

TRANSIT RIGHTS IN PETROLEUM TRANSPORTATION SYSTEMS



University of Oslo

Faculty of Law

Candidate number: 5011

Supervisor: Dagfinn Nygaard

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Preface

In Azerbaijan the main piece of legislation regarding petroleum activities is the Subsurface Law and Law on Utilization of Energy Resources. Neither of them comprises provisions on rights and obligations for transit. Thus, these issues are dealt with in respective agreements. Those agreements are chosen to be examined for the purpose of this thesis. With the rapid development of energy sector in Azerbaijan, the understanding of transit and rights under transit agreements is important for the further improvement of the system.

Introduction will emphasize the importance of transportation networks for certain levels of this system and give an overview of current transportation systems. Further, Azerbaijan's role in petroleum production and transportation will be explained. Chapter II focuses on agreements regulating Baku Tbilisi Ceyhan and South Caucasus pipelines. Discussion on transit rights and obligations will also be comprised in chapter II. For comparison of transit rights with Azerbaijan, Russian system has been chosen. In chapter IV Gazprom system and rights and obligations for transit countries under Russian contracts will be dealt with. In addition, Russian – Ukrainian gas dispute will be explained. Finally, Energy Charter Treaty and conformity of certain systems with it will be discussed in chapter IV.

1 Introduction

1.1 Petroleum transportation networks

1.1.1 Legal issues

For the purpose of this thesis several legal sources, mainly intergovernmental and host governmental agreements are used. These are intergovernmental agreements in respect to the Baku Tbilisi Ceyhan (hereinafter BTC) and South Caucasus Pipeline (hereinafter SCP) projects between Azerbaijan, Turkey and Georgia, as well as between Russia and Ukraine.

Host Governmental Agreements are applicable to the BTC and SCP projects, and concluded between host states and involved companies-shareholders. Intergovernmental and host government agreements together are referred to as Project agreements.

In addition Energy Charter Treaty and its Transit Protocol are discussed in their perspective as role models for transit relations.

1.1.2 Players of transportation networks

Uneven distribution of petroleum resources have always been significant issue for all participants of the network, i.e. resource owners, producers, transit states and consumers of these resources. Every link in this chain has its own benefits and self-interests.

(a) Resource owners and producers

In many countries revenues from exploitation and marketing of petroleum resources are the only significant export good. Without due transportation networks, export of resources would be quite an obstacle, which is why resource owners are interested in creation and development of transportation system.

Transportation of petroleum is even of more strategic importance for those owners without direct connection to a sea – landlocked countries, as well as for countries situated in remote locations from global markets. Well-developed, secure transportation grid which will link them to respective markets, is essential for overall development of such countries.

(b) Transit countries

Transit countries play an essential role in the secure and efficient transportation. In return they benefit from transportation systems passing their areas. To reach the global markets pipelines usually have to cross at least one transit country, as the producers and markets often lie remote from each other. For some states such contracts are of significant importance when it comes to both economical and political independence.

(c) Consumers of petroleum resources

Another player in energy markets are consumers. It is in their interest in the first place, to secure and diversify the transportation process. Many Western countries and USA as consumers invest in transportation networks to create reliably supply system. Obviously, they tend to choose the route that best serves their interests. Hence, every link in the transportation chain is important and one cannot operate without the other.

1.1.3 Major influences to transportation networks

There are certain problems that may influence international projects regarding creation of transportation networks. One of the problems is the economical efficiency of the project which has several elements. First, transit expenditures play an important role. It is essential how much the transit of the petroleum costs from one point to another. Second, transit fees can be another obstacle for cost-effective project. It is in interest of transit countries to demand reasonable fees to have the pipelines built via their areas. Another problem is the length of routes. When deciding among different routes it is desirable to choose a short way. Nevertheless, sometimes short way is not the safe way. Recent problems in South Caucasus, Georgia etc, show that it is better to choose longer but more stable route. In addition, general economical, political situation in countries can be another influence on projects.

1.1.4 Major transportation networks

(a) Azerbaijan

The fact that Azerbaijan does not have a direct link to open seas makes it vital to cooperate with transit countries. The transit states available for Azerbaijan are usually the same. These are Russia, Georgia, Turkey and Iran. Another possible route could be through Armenia but given the occupation by Armenia 20% of Azerbaijan territories and tense relations between

countries Azerbaijan has to consider longer routes. This was the case with the main export route in Azerbaijan BTC pipeline which runs through Georgian and Turkish lands. Another pipeline Baku Supsa pipeline crosses only one additional jurisdiction – Georgia. The first pipeline developed after Azerbaijan gain independence is Baku Novorossiysk connecting Sangachal terminal near Baku with the Russian port in Black Sea. The main characteristic for all transportation systems in Azerbaijan is that they have to pass several borders in order to reach the intended markets.

(b) Russia

Nevertheless Russia is not a landlocked country, it has certain disadvantages in transportation due to remoteness of petroleum reserves from consumers. As one of the main exporters of petroleum, Russia transports its resources to various markets both in Europe and Asia. Russia has two major companies operating oil and gas pipeline systems. Nearly all oil pipelines in Russia are operated by “Transneft”. The company transports 93% of oil produced in Russia.¹ In Russia all gas transportation and pipeline networks are merged in unified gas supply system which belongs to “Gazprom”. Even though Russian petroleum passes several Eastern Europe and Baltic countries, Ukraine is still the major transit country for Russia. This issue will be dealt later in chapter III.

1.2 Azerbaijan as a major petroleum producer

1.2.1 History of petroleum in Azerbaijan

Oil industry has a long history in Azerbaijan. The very first oil well in the history of world, “Bibiheybet” was drilled in Baku in 1848. With the beginning of Soviet Era petroleum industry was nationalized. The period was characterized with the development of several new fields and especially with the development of “Neft Dashlari”(a whole town on the Azerbaijan part of Caspian Sea) complex in Caspian Sea, meaning “Oil Rocks”. This new field is considered to be the beginning of development of subsea oil sector in Azerbaijan². Another characteristic of Soviet era was limited foreign trade. This situation drastically changed after the collapse of Soviet Union in 1991. With the independence the new phase in the history of

¹ <http://www.transneft.ru/company/> (n.d.)

² http://www.azerbaijan.az/portal/Economy/OilStrategy/oilStrategy_a.html (n.d.)

Azerbaijan petroleum industry – “New petroleum strategy” began. Recently famous to the whole world fields “Azeri”, “Chirag”, “Kepez” and “Guneshli” was discovered in at the end of 70s and beginning of 80s³.

Even though the times when Azerbaijan was the leader in petroleum production are past in 19th century, it is still one of the major producers of oil and gas. According to State Oil Company of Azerbaijan Republic (hereinafter SOCAR) Azerbaijan is in the 20th place in the list of countries with oil resources, with 7 000 million barrels and in the 24th place in the gas list with 47 675 billion cubic feet.

The production figures are also considerable. The amount of produced oil was 11,5 million ton in 1901, it reached 23,5 million⁴. However, production of oil in Azerbaijan started to decrease since 1987 continued until 1997. Since 1997 the production of oil increased and reached 1033 thousand barrels per day in 2009. The increase of productions matches with the launch of Baku – Supsa pipeline which carried oil from “Chirag” field to the world markets. Also drastic changes can be observed starting from 2005 i.e. when BTC started to operate. As to this day Azerbaijan holds 1,3% in the world’s total production⁵.

Gas production history shows nearly the same development line as oil production, however, starting later than oil industry. The same decrease since late 1980s affected gas industry as well. Gas production continued to decrease until 2005. Nowadays, Azerbaijan contributes with 0,5% to the world’s total production⁶. Correlation between the increase in gas production and launch of gas pipelines is relevant here as well. The increase in 2006 can be explained by the export of first gas through SCP in the same year.

1.2.2 Azerbaijan as a transit route for Central Asia

Central Asia is rich with petroleum resources. Nevertheless, it faces substantial disadvantages while trading its resources which are the remoteness from petroleum markets and being landlocked. Central Asian sellers have three possible routes to reach the target:

- a) Transportation through Russia
- b) Transportation through Iran

³ <http://socar.az/nefttarixi-az.html> (n.d.)

⁴ <http://socar.az/nefttarixi-az.html> (n.d.)

⁵ Statistical Review, BP (2010) p.8

⁶ Statistical Review, BP (2010) p.24

c) Transportation through Azerbaijan

(a) Transportation through Russia

Strong ties between Kazakhstan and Turkmenistan and Russia creates disadvantageous results for both countries. Such dependence strengthens Russia's role in economical life of countries and establishes dominance in the region. As a result Russia may demand such conditions for transportation which favor it, as was the case with Turkmenistan. Furthermore, Russia's actions in Chechnya and Georgia formed an image of hostile state in the eyes of world. One more downside is the recent disagreements between Russia and Ukraine where Russia again demonstrated its unreliability as a partner.

(b) Transportation through Iran

Transportation via Iran can be more disadvantageous. Despite Iran's favorable geographical situation, its international relations with Western Europe and especially USA are not at a satisfactory level. The problems in relation to Iran's uranium enrichment works and 4 UN Security Council sanctions are still ongoing. All these facts make it undesirable for potential foreign investors, financing not only pipeline networks but also exploration and exploitation works in Turkmenistan and Kazakhstan.

(c) Transportation through Azerbaijan

Azerbaijan is an alternative route with various opportunities for transportation. By one of these routes Kazakh and Turkmen oil can be transported with vessels over Caspian Sea, then via railways in Azerbaijan and Georgia.

Taken into account the fact that BTC is not fully exploited, it is capable to transfer oil shipped from Central Asia, Aktau port to Sangachal terminal in Baku and further to BTC pipeline. Negotiations over the creation of a new Trans-Caspian oil transport system that will bypass Russia and Iran are also held. Kazakhstan and Azerbaijan has expressed serious intentions for creation of joint transportation systems over Caspian. On 14 November 2008 in Energy Summit in Baku Azerbaijan and Kazakhstan signed an agreement Trans Caspian

Transportation System⁷ and another one on joint development of feasibility study on Trans-Caspian project, on 2 October, 2009.⁸

⁷ <http://www.un-az.org/undp/bulnews65/mbr12.php> (2008)

⁸ <http://socar.az/1708-news-view-az.html> (2009)

2 Pipeline systems in Azerbaijan

2.1 Legal definitions

Transit issues under BTC and SCP are regulated in two levels. Intergovernmental Agreements (hereinafter IGA) regulate the first level. These agreements are concluded between Azerbaijan, Turkey and Georgia under BTC (hereinafter BTC IGA). However, Azerbaijan signed two separate IGA with Turkey and Georgia pursuant to SCP (SCP IGA). IGA provide for basic rights and obligations.

On the second level relations are regulated under Host Governmental Agreements (hereinafter HGA). HGA with all involved states were signed under BTC (hereinafter BTC HGA), whereas only two HGA (with Azerbaijan and Georgia) are available for SCP (hereinafter SCP HGA). The other parties to these agreements are shareholders named MEP (Main Export Pipeline) and SCP participants in BTC and SCP, respectively. They include all relevant aspects of relations and provide thoroughly for terms and conditions of parties.

As BTC and SCP are sibling projects, their regulation conform to each other and the HGAs concluded in connection with SCP and BTC are nearly identical. Hence, only the varying matters regarding SCP will be discussed in this thesis. Also due to similarities of BTC HGA with different host states all references will be made to Azeri BTC HGA, unless there is a difference.

Project agreements are prevailing regimes (except constitutions) in the territories of involved states in regard to transport via BTC and SCP and supersede and nullify all prior agreements between the States with respect to the transportation of petroleum.⁹ As can be understood contracting States clearly had an intention to create a comprehensive legal regime, comprising all necessary issues with no need for any other piece of legislation. With the creation of such regime and nullification of other legislative instruments all unnecessary disagreements and misinterpretations are avoided. Instead a unified system which will have a same response for same situation in all three States is established. Another key point of the superiority is that, when a domestic or any other international regime offers less extent rights for participants or

⁹ BTC IGA art XI

more stringent obligations, such document will be of no relevance as to the participants of the Project.

As a base of these projects agreements signed between participants can be considered a step forward. They provide a legal framework for transit which is not regulated under any legislative instrument, in Azerbaijan. They not only regulate the current projects, but also constitute a background for further developments.

This chapter is dedicated to BTC and SCP systems, as well as to their respective agreements. In the first part BTC pipeline and all related aspects will be discussed, whereas the second part concerns SCP. First, the purpose of the projects and sources for the provision of petroleum will be addressed. Also the extent of the transit, i.e. the projects availability for the transit of petroleum produced outside Azerbaijan will be highlighted. Then access mechanisms for interested parties will be examined. Further the rights granted to parties under relevant agreements will be dealt with. Finally, evaluation of the benefits of the projects for the transit states will be provided.

2.2 Baku Tbilisi Ceyhan pipeline

2.2.1 History and purpose

(a) History

Azeri-Chirag-Gunashli is the largest field in the Azerbaijan sector of the Caspian Sea and was developed by Azerbaijan International Operating Company.¹⁰ The oil from the field was transported via the pipelines Baku Novorossiysk and Baku Supsa. At the moment Baku Novorossiysk route do not operate. However, Baku Supsa is still in use. Even though, Supsa project is more economically advantageous than Novorossiysk pipeline it has insufficient capacity. Also oil from both pipelines is transportation through congested Bosphorus straits, which is a great obstacle.

Negotiations between Azerbaijan, US and UK on a new route started in 1990s. The only possible route which also served the interests of international investors and participants was through Azerbaijan-Georgia-Turkey. In September, 1994 Production Sharing Agreement between BP, its partners and Azerbaijan was concluded for the development of Azeri-Chirag-

¹⁰ Sustainability Report, BP (2003) p.3

Gunashli field.¹¹ 5 years later in 1999 Azerbaijan, Georgia and Turkey signed an intergovernmental agreement “Relating to the transportation of petroleum via the territories of the Azerbaijan Republic, Georgia and the Republic of Turkey through the Baku Tbilisi Ceyhan Main Export Pipeline”. Later Host Government Agreements between the respective states and the MEP participants were concluded. The MEP Participants are BP, SOCAR, Statoil, Unocal, TPAO, Eni, Itochu, Amerada Hess, TotalFinaElf, INPEX and ConocoPhillips.¹²

The very first flow of oil was pumped in 10 May, 2005 and reached the Ceyhan terminal 28 May, 2006.¹³

(b) Purpose

BTC IGA includes principles of transit recognized by states, mutual warranties, as well as issues on access and dispute resolution. Thus, to understand the purpose BTC IGA itself should be examined. According to the preamble of the Agreement, one of the reasons is the desire of the States to attract, promote and protect investment by foreign and domestic investors. The provision expresses each state’s willingness to be part of the petroleum market. Second purpose is the need for expanded “cooperation between and among states in the energy sector”. Furthermore, the states express their intention to elaborate the current transit system which involves freedom of transit and provision of exclusive rights. Final and most important purpose of the Agreement expressed in the preamble is the necessity of a proper legislative instrument for the transportation of petroleum. The states understand the significance of integrated legal system and are acting towards such system. The states express their “consideration of the importance of creating and reinforcing an appropriate legal framework”, which should be compatible with “the transnational nature of such Petroleum transportation projects”. The legal framework should “support Petroleum sector investment opportunities” and also “establish favorable conditions to justify the commitment of the capital and resources”¹⁴ to BTC Project. Hence, the purposes can be divided into two parts:

¹¹ BTC: Diary of a pipeline (n.d.) p.28

¹² <http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=2006862> (2002)

¹³ <http://www.bp.com/sectiongenericarticle.do?categoryId=9006669&contentId=7015093> (n.d.)

¹⁴ BTC IGA Preamble

(1) the preparation of legal system meeting certain requirements and (2) justification and further attraction of investment opportunities.

Beside the main purpose, BTC project has incidental purposes, one of which is the transportation of oil produced outside Azerbaijan and establishment of connection between Europe and landlocked countries. Kazakhstan joined the project in June 16, 2006 when signed an Agreement “Assistance and Support of Oil Transportation from Kazakhstan through the Caspian Sea and Azerbaijan to International Markets via Baku-Tbilisi-Ceyhan (BTC) oil pipeline”.¹⁵ In 2007 both countries reached an Agreement regarding the “Strategic oil and gas cooperation and Memorandum on joint realization of Trans-Caspian project”. Finally, in 2008 Agreement on basic principles of Trans-Caspian project was signed. Turkmenistan joined BTC project much later than Kazakhstan. The agreement between Azerbaijan and Turkmenistan was signed July, 2010.¹⁶

BTC has the capacity to transfer oil from other central Asian countries as well but neither an agreement has been reached so far, nor is the amount of oil in those countries of significance importance.

Another possibility for the BTC is the transportation from other fields in Azerbaijan that may be discovered and developed in the future, other than Azeri-Chirag-Gunashli. With the system ready at hand, there is no need for the construction of new infrastructure and the transportation of resources can be started simultaneously with the production.

2.2.2 Access to the system

(a) Access for the shareholders

BTC pipeline is developed and being operated by the Baku Tbilisi Ceyhan Pipeline Company (“BTC Co”).¹⁷ During the establishment, each of the owners of BTC obtained a share in BTC Co. The shareholders (MEP Participants) are owners of the pipeline and enjoy the access to the pipeline and have the exclusive right to transport petroleum through BTC. According to HGA “based on the agreed terms and conditions of the Project Agreements and other commercial arrangements consistent with the Project Agreements, the MEP participants shall have the right to implement the Project and construct [...], own and/or operate the MEP

¹⁵ <http://abc.az/eng/news/22484.html> (2008)

¹⁶ <http://www.bp.com/genericarticle.do?categoryId=9029616&contentId=7064362> (2010)

¹⁷ <http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=2006862> (2002)

system, including the Facilities, and utilize the resulting capacity in the MEP system and Rights to Land”.¹⁸ By MEP system the whole BTC pipeline and related appurtenances, including Facilities are meant.¹⁹

Hence, shareholders gained not only the rights in connection with access to capacity but also rights on ownership, operation and construction with the relevant HGA. In addition, certain extent of warranties and exemptions were granted by state authorities, which will be further developed in 2.2.4

The shareholders may choose not to utilize the capacity by itself and to assign its part in the capacity to 3rd parties. However, such usage should not impede existing capacity rights of other shareholders. They have a priority in respect to 3rd parties. These issues are regulated below in (b).

To sum up, shareholders who are owners and operators of BTC pipeline and transportation capacity exercise these rights through the operation company established in 2002, BTC Co.

(b) 3rd party access

In addition to shareholders, BTC pipeline and respective agreements are open for 3rd parties (both states and companies). 3rd parties have the opportunity to choose the way they want to be connected to the pipeline, either by becoming a shareholder or obtaining a transport capacity without there being an accession to the agreements. The first opportunity seems more difficult, as requires a long negotiation process and willingness of shareholders to sell their stocks, i.e. to give up their permanent channels of revenues. The second one is more realistic as do not require a shareholder to relinquish its ownership in the pipeline. Conversely, it is rather beneficial for a shareholder when it does not have enough production to use its capacity rights. This way a shareholder can utilize excess capacity and any 3rd party in need of capacity can tender for it.

Accession to the agreements

Accession cannot be understood directly as a 3rd party access. As a result of accession, a party becomes a shareholder and obtains the whole set of rights. However, one of them is capacity

¹⁸ BTC HGA Preamble

¹⁹ BTC HGA Appendix 1

right, thus, it is important for the clarification of 3rd party access mechanism. Accession itself can occur in two situations: state accession or private company access.

State accession is regulated directly in the respective agreements. BTC IGA opens doors for a 3rd party state to join the Pipeline. Any state can access the Agreement, if all States then party consent by signature, ratification or any other agreed form. The key condition is that the acceding state cannot make a reservation to the Agreement, unless such reservation was consented by all party States.²⁰ In such way all obligations established by the Agreement will stay in force among the “old” states and the acceding states.

On the other hand the mechanism for private 3rd parties to become a shareholder, i.e. a MEP Participant is regulated in HGA. Each MEP Participant entitled to transfer, assign, share or otherwise deal with any of its rights (obviously including capacity, as it is one of the rights possessed by them). Such assignment is not only a right but also actually, foreseeable and intended by the Parties and State authorities should facilitate the process. Rights in the project can be transferred from a MEP Participant to another Participant or a 3rd party. For a transfer to become effective, only prior notification by the Participant to the State Authorities should be given. Such notification should comprise information about the recipient and details on the transferred rights. State Authorities have the right to object to the transfer, only if such transfer poses a threat to national security, defense or public safety in violation with respective domestic law.²¹ Hence, MEP Participants have the right to sell their ownership in the pipeline in open markets to both other MEP Participants and 3rd parties and by doing so they indirectly transfer capacity in the system.

When three companies (TotalFinaElf, Conoco Phillips and Inpex) joined the project after the HGA was concluded they obtained the right to capacity together with participating interest.

Transfer of capacity

Another possibility for a 3rd party to obtain capacity in the pipeline is to transfer petroleum without becoming a shareholder. State Authorities recognize MEP Participants’ right to involve in the Project other participants and their right to benefit from all rights provided under the Project Agreements.²² This way, a 3rd party can contract with a party to the Agreement for the transportation of certain amount of resources. As a result these kinds of

²⁰ BTC IGA art X

²¹ BTC HGA art 16

²² BTC HGA art 4.2

contracts have 3rd parties or shippers on one part and shareholders in their capacity as transporters on the other. Shippers are persons that have contracted for transportation services through the System and have the right to tender petroleum for transit through the System.²³ Transporters are the capacity owners that have agreed to transport contracted amount of petroleum.

3rd party access is limited to some extent. The States are restricted to grant any right which is inconsistent, conflict or may interfere with the full enjoyment by any of the Project Participants of their rights. The provision is broad and comprises all rights granted under the Agreements but it also concerns right to access to capacity. The States do not have the power to give access to capacity if such access will harm rights enjoyed by current users. Moreover, the States are not entitled to limit, reduce or condition any right given under the Agreements.²⁴ The provision can be understood as prohibiting to limit the current capacity the Project Participants have. An important point is that these provisions protect not only MEP Participants, but also all other Project Participants (shippers, contractors, etc.), including 3rd parties who have already gained access.

2.2.3 Rights enjoyed by MEP participants

The discussion below will focus on the balance of the rights given to the MEP Participants with respect to the transit of petroleum and the benefits the States gain as a result of such grant. The main point to discuss is whether the balance is objective. Do the States' benefits correspond to what they have to "give away"?

Both IGA and HGA comprise extensive rights to the MEP participants. These rights and guarantees not in all cases are directly related to the transit as such. Thus, below only relevant rights regarding the conditions for transit, ownership of petroleum, rights to land and compensation will be discussed.

The first and most important right is to carry out the Project and all related activities, as well as to enjoy all relevant rights.²⁵ This is an essential right for all Participants to be able to take part in the Project and further to transit their petroleum through the pipeline. The provision deals with not only MEP participants Project Participants. Contractor is a person supplying

²³ BTC HGA Appendix 1

²⁴ BTC HGA art 7.2

²⁵ BTC HGA art 4.1(i)

goods, works, services or technology for the Project. The States acknowledges that in order to do business MEP Participants intend to engage such participants.

(a) Conditions for transit

State Authorities are required to establish necessary and favorable conditions for the transit of petroleum.²⁶ The provision was formed as an obligation for the Authorities, constituting a right for the Participants to require such favorable conditions for their transit activities. The right also extends to the situations of armed conflict, terrorist attacks which is highly relevant taking into account the current hostile situation in Caucasus and western Turkey.

The Participants are entitled to uninterrupted transit. States are not privileged to impede the petroleum flow and are required to take all necessary actions to guard Participants' rights of non interrupted transit and avoid interruption.²⁷ To avoid interruption the states have to refrain from any kind of action that could delay or hinder the Project or otherwise negatively affect the rights granted in accordance with the Project. Since the transit of petroleum is part of the Project, the general provision also affects transit of petroleum.²⁸ Further, States have to avoid administrative, regulatory and similar procedural delays and difficulties which might affect the activities regarding the transportation.²⁹ Hence, the MEP participants are protected against the bureaucratic obstacles they might face during the in regard to the transit.

Interruption of flows can be justified only in the case of unreasonable threat to public security, cultural heritage, health, safety or the environment. Such interruption can be extended only for the period it is necessary to remove the threat. What is meant by the threat should be interpreted according to the applicable standards and practices of the Appendix to the HGA in respect of the environmental threat. In all other cases the threshold is determined by the relevant domestic law of the State where such threat occurred.³⁰

All these guarantees mentioned above have following common features:

1. Are several, independent, absolute, irrevocable and unconditional. All of them can be enforced separately from other rights.
2. Are jointly and severally enforceable against State Authorities.

²⁶ BTC IGA art II(2ii)

²⁷ BTC IGA art II(4ii), HGA art 5

²⁸ BTC HGA art 5

²⁹ BTC IGA art II(2vi)

³⁰ BTC HGA art 5

3. State Authorities do not have the right to modify, impair or render them unenforceable.

If contrary to these requirements any State impedes or threatens to impede petroleum flow, that State should by all reasonable and lawful means eliminate the threat and rectify any interruption and promote restoration of petroleum flow.³¹

Finally, the States have to ensure that petroleum flows are not only uninterrupted but also secure and safe. Each of the States should ensure such security in its Territory and if necessary should involve security forces.³²

(b) Right to title

One of the most important grants to the participants is the right to keep the title of the petroleum in transportation system. Hence, the States shall not claim ownership of petroleum in the pipeline, even when it passes their territories. The provision is applied also to shippers where they are the owners of petroleum.³³ In addition, this provision protects shippers against the MEP participants. Owners of the pipeline are not entitled to the petroleum which belongs to third parties and flows via their capacity. HGA further extends the obligation to the facilities and non-state lands owned by the MEP participants.³⁴

(c) Rights to land

In order to be able to carry out the Project the MEP participants have exclusive and unrestricted rights to a state and non-state Land in the territories of all three States. The Participants may exercise acquisition, expropriation, etc. of required non-state land subject to necessary compensation³⁵ and the States are obligated to assist the Participants. The provision facilitates the process of obtaining required land, since the States possess the necessary knowledge about their land and its owners.

The State Authorities shall not claim any of the rights to land. As it is already mentioned that the rights are unrestricted and exclusive, this provision is somehow the repetition of the nature

³¹ BTC IGA art VII(4)

³² BTC IGA art III(2)

³³ BTC IGA art VII(2)

³⁴ BTC HGA art 5.2(v)

³⁵ HGA Article 4.1 (ii)

of the right and have supplementary character.³⁶ This right was of crucial importance for the MEP participants when choosing the most beneficial and suitable route for the pipeline and secure transportation. Additionally, the States are obligated to protect the Project Participants against any loss or damage in respect of the rights to land.

(d) Right to compensation

In case of failure by State Authorities to perform all of their obligations, to maintain economical equilibrium, misrepresentation in any Project Agreement, requisitioning by governmental forces of assets of any Project participant or any other damage or destruction and finally in the case of expropriation State Authorities have to provide monetary compensation.

Apparently, State authorities had intention to give a wide range of rights and guarantees to MEP Participants and protect those rights and cooperate with them in every possible way.

2.2.4 Rights for the states

The Project Agreements do not comprise extensive rights for participant states and mostly contain obligations for states and mutual warranties between states. This is especially typical for intergovernmental agreements. Below the articles on requirements to MEP participants, liability issues, right to information, termination of contract and right to enter into new contracts will be discussed. Also provisions of taxes will be dealt with.

(a) Requirements as to MEP participants

The States have certain rights regarding the formation and current situation of the companies.³⁷ The purpose of these requirements is to ensure that the MEP participants indeed have the power to carry out the Project and perform all relevant obligations. The MEP participants can avoid their obligations only in the case of bankruptcy, insolvency or reorganization. The MEP participants are can invoke this provision only to the extent performance is impossible due to bankruptcy or any similar situation.

As to the formation of the companies each State may require the MEP participants to be licensed or qualified and be in good standing as corporation according to the jurisdiction of

³⁶ HGA Article 5.2 (vi)

³⁷ BTC HGA art 6

that State. In addition the corporation should be entitled to be engaged in business activities. As the petroleum pipeline crosses several borders and each of the involved states have the right to require the MEP participants to be organized according to their legislation, the MEP participants should be organized in a way that meets all requirements in all three countries. Beside the certain organization form the States may require the MEP participants be “litigation free” and to prove that they had not been subject to any fines, penalties, injunctive relief or criminal liability which may have material affect on their business operations, financial conditions or ability to perform the obligations under the HGA. No actions, suits or proceedings should be pending or threatened against them. However, not all proceedings are relevant under this provision. Such proceedings either have to carry the risk of materially adverse effect on business, assets or conditions of a MEP Participant or be able to result in impairment of its power to perform its obligations under the HGA. All other litigations are of no relevance. In addition, MEP Participants should warrant that it has no knowledge of violation of any order, writ, etc. which may have the above mentioned effects or impairments. All these requirements give the States opportunity to control the feasibility of the Project. In other words, the States are sure that involved companies indeed have the power and resources to carry out the Project.

(b) Right to information

The states are entitled to certain information both from other states and MEP participants. In respect of states the right comprises information about the current situation of the ratification of the Agreement.³⁸ As to the MEP participants, they are obliged to provide correct information about their litigation and penalty records. No false statement of material fact or omission in the warranties given by the MEP Participants is acceptable.³⁹

(c) Right to tax payments

One of the most important rights the States have is the right to tax payments.⁴⁰ The tax issues in regard to Turkey and Georgia are the same but the method of calculation is different in respect of Azerbaijan. However, there is a general rule identical for all states that no Project

³⁸ BTC IGA art II(4v)

³⁹ BTC HGA art 6

⁴⁰ BTC HGA Azeri art 8, Georgian art 8, Turkish art 9

participant will be subject to any taxes, with an exception to pay profit (Azerbaijan and Georgia) or corporate (Turkey) tax. The applicable legislation is the Tax Code of the relevant state if not conflicting with the HGA.

Each of the MEP participants is subject to profit/corporate tax individually. The mechanism of calculation in regard to Turkey and Georgia is based on the petroleum transported through the capacity owned by each of the MEP participants. The key point is that the amount of taxes does not depend on the amount of petroleum transported through the pipeline which is owned by MEP participant, but on the amount of all petroleum transported through participant's capacity. The owner of the petroleum (MEP participant itself or 3rd party) is not relevant.

For Azerbaijan tax payments are based on a MEP participant's share of income and deductions. The tax is formed according to a fixed rate and applied on the excess, of income over deductions for a year. The income comprises two elements: tariff income and other income. Tariff income is the amount of cash received by an MEP participant for the transportation of petroleum (of shippers or ant other customer) through the pipeline. Other income includes payments for the implementation of Project activities.

If a MEP participant assignees its interests in the Project to a partnership and receives interests in that partnership, each of the partners of such partnership will be liable to pay profit tax as if a MEP participant. In respect of Turkey and Georgia applicable tax of each partner will be based on the partner's share of the profits of that partnership and the amount of petroleum transported by the partnership through the facilities. Even though partners are regarded as MEP participants, the method of calculation differs from the profit tax calculation for MEP participants. The important factor is the amount of petroleum transported by the partnership, in other words the petroleum owned by partnership is taken into account. The tax payments payable in Azerbaijan will be based on partner's share of the items of income and deduction of the partnership.

The tax payment may be made by MEP participant or its agent to the relevant Department in each of the involved States. In the case of failure of payment interests will accrue. In addition to profit tax, a statement comprising information about the amount of petroleum transported through the whole facilities and amount transported through the capacity owned by each MEP participant should be submitted in Turkey and Georgia. Operating company is responsible for such statement. No such statement is required under Azerbaijan law.

Finally, as to the tax issues, the provisions on taxes survive the termination of the HGA. Even if the MEP participant is no longer a party to the Agreement, the Article will continue to apply and the participant will be liable for the whole period it was a party to the Agreement.

(d) Liability and right to compensation

The MEP Participants have limited liability for the loss or damage caused by or arising from any breach of any Project Agreement or applicable domestic law. The liability is limited to the extent the damage or loss does not arise from any breach by State Authorities. Also the MEP participants are not liable for punitive or exemplary damages. In addition, the MEP participants are liable to a third party, when such parties suffered damage as a result of breach of applicable standards of conduct. The same limitation mentioned above is applicable. In both cases the MEP participants have a right against any other culpable person.

When it comes to loss or damage related to adverse environmental, health or safety, the MEP participants will be liable regardless of fault or causation and be obligated to remedy the harm and restore harmed matters to the maximum extent. All the expenses will be incurred by the MEP participants. If the harm is of such nature that cannot be remedied, adequate compensation should be paid. If State Authorities do not comply with its duties and this leads to damage, MEP participants should be fully indemnified.

(e) Right to terminate the Project agreements

States have the right of termination. In the case of material breach of any of the MEP participants' joint and several obligations the States will have the right to give a written notice of such breach. If such breach later is determined to be material, MEP participants have to pay all costs incurred by the States. Material breach occurs when a MEP participant fails or refuses to take appropriate actions to assure that its project activities comply with the standards and practices as depicted by the Agreement, do not pose a threat to the national security of the state involved. Such failure should be of knowing, continuous, repeated or persistent character. In other words, the MEP participant should be aware and breach certain requirements more than once. Also material breach occurs when a breach results in frustration of the entire Agreement.⁴¹

⁴¹ BTC HGA art 3.4

The MEP participants may but have no obligation to cure such breach but the States have the right in such situation to undertake the cure. If the MEP participants agree about the occurrence and extent of the breach they are obligated to undertake efforts to effect the cure. In the case of failure to effect the cure in ninety days Government have the right to give termination notice, which will be effective in thirty days.

(f) Right enter into other Project Agreements

States retain the right to enter into any other Project Agreement, as well as to amend, replace, terminate, etc such agreements. This right covers the situations where states conclude necessary agreements with the other states or MEP participants for the furtherance of the Project. The consent of other applicable States is not necessary in this situation. However, the requirements of Articles II (6) and (7) should not be neglected.⁴² Hence, new agreements should be in consistence with BTC IGA.

2.2.5 Benefits for the states

From the above mentioned it seems as if the States have very limited rights under the Project, whereas the MEP participants receive significant rights and freedom of action. Interests of MEP participants are well described and more protected. When looking forward to the Project Agreements commercial interests of the MEP participants seem more stressed. As parties agreed in IGA Project does not provide for services for the public at large and the intention behind the Project is not the service of the public benefits or interests.⁴³ The States are required to warrant such nature of the Project. As can be understood from the provision, the Project has commercial character and does not serve the benefits of the States or their society as such.

However, such reality differs. The States receive several benefits, which are not reflected in BTC IGA or HGAs. The benefits can be divided into fiscal and socio-economic impacts. The fiscal revenues are transit tariffs earned as a result of being a transit area, which is mostly applicable for Georgia, Turkey and to some extent Azerbaijan. Socio-economic benefits can occur in the form of employment opportunities, grants to underdeveloped fields of economy and other relevant projects. Such grants and other support is not an obligation for MEP

⁴² BTC IGA art II(9)

⁴³ BTC IGA art II(8)

participants under BTC Project. These measures have been taken to minimize negative effects of the Project in respective areas. In order to better understand the results of the Project for involved states these benefits for all three States will be discussed, separately.

(a) Azerbaijan

Fiscal benefits

The benefits of BTC Project for Azerbaijan differs from the benefits the other involved States gain. As it is Azeri oil that is being transported through the pipeline, transit tariffs are out of question. However, in the case of transportation of Kazakh or Turkmen, or any other for that matter, Azerbaijan serves as a transit state and transit tariffs become applicable.

Beside that SOCAR owns 25% of BTC pipeline which guarantees revenues for the whole period of operation of the pipeline. As an owner Azerbaijan is able to transport its resources through the pipeline and also entitled to the relevant part of 3rd party payments. Once the investors of BTC Co. achieved 12,5% rate of return for 20 years the whole ownership in the pipeline will be transferred to Azerbaijan at no cost.⁴⁴ After the transfer Azerbaijan will be a sole owner with the right to access. All other interested parties will have to obtain capacity through 3rd party access which has to increase. Hence, payments from such access will also accrue.

With the development of the pipeline Azerbaijan is able to receive “profit oil” from ACG according to the production sharing Agreement⁴⁵.

Socio-Economic benefits

The employment rates increasing in connection with the construction and operation of BTC are important for Azerbaijan. 2300 people were given an opportunity of short term jobs. Also 250 people were required for long term jobs.⁴⁶

The construction of environmentally sound installation Sangachal Terminal with state-of-the-art technology is definitely an innovation for Azeri petroleum sector.

BTC owners invested USD 8 millions in connection with Community Investment Programs (CIP) and USD 2 millions in connection with Environmental Investment Programs (EIP) to promote projects in the fields of health awareness, social infrastructure and agriculture.⁴⁷

⁴⁴ Dufey (2009) p.10

⁴⁵ Elkind (2005) p.52

⁴⁶ Cornell (2005) p.62

(b) Turkey

Fiscal benefits

BTC Project has significant impacts on and benefits for Turkey. As to the revenues for being a transit state, Turkey earned as a starting transit tariff USD 0,20 per barrel. Later, the tariff was increased up to USD 0,30 and expected to continue at same level until 2020. After 2020 with the further development of the Project the tariff level is intended to be 0,37.⁴⁸ During the first 16 years of the Project the revenues for Turkey may reach 200 millions dollars per year, with the opportunity to be increased up to 290 millions per year in the next 24 years.⁴⁹ In addition Turkish national oil and gas company is one of the shareholders in the project, with 6,5% of the stocks. This will provide additional revenue.⁵⁰ However, after the transfer of pipeline to Azerbaijan, Turkey will be deprived of this revenue.

Taken into account Turkey's energy dependence, transit tariffs and revenues are not the only, direct benefit from the Project. In order to meet energy requirements Turkey imports 64% of the whole consumption. The rate is expected to reach 76% in the next decade. Turkey will be able to purchase crude oil at a lower price. This decrease in the price is explained by the reduction of transport costs and dwindling of financial costs. The oil from the pipeline will reach the refineries in 2 days, when it takes 15 days for the oil from Persian Gulf to reach refineries. After the maximum capacity of 50 million tons per year is reached, Turkey plans to buy up to 20 million tons of oil.⁵¹

Socio-Economic benefits

One of the greatest benefits for Turkey is the reduction in the level of tanker traffic passing through Bosphorus and Dardanelles straits.⁵² In September 2010, BP announced that first billion of the petroleum was shipped from the port Ceyhan. According to BP without the pipeline, this amount would pass the Turkish straits.⁵³

The Project also has significant impact on the employment rates. BP employed 6000 people as a result of the construction of BTC and SCP Projects and provided them with technical and

⁴⁷ Cornell (2005) p.64

⁴⁸ Mansley (2003) p.11

⁴⁹ Oil and Gas Journal (2002) p.89

⁵⁰ Baran (2005) p.109

⁵¹ <http://www.btc.com.tr/eng/project.html#avantaj> (n.d.)

⁵² Elkind (2005) p.49

⁵³ <http://www.turkiyegazetesi.com/haberdetay.aspx?NEWSID=725185> (2010)

practical skills, which are required in modern companies all over the world.⁵⁴ In addition to short term jobs, 350 persons were provided with long term jobs.⁵⁵ The numbers are significant given the current employment situation in Eastern Anatolia.

Finally the least developed region of Turkey – Eastern Anatolia benefiting from the economic activity⁵⁶ as result of investments by BTC owners to develop the region. BP developed a community and investment programs, to protect the natural environment and to support socioeconomic development in the communities along the pipeline route.⁵⁷ The purpose of CIP is to promote sustainable social and economic development in settlements within four kilometers of BTC pipeline corridor. With the budget of USD 9 million⁵⁸, CIP mainly focuses on agriculture projects and provided funds in nearly 300 villages.⁵⁹

(c) Georgia

Fiscal benefits

Since Georgia does not have significant mineral resources, the benefits from the Project are vital for the economical, political and social life of the country. The benefits involve both transit tariffs and relevant investment projects.

Transit tariff is a primary method of benefiting from the pipeline. The tariffs have increased since the operation of the pipeline and will increase further. If the tariff was USD 0,12 for a barrel in 2005-2009, it is expected to be USD 0,14 in 2010-2020. Starting from 2021 the transit tariff planned to be USD 0,17 per barrel. Peak transit fees are expected to be USD 50 million per annum.⁶⁰

Socio-Economic benefits

Beside the transit fees Georgia has several ongoing projects aiming to improve underdeveloped aspects. As the biggest shareholder in the Project, BP expressed its intentions in this regard. The company focuses on three issues:⁶¹

⁵⁴ Elkind (2005) p.51

⁵⁵ Mansley (2003) p.7

⁵⁶ Elkind (2005) p.49

⁵⁷ Sustainability Report, BP (2006) p.36

⁵⁸ Sustainability Report, BP (2006) p.40, 41

⁵⁹ Elkind (2005) p.50

⁶⁰ Mansley (2003) p.11, 21

⁶¹ <http://www.bpgeorgia.ge/go/doc/1339/145021/> (n.d.)

- 1) Enterprise Development – comprises provision of investment to local enterprises, diversification of the economy and development of employment;
- 2) Effective Governance – The Company supports policy initiatives in order to improve the business environment.
- 3) Access to Energy – Development of access to secure sources of energy.

The Agreement between BTC Co. and Government of Georgian on the Establishment of Grant Program for Georgia concluded in 19 of October, 2004 is one of the significant projects developed for the promotion of economic and social development and improvement of general welfare of Georgian people, as stated in the preamble of the Agreement. The Agreement acknowledges that the grant program is only one part of wide range of programs initiated for the social and environmental activities. As a result of the Agreement Georgia will be paid forty million dollars. The grant will be paid in 7 parts and different amounts. As a starting nine million dollars will be paid within 30 days after the conclusion of the Agreement. Further grant in the amount of eleven million dollars will be made after the completion of the Pipeline. Final 20 millions will be granted in equal amounts, from 2006 through 2010. Starting from the first anniversary of the completion of the pipeline Georgia will be paid 5 million dollars each anniversary until 2010. This is not the only grant paid under the Agreement. BTC Co. agreed to additional one million dollars each year, commencing in 2011 until the primary period of the Project, which is forty years.⁶²

A precondition for the grants is that they may be used only for the purposes described in the Agreement. These involve educational and health programs, construction or renovation of necessary facilities, welfare, housing or job trainings for all citizens of Georgia, employment initiatives relating to the tourism in Borjomi region and finally projects for the promotion ties between Georgian and EU businesses.

Another important project “Business Development Project in Greater Borjomi Region” supports private sector business development.⁶³ The aim is to improve product lines, competitiveness, income and organization of small-scale entrepreneurs and agro-businesses.⁶⁴ BTC partners invested 3,15 million dollars to the project.⁶⁵

⁶² Grant Program Agreement art 1

⁶³ <http://www.bpgeorgia.ge/go/doc/1339/145021/> (n.d.)

⁶⁴ RFP BDP section 1.2

⁶⁵ <http://www.bpgeorgia.ge/go/doc/1339/145021> (n.d.)

Due to low economical development Borjomi region is requires more investment that any other part of Georgia. Thus, another project regarding solid waste management was conducted in the region. The project intending to improve waste management infrastructure in the Borjomi and Bakuriani towns, was launched in 2004. Approximately USD 580.000 has been provided by BTC partners.⁶⁶ Moreover BTC partners invested USD 245.000 to the financing the Borjomi-Bakuriani Water and Wastewater Rehabilitation Project. These projects are of crucial importance to Georgia as mineral water of Borjomi Region is the only significant export good in the country. It is a primary goal for Georgia to protect, preserve and develop the region and that is exactly what the mentioned projects aim.

Relatively small projects also been conducted. BTC and SCP partners invested USD 750.000 in the establishment and innovation of three branches of the ProCredit Bank of Georgia which will provide access to banking services in previously limited areas. In order to decrease administrative barriers to small businesses a project with Georgian Government was launched in 2006. BTC partners' contribution was USD 750.000.⁶⁷

In addition to beneficial projects a significant number of people are employed due to construction of the pipeline. Approximately, 4500 Georgian citizens got short term jobs with respect to the Project,⁶⁸ as well as 250 long term job opportunities were created.⁶⁹ As a result a new group of workers, technically qualified and familiarized with health, safety and environmental practices was established.⁷⁰

Lastly, and maybe in long term the most important benefit for Georgia is the improvement of its reputation among international investors. Because of the political instability, war with Russia, corruption Georgia companies were reluctant to invest in this poorly developed country. BTC and SCP are the largest investments in Georgia, so far. Both projects will prove that foreign investors can do business successfully and achieve real results in Georgia.⁷¹

⁶⁶ <http://www.bpgeorgia.ge/go/doc/1339/145021/> (n.d.)

⁶⁷ http://www.bpgeorgia.ge/go/doc/1339/145021 (n.d.)

⁶⁸ Elkind (2005) p.51

⁶⁹ Mansley (2003) p.7

⁷⁰ Elkind (2005) p.51

⁷¹ Elkind (2005) p.51

2.3 South Caucasus pipeline

2.3.1 History and purpose

(a) History

SCP is a gas pipeline running parallel to its BTC sibling. The pipeline is transporting gas from Shah Deniz gas field which is one of the world's largest gas-condensate fields. The pipeline started operation in 30 September, 2006. The pipeline is linked to Turkish gas distribution system at its final destination.⁷²

For now the field and SCP provides gas only to Azerbaijan, Turkey and Georgia. However, after completion of the second stage which will result in the expansion of the pipeline Azeri gas will be distributed to European Union. Azerbaijan and Turkey signed an agreement on 7 June 2010, establishing a frame for the transportation to EU.⁷³

As for now Turkey and Greece has signed an agreement in 2003, on the development of pipeline connecting the two countries, which will carry Azeri oil to international markets.⁷⁴

The launch of the pipeline took place in 2007.⁷⁵ As the next step the pipeline will be expanded to carry the gas to Italy. Relevant intergovernmental agreement was signed 26 July 2007 in Rome.⁷⁶

SCP is also expected to be one of the sources for Nabucco pipeline along with Middle East and Egypt gas.

Beside the transportation of gas from Shah Deniz, SCP is able to transport gas supplies from Kazakhstan and Turkmenistan. Azerbaijan already made an offer to Kazakhstan to transport its gas through SCP.

Turkmenistan has taken more actions to make the Project real. On 18 November 1999 an intergovernmental Declaration on the principles for implementing the Trans-Caspian Pipeline was signed between Azerbaijan, Turkey, Georgia and Turkmenistan. The States ensured they will take all necessary actions if and when Turkmenistan decides to implement the Project. The Trans-Caspian gas pipeline still remains only as an idea. However, the realization of such

⁷² <http://www.bp.com/sectiongenericarticle.do?categoryId=9006670&contentId=7015095> (n.d.)

⁷³ <http://www.bp.com/sectiongenericarticle.do?categoryId=9006668&contentId=7015092> (n.d.)

⁷⁴ <http://www.botas.gov.tr/icerik/tur/projeler/yurtdisi.asp> (n.d.)

⁷⁵ <http://www.cnnturk.com/2007/ekonomi/genel/11/18/turk.yunan.dogalgaz.boru.hatti.acildi/405410.0/index.html> (2007)

⁷⁶ <http://www.botas.gov.tr/icerik/tur/projeler/yurtdisi.asp> (n.d.)

project will be for the benefit of all parties. The development of the pipeline will ensure the diversification of routes for Turkmen and Kazakh gas to reach European market.

(b) Purpose

The intergovernmental Agreement between Azerbaijan and Georgia is more comprehensive than the Agreement concluded with Turkey. Thus, objectives of the two Agreements vary to some extent.

A general goal of both IGA is the need for legal framework. Azerbaijan and Turkey do not directly mention this need. However they stress the intention of the States to further develop the relevant international principles.⁷⁷ The states recognize that existing principles are insufficient for the regulation of transit issues and should be further elaborated. Unlike this situation the IGA between Azerbaijan and Georgia directly declare the intention to create a legal framework which is in accordance with international law, transnational nature of gas transit and supports investment opportunities.⁷⁸

Further, the States assure their support for the exploration, development and production of petroleum in Azerbaijan, as well as in the other countries of the region and the transportation of such petroleum via East-West corridor.

Azerbaijan expresses its desire to develop gas resources for the domestic consumption and export to Turkey and Georgia. For Turkey the main intention is to diversify current sources of supply and satisfy increasing domestic demand.⁷⁹ For the realization of these purposes the parties ensure principles of freedom of transit of petroleum.

Finally, the parties intend to promote, attract and protect foreign and domestic investments in petroleum industry.

2.3.2 Access to the system

(a) Access for shareholders

The owner of the pipeline is South Caucasus Pipeline Company. Seven shareholders are co-owners in the Company. The shareholders are Statoil, BP Lukoil, SOCAR, Naftiran Intertrade

⁷⁷ Azerbaijan-Georgia IGA Preamble

⁷⁸ Azerbaijan-Georgia IGA Preamble

⁷⁹ Azerbaijan-Georgia IGA Preamble

and Turkish Petroleum.⁸⁰ The technical operation of the pipeline is vested in BP, whereas Statoil is the commercial operator.

IGA and HGA are the base for shareholders to gain access to the system. HGAs were concluded between shareholders and respectively, with Azerbaijan and Georgia. No such agreement was signed with Turkey. The system of access for shareholder is the equivalent of BTC system. Thus, no further discussion on the topic is required.

(b) 3rd party access

As to the accession of 3rd parties the Agreement between Georgia and Azerbaijan involves the same mechanism of accession as the IGA between BTC States.

No such general accession is considered in the IGA between Azerbaijan and Turkey. However, this Agreement has a special provision regarding Turkmenistan. The provision obligates the States to take necessary actions if Turkmenistan decides implement the Trans-Caspian gas pipeline project which envisages the transportation of Turkmen oil via SCP.

The HGAs with both States provide for the same mechanism of access for 3rd parties as in BTC Project. In order not to make a repetition reference is made to the relevant discussion on BTC Project.

Finally, it worth mentioning that, so far, no new 3rd party joined the project.

2.3.3 Rights enjoyed by the MEP participants

As BTC Project, SCP offers numerous rights and benefits for the involved parties. The provision regulating the rights granted to SCP participants are the same as included in BTC and thus, will not be dealt with below.

2.3.4 Rights for the States

Since there is no relevant HGA the rights between Azerbaijan and Turkey are regulated in IGA. Turkey is entitled to purchase up to 6,6 billion cubic meters (hereinafter bcm) of Azeri gas per year supplied from Shah Deniz field. The title for the gas will pass to Turkey at the border with Georgia. Turkey has the right to export the gas in excess of its needs.

⁸⁰ <http://www.statoil.com/en/About/Worldwide/Azerbaijan/Pages/ShahDeniz.aspx> (n.d.)

In respect with the rights between Azerbaijan and Georgia and between SCP Participants and mentioned States reference is made to the relevant discussion on rights granted according to BTC Project, due to similarities in IGA and HGA. As to the tax issues, system under SCP is similar to the one presented under HGA with Azerbaijan as a host state.

2.3.5 Benefits for the states

SCP had and continues to have significant impact on all involved states. Since BTC and SCP are sibling projects some of the benefits from BTC are common for SCP as well. The Community and Environmental Investment Programs are implemented in regard to SCP, as well as BTC. Thus, the benefits from those programs can also be attributed to SCP. According to BP USD 25 million was invested in Azerbaijan, Turkey and Georgia as a result of BTC and SCP Community Investment Programs.⁸¹ The investments help to protect and improve social and economical conditions of territories affected by the pipelines.

The project had a positive effect on the employment rates in all three countries. According to BP in the peak of the activities approximately 22.000 people were employed in the whole region in connection with both BTC and SCP.⁸²

As the only transit state, Georgia is entitled to transit tariffs. The transit fee for 2007 was USD 10 million. The fee will be continuously increased and was USD 35 million in 2010 and expected to be USD 35,7 million in 2011.⁸³ Georgia is entitled up to 5% of the gas transported via the pipeline for 60 years. It can be purchased or taken in lieu of tariff. The amount of the gas to be taken is to be determined by Georgia. The agreement envisages “take or pay” obligation for Georgia. In addition, Georgia has the priority to buy a determined amount of gas at a low price, also with “take or pay” condition. For the first year Georgia was entitled to 200 million cubic meters of such gas. However, the amount is to be increased yearly and expected to be up to 500 million cubic meters. The price for purchase of this gas is USD 55 with an increase of 1,5% per year.⁸⁴

For Turkey natural gas at a lower price is crucial for satisfaction of its domestic needs. In addition the Project will diversify the current routes of supply, which in turn will establish

⁸¹ <http://www.bp.com/sectiongenericarticle.do?categoryId=9006670&contentId=7015095> (n.d.)

⁸² Dikkaya (2008) p.108

⁸³ Billmeier (2004) p.8

⁸⁴ SCP HGA (Georgian) Appendix 7

energy security. Moreover Turkey's role as a transit state in the EU energy provision will strengthen.

The States themselves have acknowledged the great opportunities that the project will bring along. They recognized that the development in the energy sector will lead to economic prosperity and strong economical and commercial relations in the region.⁸⁵

⁸⁵ Azerbaijan-Turkey IGA Preamble

3 Gazprom pipeline systems

3.1 Introduction

The chapter below deals with the Russia system for transportation of gas resources to EU and also relations between Russia and transit states. First, brief information on Russian gas resources, unified gas supply system, and Gazprom will be given. Then the consumers of Russian gas and transit states for the transportation of gas to relevant markets will be discussed. Further, the dispute between Russia and Ukraine, its impacts for all involved parties will be presented. Finally, most important topic of rights for transit states, mechanisms of access to the pipeline system will be addressed.

3.2 Gazprom, its resources, transportation network and consumers

(a) Gazprom

With 1567,1 trillion cubic feet of proved natural gas resources, Russia has the largest gas reserves in the world equal to the 23,7% of the world's total resources. In the production of natural gas Russia is the second biggest in the world (527,5 trillion cubic feet), surpassed only by US.⁸⁶

60% of the reserves and 84,7% of the production⁸⁷ in Russia belongs to one of the largest energy companies in the world, Gazprom. Gazprom State gas concern established in 1989 was the foundation for Gazprom Russian joint stock company, created in 1993. The company was renamed as Russian open joint stock company, in 1998.⁸⁸ Today Russian Federation is the biggest shareholder (50%). Gazprom has the extensive rights in gas sector in Russia. It owns all the main gas-processing facilities and high-pressure pipelines. In addition, the whole gas storage capacity belongs to Gazprom.⁸⁹ According to the Federal law of 2006, Gazprom is the sole exporter of the gas in Russia. Hence, Gazprom holds the legal export monopoly.⁹⁰

⁸⁶ Statistical Review, BP p.24

⁸⁷ Russian and CIS Markets (2009) p.23

⁸⁸ <http://www.gazprom.ru/about/> (n.d.)

⁸⁹ Russian and CIS Markets (2009) p.23

⁹⁰ FD Gas Export (2006)

(b) Transportation network

Gazprom is the owner of Unified Gas Supply System (UGSS). This is the largest gas transportation system in the world. The system comprises gas extraction, processing, transmission, storage and distribution facilities. The length of the pipelines included in the system is 155 000 km.⁹¹

In addition, Gazprom continues development of several international transmission projects in Europe. These are Yamal-Europe, Blue-Stream, South-Stream and Nord-Stream. 2.000 km long pipeline Yamal-Europe runs through Russia, Belarus, Poland and Germany. The full capacity 33 bcm per year was reached upon the completion of the last compressor station in 2006. Blue Stream pipeline was designed so that to avoid any transit country. Thus, the pipeline starts in Russia, runs the bottom of Black Sea and ends in Ankara, Turkey. With the potential capacity of 16 bcm per annum, the pipeline started operation in February, 2003. Another promising project is the South Stream Project, developed in cooperation of Gazprom and ENI. As the Blue Stream pipeline South Stream will also run across the Black Sea starting from Russia. Further it will cross Bulgarian territory. In 2008-2009 Bulgaria, Hungary, Greece and Serbia signed IGA and will construct pipeline sections passing their territories.⁹² The Nord Stream is a new route for the transportation of gas to EU with no transit states on its way. The pipeline will connect Russian coast with Germany, crossing the Black Sea. The pipeline will be connected to the UGSS. The shareholders in the Nord Stream AG are Gazprom, Wintershall, E.ON Ruhrgas and Gasunie, with Gazprom holding 51% of the shares. After the completion of the second string, which is planned to be in 2012 the capacity will reach 55 bcm.⁹³

As can be seen there are several transit states for Russian gas. However, the biggest part (75%) of gas was being transported over Ukraine, in late 2000s.⁹⁴ The discussion of transit relations between Russia and all of these states are beyond the purpose and extent of this thesis. Thus Ukraine will be used as an example below to deal with issues related to transit.

⁹¹ <http://www.gazprom.com/production/transportation/> (n.d.)

⁹² <http://eng.gazpromquestions.ru/index.php?id=2> (n.d.)

⁹³ <http://eng.gazpromquestions.ru/index.php?id=2> (n.d.)

⁹⁴ Russian and CIS Markets (2009) p.80

(c) Consumers

Consumers of Russian gas are Europe and Commonwealth of Independent States (CIS) and other states, which are 31 in total.⁹⁵ The only major European gas markets not importing gas from Russia are Spain and Portugal.⁹⁶ Gazprom supplied to Europe 184,4 and to CIS 96,5 bcm of gas in 2008.⁹⁷ The amount supplied reflects the extent of Europe's dependence on Russian blue fuel, as the whole consumption of gas in EU, in 2008 was 489,9 bcm.⁹⁸ The largest consumers of Russian gas are Ukraine, Germany and Turkey.⁹⁹

3.3 Access to the system

As the owner of UGSS Gazprom has primary access to the system. However, with the Government Decree of 1997¹⁰⁰ third party access to Gazprom's domestic network was established.¹⁰¹ The Decree regulates the conditions for access and the right for Gazprom to reject such access. Gazprom can only reject in the case of lack of capacity, when the gas to be transported does not correspond to the technical specifications and 3rd parties do not have necessary input and delivery points.¹⁰²

The number of companies gained access to the system has been increased since the adoption of the Decree. When there were 24 companies with the right to access in 2001, the number increased to 33 in 2004. However, a year later the number slightly decreased and was 31. The total amount of gas supplies from 3rd parties developed from 92,4 to 114,9 bcm between 2001 and 2005. This is 16% of the total amount (699,7 bcm) transported through UGSS in 2005.¹⁰³ However, the amount of 3rd party access could be increased by the expansion of the system. The tariffs for the 3rd parties are being regulated by the Federal service for tariffs of Russian Federation (FST). Before August 1, 2006 the method of fixed rate equal to RUR 23,84 per 1.000 cubic meters/100 km was used. Now a new differentiated rate setting method is used. According to the new method rate includes two components, charge for shipping and charge for using gas mains. The charges are determined according to the points of entry and exit of

⁹⁵ <http://eng.gazpromquestions.ru/index.php?id=4> (n.d.)

⁹⁶ Russian and CIS Markets (2009) p.80

⁹⁷ <http://eng.gazpromquestions.ru/index.php?id=4> (n.d.)

⁹⁸ Statistical Review, BP (2010) p.27

⁹⁹ <http://eng.gazpromquestions.ru/index.php?id=4c> (n.d.)

¹⁰⁰ FD Gas supply in RF (1999)

¹⁰¹ Stern (2005) p.179

¹⁰² <http://www.gazpromquestions.ru/?id=36#c249> (n.d.)

¹⁰³ <http://www.gazprom.ru/production/transportation/system-access/> (n.d.)

gas. Since 1 March, 2007 according to the decision of FST tariffs for gas transmission and gas transmission services was increased by 15%.¹⁰⁴

Despite the adopted legislative framework and increasing numbers the 3rd party access is not extended to export pipelines.¹⁰⁵ This reflects Gazprom's reluctance to give up their export monopoly, which was legalized by the Federal Decree. The Decree established Gazprom's status as a sole exporter and the problem of 3rd party access to such pipelines is not relevant.

3.4 Gas dispute between Russia and Ukraine

3.4.1 Background of the dispute

Disputes over gas transit and transit tariffs are not a novelty in Russian – Ukrainian relations. They have a fairly long history, starting from the collapse of Soviet Union. These disagreements have significant effect on all parties including not only, Russia and Ukraine, but also the customers of Russian gas. The background of the disputes, as well as the impacts for the parties will be dealt below.

Starting from 1990s several problems never ceased to exist between Russia and Ukraine: low transit tariffs, unpaid Ukrainian debts, theft of gas from the system and Russia's pressure on Ukraine to exchange the rights in transit network and gas storage facilities for gas debts.¹⁰⁶

(a) 2005-2006

First major dispute occurred in 2005 when Russia demanded gas price increase, however some other CIS countries purchased gas at relatively low prices. Russia requested Ukraine pay USD 230 instead of USD 50 for 1.000 cubic meters of gas.¹⁰⁷ As a result Russia cut off gas starting from 1 January, 2006.¹⁰⁸ In addition, Russia accused Ukraine in theft of the gas indented for the transit. First, Ukraine denied the accusations, but informed that they have the right to siphon off 15% of the remaining supplies as payment for transporting the gas to Western Europe and will do so if the temperatures would fall below certain degree.¹⁰⁹ Ukraine indeed had the right to take gas from pipelines in lieu of tariff. The amount that can be taken

¹⁰⁴ <http://www.gazprom.com/production/transportation/system-access/> (n.d.)

¹⁰⁵ Stern (2005) p.197

¹⁰⁶ Pirani (2009) p.5

¹⁰⁷ <http://news.bbc.co.uk/2/hi/europe/4574630.stm> (2006)

¹⁰⁸ http://www.nytimes.com/2006/01/01/world/europe/01iht-web.0101gas.html?_r=1 (2006)

¹⁰⁹ <http://news.bbc.co.uk/2/hi/europe/4574630.stm> (2006), <http://news.bbc.co.uk/2/hi/europe/4573572.stm> (2006)

was regulated under quarterly contracts. Ukraine had to pay for the excessive take off. As these contracts are not available, it is impossible to discuss whether Ukraine's allegations were substantiated. However, later Naftogaz (leading company concerned with Ukraine's fuel and energy sector) admitted withholding of Russian gas supplied for the transit, to cope with cold winter. The dispute was settled on 4 January, 2006. Under the 5 year contract Ukraine agreed to pay USD 230 per 1.000 cubic meters of Russian gas. The gas was supplied through Rosukrenergo, a Russian Swiss company responsible for the transportation of Turkmen gas to Eastern Europe.¹¹⁰ Even though the parties assured Europe the contract will provide secure supply of gas, following years proved it was not so.

(b) 2007-2008

The next disagreement occurred at the end of 2007 when Russia alleged that Ukraine owes USD 1,3 billion.¹¹¹ Gazprom warned that taken into account the history of their relations with Ukraine and previous unpaid debts, the company may cut off the gas. After European Commission's call for "speedy solution" parties settled the dispute and agreed on a payment scheme. However, the settlement did not last long. Already in January of the next year Russia again warned Ukraine about cut off if the debt would be unpaid by the 11 January. By that time the alleged debt rose to USD 1,5 billion.¹¹² Gazprom assured the cut off will not affect Europe. The problem seemed like settled when the agreement on the gas prices was signed on 12 February, 2008 and Ukraine agreed to pay its accumulated debts. Parties agreed to replace Rosukrenergo with trader owned jointly by Gazprom and Naftogaz Ukrainy, also replace Ukrgaz-Energo (company coordinating gas supplies from Central Asia to Ukraine) with Naftogaz.¹¹³ Ukraine's persistence on not paying its debts constituted a reason for the beginning of a new row between parties. Already at the end of the February Russia warned that the gas supplied would be stopped by 3 March, unless Ukraine paid the debt which also included 1,9 bcm missing gas. In counterattack Ukraine warned that if Russia could not guarantee supplies to Ukraine, Naftogaz will not be able to ensure transit of volumes to

¹¹⁰ <http://www.kommersant.com/page.asp?id=-7864> (2006)

¹¹¹ <http://news.bbc.co.uk/2/hi/business/7024294.stm> (2007)

¹¹² <http://news.bbc.co.uk/2/hi/business/7233401.stm> (2008)

¹¹³ Pirani (2009) p.12

Europe¹¹⁴ and alleged that they have paid the debt. This time parties could not agree on any settlement and the gas supply was reduced to 50% by 4 March. Apparently, the cut off had positive effect on Ukraine and soon they reached an agreement on the payment of the gas bill. However, the Prime Minister of Ukraine informed that the cabinet would not execute previously concluded agreements and opposed the provision of the Agreement on the establishment of joint Naftogaz-Gazprom venture.¹¹⁵ Nevertheless, Ukrainian Prime Minister Yulia Timoshenko and her Russian counterpart Vladimir Putin signed a memorandum in October, 2008 which reflected the same issues as the Agreement signed in February in more detail. The memorandum envisaged the clearance of Ukrainian debts and timely payment for future deliveries. Also the import prices and transit tariffs were subject to gradual increase to 'market, economically based and mutually agreed levels'. At the end of October Gazprom and Naftogaz signed an agreement on the principles of long-term cooperation in the gas sector.¹¹⁶ Even though, the relations between states seemed to improve, they failed to implement what was agreed. In December Ukrainian president said that they paid some of the debt, which was denied by Gazprom.

(c) 2009

The dispute continuing throughout 2008 lead to the crisis in 2009. Gazprom said that if the debts would not be paid, no supply contract could be signed.¹¹⁷ Later Putin warned that if there would be interference with the transit gas flow, supply to Ukraine would be cut off, with possible effects to Europe.¹¹⁸ Following this, Ukraine had to pay USD 1,52 billion on 30 December 2008. However, Russian demanded the payment of further USD 450 million, as fines and penalties, which was denied by Ukraine.¹¹⁹

Russia cut off the gas flow for domestic consumption in Ukraine on 1 January 2009. However, Europe was not affected as the transit flows continued to be pumped. The real crisis became inevitable when on 5 January Russia alleged that 65,3 million cubic meters of gas which was intended for the transit to Europe was stolen. Ukraine rejected the allegations to

¹¹⁴ Pirani (2009) p.12

¹¹⁵ <http://unian.net/eng/news/news-239931.html> (2008)

¹¹⁶ Pirani (2009) p.13

¹¹⁷ Pirani (2009) p.15

¹¹⁸ Pirani (2009) p.16

¹¹⁹ <http://www.upstreamonline.com/live/article168753.ece> (2008)

some extent (admitted only 52,2 millions) and in return claimed that it is entitled to such withdrawal of technical gas (gas required to run the compressor stations) for the operation of the network.¹²⁰ Ukraine “blamed” Russia for not sending necessary volumes and warned about possible interruptions.¹²¹ On 7 January gas flows to Europe was stopped entirely. Russia claimed it stopped the flows because Ukraine closed the system and Ukraine said it has closed the system because Russia stopped the gas flows.¹²² With the both parties accusing each other Europe started to feel the outcomes of supply shortage which continued for 13 days. Major European gas companies’ oversight of gas flows did not help the situation. Only on 19 January the parties reached an agreement on supply and transit covering 10 years which will be discussed below. The next day gas flows was restarted.

These 20 days once more proved that the energy resources with gas and oil at the top are not only economical issues. As long as energy relations between states are matters of concern, politics will be involved. Throughout the crisis Russia was accused for using its energy resources as a political weapon, in particular against Orange Revolution in Ukraine and the new president. The argument was denied by Russian government. However, from the commencement of the crisis Russia accused Ukrainian president in being responsible for the deteriorated negotiation process. Russia claimed that president Yushchenko prevented prime minister from signing the agreement on gas supply and transit tariffs at the end of 2008¹²³, which led to the crisis in first place.

3.4.2 Results of the dispute

(a) Russia and Ukraine

The outcomes of the crisis for Russia and Ukraine are more or less connected to their credibility as a reliable supplier and transit country. Czech Foreign Minister expressed his views on January 21, “The main lesson learned from this crisis is that Russia and Ukraine aren't reliable suppliers. Europe must think about alternative sources and pipelines. In this context, project Nabucco¹²⁴ becomes more important.”¹²⁵ EU president José Manuel Barroso

¹²⁰ Pirani (2009) p.20

¹²¹ <http://news.bbc.co.uk/2/hi/europe/7809450.stm> (2009)

¹²² Pirani (2009) p.22

¹²³ Pirani (2009) p.31

¹²⁴ Nabucco is intending to link Erzurum, Turkey to Austria and is seen as a rival to South Stream. SCP expected to be one of the sources for the pipeline.

also expressed his concerns about the two countries, saying the European Parliament that failure to honor supply agreements would mean Russia and Ukraine could no longer be regarded as reliable.¹²⁶

Another outcome is the financial difficulties. Revenues from the gas trade play a significant role in both countries' economical life and can not be disregarded. As reported after the dispute Russia had suffered USD 1,5 billion due to the lack of sales.¹²⁷ Ukraine lost USD 100 million as the steel and chemical plants were shut down.¹²⁸

However, the possible results for Ukraine in long term can be more significant. After the disagreement and Ukraine reluctance to accept Russian conditions in transit contracts may bias Russia towards more "friendly" transit countries. One of such countries is Belarus with whom Russia has already signed a transit agreement covering 2007-2011 and increased transit tariffs with the supplement to the agreement. In addition Russia developed a new project Yamal-Europe transporting Russian gas to Europe via Belarus.

Another outcome of the dispute was that Russia develops projects to deliver gas to Europe bypassing any transit country. These are BlueStream, South Stream and Nord Stream. Blue Stream is not relevant to Europe as it supplies Turkey with gas. However South and Nord Stream projects are of significant importance for Europe. These pipelines are deemed to deliver gas to Europe without passing any other transit countries. South Stream will connect Russia with Bulgaria and later on passes through several European countries. Nord Stream is a unique project that intends to link Russia with Germany without crossing any border.

Whether Russia bypasses any transit country or uses other transit countries behaving in accordance with Gazprom's interest, the results for Ukraine will be burdensome. Reduction of transit flows is something that a country with a budget deficit of 5,3% of gross domestic product (in 2010) can not afford to lose.

(b) Europe

¹²⁵ http://goliath.ecnext.com/coms2/gi_0199-9938719/Interfax-Czech-Republic-Slovakia-Business.html (2009)

¹²⁶ <http://www.reuters.com/article/idUSTRE5062Q520090114?pageNumber=2&virtualBrandChannel=0> (2009)

¹²⁷ Russian and CIS Markets (2009) p.62

¹²⁸ <http://www.worldpress.org/Europe/3307.cfm> (2009)

Europe imports half of its general energy consumption¹²⁹ and according to Gazprom Russian gas constitutes one third of the whole gas import to Europe.¹³⁰ Taken into account that some European countries as Slovakia, Finland and Baltic states import 100% of their gas consumption from Russia¹³¹, European dependence on Russian gas is undeniably strong. Hence, the impacts of Russian-Ukrainian gas disputes were inevitable. While crisis of 2006 did not affect Europe directly (only supply to Ukraine was cut, transit to Europe continued), 2009 crisis with gas cut off of 13 days was something that had not happened before. Most of the European states, especially in the west have gas storage reserves able to cover the lack of transit gas for several weeks. Also while the crisis continued gas exports from other sources as Norway, Algeria and Libya was increased. In addition most states used alternative fuels to replace lacking gas imports.¹³²

South-east of Europe felt the impacts of the crisis most, some of them experiencing 100% gas supply disruption. The worst scenario was in Moldova with no gas storage and no alternative fuel options and 100% dependence on Russian gas. Minimal supplies from Ukraine helped to restore failed heating systems in some parts of the country. Some of the countries imposed restrictions to gas supply to commercial consumers (The Former Yugoslav Republic of Macedonia, Bulgaria) and the in some countries even apartments in some cities were without heating (Bosnia and Herzegovina).¹³³

To avoid such problems in future Europe seeks new routes for the reduction of dependence on Russian gas. One of these projects as EU president said is the Nabucco pipeline. In addition Europe expressed its support to the project aiming to transport Azeri gas to Turkey with possible future transportation to Europe, SCP. SCP has the potential Turkmen and Kazakh gas which also can be a great instrument for Europe to lessen the dependence on Russian gas. However while these projects are not implemented in full potential Gazprom has a great dominance in European energy supply.

¹²⁹ SIEPS (2008) p.3

¹³⁰ <http://www.gazpromquestions.ru/index.php?id=34> (n.d.)

¹³¹ SIEPS (2008) p.24

¹³² Stern (2009) p.55

¹³³ Kovacevic (2009) p.14

3.5 Regulation of gas transit

3.5.1 Legal background

The mechanisms of the transportation of gas to Europe are regulated under long term up to 25 year contracts. These contracts as a rule include “take or pay” rule which implies that customers have to pay for the minimum amount of gas even though the less amount was used. This way Gazprom is protected against risks related to the inability of customers to purchase the agreed amounts. Another peculiarity of those agreements is that they establish different gas prices for Russian customers, Europe and CIS and Baltic countries.¹³⁴

As Ukraine is the biggest transit route for Russian gas relations in energy sector between two states and the regulation of transit issues are of crucial importance. The transit of Russian gas via Ukraine is guaranteed under the agreement concluded between the Government of Russian Federation and Cabinet of Ministers of Ukraine, on 22 December, 2000. Under “2000 Agreement”, Ukraine has undertaken transit and storage of gas¹³⁵, in return for payment. At the time of conclusion Russian part had taken obligation to supply certain amount of gas instead of monetary payment¹³⁶. However, after 2009 gas dispute the parties agreed on monetary payments only. In addition Russia had the obligation to transit Turkmen gas to Ukraine for domestic purposes, which is also omitted with “2009 Agreement”.¹³⁷ The changes in the Agreements will be dealt with below.

The agreement was further extended until 2013 according to the Agreement on additional measures on securing the transit of Russian gas over Ukrainian territory.¹³⁸ However Articles 2, 5 and 9 did not continue to be in force. The issues covered in those articles (the amounts of Russian gas for transit, the amount of transit fees and the amount of Turkmen gas for domestic consumption in Ukraine) is set by annual intergovernmental Protocols.

Further details such as amounts and conditions of transit of Russian gas through Ukraine are regulated pursuant to the agreement between Gazprom and Naftogaz Ukrainy. Such agreement covering 2003-2013 was signed on 21 June, 2002. “2002 Agreement” comprises conditions and volumes of the transit gas, quality requirements of this gas, transit tariffs,

¹³⁴ <http://eng.gazpromquestions.ru/index.php?id=4> (n.d.)

¹³⁵ R/U IGA art 1

¹³⁶ R/U IGA art 2

¹³⁷ R/U IGA art 9

¹³⁸ Agreement on additional measures art 1

liability and dispute resolution provisions. According to “2002 Agreement” the termination was not until 2013, however after the gas dispute of 2009 it was clear that several amendments and additions was necessary in order to stabilize current tension between the parties. Hence, the parties signed a new agreement on 19 January, 2009, covering 2009-2019. In order to understand the development of the Agreements, both 2002 and 2009 Agreements will be dealt with.

Finally, it should be noted that even though according to Article 13 these Agreements are confidential and the parties have the obligation to take necessary steps to avoid the promulgation of the contents of the Agreement¹³⁹, they have leaked and were published in the newspaper “Ukrainskaya Pravda”.

3.5.2 Rights and benefits

(a) Volumes of the transit

Under the Agreement Ukraine is responsible for the provision of transit services to European countries, between the years 2009-2019. The relevant points of entry and exit of gas is determined in the Agreement. The amount of the gas to be transported will not be less than 110 bcm. In 2009 the amount transported was 120,083 bcm. Further years the amounts will be determined in addendums to transit Agreement. The Agreement provides for increase and decrease of volumes. Ukraine should ensure the increase of annual transit volumes if technical conditions are sufficient. The consent of Ukraine is not required in this situation.¹⁴⁰ Ukraine is also responsible to reduce the volumes of export in certain directions if Russia requests so. The precondition is the written notice given 48 hours prior the reduction of volumes and the technical feasibility. However, the provision does not give further explanation of the technical feasibility.¹⁴¹

The Agreement comprise an opportunity for Russia to increase or decrease quarterly amounts for transportation, however does not oblige Ukraine to follow with such request. The question of the change of the volumes is decided upon the agreement of parties. Redistribution of gas flows between the directions is also possible.¹⁴²

¹³⁹ 2009 Agreement art 13.3

¹⁴⁰ 2009 Agreement art 3.1

¹⁴¹ 2009 Agreement art 4.7

¹⁴² 2009 Agreement art 3.3

The parties created rather flexible system for the transit which is rather beneficial for Russia. Depending on its internal production Russia can change the volumes and even directions of flow. Considering the dominance of Russia in its relations with Ukraine, it will not be an obstacle to obtain Ukraine's consent.

Opposite to Article 3.3 (change of volumes) the Agreement restricts deviation from monthly and daily volumes. Such a deviation must not exceed $\pm 6,5\%$ (under "2002 Agreement" the rate was 5%). In the case of take off exceeding this amount and unavailability of the agreement for the storage of gas to compensate the deviation or the unavailability of written notice about the take off, Russia should compensate the deviation with additional volume of gas. If Russia fails to do so Ukraine is not responsible to ensure contractual obligations on receipt and transmission of gas.¹⁴³ Additionally, Russia is responsible for the payment of additional volumes transported per year.¹⁴⁴

The provision on the transportation of Central Asian gas purchased by Ukraine for the purpose of domestic use, over the territory of Russia is omitted in 2009 Agreement, despite it being in the 2002.¹⁴⁵

(b) Payment of tariffs

An important difference between the two transit Agreements is that "2009 Agreement" provides for only monetary payment of transit services.¹⁴⁶ The tariff for the transit of 1.000 cubic meters of gas was USD 1,7, for every 100km.¹⁴⁷ Further, negotiation of the rate of transit tariffs is possible if conditions establishing transit tariffs would substantially change (in comparison to what parties reasonably expected when concluding the Agreement) or the rate of transit tariffs would not be in accordance with the tariff levels on European markets.¹⁴⁸

(c) Liabilities of states

¹⁴³ 2009 Agreement art 3.4

¹⁴⁴ 2009 Agreement art 3.6

¹⁴⁵ 2002 Agreement art 3.7

¹⁴⁶ 2009 Agreement art 9.1

¹⁴⁷ 2009 Agreement art 8

¹⁴⁸ 2009 Agreement art 8.7

Parties are responsible for the violation of the obligations under the Agreement, to the extent of proven losses.¹⁴⁹

For the purposes of transit Ukraine should ensure safe and uninterrupted functioning of gas systems and is responsible for any loss of natural gas transported from Russia for the transit purposes.¹⁵⁰

The quality of gas exiting Ukrainian territory should not be worse than the quality of the gas entering gas pipeline system of Ukraine. If such deterioration occurs Ukraine is responsible for the damage caused to Russia due to the lower quality of gas. The damage can be manifested in paid fines to customers or provided discounts due to the low quality gas.¹⁵¹

Further, if Ukraine removes gas provided for transit, the removed amount is formalized as a sale agreement.¹⁵² The provision should not be understood as the right for Ukraine to take gas from pipelines. It merely requires Ukraine to pay if it siphons gas.

Finally, interest at the rate of 0,03% per day for the non payment of the transit services is applicable.¹⁵³ The Article in “2002 Agreement” provided for the rate up to 0,3% in the case of delay continuing more than 90 days which is omitted in “2009 Agreement”.¹⁵⁴

The overall assessment of the Agreement creates an impression that the involved parties are equal and rights and obligations are balanced to some extent. However, actual relations between the states prove that this is not completely true. With cut off of the gas supply through Ukraine to Europe Russia showed to the world who is actually dominant in their relations. Russia’s approach to the gas supplies and the whole crisis occurred thereafter was interpreted as “Russian energy blackmail”.¹⁵⁵ Even the transit fees for Ukraine reflect the unfair situation between parties. According to the Energy Charter Secretariat transit fees paid to Ukraine were lower than anywhere else in Europe, in 2005.¹⁵⁶ The tariff payments are even less than the payments made to some other CIS countries, as Moldova, Azerbaijan, Georgia,

¹⁴⁹ 2009 Agreement art 10.1

¹⁵⁰ 2009 Agreement art 4.5

¹⁵¹ 2009 Agreement art 10.2

¹⁵² 2009 Agreement art 10.4

¹⁵³ 2009 Agreement 10.3

¹⁵⁴ 2002 Agreement art 10.5

¹⁵⁵ Russian and CIS Markets (2009) p.409

¹⁵⁶ Russian and CIS Markets (2009) p.113

etc¹⁵⁷. Even though the tariffs have been increased since then, they did not go beyond the ones paid to Russia and Bulgaria¹⁵⁸.

¹⁵⁷ Russian and CIS Markets (2009) p.413

¹⁵⁸ Russian and CIS Markets (2009) p.114

4 Comparison: Energy Charter Treaty, Azeri and Russian systems

4.1 Energy Charter Treaty

Energy Charter Treaty (hereinafter ECT) signed in 1994 is a legal framework for energy cooperation. The purpose of ECT is to promote long-term cooperation in the energy field.¹⁵⁹

The Treaty entered into legal force in April, 1998 and so far is signed by fifty one states, the European Community and European Atomic Energy Community. ECT focuses on four areas¹⁶⁰:

- protection of foreign investments;
- non-discriminatory conditions for trade, reliable cross-border energy transit flows;
- dispute resolution;
- the promotion of energy efficiency, and attempts to minimize the environmental impact of energy production and use.

Final act of the European energy charter conference obliges participating states to ensure non-discriminatory basis for transit consistent with the principle of freedom of transit. To furtherance these provisions negotiations started over a Transit Protocol (hereinafter Protocol) which is still under discussion. The Protocol will provide for a regime of principles covering energy transit flows and ensure security and non-interruption.

Below first, provisions on energy transit under both ECT and Protocol will be examined. Further, the correspondence of BTC, SCP and Gazprom system with ECT and the Protocol will be discussed.

4.2 Regime under ECT

(a) Conditions applied to transit

For the purpose of ECT transit can occur in two possible situations. First, transit of energy materials through participant state, from an area of a third state to an area of another state. One of the non-transit states have to be a participant state. Second, possible way is the

¹⁵⁹ ECT art 2

¹⁶⁰ <http://www.encharter.org/index.php?id=28&L=> (n.d.)

carriage through one participant state of energy materials originating from another participant state to that another participant state.¹⁶¹

ECT obliges states to take all necessary measures meeting certain requirements to facilitate the transit in energy field. One of the requirements is the principle of freedom of transit. Second, the transit should be available to everyone without distinction as to the origin, destination or ownership of energy materials and no discrimination should be exercised on the base of those distinctions. These conditions are also supported in the Protocol. Third, no one should face unreasonable delays, restrictions or charges.¹⁶² These provisions preclude states from executing bureaucratic hindrances to energy related companies or preclude them from trading their energy resources to desired destinations. Despite the extensive rights granted to participants of energy field, ECT does not oblige participants to provide for mandatory 3rd party access.¹⁶³ The provision should be understood as entitling for expansion of existing system.

Both ECT and the Protocol require the guarantee of non-interruption of transit flows. According to ECT even in the event of a dispute over transit matters energy flows should not be reduced or interrupted. Transit flows should be uninterrupted until the dispute is settled.¹⁶⁴ Proving the same point the Protocol requires that risks of interruption, reduction or stoppage should be minimized. According to the Protocol if such interruption occurs normal operation of interrupted flows should be expeditiously restored and concerned participants should be informed. Realistic expectations as to the recommencement of transit should be prepared.¹⁶⁵ In addition to non-interruption the Protocol envisages conditions for transit such as secure, efficient transit. These principles are the cornerstones of transit relations.

Supporting the idea of non-interruption and security, the Protocol prohibits states to interfere with transit flows and claim title in such resources.¹⁶⁶

Finally, states should provide for national treatment for energy materials and products in transit. This treatment ensures that the relevant domestic legislation puts them in no less

¹⁶¹ ECT art 7(10)

¹⁶² ECT art 7(1)

¹⁶³ ECT art 7(4), FA EECC art IV(25)

¹⁶⁴ ECT art 7(6)

¹⁶⁵ TP art 16

¹⁶⁶ TP art 6.1

favorable manner than the materials and products originating in or destined for that state's own area.¹⁶⁷

(b) Expansion of the capacity

Developing freedoms given to the participants of energy sector, ECT prevents states from rejecting of new capacity being established if transit cannot be achieved on commercial terms.¹⁶⁸ This provision corresponds to Article 7.2 providing for the commitment of participants to promote modernization, development and operation of energy transport facilities.¹⁶⁹ Establishment of new capacities can be prevented if a state can demonstrate that such capacities will endanger the security or efficiency of its energy systems and security of supply.¹⁷⁰ ECT also recognizes the states' relevant legislation on environmental protection, land use, safety or technical standards may provide otherwise.¹⁷¹ Finally, this Article can be suspended temporarily for a state to adapt to the requirements of a market economy.¹⁷²

(c) 3rd party access

Even though ECT does not provide for 3rd party access, the Protocol regulates this issue thoroughly. The provisions under two documents contradict to each other. All transit provisions envisaged in ECT should be applied in accordance with the Protocol which supplements and amplifies ECT¹⁷³. Hence, the provisions enabling 3rd party access provided by the Protocol override ECT. Of course, these arguments are still on discussion level, until the Protocol will actually enter into force.

Pursuant to Article 8 participant states are responsible for the provision of 3rd party access. Under the Protocol access is only granted for the transit purposes.¹⁷⁴ It is their responsibility to ensure that negotiations between potential 3rd parties and owners or operators of transport facilities are conducted in good faith and based on transparent procedures, on commercial terms, and be non-discriminatory conditions. In case of denial of access the Protocol requires

¹⁶⁷ ECT art 7(3)

¹⁶⁸ ECT art 7(4)

¹⁶⁹ ECT art 7(2)

¹⁷⁰ ECT art 7(5)

¹⁷¹ ECT art 7(4), FA EECC art IV (8)

¹⁷² ECT art 32 (1)

¹⁷³ TP art 2

¹⁷⁴ TP art 4.2

for a duly substantiated explanation, such as incompatibility of technical specifications which cannot be reasonably overcome.¹⁷⁵ Also, the article requires that upon the expiry of transit contracts existing users should have the same rights of negotiations as potential users. The only advantage for existing users is the first opportunity to accept the conditions of transit agreements.¹⁷⁶ The Protocol includes an exceptional situation where due to relations between states a private company can be denied of access. A participant state does not have the obligation to provide for 3rd party access if the potential accessor is of a third state that does not have diplomatic relations with denying state. Third, measures adopted by a participant state, prohibiting transactions with state entities of the third state are a base for denial. Finally, the application of the Article can be restricted if a participant state adopted measures that would be violated in case of 3rd party access.

(d) Transit contracts and tariffs

The Protocol provides for the application of transit contracts between the participants and requires them to ensure domestic law establishes effective and non-discriminatory means for the assertion of claims and the enforcement of rights under the transit contracts.¹⁷⁷ Hence, ECT and the Protocol are not in themselves a piece of legislation that regulates all relevant relations between two parties in a given situation. More detailed provisions should be depicted in bilateral agreements.

The Protocol covers the problem of transit tariffs. According to the Protocol the tariffs should be objective, reasonable, transparent and non-discriminatory, as well as not be affected by market distortions and abuse of a dominant position of owners of energy resources. However, the Protocol does not skip the interests of capacity owners. The tariffs should meet operational and investment costs and ensure reasonable rate of return.¹⁷⁸

(e) Dispute resolution

ECT has a system for a dispute resolution that faced numerous criticisms. The reason for such criticism is that it has never been used by any participant state. Although ECT Secretary

¹⁷⁵ TP Understandings art 9

¹⁷⁶ TP art 8

¹⁷⁷ TP art 5.3

¹⁷⁸ TP art 10

General offered parties to use conciliation system, during both Russian Ukrainian disputes, parties did not refer to the mechanism envisaged by ECT. A precondition for the application of this provision is the exhaustion of all relevant contractual or other dispute resolution remedies previously agreed. It is up to the parties to a dispute to decide when the all relevant remedies are exhausted. Hence, no matter how a dispute is affecting other involved parties, application of dispute resolution will always depend on the willingness of parties to a dispute. After a party refers a dispute to the Secretary General, an independent conciliator is appointed who has the power to decide interim tariffs and other relevant conditions for up to twelve months if parties cannot reach an agreement even with the supervision of the conciliator.¹⁷⁹ The dispute resolution provided in the Protocol differs from the mechanism described in ECT. The Protocol establishes a two level resolution mechanism. First, the parties should settle the dispute through diplomatic channels, and then the parties may refer the case to the ad hoc tribunal in accordance with Article 27 of ECT.¹⁸⁰ No interim terms are available under the Protocol.

4.3 Comparison of BTC and SCP systems to ECT

All the states involved in BTC and SCP (Azerbaijan, Turkey, Georgia) are members of ECT and have ratified it. As the system under BTC and SCP are rather similar only BTC will be discussed.

The principles of freedom of transit and non-discrimination are recognized under BTC framework which is in accordance with ECT. The relevant agreements also meet the requirement as to the non-interruption of energy flows. BTC IGA Article II 4(ii) obliges state authorities not interrupt or impede the freedom of transit of Petroleum and take measures necessary to avoid and prevent such interruption. In addition Article VII.4 requires states to use reasonable endeavors to rectify any interruption of petroleum flow if interruption occurs. 3rd party access under BTC is not as precise as pursuant to the Protocol and the agreements do not openly provide for it. However, it is possible to obtain interest in the pipeline through accession to the agreements or assign capacity rights, which will result in 3rd party access.

¹⁷⁹ ECT art 7(7)

¹⁸⁰ TP art 21

Regarding tariffs there is no direct regulation under BTC system. However, Article 8.2 (v) of the HGA requires that the tariff income should be allocated according to the amount of capital expenditures and length of the MEP System. This is to some extent corresponds to the Protocol as can be regarded as objective and reasonable system.

BTC system has requirements similar with obligation not to interfere or take from energy flows. According to Article VII.2 the states authorities should not claim title in the petroleum transported through its territories. It is obvious that with no title in petroleum states cannot withdraw it from the system.

Lastly, the dispute resolution provisions of BTC IGA make a reference to Article 27(3) of ECT. Thus, Energy charter conference recognized that regulatory frameworks for energy flows in Azerbaijan are in accordance with the principles of the ECT.¹⁸¹

4.4 Comparison of Gazprom system to ECT

4.4.1 Russia's withdrawal from ECT

Russia signed ECT in 1994, however, never ratified it. On 30 July, 2009 Russian Prime Minister V. Putin declared that Russia officially rejects ECT and offered a new energy charter. The document – “The conceptual approach to new legal framework for international energy cooperation”¹⁸² requires that either a new charter will be prepared or the existing one will be significantly amended, which was also stressed by Russian president D. Medvedev.

The reason why Russia left ECT was subject to wide range of speculations. According to the Russian Oil and Gas Report, Russia finds some provisions of ECT completely unacceptable.¹⁸³ Regarding this argument some politicians expressed that if Europe would be able to contract for cheap gas directly with Central Asia, Russian dominance as an importer of gas would be threatened, as the tariffs through Russia are relatively low.¹⁸⁴ Moreover, V. Putin said in his speech at the World Economic Forum in Davos, right after the Russian-Ukrainian dispute that ECT failed to become a working instrument for regulation of current problems.¹⁸⁵

¹⁸¹ <http://www.encharter.org/index.php?id=141&L=0> (n.d.)

¹⁸² <http://archive.kremlin.ru/text/docs/2009/04/215303.shtml> (2009)

¹⁸³ <http://www.nortonrose.com/knowledge/publications/2009/pub22691.aspx?lang=en-gb> (2009)

¹⁸⁴ Konoplyanik (2009) p.36

¹⁸⁵ Pirani (2009) p.52

4.4.2 Comparison between two systems

There is no unified framework in Russia for the transit of energy resources. Relations are regulated under bilateral agreements with relevant states. The discussion in this thesis was around Russian-Ukrainian relations. Hence, below the 2009 transit Agreement between these two states (hereinafter “2009 Agreement”) will be addressed.

Unlike ECT and the Protocol “2009 Agreement” does not directly provide for the principle of freedom of transit. This principle is not relevant for the whole Gazprom system. Russian authorities already mentioned that freedom of transit will deprive Russia from the right to control Central Asian gas flows over its territories which is not in their interests.¹⁸⁶ With implementation of principle of freedom of transit Ukraine would be able to supply gas from Central Asia directly which would create more competitive and diverse system. Since it is not an opportunity due to Russian policy, “2009 Agreement” is concluded on discriminatory bases. However, as the “2009 Agreement” is bilateral and no 3rd party access is possible, expressions of principles of prohibition of distinction between different owners of petroleum are not relevant.

The problem of non-interruption of transit flows is indirectly expressed in Article 4.5 of “2009 Agreement”. According to which Ukraine is responsible for the secure and uninterrupted operation of gas transportation system of Ukraine, its supply with technical gas and for the loss of transit gas.¹⁸⁷ Even though the Article does not directly provides for the uninterrupted gas flow, an uninterrupted transportation system, fully ready to transit gas flows has the same outcome. Further, Article 5 relieves parties from possible responsibilities if the transit is interrupted due to repair works in the pipeline system.¹⁸⁸

While there is no access for 3rd parties pursuant to ECT, the Protocol pays great attention to this issue. The current situation in Russia differs. Gazprom has the legal export monopoly in Russia and control to a large extent domestic distribution. According to the federal decree only Gazprom has the right to export gas in Russia. As a result not only Russian gas, but also gas from other sources, such as Central Asia is being sold by Gazprom who first purchases from Central Asian sellers and then sells onward purchasers in Europe. As a consequence, Russia is not a transit state in its relations with mentioned region.

¹⁸⁶ <http://www.nortonrose.com/knowledge/publications/2009/pub22691.aspx?lang=en-gb> (2009)

¹⁸⁷ 2009 Agreement art 1.5

¹⁸⁸ 2009 Agreement art 5.1

Like the Protocol “2009 Agreement” includes a provision regarding the interference with the transit flows. The Protocol does not provide for any measures if such interference happens. However, Article 10.4 of “2009 Agreement” obliges Ukraine to pay for the gas withdrawn from the system.

As to the Protocol’s requirement on the tariffs that are not affected by abuse of a dominant position of owners of energy resources it is hard to say that tariff level for Ukraine is in consistent with this provision. As already mentioned tariffs for Ukraine are below the tariffs for some other states, including CIS states.

Finally, both the Protocol and “2009 Agreement” contain provisions on two level dispute settlements. As the Protocol the Agreement requires the parties to settle the problem through diplomatic channels. Only in case of failure the parties may take the case to the arbitrage in Sweden.

5 Conclusion

Azerbaijan as one of the major oil and gas producer has taken significant efforts both in attracting foreign investments to petroleum sector and establishing legal framework for transit activities. The Project agreements discussed in this thesis regulate the most major projects developed in Azerbaijan so far. Thus both BTC and SCP play an important role in the creating of legal background for future projects.

Both projects thoroughly answer the most important issues for the energy sector from government guarantees to tax and dispute resolution issues. Both agreements grant an extensive range of right to project participants. However, in return the host states benefit from the respective projects, in grants, increase of employment, development of international trade and relations. In addition, not only member states, but also final consumers of petroleum resources benefit from these projects. The diversification of existing routes lessens energy dependence and establishes more competitive market. Despite the modest amounts of foreign petroleum in BTC and none in SCP, future transportations are not excluded. In fact, negotiations in this context are held between relevant states.

The role of Russian gas is certainly undeniable for Europe. Even with further diversification of routes and sources Russia will always distribute an important part of gas consumption in those states. Thus, Europe is significantly interested in energy relations between Russia and transit states, in particular Ukraine. Past crisis left indelible consequences on mutual relations and credibility of supply, as well as transit states.

As a result Russia seeks new routes for the transit of its resources. New transit states as Belarus or pipelines bypassing any transit states can be positive step toward more secure energy supply. However, involvement of a new transit state does not seem like helping the situation. Russia had with Belarus the same kind of disputes as with Ukraine. On June, 2010 Russia reduced gas flows to Belarus, claiming unpaid bills, but assured it would not affect Europe. In return Belarus started gas siphoning. Even though the dispute was settled before hitting Europe, it proves the vulnerable position European customers are put in. Without doubt no matter who is to blame for these crises, the customers of the Russian gas are the ones to suffer from it.

After comparing two systems, Azeri system may be regarded more attractive for application in transit relations as it deals with rights and obligations in more detail. Hence, it more likely to avoid transit disputes, which are usual under Russian system. Under Azeri system on one hand transit states are provided secure and beneficial conditions, whereas on the other hand owners of petroleum obtain extensive rights and warranties. Finally, taken the prohibition of 3rd party access to export in Russia, Azeri system seems to balance the rights between parties more equitably.

Finally, the Energy Charter Treaty, Transit Protocol and correspondence of given regimes to these two instruments were discussed. ECT and the Protocol are so far the only international systems regulating energy transit and covering all significant problems. Hence, it can constitute a good framework for the current energy relations in mentioned regions. In addition, the existence of a unitary system comprising every participant of energy markets would definitely facilitate the transit relations. Having different legal regimes puts a significant burden on both negotiation and to the actual transit processes. Thus, existence of common framework is in interest of all levels of energy relations.

The countries involved in BTC and SCP have already ratified ECT and the Protocol. Both BTC and SCP systems are to a considerable extent in accordance with these two international instruments. However, parties have not implemented ECT as a basis for their relations in the Agreements, thus the IGA and HGAs are still the main legislative pieces when it comes to the energy relations.

Russia's withdrawal from ECT caused numerous speculations as to the real reasons of the rejections. The negotiations over the Protocol had already been suspended in 2003 due to the differences between Russia and EU. Now that Russia rejects to participate in ECT the creation of a common framework for the key participants of energy market seems impossible, as Russia is one of the biggest oil producer and the biggest gas producer. The preparation of a new charter will mean about a decade of the preparation and adoption of ECT was wasted.

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