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**CONFLICT OR COINCIDENCE OF INTEREST OF MAIN OIL AND GAS
IMPORTING, EXPORTING AND TRANSIT COUNTRIES**

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Conflict or Coincidence of Interest of Main Oil and Gas Importing, Exporting and Transit Countries

By virtue of providence the main possessors and producers of hydrocarbon resources are located in the Middle East, Central Asia and Russia, and the main hydrocarbon importers are the economically and technologically advanced nations of the EU, US, Japan and the emerging powers of China and India. Thus, the developed world is dependent on resources of the Middle East, Central Asia and Russia, and these nations, in turn, depend on the former as regards markets, investments and technologies.

Proceeding from the above, the interests of the hydrocarbon exporter and importer countries should, in theory, coincide. However, recent developments on the energy market show that oil and gas exporters and importers find it difficult to cooperate on such important issues as market and resource availability, access to investments and technology, and the environment. The position of transit countries further aggravates the vulnerability of the energy market. Stability and predictability on the energy market cannot be achieved without cooperation of exporters, importers and transit countries.

The new millennium brought new challenges and concerns related to energy security. These new challenges have to do with the new structure of the energy market, which having been regional in seventies has become fully global by the end of the century. In these conditions, energy security concerns on the global market can no longer be dealt on a regional or a national level. The new challenges in the globalized world demand coordinated and coherent efforts of all nations interested in the interrupted supplies of oil and gas and the stability of the energy market.

On the webpage of the US National Security Network, the article "Progressive Approach of Energy" highlights the perception of energy security of the majority of energy experts in US. This article quotes: "Energy security means keeping supplies flowing". "Keeping supplies flowing" could be endangered by physical shortage of resources or incidental and/or intentional disruption of supplies. Thus, availability of resources and threats of the interruption of supplies, after 40 years of relative stability, have come back to the energy security agenda.

In the global energy market, a disruption at a single point in the distribution system can have dramatic economic consequences around the world. "Keeping supplies flowing" means security of these supplies along the whole production, transportation, distribution chain, which should involve producers, consumers and transit countries equally. However, oil and gas exporters, importers and transit countries practice different and often controversial approaches toward the same factors of energy security namely: resource exhaustibility, market and resource availability, the price and access to investments and technology.

Major Factors of Supply Shortages and Disruptions

Reserves Exhaustibility: First of all, hydrocarbons (oil, gas, coal) are an exhaustible source of energy. According to some expert assumptions, as a result of intensive exploration the major oil and gas provinces in the North Sea, US, EU, Mexico and Indonesia have reached their peak production and have started declining. Indonesia's oil production dropped so significantly that it suspended its OPEC membership in January 2009. The UK which used to produce significant volumes of natural gas in its North Sea fields for domestic consumption, as well as for exports to the European market, became a net importer in 2006¹. Large Dutch onshore fields also have been depleted as a result of intensive production during the last twenty years.

In Russia oil and gas production has passed its peak in the early nineties and started declining in traditional areas like Tatarstan, Bashkiria and West Siberia in general. Currently, the most promising oil and gas fields in Russia are located in East Siberia and in the North Arctic permafrost areas of the Yamala peninsula and in the off-shore Arctic Ocean. Thus, the resource base which substituted the OPEC supplies after the 1973 crisis, has passed its peak production everywhere and has since been gradually declining.

However, according to the BP Statistical Review of World Energy there is enough oil and gas to meet the world demand for these resources for another 42 years, and 60 years respectively at the current production/consumption rate. According to EU energy statistics² the total world oil reserves as of January 1, 2010 is 1 175 686 472 626

barrels with the estimated date of exhaustion on October 22, 2047; natural gas reserves measure 171 514 266 542 404 cubic meters with estimated date of exhaustion on September 12, 2068³; and with coal reserves measuring 834 684 384 000 metric tons, with an estimated date of exhaustion on May 19, 2140. Exhaustion dates have been calculated based on current consumption rates and estimated demand in the future.

In the meantime, hopefully new scientific and technological achievements in renewable, nuclear and other sources will allow the world to shift to more advanced and environmentally friendly energy sources.

Exhaustibility of oil and gas is a very important factor for both oil and gas exporters and importers alike.

By the time oil and gas reserves are exhausted exporters, especially those who are largely dependent on oil and gas for their export earnings, should already have diversified their economies, substituting the energy export by some other export oriented industries. Among large energy exporters Norway has the most diversified economy with oil and gas exports constituting 30%⁴ of all export earnings. The next is Russia where, according to international sources, about 40% of all export revenues come from oil and gas sales. However, the Russian sources (the minister of Finances Koudrin) claim oil and gas exports represent 25% of all export earnings with a projected decline to 14% by 2020, as a result of diversification efforts undertaken by the government. Energy export dependence of the OPEC countries ranges from 60% to 90% of their exports⁵.

By the time oil and gas reserves are exhausted, importer countries on their part should have transferred to other sources of energy compatible to substitute both, oil and gas on their domestic market.

Reserves Location: There is a significant mismatch between hydrocarbon production areas on the one hand and consumption on the other. Over 70% of oil reserves are located in the OPEC countries, FSU and Russia, and about 80% of natural gas reserves are located in FSU, Russia, Qatar and Iran. Furthermore, the OPEC countries and Russia, which possess about 70% of the proven oil reserves together, produce about 40% of oil consumed worldwide, while the remaining

60% of demand is met by moderate, small and declining reserves located elsewhere outside of OPEC and Russia⁶.

Natural Gas: 41% of the proven reserves are located in the Middle East and 34% in Eurasia, which includes the reserves of the Former Soviet Union countries, Russia, Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan (FSU reserves amount to 30.5% of total). In 2008 countries in the Middle East produced 12% of total gas and consumed 10% with a small margin left for exports. In the same year Eurasian countries produced 35.4% of total gas (FSU -25.8%) and consumed 37.8% (FSU -19.1%) with a small margin left for imports. Shale and other non conventional gases are distributed more evenly, with the US having the largest reserve.

Reserves Availability versus Market Availability

Reserves Availability: Importer's Stand Point – Need to access upstream reserves- The main oil and gas importers are economically and technologically advanced nations and their oil industry possesses enough financial resources and know-how to develop the most complex and difficultly accessible oil and gas fields elsewhere, including deep water and Arctic permafrost areas in Russia. However, the major part of the oil and gas reserves in exporter countries has been under the control of national oil and gas companies. The majority of oil and gas endowed nations' legislation does not provide for the unhindered access of large majors (FDI) in their upstream reserves under the fear of losing control over their strategic export item.

Reserves Availability: Exporters Stand Point –Retain Profits

The majority of oil and gas exporter countries depends heavily on their hydrocarbon resources as a major source of their export earnings. The dependence on energy of the OPEC countries ranges from 60% to almost 90% for the Middle East. But their profit from oil business is much less than the profit of consumer countries in the form of various taxes. Many studies highlight that about 70% of total profit generated by oil business go to consumer countries and their international oil and gas companies. For example, according to Marie Claire Aoun's 2004 study "Oil and Welfare: Middle East & OPEC

Countries”, oil business generated a \$1,800 billion surplus. The partial distribution of this surplus in 2002 was⁷:

- 1,095 billion or 62% taxes in OECD countries
- 523 billion or 30% export revenues of main producer countries
- 144 billion or 8% profits of oil companies (publishing financial data)

Motivated by the desire to retain their profits, the main exporters seem increasingly reluctant to allow international majors in their upstream reserves. As it was already mentioned above oil and gas reserves in the majority of OPEC countries, Russia and the Caspian region have been developed by publicly owned oil and gas companies, which often suffer from shortage of financial resources, technologies and expertise.

Russia and the Caspian countries, which, immediately after the disintegration of the SU, welcomed Production Sharing Agreements (PSAs) as a main form of contracts (direct foreign investments in their upstream) with majors, have changed their position with the recovery of their economies. They started viewing PSAs as being detrimental to their interest given that they provide for a limited foreign ownership of their reserves. The PSAs concluded in Russia and Kazakhstan before 2003 have been revised in favor of local public companies⁸. There have been no PSAs concluded in the Caspian countries and Russia since 2003⁹.

In Saudi Arabia, Kuwait, Iran and Qatar public companies have the monopoly over production and exports of oil and gas. In these countries foreign companies are invited to work under service contracts which allow them to bring their finances, technologies, know-how and expertise for oil and gas exploration and production in exchange for volumes of oil and gas. These volumes have been calculated on the basis of expenditures borne by these companies during the project development and a fair profit margin.

Market Availability: Importers’ Standpoint

The main oil and gas importers are economically advanced nations whose oil and gas companies supply about 60% of crude oil to the world market. In addition, energy companies of importer countries control their respective domestic energy markets, not

allowing exporters' (OPEC and Russian) companies in their downstream, wholesales market and distribution¹⁰. Furthermore, oil and gas importer nations tend to develop strategies for reduced import of oil and gas and implementing:

- energy efficiency measures
- strategies for increased production of domestic renewable sources of energy¹¹
- carbon dioxide emissions reduction strategies meaning reduction of hydrocarbon consumption as the main source of these emissions

Market Availability, Exporters' Standpoint – The above measures lead to reduction of oil and gas consumption by main importer countries **leaving energy resource producers uncertain about the future demand for their resources on international energy market**. Uncertainty of demand for oil and gas prevents the main energy producing nations from making long-term investments in their resource development, potentially creating capacity constraints on the market. Many experts assume the price hikes in 2008 were results (apart from speculative manipulations on financial markets) of capacity constraints created by the resurge of demand in emerging economies, namely in China¹².

The main oil and gas producers, especially Russia which is the number one supplier of gas and number two supplier of oil to the EU market, claim that they need access to the downstream wholesales market in order to properly forecast the demand, and thereby adopt fair and reliable investment decisions. Russia initiated a new energy security strategy in the end of January 2009 after the Russia/Ukraine gas crisis and presented it to the G-20, G-8 and CIS leaders in the same year. The Russian initiative provided for the creation of a similar partnership between producers and consumers as established by the European Coal and Steel Community in 1951¹³, which established the foundation for the EU. The Russian indicative has been discussed at various levels but was granted limited attention by consumer countries.¹⁴

Demand on oil and gas: The demand for primary energy is expected to grow by at least a third by 2030. The current demand on the market stands at about 84 million barrels per day. The major part of this increased demand will be met by oil and gas. Thus,, by 2030 the world should be able to produce additional 14 million barrels per day in order to meet demand. The growth in demand is not expected to come from the US, EU and Japan. As energy sector experts forecast, the demand in the coming decades will be driven by the emerging economies of China, India and South East Asia in general.

At present the emerging markets of China and South East Asia have also been dominated by their own energy companies. There are no signs yet that these countries would be willing and ready to open their downstream to foreign direct investments shortly. Thus, producers have access to neither mature nor emerging markets to make a proper assessment of demand and adopt, as they claim, fair and reliable investment decisions.

Funding and Technology Constraints: New oil and gas reserves are increasingly difficult and costly to access, often in remote and challenging locations like deep water permafrost Arctic areas, or Russia's deep heartlands of Siberia. If in the nineties a "mega project" might cost \$500 million to \$1 billion, today the cost is more likely to be \$5-10 billion. The majority of resource-endowed countries still have oil based economies which means that low prices on oil during the last fifteen years did have a negative impact on their oil and gas exports earnings. So, they may not be able to set up large financial reserves for investment purposes,.

But shortage of finances is not the only problem. In some cases these countries do not possess advanced technologies and expertise to develop difficult fields (for example deep offshore waters or Arctic areas). In such cases these countries grant limited access to their reserves in exchange for technologies and know-how. For example, Russian Prime Minister Putin invited international majors to develop Russia's Arctic energy provinces in Yamala¹⁵ and the Barents Sea¹⁶ during his meeting with top executives of international majors in September 2009.

As spelled out by Russia's Energy Minister Shmatko and Economic Development Minister Elvira Nabiullina, international strategic partners in the Yamala project would be asked to: transfer Western technologies for the manufacturing of advanced drilling equipment, onshore and offshore, to Russia; allow Gazprom direct access to gas markets in consumer countries, using the distribution networks of partner companies; recognize the right of Russian companies to acquire energy infrastructure on territories of consumer countries; and to assist Gazprom with marketing methods and personnel training.¹⁷ This is an offer of assets on the part of Russia in exchange for technologies and a share in the downstream –distribution in consumer countries.

However, there is no significant progress observed towards either the initiative on broader cooperation or on the assets in exchange for technologies offer promoted by Russia with a view to stimulate producer/consumer dialogue so far.

According to IEA estimates, \$22 trillion of new energy investments are required by 2030, in order to meet demand. Resource endowed exporter countries have either to make investments into their upstream themselves, or allow the international majors to do it, in order to meet expected demand on oil and gas in the coming years. Otherwise, as some energy analysts assume, the skyrocketing price of oil in the coming years will push the world economy into long-term recession and social turmoil. Thus, producer/consumer dialogue looks like an inevitable factor for a stable and uninterrupted flow of energy.

Instability of the Energy Market - Volatility of Prices: *the* global market is characterized by high volatility. Many factors may have effects on the price of oil apart from traditional supply-demand pattern. These factors are political risks, operational challenges, supply chain bottlenecks, environmental specifications, speculation on financial markets, dollar exchange rate, etc. It is very difficult if not impossible to make a proper analysis of the market conditions and to foresee how prices would react to this or that event.

The only evident factor which can bring up or down prices is a spare capacity of production. Oil and gas production and transportation projects are long term projects that take up to ten years to

design and another five to eight years to implement. For example, the “Contract of the Century” on the development of Azeri-Chiragui-Guneshli field in Azerbaijan was concluded in 1994, and the pipeline for delivering the Azeri light oil to the Turkish port of Ceyhan was commissioned in 2006. Thus, it took twelve years from the contract signing to the oil delivery to international market.

These projects require huge financial resources that may potentially be recovered in the medium- or long-term. Producers shall have to be sure that the market will be there for their resource after ten years when the project is implemented to recover their investments. In the reverse, if producers do not invest in the development today, they will not be able to produce additional volumes of oil and gas in four, five or six years. The market is very sensitive to such investment uncertainties and responds by price hikes. Thus, in order to create production capacity to meet future demand, both components, market certainty and availability of investments, should be present and supplement each other.

Evidently capacity constraints can become a major disturbing factor in the demand/supply chain. But there are also other factors contributing to volatility on the energy market, the most challenging of them are political risks.

Political instability in energy exporter countries, Nigeria, Venezuela, Iran and Iraq, as well as last year’s tensions between Ukraine and Russia on the transit of Russian gas, do not give ground for hopes that such factors destabilizing the market will not appear again in the future. Nor is there any evidence that new attacks and disruptions at various parts of the transportation chain will not happen and drive prices high. Even more, there is no certainty that a new world scale financial and economic crisis will not happen again. These challenges come from multifaceted backgrounds and are extremely difficult to be calculated let alone dealt with.

Indeed, uncertainties on energy market and price volatility make it extremely difficult for producers to make long term decisions for the development of costly mega projects should it be for the development of oil, gas or renewable and alternative energy sources of energy.

Summing up the above, it can be concluded that there are enough oil and gas resources to meet the expected growth of demand for several decades to come, but the resource-endowed nations have limited financial resources, lack most advanced technologies and mastership to develop challenging energy provinces and increase their production in the coming years. Furthermore, even if they found finances, they claim to lack enough certainty about the demand for oil and gas in the future¹⁸ to make wise long-term investment decisions.

On the other hand, the main oil and gas importer nations possess financial resources, technologies and market instruments to forecast demand and make adequate long-term investment decisions, provide funds and technologies for the development of the most complex fields elsewhere upstream. But they have limited or no access to upstream reserves. ***Exporters and importers have to cooperate in upstream and downstream in order to avoid physical shortages of supply and ensuing volatility of the market.***

Policies vis a vis Prices: Historically, producers and consumers have had clearly opposing interests, with producers favoring higher prices and consumers favoring lower ones, depending on the stage of development of their economies. At present, there is a growing understanding in both groups that oil price that are either too high or too low can damage both producers and consumers equally. Low oil prices constrain the flow of investment required by the industry to ensure stable production and supplies. High and volatile oil prices can damage the prospect of global growth and lead to reduction of consumption. Thus, producers and consumers are equally interested in moderate prices on oil and gas.

International Energy Forum: Proceeding from the above, producers and consumers of energy agree about the urgent need of holding regular exchanges of information and dialogue on the demand and supply of energy for the stability of the international energy market. This dialogue started in 1998 when the International Energy Forum was established with its headquarters in Riyadh (2005), Saudi Arabia. The IEF holds its annual meetings regularly, hosting members of both

OPEC and IEA. The IEF is unique in that its participants include not only IEA and OPEC countries, but also Russia, and the emerging giants China and India. The IEF countries account for more than 90% of global oil and gas supply and demand.

In response to increased concerns about the lack of exchange of information between producers and consumers and the need for the oil data transparency six organizations, the Asia Pacific Economic Co-operation (APEC), the Statistical Office of the European Communities (Eurostat), the International Energy Agency (IEA), the Latin-American Energy Organization (OLADE), the Organization of Petroleum Exporting Countries (OPEC) and the United Nations (through the UN Statistics Division) have set up the Joint Oil Data Initiative.

Unfortunately, the IEF dialogue and its oil data transparency initiative could not prevent the 2008 oil price crisis and ensuing collapse of the demand. Furthermore, in late 2009 and early 2010 there was a severe shock on the EU gas market with considerable consequences for long-term pipeline gas contracts with Norway and Russia. To the great surprise of gas exporters, US companies had made a breakthrough in the technology of gas production from the shale rocks in Texas. In 2009 gas produced from shale rocks reached unprecedented levels and covered almost half of gas demand in US¹⁹.

Availability of non-conventional gas undermined LNG contracts of US consumers with producers in Angola and Equatorial Guinea. The West African LNG, not finding its contracted market in US²⁰, started a trans-Atlantic (to Europe) journey to line up at the EU degasification terminals, and thus bringing down gas prices on the spot market. For the first time in the history of gas production, LNG on the spot market was much cheaper than pipeline gas supplied by long term contracts with Norway and Russia. The emergence of unexpected shale gas thus created instability and uncertainty on the gas market. Indeed, with a more open producer/consumer dialogue and information/data transparency, uncertainty on the gas market would have been reduced.

The case of shale gas shows that there is a lot still to be done for stimulating dialogue, data transparency and confidence building between producers and consumers worldwide.

Environmental Constraints, Global Warming- The Copenhagen Summit revealed controversies between oil and gas consumers and main exporters on emissions reduction as well. The majority of oil and gas producers are not interested in sharing the burden of emissions reduction with the main consumer nations. On the contrary, they fear that emissions reduction will lead to the reduction of oil and gas consumption in the world to the detriment of their export interests and demand compensation. This is an important issue which will stay on the agenda during the meetings and discussions dedicated to after Kyoto (after 2012) settlement.

The Role of Transit Countries in the Stability of the International Energy Market: the reliability of transit countries and their commitment to their international obligations is crucial for assuring the uninterrupted flow of energy. Transit countries, like producer and consumer countries, can use their position to strengthen their geopolitical stand within the region, or to broker better oil and gas supply deals for their domestic markets—or both. There were several cases when transit countries used their transit position as leverage for achieving their geopolitical, or economic objectives. But there is a question whether the gains they made as a result were short- or medium-term, and whether these gains are sustainable in the long run. From country to country, in some cases these gains were sustained, in some other cases the results were quite the opposite of what the transit countries had strived for.

Resource and Transportation Availability across Eurasia, the Role of Transit Countries, the Energy Charter Treaty: The EU is located in the immediate neighborhood of the core hydrocarbon resource endowed areas of the North Sea, Middle East and Russia. After the collapse of the Soviet Union in 1991, the Cold War ended and ideological confrontation disappeared. The new era offered an unprecedented opportunity to overcome previous economic divisions and develop mutually beneficial cooperation in the energy sector. The energy field was selected for cooperation between the former adversaries for several reasons:

1. Russia and Central Asian countries were known to possess the second largest oil and gas resources after the Middle East.;

2. The Soviet Union was historically one of the largest producers of oil and gas, and Europe had been historically its major market for oil, and the only market for natural gas;
3. The Soviet Union, as an energy export dependent economy, had developed a large oil and gas transportation infrastructure which linked it with its market in Europe.

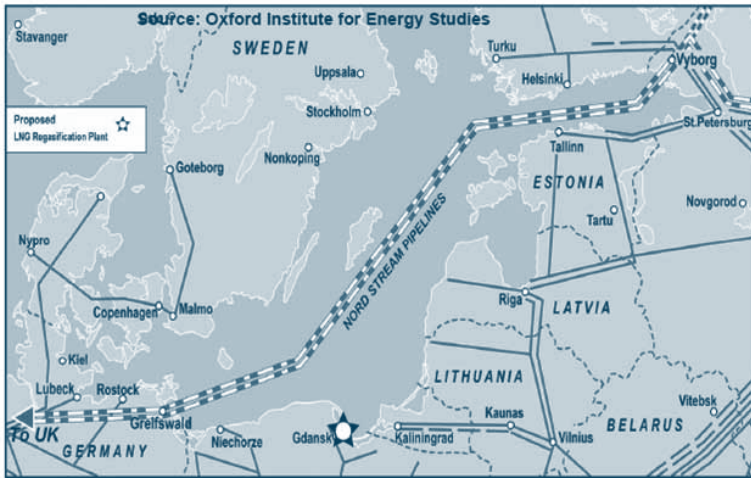
This infrastructure was mostly new and could serve as an important linkage between the production area and the market for several years. Thus, after the collapse of SU there was a resource base in Russia and Central Asia, there was a traditional market in Europe, and there was a well developed infrastructure to link producers with consumers. All sides recognized the need for the commonly accepted legal framework to be established for developing energy cooperation among the states of Eurasia. On the basis of these considerations, the Energy Charter process was initiated.

“The Energy Charter Treaty and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects were signed in December 1994 and entered into legal force in April 1998. To date, the Treaty has been signed or acceded to by fifty-one states. The Treaty was developed on the basis of the 1991 Energy Charter. Whereas the latter document was drawn up as a declaration of political will to promote energy cooperation, the Energy Charter Treaty is a legally-binding multilateral instrument”.²¹

The fundamental aim of the Energy Charter Treaty is to strengthen the rule of law on energy issues by creating an equal playing field of rules to be observed by all participating governments, meant for mitigating risks associated with energy-related investment and trade. In addition, the ECT provides for a dispute settlement mechanism which the parties can apply to in case of a dispute.

Further, The Transit Protocol, an annex to the Energy Charter Treaty, when agreed upon and adopted by the parties, is entitled to set unified, transparent and non-discriminatory rules and procedures of trans-border flow of energy resources. As Russia possesses the largest Eurasian oil and gas pipeline network built under SU, this is mainly about applying transparent and non-discriminatory rules of transit, and providing a third party access to its network.

Nord Stream Gas Pipelines



Problems of Energy Transportation on Land – FSU, After the disintegration of SU new challenges emerged on the way of a safe transportation of oil and gas from Central Asia to the West through old Soviet oil and gas pipelines. Under SU oil and gas produced everywhere, in West Siberia or Central Asia, was delivered to the European market through the territory of Russia, Ukraine and Belarus. The land-locked Central Asian countries, including Azerbaijan on the west of the Caspian Sea, had only access to the market through the unified pipeline systems running across these countries.

After the disintegration of the SU in the beginning of nineties, the countries of the Caspian basin thus were fully dependent on their neighbor's goodwill for their oil and gas exports. For example, Azerbaijan resumed its oil exports only in 1998 after the commissioning of Baku/Supsa oil pipeline across Georgia²². Gas exports of Turkmenistan were reduced to nearly zero in 1998- 2000 years when Gazprom did not buy it due to a low demand on European market. Turkmenistan did not have another gas pipeline to deliver its gas to other markets outside Russia until Turkmenistan-Iran gas pipeline was commissioned in 2001. The financial losses of the country for this loss of income from exports were immense.

Russia- Central Asia Transit Issues – As it was mentioned above, the main point in the Energy Charter Treaty is the “obligation on member countries to facilitate energy materials and products transit across their territory, in line with the principle of freedom of transit.” This means that once Russia ratified the treaty, it would have to permit free transit of Central Asian gas to Europe across the Russian territory. The Russian authorities considered this provision dangerous for the country’s vital interests and completely unacceptable.

They assumed that oil and gas produced in the Caspian eventually could create competition to Russian resources on the European market and undermine Russia’s expected exports earnings as it largely depended on oil and gas exports, especially in the years that followed immediately after the collapse of SU. Furthermore, a free access to the network would stimulate large influx of financial resources of the international energy giants to the Caspian countries’ upstream sector, contributing to their fast economic growth. Such developments would, as Russian experts assumed, in a short time erode Russia’s geopolitical, political and economic stance in the region.

All efforts to convince Russia to ratify the Treaty were in vain, as Russia viewed it as detrimental to its interests having being itself the largest producer of oil and gas. Instead Russia decided to withdraw from the Energy Charter Treaty in summer 2009, leaving other members uncertain about the future of ECT.

Instead of providing a third party access to its energy network, Russian companies concluded oil and gas purchase contracts with local producers in Central Asia. These contracts had been revised on an annual basis, and their terms had been modified in conformity with the increasing influence of Central Asian countries. Meaning that, with the commissioning of a new oil or gas pipeline towards other directions (for gas towards Iran and China, for oil towards China,) Russian companies have of necessity become more sensitive towards the interests of producers in the region.

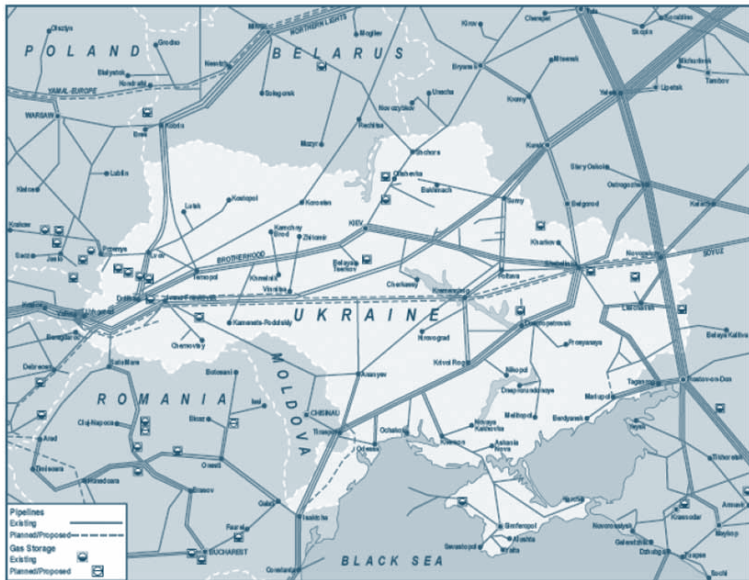
Indeed, by denying a third party access to its network Russia on the one hand attempted to control the production of oil and gas in the Caspian region countries (through hampering flow of investments in their upstream), and on the other hand, undermined the ability of EU countries to diversify their energy supply sources. In addition, Russia

used the Caspian region countries energy export dependency to preserve its political and economic influence over the region for about fifteen years before new alternative pipelines were built in the region {Baku-Tbilisi-Ceyhan (2006), Baku/Tbilisi/Erzurum (2007), Caspian Pipeline Consortium (2002), Kazakhstan China oil pipeline (2003) and Turkmenistan-Uzbekistan-Kazakhstan-China gas pipeline (2009)}.

Beginning from 2006, the demand on gas in EU (and accordingly prices) grew so rapidly, that Gazprom found it difficult to meet it by its own production. So, Gazprom appeared in the imminent need to buy increased volumes of natural gas from producers in Central Asia. But this time Gazprom had to pay a much higher price for Kazakh and Turkmen gas²³ than ever before (calculated according to international price formula based on the price of crude oil and oil products). Otherwise Gazprom would not have been able to meet increasing demand for natural gas in EU, and would hardly have been able to win in a hard competition for Central Asian gas waged by potential buyers from EU, China and Iran. But the situation has changed after the collapse of the market in the end of 2008, Gazprom did not need the Turkmen gas especially for the price it was contracted. The parties could not agree neither on the volumes, not on the price of the Turkmen gas.

Since 8 April 2009, as a result of an explosion on the Turkmen gas pipeline (Central Asia/Center pipeline) near the Kazakh border, Gazprom stopped receiving Turkmen gas at all, and did not resume it even after the pipeline was rehabilitated. According to international sources, starting from April 2009 until the resumption of gas exports to Russia in January 2010, Turkmenistan had been losing \$1 billion per month in terms of defected exports earnings. Russia and Turkmenistan were negotiating for several months before they came to agreement on the volumes and price of Turkmen gas delivered to Gazprom's network. The new agreement signed in the end of December 2009 provides for the purchase by Gazprom of maximum 30 bcm per annum (pending the gas demand in Ukraine) of Turkmen gas for \$190 per thousand m³, which is a much lower price than that demanded by the Turkmen side during the negotiations (\$250 – 270).²⁴

Obviously, the problem with Russia is that it is the largest producer of natural gas and the largest transit country at the same time. As the largest producer, Russia is interested in purchasing Central Asian gas



when the demand on the EU market is so high that it can not meet it just by its own production. When the demand collapses, Russia would rather prefer to sell its own gas, than to allow other countries gas to be delivered to EU market through its network. By granting a third party access to its gas network, Russia would lose the ability to prevent the emergence of a competitive Central Asian gas to its only and major market in Europe.

Russia's leverage over the transit of Central Asian oil and gas was short and medium term and could only be sustained before new oil and gas pipelines from the region were built towards China, Iran and EU (Baku-Tbilisi-Ceyhan and Baku –Tbilisi- Erzurum). Currently, producers in the Caspian region have diversified exports outlets for their oil and gas not depending on Russia.

Russia/Ukraine, Russia/Belarus transit dispute - Russia itself depends heavily on its immediate neighbors for its exports to the EU. Indeed, about 80% of its gas exports transits through Ukraine, with the remaining 20% transiting through Belarus. These countries having being reliable transit partners for several years, enjoyed preferential tariffs for Russian gas consumed on the domestic market. During several years when they

Blue Stream and South Stream Pipelines



South Stream becomes urgent for security reasons

maintained strategic partnership relations with Russia, Russian gas price for Ukraine and Belarus²⁵ was one third or a half of that in EU.

The new leadership which came to power in Ukraine after the Orange Revolution in 2006, changed the country's foreign policy orientation completely. President Yushchenko and its team took a firm decision to build a strategic partnership with NATO, disregarding strong Russian objections. In response, Gazprom demanded that Ukraine should pay a market price for Russian gas consumed on its domestic market. Then, Ukraine demanded that Russia paid a market price for the transit of its natural gas. As the countries failed to come to an agreement before the new 2009 year, Russia reduced gas volumes delivered through Ukrainian infrastructure, allowing only the volumes of gas destined to the EU market. Upon finding out that the contracted volumes crossing Ukrainian pipelines did not reach the EU market, Russia accused Ukraine of illegal off takes and stopped delivering gas completely²⁶.

As a result of (at one sight) a commercial dispute the parties failed to assume their contractual obligations, Russia for supplying and Ukraine for allowing the transit of Russian gas to the EU. This dispute deprived EU consumers in Eastern EU of heating in the severely cold winter of 2009. Altogether 4.5 billion cubic meters of Russian gas did

not reach the market as a result of the crisis. Gazprom pledged that it failed to fulfill its contractual obligations to supply because of a failure by the transit partner to fulfill its commitments to ensure an unhindered transit of the Russian gas. Ukraine blamed Russia on its part. However, neither of the parties applied the Energy Charter Dispute Settlement mechanism despite the fact that both had signed the treaty in 1994. Russia did never ratify it, so it had no legal commitments under the treaty. Ukraine did not apply to ECT for the dispute settlement although it had ratified it in 1994 and enacted in 1999²⁷.

Another dispute erupted between Russia and Ukraine and Russia and Belarus, this time on the transit of Russian oil through the old Soviet oil pipelines crossing these countries in January 2010. Out of ten million barrels of oil produced in Russia daily, about three million barrels per day have been delivered to the EU market through the pipelines running across Ukraine and Belarus. The parties could not agree on the transit tariffs and the price of Russian oil for their domestic refineries. Both Belarus and Ukraine assumed they had the right to preferential tariffs as major transit partners for Russian oil to the EU market. In both cases, domestic interests of transit countries prevailed to their international commitments to allow a free flow of resources across their infrastructure, thus exporting the damage to consumers' interests in the EU. Again neither of the parties in the dispute (consumer, producer or transit) resorted to dispute settlement instruments provided by the Energy Charter Treaty for such cases.

Russia, which had not ratified the ECT and therefore had no commitments under the treaty, pledged that the Energy Charter Treaty and its Transit Protocol²⁸ had failed to fulfill the goals it had been set up for, and needed to be reformed or dismissed.

Conflicts with Ukraine and Belarus on the transit provided grounds to Russia to claim that transit countries may represent a threat for unhindered flow of energy. Therefore, it would have been wise to build pipelines going directly to the market, avoiding the transit countries. And Russia started promoting:

- North Stream gas pipeline going directly from Russian Baltic coast to EU, avoiding Belarus and Poland. The building of North Stream has commenced, and it will be operational in 2012;

- South Stream gas pipeline linking Russia and Bulgaria across the Black Sea has been under discussion with several HCA already signed²⁹
- Several years earlier Russia built a new oil terminal in Primorsk on its Baltic Sea coast, depriving FSU Baltic countries' (when they joined NATO) oil ports from their traditional oil cargos coming from Russia.

Turkey-Azerbaijan Negotiations on the Transit of Azerbaijani

Gas: Turkey's position was crucial for the design and implementation of BTC and BTE international oil and gas transportation projects. But Turkey, whose EU accession negotiations stalled and strategic partnership with US gradually eroded³⁰, became reticent in negotiations on the transit. Since the commissioning of these pipelines Turkey's position vis-à-vis strengthening of South Caucasus corridor became controversial, and to some extent, even detrimental to the interest of Azerbaijan and other landlocked Caspian region countries, which heavily depend on their immediate neighbors for their export outlets to the EU market.

This is especially pertinent for Azerbaijani gas of the giant Shakh Deniz gas field, where the development of phase 2 which projected for 2012, was recently put off to 2017 due to the tough position of Turkey on transit issues. Furthermore, Azerbaijan and Turkey long failed to come to an agreement on the price of Azerbaijani gas delivered through BTE for Turkey's domestic consumption. The previous contract established the Azerbaijani gas price for Turkey's domestic market at \$120 per 1000 cubic meter, providing for the revision of the price with a view to bringing it to the market price in spring 2008.

By the end of 2009 the parties reportedly reached an agreement on the price of Azerbaijani gas, and on the compensation of the deferred price value during the period of negotiations starting from when the previous contract was expired. However, the parties so far failed to agree on the terms of transit of Azerbaijani gas to the EU through the Turkey/Greece interconnector or through a long awaited NABUCCO gas pipeline, which is designed as an extension of BTE pipeline from the Turkish city of Erzurum onward to EU. Turkey's demands varied from becoming a trade hub³¹ to insisting on large volumes of gas to

be left for domestic consumption. An abrupt downturn in US Turkey relations in March 2010 ported a new blow to the preliminary agreement between Azerbaijan and Turkey on the price which, by optimistic assessments, would lay grounds for conclusion of the transit agreement.

Turkey's negotiations on joining the Energy Community and the Energy Charter Treaty Transit Protocol also show limited progress. Both organizations' membership provide for a progressive implementation of EU regulations on domestic energy sector development and the transit. Apparently, Turkey views joining these international bodies and its transit position in package with its negotiations on EU membership. With EU accession negotiations stalled, Turkey, has few incentives to make a rapid progress in regard to energy sector reforms and the transit as required by the membership of these organizations. Against the backdrop of Russia/Ukraine³², Russia/Belarus³³ differences on the transit of Russian³⁴ oil and gas through these countries, Turkey's current position on the transit leaves a very limited room for options of the development of alternative energy transportation network from the Caspian region to the EU.

Azerbaijan and Georgia have been developing two options of Azerbaijani gas transportation to EU both avoiding challenging transit routes through Russia/Ukraine and Turkey.

White Stream: White stream is a gas pipeline project linking Azerbaijani gas production area through the Georgian gas network to a pipeline under the Black Sea which finally drops into an EU network in Romania and possibly Ukraine. This pipeline project has been discussed for several years. The governments of Azerbaijan and Georgia have been skeptical about a rapid progress on this project due to the fact that it cannot be built without a formal approval from either Russian or Turkish sides whose exclusive economic zones it shall have to cross if built.

These coastal countries, however, do not have the formal legal means to prevent construction and operation of White Stream based on the UN Convention on the Seas³⁵. According to Roberto Pirani, Chairman of the Board of White Stream Consortium, "International Law guarantees freedom to lay pipelines on the continental shelf and in the exclusive

economic zones³⁶. The fact that Russia and Turkey already have the Blue Stream gas pipeline under the Black Sea is, according to R. Pirani, a positive factor facilitating the decision making on the White Stream project. The building of a pipeline under the Black Sea is already a challenging task from a technological standpoint and would demand the most advanced technology and mastership. In addition, it will be capital intensive, but most importantly, it will require an official approval either from Russia³⁷ or Turkey both having their own agenda on transit of oil and natural gas from the Caspian region to EU.

Georgia formally signed a memorandum of understanding with the London-based “White Stream” consortium in March 2009 during the annual International oil and gas Conference in Tbilisi. As activation of White Stream project strangely coincides with ups and downs of negotiations with Turkey, it can be viewed as a tool of leverage to make it more talkative on transit.

CNG or LNG Terminal on the Black Sea: As it has been mentioned above the Governments of Azerbaijan and Georgia have been aware of potential difficulties on the way of implementation of the ‘White Stream’ pipeline project. Therefore, the parties started looking for the development of CNG and/or LNG terminals near Khulevi, a Black Sea port in Georgia. Khulevi, located near the Poti port has been on a long term lease of SOCAR, the Azerbaijani State Oil Company. The LNG terminal project outlines were presented first at the Batumi Energy Conference on January 14, 2010.

Funding for a feasibility study for this project is expected to be provided by the US Trade and Development Agency. The regional political leadership of Azerbaijan, Kazakhstan, Georgia and Romania has officially supported the idea of building an LNG terminal in Khulevi, and signed a Memorandum thereon in Bucharest on 12 April 2010. According to the Georgian Ministry of Energy³⁸ the capacity of LNG terminal at Khulevi has been assessed at maximum 7-10 bcm per annum with €4 bln capital cost for building of a liquefaction plant, 10% of this amount would be required for a degasification terminal in Romania.

Further progress on both White Stream and Azerbaijan/Georgia/Romania LNG projects - depends on the one hand on the Turkish

position on transit and on the other hand, on a strong determination of SOCAR and other producers in the Shakh Deniz consortium, to develop a direct and reliable access to the EU market. Many experts and industry people both in Azerbaijan and Georgia question how reliable Turkey would be in the future as a transit partner in case NABUCCO or other networks were built. Obviously, Turkey would be able to create problems even after NABUCCO having being built if it found its national interests threatened or neglected, just like Ukraine did during the Ukraine/Russia commercial dispute in January 2008.

The above discussed disputes between producers and transit countries show that, sooner or later, transit countries loose their leverage on the transit, as both producers and consumers finally manage to diversify their exports outlets and supply sources. But before a solution is found unresolved transit issues may cause supply disruptions and create uncertainty on the market.

Conclusions

The transit conflicts between Russia and its partners Ukraine and Belarus as well as long and difficult negotiations on the transit of Azerbaijani gas to the EU market highlighted:

- The role of transit countries is crucial in interrupting flows of energy resources across borders.
- There are serious shortcomings to the Energy Charter Treaty dispute settlement mechanisms since neither of the parties in dispute (Russia, Belarus, Ukraine) adhere to it;
- Vulnerability of both producers and consumers vis-à-vis commercial interests and strategic considerations of transit countries;
- The urgent need for the establishment of transparent, non-discriminatory and acceptable for all sides (producer/consumer/transit countries) rules and procedures for unhindered cross-border flow of energy resources.

Proceeding from the above, it can be concluded that the involvement of transit countries in the producer/consumer dialogue is an expedient and urgent necessity for the stability and security of the energy market.

Endnotes

- 1 In 2006 UK the first time since the discovery of resources in the North Sea, started importing natural gas from Russia (swap deal)
- 2 www.eurostats.org
- 3 The break-through in the production of shale gas in 2009 may significantly extend availability of natural gas beyond 2068
- 4 Energy Nation Norway, KonKraft Report 1, www.konkraft.no
- 5 Oil and Welfare: Middle East and OPEC Countries, Marie-Claire Aoun, Université Paris Dauphine, January 25th. 2007, www.dauphine.fr
- 6 www.bpstatisticalreview of world energy 2008
- 7 www.daufine.fr
- 8 PSA on Sakhalin 2 was revised in favor of Gazprom, PSA in Kahsgan was revised in favor of Kazmunaigas
- 9 Azerbaijan is an exception in this regard
- 10 Gazprom's move to get direct access to consumers in France, Germany and Italy has raised serious concerns in the EU. OPEC countries have no direct access to the EU market at all.
- 11 According to a recent study by Price Water Coopers the EU will be able to meet 100% of its demand in energy by renewables by 2050, Bulletin de l'Industrie Pétrolière, le 30 mars 2010
- 12 Center of Global Energy Studies comments
- 13 Treaty of Paris of 1951
- 14 Finally Russia was so unhappy by the way its energy security indicative was approached that withdrew from the Energy Charter Treaty in Summer 2009
- 15 In September 2009 the Russian government invited major oil and gas companies and IFIs in Yamala and offered them to bid for the reserves development under government conditions.
- 16 On the giant Stokman gas field in the Arctic Barents sea Gazprom concluded a PSA with Total and Statoil
- 17 Interfax, RBK, September 24
- 18 Because of oil and gas consumption, and thus, imports reduction strategy developed by consumer countries
- 19 That year US produced 300 bcm of shale gas – Gas non-conventionel, Bulletin de l'Industrie Pétrolière, 6 Janvier 2010
- 20 US regazification terminals operate at 10% of their capacity
- 21 www.energycharter.org
- 22 The pipeline Baku-Novorossisk across Russia (North Caucasus) was not operational for many years because of war in Chechnya.
- 23 According to V. Socor the price Gazprom had agree to pay was \$340 per thousand m3, Turkmenistan Taking Time out of Gazprom, Jamestown Foundation, September 15, 2009
- 24 Kommersant, Turkmenistan Pobedil na Troix, April 15, 2010
- 25 Gas price for Belarus in 2010 was \$171 per thousand m3.
- 26 Oksana Mitrofanova, "Guerre du Gaz", Ukraine: Etranger Très Proche, "Outre Terre, Revue Européenne de Géopolitique", 2011, p.275-287, www.outreterre.com
- 27 www.energycharter.org
- 28 The Text of the Transit Protocol has been under discussion since 2006 but the ECT members have not yet agreed on the final text of the protocol.
- 29 The building of South Stream depends on the outcome of negotiations of Ukrainian and Russian authorities
- 30 The US -Turkey relations already depredated by the war in Iraq was further aggravated by the discussion in the US Senate on recognition of the Armenian Genocide during the spring of 2010.

- 31 Turkey signed preliminary agreements on joint commercialization of Iranian and Turkmen gas delivered by Turkey/Iran gas pipeline.
- 32 Russia/Ukraine dispute on Russian gas transit left tens of thousands of EU households without heat in cold winter days in January 2009
- 33 Russia/Belarus dispute on the transit of Russian oil through Druzhba oil pipeline left EU consumers without Russian crude in January 2010
- 34 In 2009 Russia decided to withdraw from the Energy Charter Treaty leaving no hope about providing a third party access to its huge Eurasia energy network
- 35 Dr. Sedat Cal, Senior Expert, Energy Charter Secretariat, discussed the UN convention as an instrument of International Law potentially allowing the lay of pipelines on continental shelf and economic zones of other countries in April 2010 at a conference in Baku.
- 36 Roberto Pirani, Chairman of White Stream Consortium, "The Current Status of the White Steam Project" – presentation made at Georgian International Oil and Gas Conference, on 24 March 2010
- 37 Russia needs an official approval from Turkey to build South Stream across Turkey's exclusive economic zone
- 38 Interview with the First Deputy Energy Minister on 6 April 2010 (author)

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