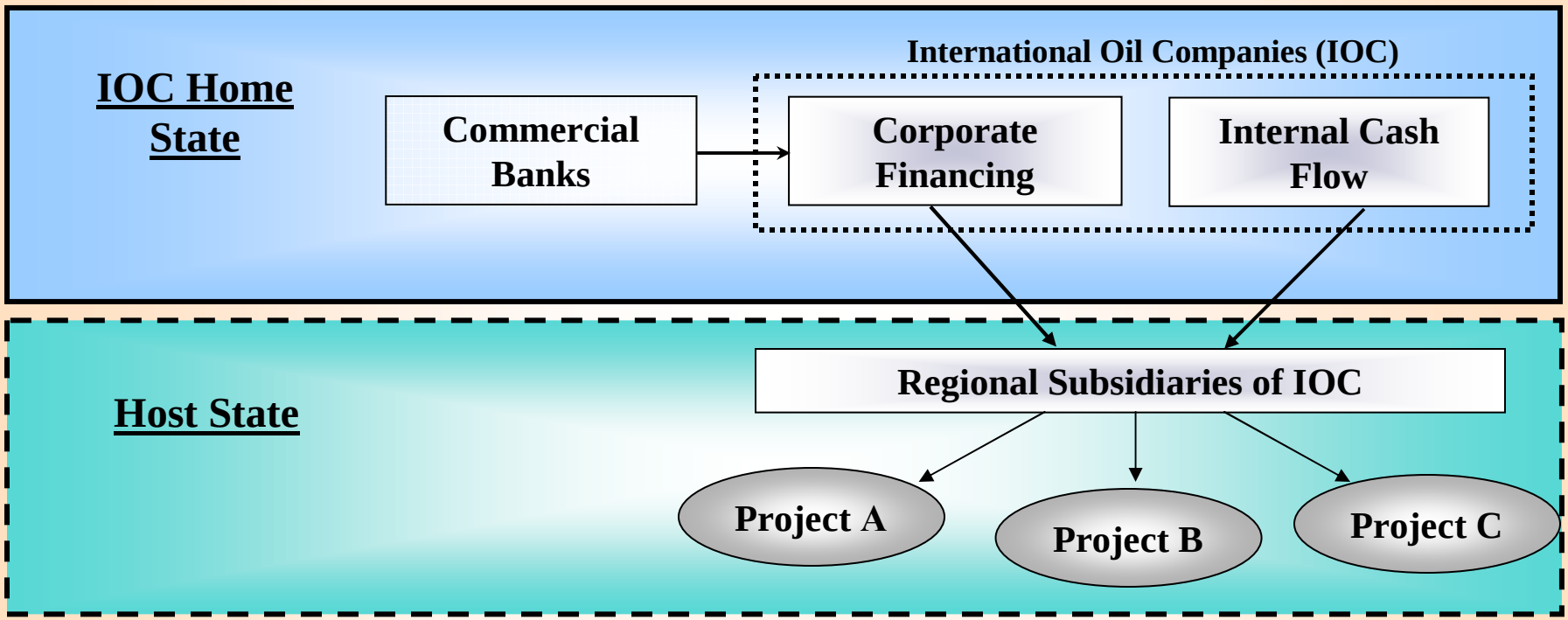
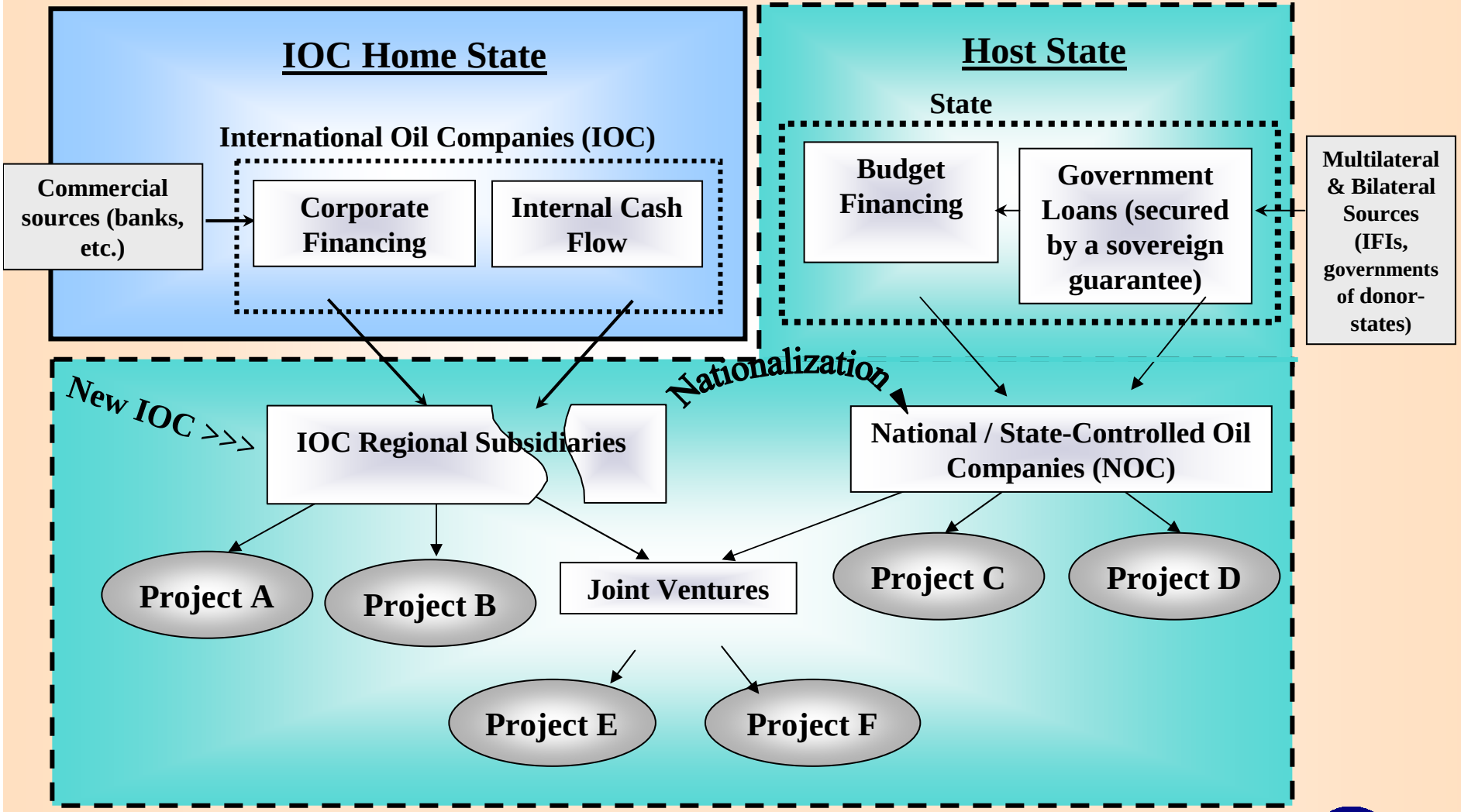
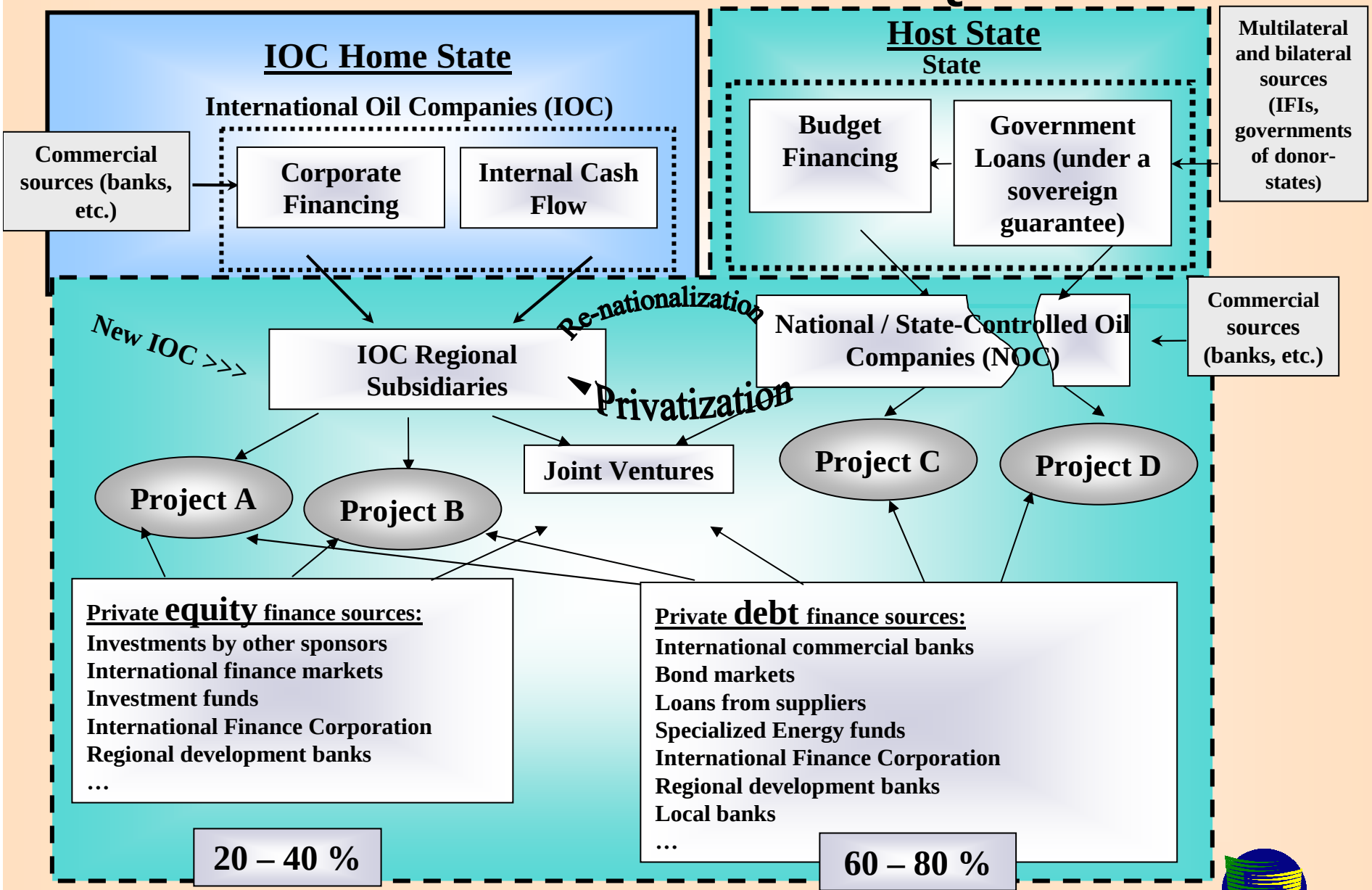
FINANCING HYDROCARBON PROJECTS BEFORE THE 1970's



FINANCING HYDROCARBON PROJECTS OVER 1970-1980



FINANCING HYDROCARBON PROJECTS DURING THE 1990's & OVER SUBSEQUENT YEARS



FINANCING ENERGY PROJECTS: FROM EQUITY TO DEBT FINANCING

Equity/debt financing ratio:

Pre-1970's = ~ 100 / ~ 0

Nowadays = ~ 20-40 / ~ 60-80,

f.i. most recent:

BTC pipeline = 30 / 70

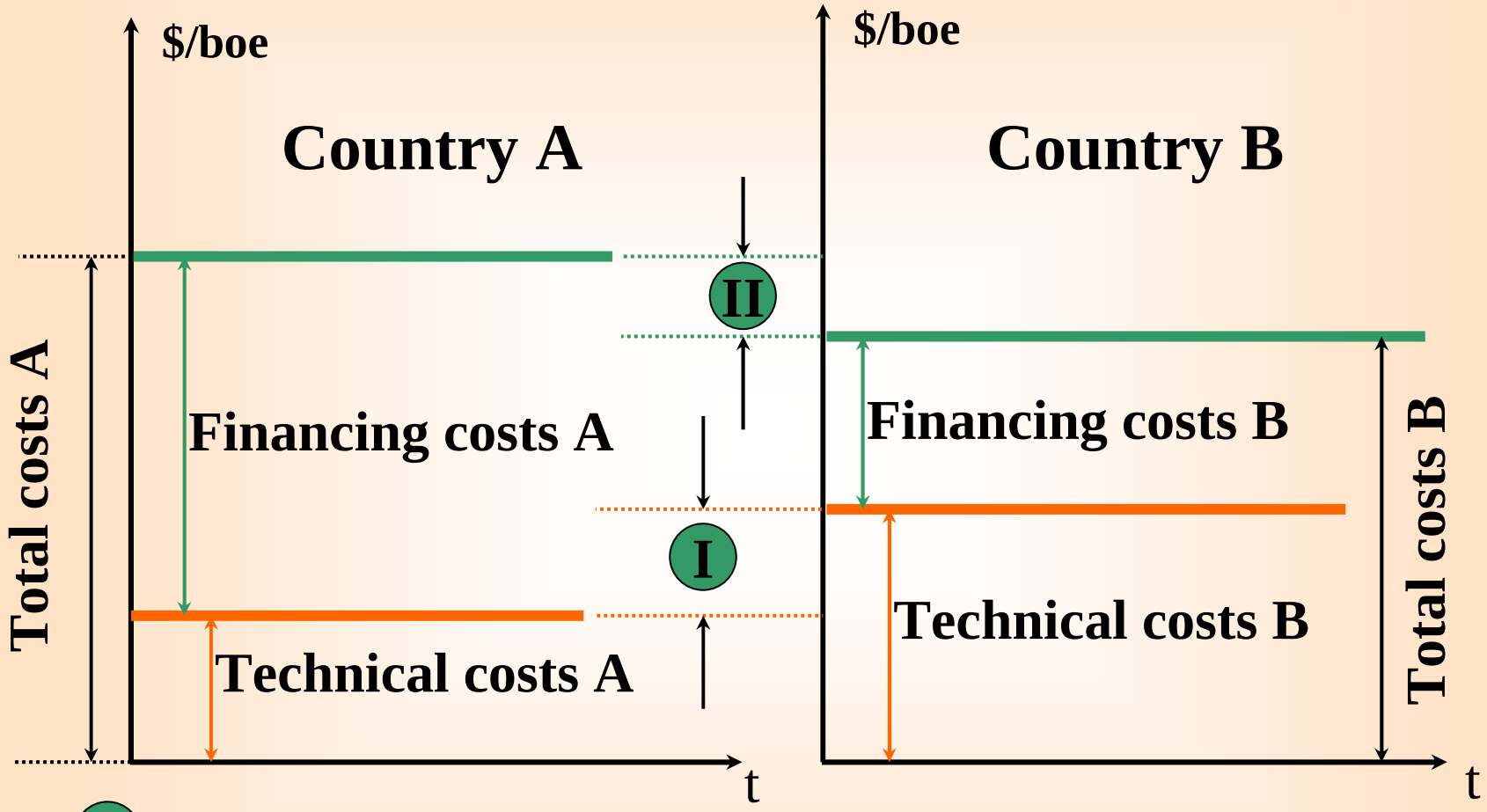
Sakhalin-2 (PSA) = 20 / 80

(2 fields+pipeline+LNG plant)

➔ Increased role of financial costs (cost of financing) of the energy projects

➔Availability and cost of raising capital = one of major factors of competitiveness with growing importance in time (bankability/financiability of energy projects)

"NATURAL" VS. FINAL COMPETITIVE ADVANTAGES OF ENERGY PROJECTS



I "Natural advantage" of country A over country B

II Final competitive *dis*advantage of country A over country B

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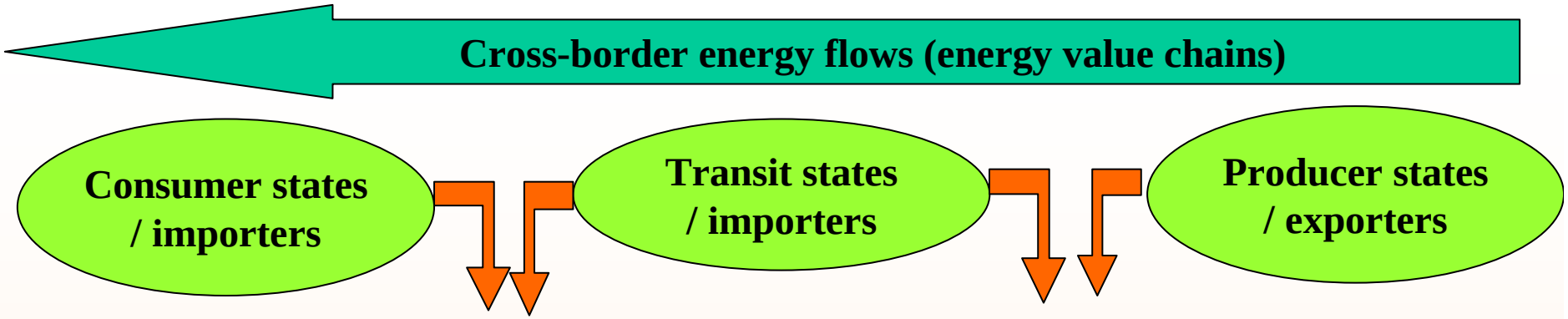
International Energy: competition & investments



Aim of importers = to increase import supplies of EMP in order to decrease energy prices for end-users => competition is not the end in itself, but the mean to achieve major aim => competition between exporters (!) => diversification of supply routes from few existing exporters (multiple pipelines) + few new exporters & new supply routes (multiple supplies) => **CAPEX + time** => competition (or cooperation !) between few major producers;

But: competition leads to increase of energy prices for end-users - if organised as increase of number of traders (especially of small re-sellers) at the market of consumer/importer state under limited supply (restricted, *inter alia*, by liberalization risks for exporters)

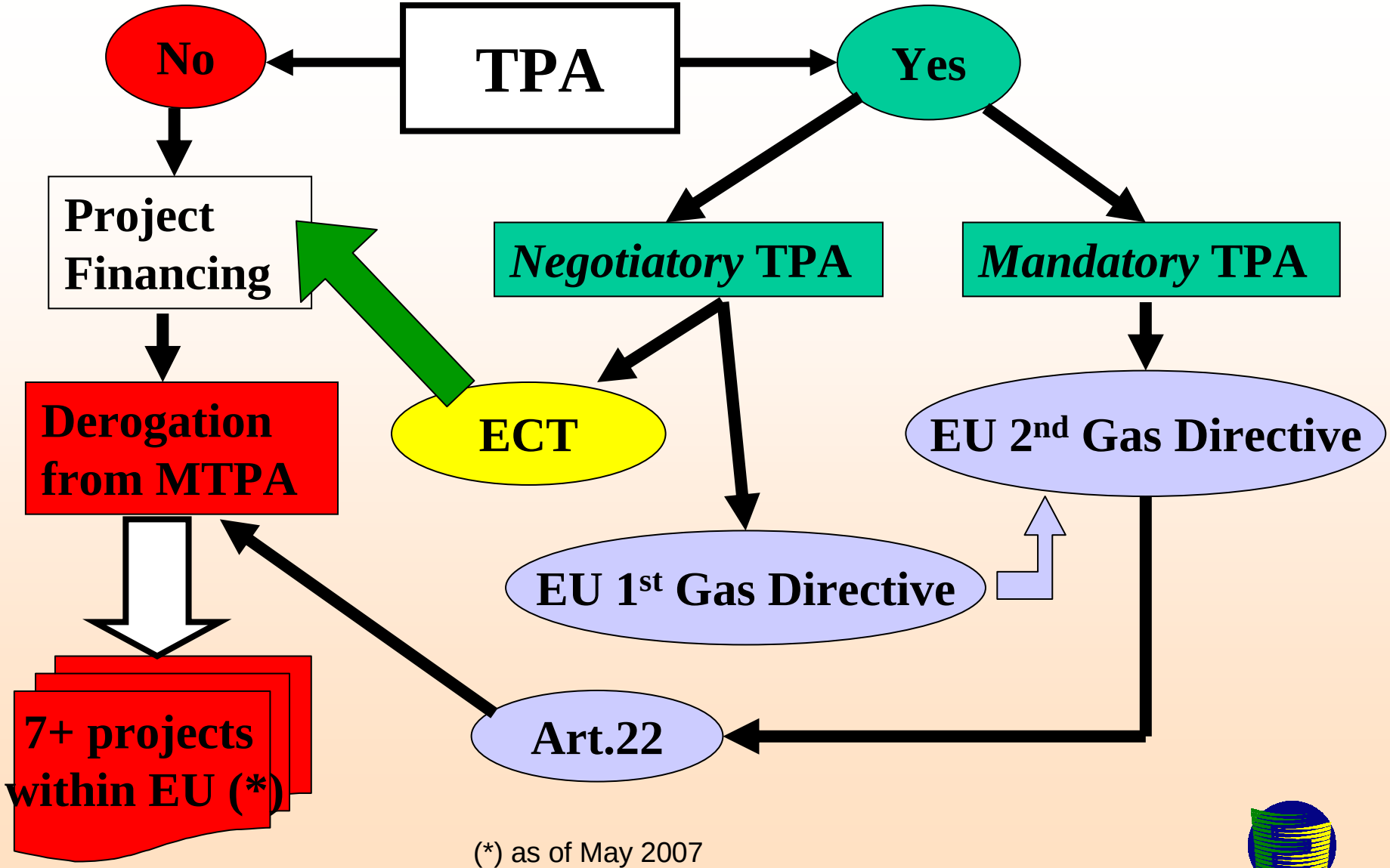
Non-renewable energy resources: limited number of producers / exporters + national sovereignty on energy resources;

Aim of exporters = maximization of Hotelling rent;

Competition (for exporters) = diversification of supply routes to existing markets & access to new markets => **CAPEX + time**

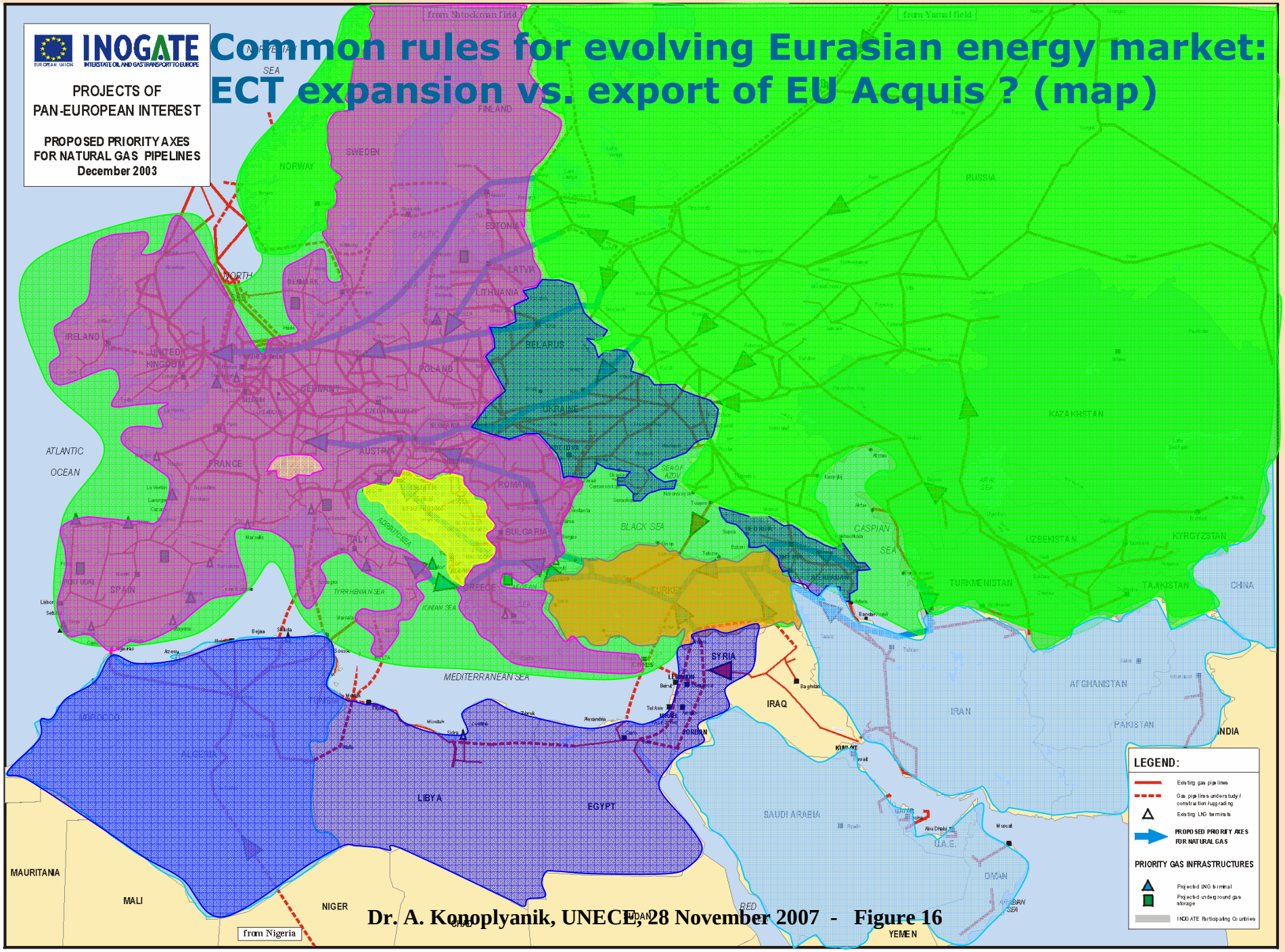
Competition = f (CAPEX + time + …) !!! => investment rules !!!

Competition & investment: Debate on Third Party Access (TPA)



(*) as of May 2007

Common rules for evolving Eurasian energy market: ECT expansion vs. export of EU Acquis ? (map)



Dr. A. Konoplyanik, UNECE, 28 November 2007 - Figure 16

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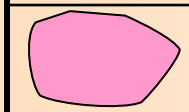
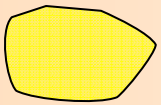
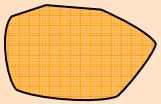
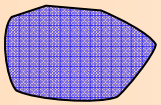
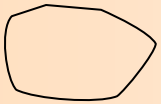
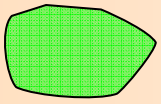
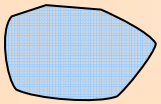
Common rules for evolving Eurasian energy market: ECT expansion vs. export of EU Acquis ? (legend)

Zone	States within the zone	Description
	**EU Members:** 27 EU countries	EU legislation, including the energy legislation, is fully applicable
	**Energy Community EU-SEE Countries:** Croatia, Serbia, Montenegro, Croatia, Bosnia, FYROM (Macedonia), Albania, UNMIK (Kosova); other Energy Community members are already EU members	Only EU legislation on internal electricity and gas markets is applicable
	**EU Candidate Countries:** Turkey (Croatia is already an Energy Community member so applying the EU energy market acquis)	Still in the process of alignment to the EU legislation but full compliance not likely before membership
	**EU Neigbourhood Policy Countires:** CIS (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine) and Northern Africa (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, the Palestinian Authority, Syria, Tunisia)	Enhanced energy cooperation based on National Action Plans with Ukraine and Moldova (as well as with Israel, Jordan, Morocco, the Palestinian Authority and Tunisia); partial application of EU energy policies and legislation may be possible in the future
	**EU-Russia Strategic Partnership**: EU & Russia	Based on shared principles and objectives; applicability of the EU legislation in Russia is out of question
	**ECT member-states:** 51 states of Europe & Asia	ECT is fully applicable within the EU as minimum standard; EU went further in liberalizing its internal energy market, BUT whether EU can demand that other ECT member-states follow same model and speed of developing their domestic markets?
	**ECT observer-states:** 20 states of Europe, Asia (e.g. Middle East, South-, SE- & NE-Asia), Africa, North & Latin America	Shared ECT aims & principles; did not take ECT legally binding rules; not ready to take more liberal rules of EU Acquis

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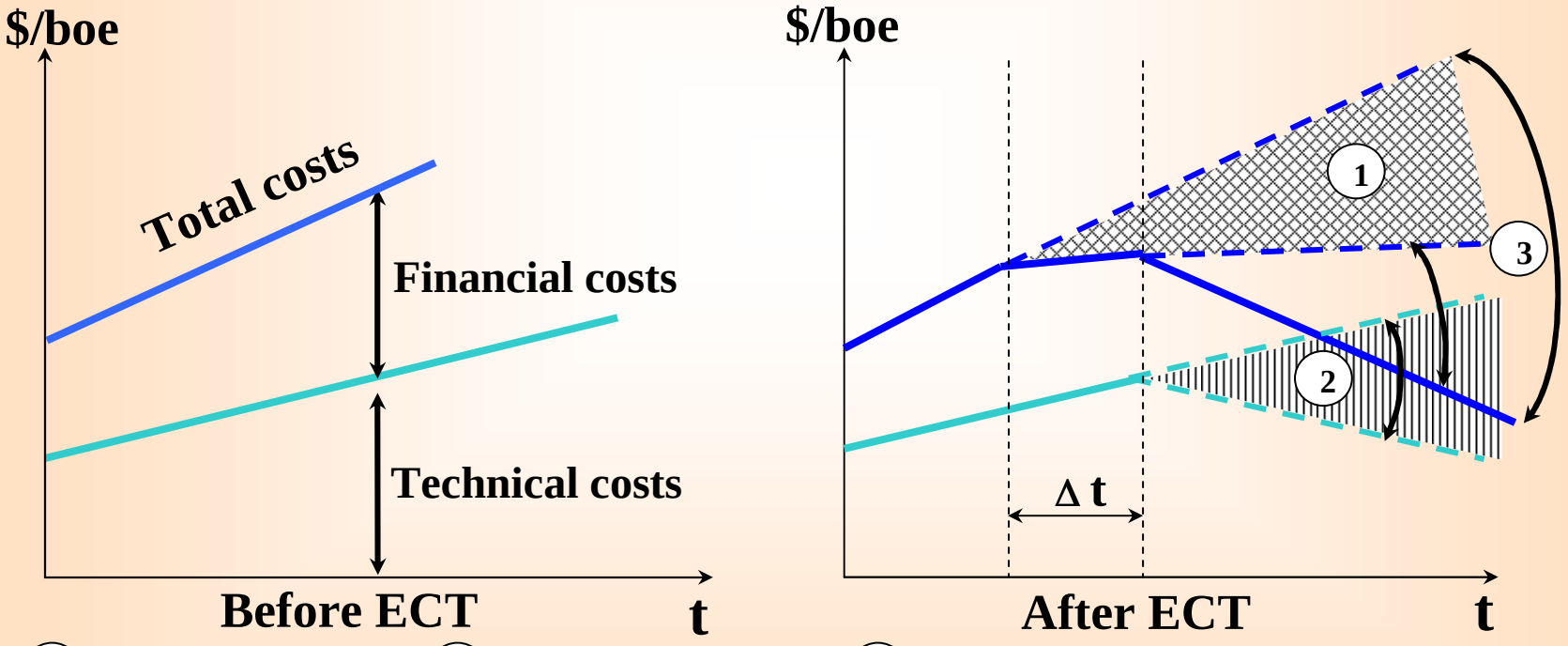
ROLE OF THE ECT FOR PROJECT FINANCING (ECT IS A BUSINESS-ORIENTED TREATY)

ECT/Legislation → ↓ risks → ↓ financial costs (cost of capital) = (1) → ↑ inflow of investments (i.e. ↑ FDI, ↓ capital flight) → ↑ CAPEX → ↓ technical costs = (2) → (1) + (2) = (3) → ↑ pre-tax profit → ↑ IRR (if adequate tax system) → ↑ competitiveness → ↑ market share → ↑ sales volumes → ↑ revenue volumes

ECT provides multiplier legal effect in diminishing risks with consequential economic results in cost reduction and increase of revenues and profits



(1) Δ Financial costs (2) Δ Technical costs (3) Cumulative Δ costs

Thank you for your attention!

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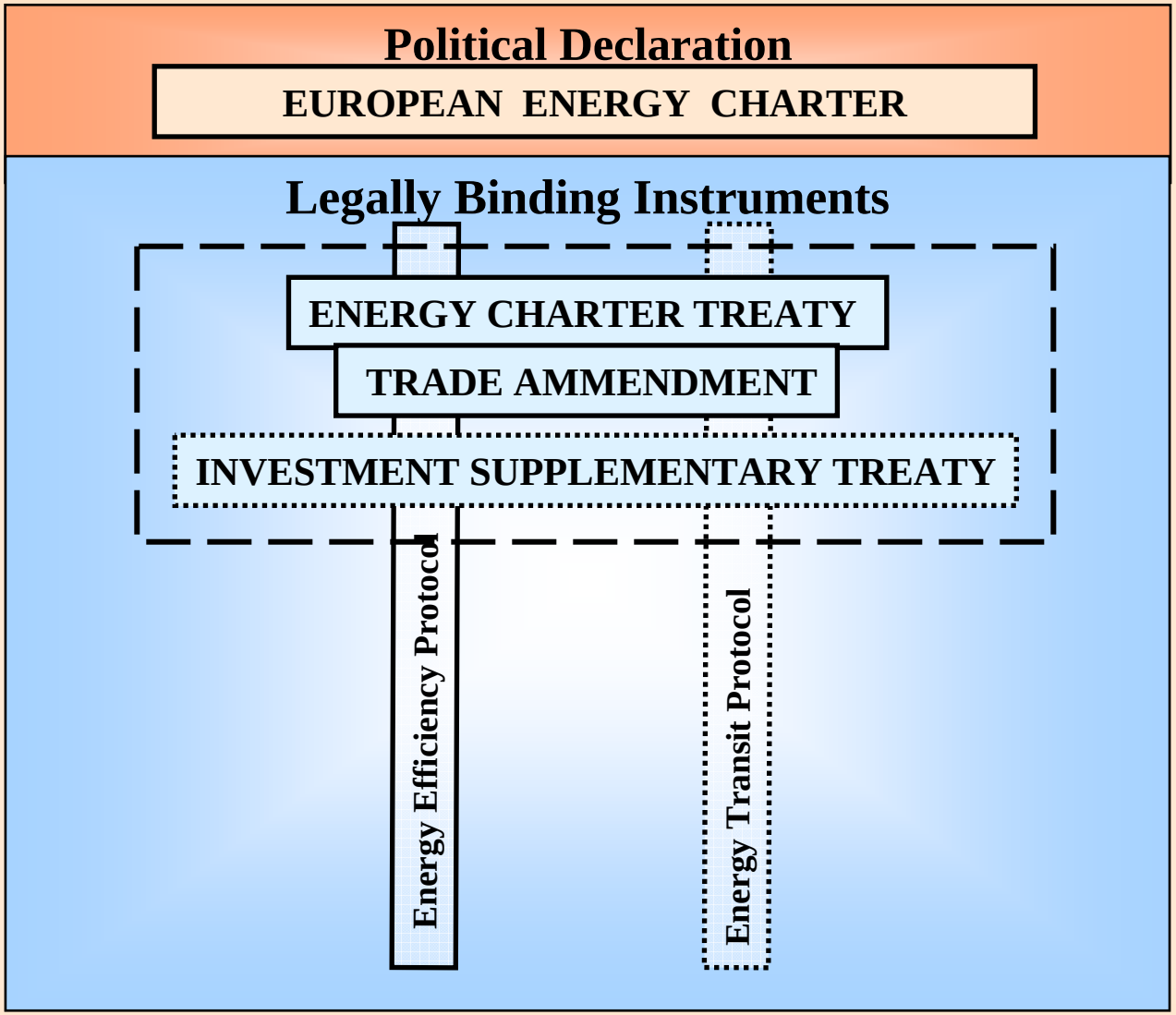
Back up slides

ENERGY CHARTER AND RELATED DOCUMENTS



- in force

- negotiations not finished yet

ENERGY CHARTER SPECIFIC ROLE

- **Energy Charter *Treaty*:**

  - Unique coverage of different areas for *energy* cooperation:
    - investment, trade, transit, energy efficiency, dispute settlement,
    - energy materials & products + energy-related equipment,
    - 51 member-states (52 CPs) + 19 observer-states + 10 observer international organisations

  - First and only one multilateral investment agreement with high standard of investment protection, incl. dispute settlement

- **Energy Charter *process*:**

  - *Implementation* of ECT,

  - Specialized forum for "*advanced" discussion* of the issues of energy markets evolution that *might create new risks* for development of energy projects in ECT member-states,

  - Platform for *preparation of new legally binding instruments* to diminish such risks within ECT member-states (e.g. broadening & deepening of ECT & upgrading its "minimum standard").

ECT = THE FIRST MULTILATERAL INVESTMENT AGREEMENT (1)

- Based on:
  - well-established practice of BITs (about 400 BITs at the beginning of the 1990's - around 2500 BITs as of today)
  - investment chapter XI of NAFTA (US, Canada, Mexico)
  - some interaction with then proposed "Multilateral Agreement for Investment" (MAI – aborted in 1998)
- Within 51 member-states ECT is equal to 1275 BITs
- MFN and National Treatment for investors:
  - *hard-law* obligations (binding guarantee) of non-discriminatory treatment for *post*-establishment phase,
  - *soft-law* obligations for *pre*-establishment phase (stage of making investment)

ECT = THE FIRST MULTILATERAL INVESTMENT AGREEMENT (2)

- Protection against key political/regulatory risk:
  - expropriation and nationalisation,
  - breach of individual investment contracts,
  - unjustified restrictions on transfer of funds
- Reinforced by access to binding international arbitration in case of dispute:
  - State-to-state, and *(NOVELTY!)* investor-to-state => direct dispute settlement at investor's choice at ICSID, UNCITRAL or ICC Stockholm,
  - Awards:
    - ✓ final and enforceable under NY convention,
    - ✓ usually as entitlement to payment (no risk of vicious circle for retaliating measures),
    - ✓ retroactive to start of dispute, may include interest (no incentive to delay process)

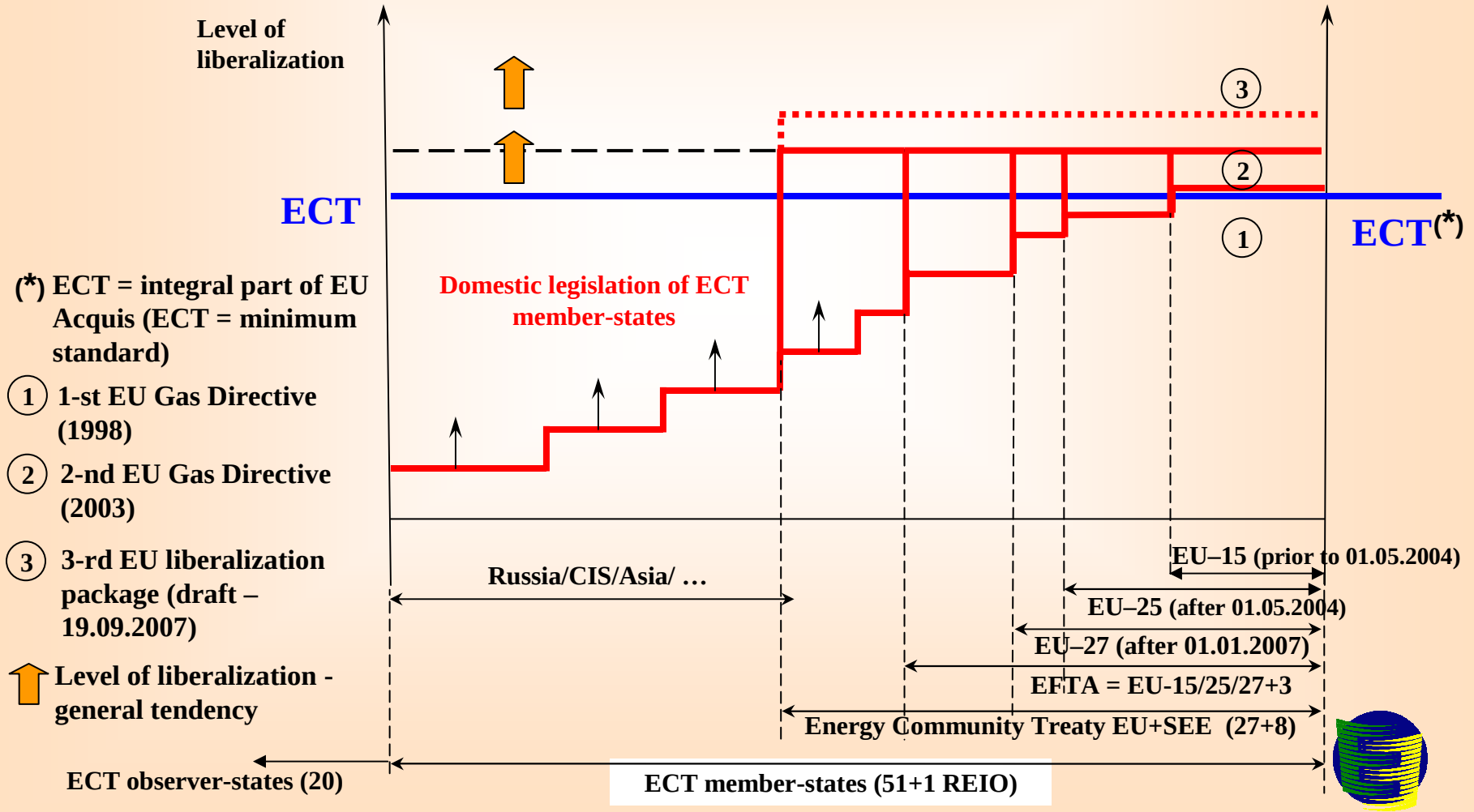
SELECTED INTERNATIONAL INVESTMENT-RELATED AGREEMENTS

Organisation (member-states/CPs)	Legal Status	Scope	Investment	Trade	Transit	Energy Efficiency	Dispute Settlement
ECT (52/53)	**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 specialised energy-related organisations: OPEC, IEA, IEF, UN ECE (broader than just energy), IAEA, …

=> Plus specialised "regional" organisations: BSEC, BASREC, …

ECT & EU acquis: "minimum standard" within evolving Eurasian common energy space vs. more liberalized model

Legal norms (examples)	ECT	EU Acquis (2-nd EU Gas Directive)
Mandatory TPA	No	Yes
Unbundling	No	Yes