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COMMISSION STAFF WORKING PAPER

Energy dialogue with Russia:

Update on progress since the November 2002 EU-Russia Summit

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1. INTRODUCTION

1.1. The initiative

As the EU-Russian Energy Dialogue enters into its third year, it has become an important part of bilateral relations between the EU and Russia, a fact that has been stressed by all the recent EU-Russia summits.

The short and medium term tasks for the Energy Dialogue were established at the EU-Russia Summit of October 2001 and further issues were identified at the Russia-EU Summit of May 2002 *(annex 1)*. A third joint progress report from the two sole interlocutors was presented to the EU-Russia Summit of November 2002 and a detailed Commission Staff Working Paper[1] issued in the same month.

At the informal Ministerial meeting on energy held in Thessaloniki on 22 February 2003, an oral presentation of the latest developments in the Energy Dialogue was given by Commission Vice President Mrs De Palacio and welcomed by the Energy Ministers from the Member states.

The EU-Russia energy dialogue has already produced a number of concrete results. The purpose of this report is to give a comprehensive overview of the progress achieved since the latest Commission staff working paper on this issue, in view of the forthcoming EU-Russia Summit which will take place in St-Petersburg on 31 May 2003.

1.2. Recent and foreseen developments in the EU and Russian energy sectors

The establishment of an internal gas and electricity market in 2004 for non-household consumers and 2007 for every consumer will be a decisive step for the creation of a real internal market in energy. The two sole interlocutors, Russian Deputy Prime Minister Khristenko and Commission Director General for Energy and Transport Mr Lamoureux organised a "round table" on gas issues in Brussels on 10th December 2002. The Russian delegation included representatives from the Russian ministries concerned, as well as Gazprom. EU participants included Commission Vice President Mrs De Palacio, Commissioner Monti, the President of the EBRD Mr Lemierre and representatives of the energy sector. During this "round-table", the Russian authorities acknowledged that the EU decision on market opening was irrevocable and expressed great interest in the possibility of being a full operator in what will be the largest integrated energy market in the world. They also underlined that they take as a reference some elements of the EU model for the reform of their own energy market, notably the separation of the transportation function from production.

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[1] Energy Dialogue with Russia – update on progress. SEC(2002) 1272 of 20.11.2002

Regarding the situation in Russia, the Russian government continued its policy of selling off the remaining state holdings in the country's oil companies on 18th December 2002 with the sale of its nearly 75% holding in Slavneft to the Russian oil companies Sibneft and Tyumen Oil Company.

On 11th February, British Petroleum signed a memorandum with the Russian Tyumen Oil Company (TNK) to create the third largest oil company in Russia. The new company will produce 1.2 million barrels per day, have reserves of 5.2 billion barrels, and operate five refineries and 2,100 filling stations.

On 21st February, the Duma finally approved a package of six bills dealing with the reform of the electricity sector. The package included the federal law on electricity, changes to the federal law on the state regulation of electricity and heat tariffs, the law on the functioning of the electricity sector in the transitional period, and federal laws amending the Civil Code, the law on the natural monopolies and the law on energy conservation.

The reform of the Russian gas sector is currently under consideration and the recently announcement that the Russian Government and Gazprom itself together now own 51% of the shares in the company should be seen in this light. While there appears to be an acceptance of the necessity of unbundling, separating the transportation function from production, a variety of ideas are under consideration.

The Russian Cabinet is due to discuss the latest draft energy strategy up to 2020 during May 2003, which should address the issue of reforming the Russian gas industry.

2. RECENT PROGRESS ON THE ISSUES IDENTIFIED

2.1. Energy infrastructure projects of "common interest"

The EU-Russia Summit of October 2001 identified a number of major energy infrastructure projects as being of "common interest" for the EU and Russia. These were:

- the northern trans-European gas pipeline from Russia under the Baltic Sea to the EU,
- the development of the Shtokman field in the Barents Sea,
- a second Yamal-Europe gas pipeline network through Belarus and Poland, running parallel to the first,
- connection of the Druzhba oil transmission system, through Belarus and Ukraine, with the Adria network. This would mean reversing the oil flow of the Adria network, permitting Russian oil from the Druzhba pipeline to transit the Adria network to the Croatian Adriatic port of Omisalj.
- interconnection of the Parties' electricity networks.

In the light of the recent accidents involving the maritime transportation of oil and following the Commission decision of 20th December 2002 to propose a series of new measures to improve the safety and security of the maritime transportation of oil, the Commission has approached Russia with the proposal to associate her and other neighbouring countries in implementing these proposals.

This is also one of the reasons why the Commission is ready to assess the opportunity for extending the list of projects of common interest to enhance and develop pipeline

infrastructures to carry oil overland from Siberia as an alternative to maritime-based projects and to ensure the geographical balance between the different parts of Europe.

The Commission staff working document on the Energy Dialogue with Russia of November 2002 indicated that, in the framework of the TACIS programme, the Commission had mandated a team of experts to assess each of the projects of "common interest". These experts expressed the view that the common interest projects identified at the October 2001 EU-Russia remain of mutual interest and strategic importance, and also suggested that there are additional projects which could benefit from being defined as being of "common interest".

It is evident that all such projects and the specific routes chosen remain the responsibility of the companies concerned, based upon commercial and economic considerations, as well as on the countries involved. However, it is also clear that the Energy Dialogue has an important role to play in acknowledging all those projects which are clearly in the mutual interest of the EU and Russia, and to work to facilitate their realisation.

2.2. Non-commercial risk guarantee fund

The experts mandated to assess each of the projects of "common interest" were also requested to propose an outline for a specific and practicable scheme to mitigate the residual non-commercial risks associated with the limited number of projects selected.

The experts have submitted their report in which they recognise the importance of developing a scheme to protect investors against certain risks of a non-commercial nature which could otherwise act as a disincentive. To this end, they have proposed the creation of a Guarantee Fund to insure against risks of non-enforcement of an international arbitral award granted in relation to a claim arising from a default by a private party or by a State in the performance of its obligations *(annex 2)*. Contribution to the Guarantee Fund could come from different sources such as the Russian Authorities and International Financial Institutions, as well as the private banking sector. It is however anticipated that this Fund should be neither financed by Community funds nor managed by the Commission.

A seminar was held in Moscow on 6th November 2002 at which the outline of the guarantee fund was presented by the experts to the representatives of the Member States and EU companies. The scheme for a guarantee fund was well received by the participants. It is intended that further "round tables" consisting of the public authorities involved, international bodies, financial institutions and energy companies will be held to "refine" the scheme for a guarantee fund and promote the necessary investments for the projects of common interest. The next "round table" is expected to take place in Moscow in April 2003.

The proposal from the experts will now be the subject of a full feasibility study in close collaboration with International Financial Institutions. To this effect, the Commission has had a series of bi-lateral contacts with the European Investment Fund (EIF) and the European Bank for Reconstruction and Development (EBRD).

2.3. Gas supplies and long term contracts

In its decisions relating to the establishment of the internal energy market, the EU has confirmed the important role that long term natural gas supply contracts have played and will continue to play in ensuring the security of gas supplies into the EU market, by providing a risk sharing arrangement between producers and buyers which has enabled important new production and infrastructure projects to be undertaken. It is convinced that the internal gas

market will continue to provide for the existence of such contracts, as EU gas purchasers recognise security of supply as a vital criteria.

In this context, the Commission's services continue to examine and regularly discuss with the market operators certain clauses that exist in some long term natural gas contracts which prevent the purchaser from reselling the natural gas outside its principal supply area. Discussions are now ongoing between Gazprom and its European clients to find a mutually acceptable commercial alternative that is compatible with Community law. Considerable progress has been made in the negotiations and the Commission has been informed of, and has welcomed, the progress to date. While a number of issues remain to be finalised, there is reason to believe that a mutually acceptable solution is now close at hand. The importance of resolving this issue swiftly was recognised by EU energy ministers at the informal meeting held in Thessaloniki on 22nd February 2003.

2.4. The legal framework

The recently-announced planned major investment by BP in the Russian energy sector in the form of a joint venture with the Russian TNK oil company is a clear indication of an increasing confidence by European companies in the investment environment in Russia. The third joint report by the two single interlocutors presented to the November 2002 EU-Russia Summit underlined that, to underpin the attractiveness of legal frameworks such as concessions and joint ventures for investments, it is important to ensure appropriate access to the energy transport networks and for appropriate rules providing a stable framework to ensure non-discriminatory access to the energy transport networks. It is also important that energy prices reflect the commercial imperative for investing companies that at least the capital and operating costs can be recovered.

Nonetheless, the Commission continues to believe that, for certain types of heavy investments and where, due to technical complexities, Russian companies may lack expertise[2], Production Sharing Agreements (PSA) will remain the ideal, indeed necessary, vehicle for some types of high risk investment. Without a comprehensive and efficient PSA regime, certain projects will just not happen.

After the postponement of the second reading of the Tax Code, the Commission notes the intention of the Duma to examine this draft legislation during March 2003. The Commission, in discussions with Russia in the framework of the Energy Dialogue, has and continues to strongly underline the importance of rapidly completing the Tax Code as it applies to PSAs, along with the remaining outstanding normative acts, the dispute settlement procedures, the issue of access to foreign markets, and the further development of the "one stop shop" investors' facility.

As recognised in the last joint report presented to the EU-Russia Summit of November 2002, it is also important to ensure appropriate rules providing a stable framework to ensure non-discriminatory access to the energy transport networks in order to encourage the use of legal frameworks such as joint ventures and concessions. This is an important precondition for significantly increasing investments.

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[2] Off-shore projects are typical examples.

2.5. Trade in nuclear materials

As noted in the joint statement on energy from the May 2002 Russia-EU Summit, the existing situation with respect to the import of nuclear materials to the EU Member states is a matter of concern for the Russian side. With the objective of reaching a mutually acceptable solution, the Commission has elaborated a mandate for negotiation with the Russian authorities. The Commission is now awaiting the approval of the Member states. In the context of the impending completion of the EU's internal market and enlargement, Russia has repeatedly underlined in discussions the importance of addressing this issue rapidly.

2.6. Electricity

In the context of a closer integration of the EU and Russian energy markets, it would be inappropriate to leave aside the issue of the eventual interconnection of the EU and Russian electricity grids. The Commission's Green Paper on Security of Energy Supply has underlined the importance of better interconnections between the networks of the EU and those of the applicant countries and Russia and it is clear that preparatory work must be undertaken to examine all aspects of this issue in detail. Russia has been giving an increasing importance to this in discussions and the EU electricity industry has shown considerable interest in the Russian electricity sector.

On 20 March 2002, a Protocol was signed in Warsaw between the CIS Electric Power Council (CIS EPC) and the Union of the Electricity Industry (EURELECTRIC) which committed the parties to encourage the development of a dialogue between the associations, including annual meetings to follow-up and assess progress made towards interconnection and in the fields of market structure and environmental aspects. Russia also participated in the 9th meeting of the European Electricity Forum held on 17th-18th October 2002 in Rome.

For the EU, however, there are a number of prerequisites for Russia to sell on the European electricity market[3]. These include:

– reciprocity in terms of market opening and the basic elements of market structure,

– environmental protection,

– a high level of nuclear safety comparable to that which exists in the EU Member states.

In addition, there would evidently have to be compliance with the general trade regime of the European Community, notably with respect to the anti-dumping and anti-subsidy rules.

With respect to the technical aspects of interconnecting the networks, the Commission intends to work together with the Union for the Co-ordination of Electricity (UCTE) representing the transmission system operators in continental Europe and the Russian electricity company RAO UES to define, by September 2003, the terms of reference for a full feasibility study. Such a study would include an examination of the actual and potential bottlenecks in interconnection and the technical issues related to any incompatibility of the Russian electricity system with that of continental Europe.

[3] These must respect the conditions established under Article 19 of the Partnership and Co-operation Agreement between the EU and the Russian Federation.

It is clear that the preconditions established by the EU must be addressed at the same time. There needs to be a full assessment of the current and developing situation both in Russia and the EU, particularly as market reform and further market opening respectively are progressively altering the structure and players on the electricity market. At the same time, matching EU environmental and safety standards will require very significant investments. The scale of these investments, in the probable context of an increasing internal demand for electricity in Russia and the priority on constructing additional capacity, rather than upgrading existing capacity, will necessitate the development of a coherent strategy.

The Commission therefore proposes to prepare, together with the representatives of the EU and Russian electricity industry, factual reports of the situation in both the EU and Russian electricity markets by September 2003. A first meeting to examine this question took place on 25th March 2003 in Brussels and involved the Russian authorities, the Russian electricity producer RAO UES, the European electricity producers association, Eurelectric and various services of the Commission.

2.7. Pilot projects in energy savings in Archangelsk, Astrakhan and Kaliningrad

Missions to Astrakhan in January 2002, Archangelsk in April 2002 and Kaliningrad in October 2002 prepared the ground for concrete pilot energy efficiency programmes. Work is now underway with the Russian authorities to produce specifications for technical assistance projects to be financed under TACIS programme 2003, with an overall budgetary envelope of some € 3 million. The combination of low energy prices in Russia and an undemanding Kyoto target for the first commitment period (2008-2012) means that energy efficiency and energy savings have not been given a high priority in the implementation of the overall Russian energy policy.

With the decision of the May 2002 EU-Russia Summit to extend the pilot projects in the rational use of energy and energy savings to the Kaliningrad Oblast, an exploratory mission took place during the week of 14th October to evaluate the possibilities for improving energy demand management and energy saving in the household and industrial sectors. The mission included meetings with regional and municipal authorities, energy utilities and local agencies. All indicated that a huge potential for energy savings exists in district heating for public and residential buildings. It is therefore proposed to launch a project that should demonstrate the technical and financial viability of integrated innovative and conventional technologies for rational use of energy in buildings. Such an integrated approach would include: power generation, transmission and distribution of heat, insulation of buildings, metering as well as new tariff and legislative measures which would reward energy saving measures. An important objective would be to ensure that the results could serve a as good reference for other regions and be easy to replicate. Different opportunities to finance the project are currently under investigation.

2.8. Oil and gas security

Recent developments on the international oil market have served to underline the importance of extending the scope of the Energy Dialogue to examine possible ways of jointly promoting energy security and market stability on the European continent. Russia remains by far the world's largest exporter of natural gas and the second most important exporter of oil and oil products. It is estimated to hold the world's second largest reserves of crude oil and natural gas liquids after Saudi Arabia and over 30% of the world's proven natural gas reserves. In addition, both President Putin and Prime Minister Kasyanov have underlined that Russia is prepared to co-operate more closely with the EU on oil matters.

Recognising that appropriate measures are required to mitigate the risks associated with the potential disruption of external energy supplies as the internal energy market moves towards completion, the Commission submitted a proposal to the Member states in September 2002 to develop an effective co-ordination system for oil and gas stocks, and Russia has been following this proposal with great interest. In this context, a first discussion on the possible input by Russia into the Community efforts to improve oil and gas security was held at the Informal Ministerial Meeting on Energy in Thessaloniki on 22nd February 2003.

The importance of constantly monitoring the hydrocarbon transportation infrastructure and the necessity of rehabilitating and upgrading it where necessary, has been recognised from the outset of the Energy Dialogue. There is an agreement to collaborate in the framework of an observatory to ensure the safety of the energy transportation network, including a commitment to examine the development of a regional satellite monitoring system for accident prevention and leak detection for oil and gas infrastructures, relying principally on the GALILEO and GLONASS satellite navigational systems. A programme could be envisaged in the framework of TACIS.

2.9. Clean coal

With the main provisions of Russia's "Energy Strategy until the year 2020" document projecting a 75% increase in coal production[4] and for an increasing role for coal in electricity generation[5], it is important to encourage the use of modern, efficient and cleaner coal combustion technologies.

For this reason, and to order to promote the most efficient EU Clean Coal Technologies, Russia has been considered a priority in both the 2001 and 2002 call for proposals[6] under the CARNOT programme[7] related to the promotion of the clean and efficient use of solid fuels.

Three CARNOT projects are currently underway related to Russia:

– *"Cost Effective Clean Coal Improvements to Russian Utility Plant".* The objective is to gain better market and technical information to facilitate the technology transfer of relatively low cost methods to improve the efficiency and environmental performance of conventional coal-fired power plants in Russia. This will be achieved through workshops which are currently planned to take place on 24th-25th April 2003 in Novosibirsk, 28th April in Ekaterinberg and 26th-27th May in Moscow.

– *"Promotion of Renovation Activities in the Russian Energy Sector"*. This study will be a market assessment of the perspectives for rebuilding/rehabilitating coal-fired power plants in Russia to increase efficiencies and thereby reduce the greenhouse gas emissions. Data is currently being collected on the Russian coal-fired power sector in co-operation with the VTI All-Russia Thermal Engineering Institute with a view to suggesting measures for the modernisation of selected power plants. The results of

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4 From a 258 million tonnes in 2000 to between 340 and 430 million tonnes in 2020.

5 The Strategy calls for coal-fired electricity generation to increase from 17% of total generation in 2000 to 29% by 2020, which could double coal consumption in the power sector.

6 Call for proposals for 2001.
Published in the Official Journal of the European Communities, C 270 of 25.9.2001, page 8.
Call for proposals for 2002.
Published in the Official Journal of the European Communities, C 64 of 13.3.2002, page 11.

7 Council Decision 1999/24/EC of 14.12.1998.
Published in the Official Journal of the European Communities, L 7 of 13.1.1999, page 28.

this work will be presented to the workshop being held in Moscow on 26th-27th May in Moscow. This will then be followed by field visits to the most representative Russian coal-fired power plants.

– *"Circulating Fluidised Bed for the Clean and Very Efficient Retrofit of an Existing Coal-Fired Power Plant"*. This project is studying the rehabilitation of the "Novocherkasskaya GRES" coal-fired power plant, with the focus on the operational problems and determining the most appropriate technical solutions, bearing in mind the quality of the coal used and the increasing environmental constraints. Currently data is being collected from similar Clean Coal Technologies world-wide. This will be followed by the work on the specific plant, which will result in a detailed technical description and cost estimation of the Circulating Fluidised Bed technology, as adapted for the plant, being prepared and presented to the plant's operators. The replication potential of this project across Russia and Eastern Europe will then be assessed and a training seminar will be held aimed at the local market actors and decision makers.

In addition, under the 5th Framework Programme, a project is now underway on "Securing Energy Supply and Enlarging Markets through Cleaner Fossil Technology", which will specifically look for new opportunities for EU Clean Coal Technologies in the markets outside the EU, such as Russia.

2.10. Energy Technology Centre

The EU-Russia Energy Technology Centre[8] was opened in Moscow on 5th November 2002 in premises provided by the Russian authorities. The Commission is now working closely with the Russian authorities to ensure that it is developed as a highly visible focal point for technology collaboration and for promoting new energy-efficient technologies in Russia.

As a result of a call for proposals for RTD actions under the specific programme for research, technological development and demonstration on 'energy, environment and sustainable development (1998-2002), a consortium of European entities has been selected to operate this Centre. Commission funding is being provided for a period of three years, alongside the funding provided by the consortium and Russia.

The specific objectives of the Centre are to:

– Establish a contact point between EU and Russian energy sector actors,

– Provide a forum for the exchange of ideas, information and discussion on technologies in oil and gas, coal, electricity, renewables and energy saving and energy efficiency sectors,

– Provide training to specific target groups on energy technologies in these sectors,

– Provide technical assistance for the introduction of advanced energy technologies in Russia,

– Liaise and co-ordinate with other Energy Centres that are in operation in Russia,

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[8] Further details on the Centre can be found at the following web address: http://www.technologycentre.org/eng.htm

– Undertake information dissemination and communication activities on energy technologies.

The work of the Centre has been grouped into a number of work packages covering oil and gas, coal, electricity, renewables and energy saving and energy efficiency, reflecting the main priorities highlighted in the report prepared by the thematic group on "Technology transfer and energy infrastructure". Specifically, state-of-the-art technologies in the following areas will be promoted:

– Hydrocarbons: exploration and reservoir management, enhanced recovery and improved drilling techniques, Health, Safety, Quality and Environmental aspects both upstream and downstream, the production of clean fuels, gas chain management and transportation,

– Coal: coal bed methane, coal preparation, coke production and coal gasification,

– Electricity: power plant technology and operation, power demand structure, waste management policy and carbon sequestration,

– Renewables and energy efficiency: use of small hydropower, biomass technologies, wind energy and photovoltaic.

2.11. Co-operation on implementing the Kyoto Protocol

On the initiative of Russian President Putin, Russia will be hosting a World Conference on Climate Change in Moscow from 29th September to 3rd October 2003. However, Russia has yet to ratify the Kyoto Protocol and, in all the meetings with the Russian authorities in the framework of the Energy Dialogue, the Commission has underlined the importance of an early ratification. Ratification by Russia is a *sine qua non* for the Protocol to enter into force and would offer important opportunities to Russia. In particular, Russia will be able to take advantage of the flexible mechanisms foreseen under the Kyoto Protocol. First of all, Russia will benefit from emissions trading with other Parties that have accepted targets under the Kyoto Protocol, including EU Member State governments. Secondly, investments in Joint Implementation projects will lead to the transfer and development of environmentally sound and modern technologies to Russian companies and generally enhance the pace of economic modernisation towards sustainable development. The Commission regrets the postponement of the Russian decision in this respect as it is delaying progress on co-operation in the field of energy efficiency which is expected to benefit significantly from the value of the CO2 emission reductions associated with such projects.

3. SUMMARY

Russia is increasingly demonstrating a keen interest in playing an important role in the EU's internal market for gas and electricity, and the Energy Dialogue is proving an important framework for addressing relevant issues. Bearing in mind the forthcoming enlargement and the objective of the Energy Dialogue of enhancing the security and sustainability of energy supplies across the entire European continent, the Commission takes into account the interests and concerns of the Candidate Countries.

With respect to the projects of common interest, it is evident that priorities between the various projects must now be defined. An important priority is clearly the northern trans-European gas pipeline. However, it is also necessary to examine the possibility of identifying additional oil pipeline infrastructures as an alternative to the development of new maritime-based projects. In this context, it is important to ensure that the full feasibility study to develop the proposed non-commercial risk guarantee fund is completed as rapidly as possible.

In particular, the important progress made towards resolving the issue of the destination clauses which exist in certain long-term contracts for natural gas has been the result of this Dialogue and it is becoming increasingly important to rapidly resolve this issue as the EU market opens and expands.

The Commission continues to underline the importance of making rapid progress on the completion of the PSA legal framework. Progress on the aspects relating to PSAs in the Tax Code was apparent towards the end of last year, but has since stalled. It is important that the momentum is re-established and that PSA's do become an attractive vehicle for investments in high-risk projects which would otherwise remain unachievable.

In addition, in the framework of the Energy Dialogue, the Commission and Russia have identified the importance of giving mutual access to one another's electricity markets on the basis of fair and equivalent trading and environmental conditions. This is becoming particularly important and urgent as certain accession countries are linked into the CIS-Russia electricity grid and not the continental European UCTE grid.

Russia continues to underline the importance of an early discussion on the issue of trade in nuclear materials, where the Commission is awaiting the approval of the Member States on a negotiating mandate.

It is also clear that, despite Commission efforts, Russia is not currently attaching sufficient priority to the projects on energy saving and energy efficiency.

Russia is following closely the developments surrounding the Commission's proposal on safeguarding the security of oil and gas supplies, and has expressed its interest in participating in the proposed European Observation System.

Finally, the Commission is examining ways of enhancing the practical involvement of the EU and Russian energy sector industry in the energy dialogue.

Annex 1: Issues addressed by the Energy Dialogue

a) Objective

The EU-Russia Energy Dialogue was launched at the EU-Russian Summit of 30th October 2000 in Paris to give an impetus to the definition and arrangements for an EU-Russian Energy Partnership to be established within the framework of the Partnership and Co-operation Agreement (PCA). The remit of the Energy Dialogue was defined in the Joint Statement to the Summit of Paris as providing a framework within which "to raise all issues of common interest relating to the [energy] sector, including the introduction of co-operation on energy saving, rationalisation of production and transport infrastructures, European investment possibilities, and relations between producer and consumer countries".

In pursuing the dialogue, the Commission is also very conscious of the necessity of continuing to ensure coherence with other legal frameworks such as Energy Charter Treaty process, as well as regional initiatives such as the energy component of the Northern Dimension. The Commission continues to underline the importance of an early ratification of the Energy Charter Treaty by Russia in meetings with the Russian authorities.

b) Issues identified at the EU-Russia Summit of 3rd October 2001

The Summit recognised that, in the short term, progress could be obtained in the following areas:

- improvement of the legal basis for energy production and transport in Russia, completion of the regulatory provisions for production sharing agreements and a mechanism for assisting investors in the energy sector, aimed primarily at simplifying administrative and licensing procedures, which are essential preconditions for boosting European investment in the energy sector;

- ensuring the physical security of transport networks. In this context, the European Union is ready to co-operate in the export networks, if and when this is considered necessary by the Parties. The development of a regional satellite monitoring system for accident prevention and leak detection for oil and gas infrastructures will be examined;

- legal security for long-term energy supplies, recognising the important role played in this context by long-term contracts and energy markets in ensuring energy security. Russia stresses the importance it attaches to long-term "take or pay" contracts;

- the recognition of certain new transport infrastructures as being of "common interest", such as interconnection of the Parties' electricity networks, the northern trans-European gas pipeline, the Yamal-Europe gas pipeline network through Belarus and Poland, the development of the Shtokman field and, in the case of oil, connection of the Druzhba transmission system, through Belarus and Ukraine, with the Adria network, which will ensure non-discriminatory transit of energy products and increased supplies to the EU and the candidate countries. Russia considers the implementation of the Kobrin-Velke Kapoushany gas pipeline a priority. Such projects, and the choice of routes, are the responsibility of the States and companies concerned;

– in the light of the importance of rational energy use and savings, it is recommended that pilot projects in the Arkhangelsk and Astrakhan regions of Russia be carried out as soon as possible. During 2002, detailed summary reports for these regions will have to be drawn up with financial support from various European sources including industry. This should create a basis for the implementation of other such regional projects.

The Summit also recognised that certain other important issues required further examination and technical study:

– the potential and merits of an investment support scheme which would mitigate non-commercial risks;

– a study of the prospects that the flexible mechanisms of the Kyoto Protocol could offer to Russia for attracting investment in the modernisation of its energy sector;

– the conditions for reinforcing energy science and technology co-operation, notably through the creation of a Russia-EU Energy Technology Centre in Moscow. The added value which co-operation between such a centre and any national energy centre set up under bilateral co-operation between Russia and an EU Member State should be taken into account;

– certain preconditions which should be required for the supply of electricity, such as sufficient availability on the Russian installed capacity market, measures to protect the environment and a high level of nuclear safeguards, comparable to those in force in the EU Member States;

– a study of the possibilities for common implementation of energy-saving and renewable energy projects, in particular by drawing up a catalogue of such projects in Russia which could be financed under the joint implementation mechanism provided for in the Kyoto Protocol;

– the organisation of training in corporate governance.

c) Issues identified at the Russia-EU Summit of 29th May 2002

– extension of the pilot energy saving projects from the Archangelsk and Astrkakhan Oblasts to include Kaliningrad;

– necessity of jointly examining any constraints to the trade in primary energy;

– for electricity, the necessity of moving forward on the questions of reciprocity in market access and environmental and nuclear standards;

– and, for the trade in nuclear materials, highlighted the importance of reaching a mutually acceptable solution in accordance with Article 22 of the PCA.

Annex 2: non-commercial risk guarantee fund proposed by the independent experts

The views expressed in this paper reflect those of the experts and do not necessarily reflect the views of the Commission

Arbitral Award Guarantee Fund

1. Background

The European Union and the Russian Federation decided at the Paris Summit in October 2000 to establish an Energy Partnership building on the new significance given to EU-Russia relations and energy security.

The growing demand for energy in the European Union calls for the implementation of new strategic projects of common interest integrating the development of new energy production and transportation projects in Russia. Such need is even more relevant with a view to the forthcoming accession to the EU of new Member States following the conclusion of the Enlargement negotiations.

While projects of common interest are the responsibility of the companies involved, both the EU and Russia are desirous to facilitate the financing and implementation of these projects. In that context it was decided by the EU and Russian authorities to explore, among other things, the possibility of creating a new and practicable scheme for the mitigation of residual non-commercial risks associated with projects of common interest. It is in response to this decision that the following concept has been developed by a group of experts appointed jointly by the EU and Russian authorities.

2. Purpose

The proposed Guarantee Fund is designed to insure against a failure by a State to enforce an international arbitral award granted in relation to a claim arising from a default by a private party or by that State in the performance of its obligations under an Eligible Contract.

3. Eligible Contracts

All contracts relating to energy projects which are of common strategic interest for both the EU and Russia. Projects would be granted the status of 'Project of Common Strategic Interest' following a formal decision, on a case-by-case basis, jointly by the EU and Russian authorities. The approval process will need to be structured in such a way that it will provide for a formal endorsement of such projects by the Governments concerned without however opening the door for interference by Government officials in the negotiations among the private parties involved in these projects.

Eligible projects should meet the following criteria:

i. They should contribute directly or indirectly to the export of energy resources from Russia and to the imports into the EU.

ii. They should be of sufficient size to justify the involvement of Russian and EU authorities, i.e. requiring in excess of 100 million Euros of financing.

iii. The primary partners in such projects should be either European or Russian.

iv. Projects should be economically and financially viable, with a fully underwritten financing plan (including both debt and equity).

v. The projects should not violate any of the applicable laws either in Russia or in the EU, including in areas such as the environment, competition law and market access.

For a contract to be eligible, it will need to be subject to international arbitration in accordance with one of the existing and well-established procedures acceptable to the governments of Russia and the EU.

It is anticipated that loan and other credit agreements, which are usually not subject to international arbitration, would not be eligible for direct coverage by the proposed Fund as this Fund is not meant to be a loan guarantee scheme duplicating the type of support provided by Export Credit Agencies and other multilateral organisations but is meant to provide a type of support which is complementary to what is already available. The lenders are nevertheless likely to benefit directly from the coverage provided by the Fund as it is expected that, in the context of typical project financing arrangements, the benefits of the coverage of the Fund and the proceeds of any payment by the Fund in relation to a dispute which has affected a borrower's ability to service its debt would be assigned in whole or in part to the lenders.

4. Coverage and Term Provided

In case a monetary arbitral award that is made in accordance with the approved international arbitration procedures and that is entitled to recognition and enforcement under the 1958 New York Convention, has not been satisfied within [6-12] months of an application for recognition and enforcement to the competent authority in the State in which enforcement is sought, the Fund will pay the injured party the amounts awarded up to the agreed underwritten limit.

It is anticipated that there will be some limited exclusions:

– "Genuine" insolvency of the defaulting party. Indeed, the purpose of the Fund is not to underwrite the credit worthiness of parties to a contract but to protect them against the risks of non-enforcement of international arbitral awards arising from the weakness of local judicial systems or other factors of a political nature.

– Events of Force Majeure leading to wholesale renunciation/invalidity of contracts concluded previously between EU and Russian parties. Such "non-project specific" event would need to be dealt with at a State to State level with the recovery of awards and other damages on behalf of

private parties being handled directly by the respective States as is customary in cases of international crises.

The Fund should pay once all the possibilities to appeal or challenge the international arbitral decision will have been exhausted, including any challenge to the enforceability of the award being made in accordance with the provisions of the New York Convention of 1958. The Governments should also agree not to invoke Sovereign Immunity as a way of avoiding satisfaction of an international arbitral decision rendered against them.

The term of the coverage provided by the Fund will depend on the duration of the contracts being underwritten. Because of the nature of the projects and of the contracts to be covered and the likely tenor of the financing of these, it is expected that the Fund will provide long-term coverage of up to 10-15 years.

While the risk profile of each contract (or exposure) will vary over time and while, therefore, the coverage provided will need to be modulated over time to reflect this, it is anticipated that no renegotiation of the coverage will be allowed during the term of the policies in order to avoid " adverse selection" problems.

5. Number of Projects and Contracts Insured

This should be determined following a thorough analysis of the likely demand. There are two broad approaches:

i. Alternative One: Concentrate on a small number of big projects (e.g. four to five projects) recognizing that this might create risk concentration issues.

ii. Alternative Two: Diversify risks over a larger number of projects or risks. From a risk management standpoint, this latter alternative would be preferable.

For any given project, a number of separate contracts could be covered involving different counterparties. The Fund's underwriting policies, however, will need to address the issue of 'correlated risks' and 'domino effect' and set exposure limits both for individual contracts as well as for groups of contracts where there is a correlation of risk.

6. Amounts Insured

It is anticipated that the maximum risk exposure on anyone insurance policy and/or aggregate occurrence could reach up to 500 million Euros. Out of these 500 million Euros, the net retention of the Fund, excluding any reinsurance support, should not exceed 100 million Euros and, preferably, should be lowered to around 50 million Euros or less.

The average gross exposure will depend on the approach chosen relating to the number of projects. From a risk management standpoint an average gross exposure (including reinsurance) of 100 million Euros or less would be preferable (with possibly a very small number larger exposures of 500 million Euros).

7. Premiums

Premiums would be payable on the amounts insured. The premium level will be determined following a detailed analysis of the financial viability of the Fund and of the costs of reinsurance or other forms of risk sharing arrangements. The premiums should be sufficient to allow the Fund to cover its operating expenses and generate an acceptable return on capital.

It is expected that the premium level will be in the range of 0.5% - 1.5% of the amounts insured.

8. Expected Aggregate Commitment and Exposure

From the outset the Fund should be capable of carrying up to twice its subscribed capital on a net retention basis and to leverage this further through reinsurance agreements. The goal is to enable the Fund to carry an aggregate exposure from the outset of up to 3 billion Euros, building up gradually to 5 billion Euros and maybe beyond depending on the degree of diversification of the portfolio of risks underwritten by the Fund and on the appetite of the private and government backed political risk insurance and of the broader reinsurance market.

9. Capital Structure

The total subscribed capital of the Fund should be no less than 400-500 million Euros.

The initial paid in capital would represent 25% of the callable capital, or 100 – 125 million Euros.

In addition the Fund will be expected to build up significant reserves, in as much as it has positive technical results and that it does not make any dividend distributions, at least for the first 10-15 years of its existence.

As to the ownership structure of the capital there are several broad alternative ways of structuring the capital:

i. Alternative One: The EU (through EU suitable bodies or institutions) and the Russian government with equal parts.

ii. Alternative Two: The EU (through EU suitable bodies or institutions), the Russian government and transit country governments.

iii. Alternative Four: Any of the above, together with energy industry or financial sector participants.

10. Fund Legal Structure

The Fund would be incorporated as a separate legal entity in an appropriate jurisdiction and, in view of the unique type of insurance coverage provided, it should be structured in such a way that it will not be subject to normal insurance regulations.

11. Re-insurance

In order to increase its risk taking capacity and leverage up its own capital, the Fund will attempt to structure a comprehensive reinsurance program with the specialized insurance, reinsurance and financial markets.

In the present context of the insurance industry, it is highly unlikely that any kind of support can be obtained from the private market on a "risk attaching" basis (providing reinsurance protection on all policies issued during a given period and for the same duration as these), whether on proportional basis or on a non-proportional basis (excess of loss – XL). Certain government or multilateral backed agencies however might consider such an option. It might nevertheless be possible to organize a reinsurance program involving the private market so long as it is structured on a "loss occurring" basis (providing reinsurance protection for any loss declared during a given period). While such program would be launched from the outset, it will have to be re-negotiated on an annual basis in accordance with industry practices.
Two alternative approaches could thus be envisaged for the structure of the reinsurance program:

1. Combination of proportional and non-proportional reinsurance.

   The Fund would cede up to 50% of its gross exposure on each contract to Government backed agencies (a combination of ECAs and MIGA) on a risk attaching proportional basis. The remaining exposure balance would be reinsured through a non-proportional XL program that would absorb the portion of any loss above a certain amount. This XL program would be structured on a loss-occurring basis.

2. Non-proportional reinsurance only.

   If the above is not feasible or is not economical, the Fund would reinsure its exposure through an XL reinsurance program made up of several layers. The first layer would ideally be placed with government-backed agencies either on a risk attaching or loss occurring basis. The following layers would be placed in the private markets on a loss-occurring basis.

In either case, depending on market availability, the Fund might seek to further protect its retained exposure through a portfolio protection program negotiated with the traditional reinsurance market or through the issuance of CAT bonds in the financial markets.

Using the various techniques above it is estimated that the Fund should be able to reinsure, from the start, up to twice the amount of exposure it would retain (or 2 billion euro). The amount of reinsurance it would be able to purchase could gradually increase possibly up to 4 times the Fund's net retained exposure, and even more, depending on the profile of its risk portfolio and its track record of losses and recoveries.

12. Loss Recovery

Once a loss has occurred and the Fund has made a payment, the Fund will be fully subrogated to the rights of the party to which the Fund has made the payment.

In addition, any payment by the Fund will immediately give rise to a financial claim on the Government of the country in the jurisdiction of which the failure to execute the arbitral award has occurred. When constituting the Fund, an agreement to that effect will need to be entered into by the various Governments concerned by which they make a commitment to compensate the Fund for any payments the Fund has made. In view of the multilateral nature of the Fund's backing, it would be justified to obtain for the Fund the benefit of 'preferred creditor status' similar to that of other multi-lateral agencies and to ensure that failure by the obligor Government to meet its financial obligation to the Fund would trigger cross-default clauses with other important official lenders such as EBRD, EIB, IBRD and possibly others.

In order to be able to syndicate as much as possible of the risk in the private re-insurance market, it would be critical that any recovery be used in priority to compensate the reinsurers and other private sector parties who have been involved in covering a specific loss.

13. Link with the Existing Treaty between Russia and the EU, the Partnership and Co-operation Agreement (PCA)

A formal link should be established between the Fund and the existing EU-Russia Partnership and Co-operation Agreement (PCA). Such link could be established through a 'political blessing' from the EU-Russia Summit on the basis of article 98 of the PCA by which the parties explicitly support the use of international arbitration for dispute resolution in the context of investment projects.

Additional support for such a link can be found in the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards, which is in force in EU countries as well as in the countries of the former Soviet Union.

14. Extension to other Countries

As a number of projects of common interest are likely to span several countries outside of Russia and the EU, the proposed scheme should also be designed to protect against the risk on non-enforcement of contractual rights in these other countries. For this, these countries should enter into agreements with the Fund by which they commit to enforce international arbitral awards on their territories and to compensate the Fund for any payments it has made as a result of a failure to do so. It will also require incorporating in such agreements cross-default clauses with the existing international treaties between these countries and the EU.

Such countries would not necessarily have to participate in the capital of the Fund.

15. Governance and Management of the Fund

A Board of Directors representing the shareholders in the Fund would govern the Fund.

Day to day management of the Fund could be entrusted to a small staff (or Permanent Secretariat) or could be delegated to one of the parent institutions. It should be noted that the burden of managing the Fund should be relatively light.

The main task will be to manage the Fund's exposure and to syndicate the risks in the broader insurance, reinsurance and financial markets. This task could be contracted out to a small and specialised underwriting agent constituted for this purpose. This agent could be jointly owned by the Fund and by key energy industry participants as a means of involving the Fund's beneficiaries in the management of the risk syndication process.