

“EU-RUSSIA ENERGY DIALOG”

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I. INTRODUCTION

In my research I examine the important role of energy policy and energy security ,principles and basis of energy cooperation, the importance of energy dialog between Russia and European Union and huge role of Russian Federation in energy sphere.

What means Energy dialog between Russia and European Union? Why EU needs Russian Federation? Why Russia signed but still has not ratified Energy Charter Treaty? How we can build energy security system? What we are waiting from G8 Summit in area of energy dialog? These and other vital and issue questions I examine in this workpaper.

In this research I would like to emphasize firstly the importance of energy policy to the wellbeing and prosperity of societies across the globe and secondly, the important role that Russian Federation itself can play in promoting reliable and secure energy supply.

I would like to focus my research on Russia's role as a major gas supplier and reliable energy partner, in particular to the European Union, and how this role may develop in the future. Also I wish to look at the issue of energy security of Russia and the European Union. This topic will be at the top of the agenda during Russia's presidency in G8 this year.

In my opinion the aim of any discussion on energy security should be to find a balance between producers, transit countries and consumers of energy. This balance of interest provides the basis for stable international cooperation, and this is the philosophy that lies at the heart of EU-RUSSIA ENERGY DIALOG.

Energy plays important role in the EU-Russia economic relationship and promotion of deeper integration between Russian and European markets. Commercial relations between Russia and Europe had been developing quite well. Energy supplies from Russia to European nations had reached record highs last year, almost 400 million metric tons of oil equivalent of hydrocarbons, or almost one-third of oil & gas consumption in the EU-25 countries. New commercial plans and projects targeted to further increases of energy supplies from Russia to Europe are discussed.

Russian and European politicians together can and, actually, should contribute a lot to help establish reliable, mutually respectful and environmentally friendly common energy space in Europe and Eurasia.

II. RUSSIA/EU ENERGY PARTNERSHIP

2.1 RUSSIA-is reliable gas supplier and partner

Recently, foreign mass media have been engaged in a heated debate on whether Russia will honor its commitments on natural gas supplies.

Claude Mandil, executive director of the International Energy Agency, is often quoted as saying that Gazprom, Russia's state-controlled gas monopoly, is not a reliable gas supplier to Europe in the long term. The Russian gas giant is reproached for producing gas from old fields and investing too little in the development of new ones. There are also speculations that Gazprom's ability to honor new contracts depends seriously on its purchases of Central Asian gas, which is seen as a dubious guarantee of future gas supplies.

However, statistics of global gas reserves is quite controversial, as is the assessment of Russia's share of them. Different sources estimate it at one fourth to one third. Anyway, this share is a key one on the global gas market. The world's proven reserves amount to 150 trillion cu m, which is enough to fuel economic development for about 70 years. Russia is an obvious leader in this respect, given its reserves and energy consumption (its gas security is well above the world's average). Moreover, the U.S. Geological Survey estimates that about 25% of still undiscovered oil and gas reserves lie in the Arctic, mainly in Russia.

The question is whether gas reserves on Russia's sub-polar shelf are ready for industrial exploitation and bring export revenues any time soon. The current situation on the gas market and available capacities to develop hard-to-access fields in the Extreme North and in the shelf of Arctic seas show that their development is at present sufficiently profitable compared to the mid 1990s. The necessary technologies are now close at hand.

This is why I believe the issue of global gas supplies is now politically motivated, making the debates around Russia's reliability as a gas supplier so heated. The possibility of a gas OPEC appearing in the world is becoming more and more evident. With Russia controlling 27% of the world's gas reserves and Iran 15%, these two countries together boast huge potential in terms of global gas distribution, which cannot but cause concern of major gas consumers.

Under different estimates, about three fourths of the world's gas reserves are concentrated in the Middle East and the former Soviet Union. This is an impressive figure and it obviously irritates the West, given that natural gas is becoming a leader in global energy consumption. As a result, the

West is increasingly viewing Russia as a state that dictates its will on its partners guided by its own political interests. This leads to a new wave of Russophobic sentiments, especially in the EU and U.S. political circles.

Western countries stubbornly demand that Russia de-monopolize its gas transportation network and allow Central Asian gas to the network on conditions of simple transit. Simultaneously, they are pushing for alternative projects of shipping the same gas, such as the Trans-Caspian pipeline. However, the political moves related to Russian gas do not always gain support from business circles orientated towards intensive cooperation with Gazprom. Good examples are Germany's E.ON, Italy's Eni and other companies.

Russia, in its turn, combines inter-government contacts with robust commercial activities of Gazprom and its affiliated structures, supported by high-ranking officials. Recently, Russian Finance Minister Alexei Kudrin said that only Russia could be the founder of the global gas market. An element of Russia's state policy in gas supply is selection of Gazprom's potential partners in large projects by their loyalty, but without detriment to the economic expediency of cooperation. So Russia has a sufficient investment resource for developing the gas industry, given Gazprom's own potential and its foreign partners' interest.

Russian government sources and independent experts, such as British Petroleum, estimate Russia's proven gas reserves at 48 trillion cu m (27% of the world's total) in late 2004. Russia's gas output may reach 645-665 billion cu m by 2010 and 710-730 billion cu m by 2020. At present Russia produces about 600 billion cu m annually, of which 200 billion cu m is exported. Obviously, there is no ground to fear the shortage of export resources.

At the same time, about 51% of proven reserves lie in Russian regions with developed gas infrastructure, and these regions account for the bulk of gas production. So the question is whether Russia can successfully develop new gas producing regions and provide them with the required export infrastructure.

Yet even a superficial analysis of the situation in the Russian gas sector shows that Western concerns are rather demonstrative and politicized. The production base for gas development at new fields was created during the last decade, and now it is being revived due to the changing gas prices on the global market. The necessary transportation routes are also being built promptly.

Most probably, the West is apprehensive not so much of gas dependence on Russia, as on the possibility that its partner, bolstered by export revenues, may expand to European markets and buy into local energy companies. This is why European politicians show little enthusiasm about Russia's concept of asset swap. However, foreign companies cooperating with Gazprom demonstrate a better

understanding and are busy working out competitive proposals. This is true of Norway, Italy and France.

Russia's stance was clearly formulated by President Vladimir Putin at a briefing following the Russia-EU summit: "If our European partners want to be admitted to the sanctum of our economy - the energy sphere, then we expect their similar moves in response."

Europe is also resisting Russia's desire to sign long-term gas contracts with consumer countries. It views such contracts as a possible tool for market monopolization and subsequent gas blackmail on the part of Russia. Gazprom retorted by asserting its commitment to free trade principles and hinting that it has other promising markets, such as China and Japan.

Consequently, Russia has every chance to increase its gas exports and strengthen its foothold on global markets. However, there are still problems with developing new fields at a pace adequate to that of constructing additional export routes. The growing anxiety around the issue testifies not so much to Gazprom's production difficulties, as to the political controversies between Russia and the West.

2.2 Energy Charter Treaty

1). Why Russia refuses to ratify Energy Charter?

The energy ministers of the European Union (EU) have called on Russia to speed up the ratification of the Energy Charter, but Russia is not in a hurry to comply.

The reasons for procrastination have returned to the top of the Russia-EU agenda.

The Energy Charter stipulates free market relations in energy between the countries that ratify it. It was drafted in Europe in the early 1990s within the framework of the nascent East-West energy cooperation. Since then, all the EU member states and more than 50 other countries have signed or joined the treaty.

Russia signed the charter in the early 1990s, but has not ratified it. The EU, which is the main consumer of Russian energy resources, was seriously alarmed by the Russian-Ukrainian gas conflict

in January 2006 and, in attempts to protect its interests, has insisted that Russia ratify the treaty. However, Moscow considers its individual clauses too harsh and has called for amending it.

Presidential Aide Igor Shuvalov said Russia would refrain from ratifying the Energy Charter Treaty and would demand its amendment.

One of the main Russia-EU contradictions concerns the transit protocol to the charter, which stipulates the non-discriminating access of companies and other countries to Russian pipelines, primarily the gas transportation network controlled by state-owned gas holding Gazprom. In fact, Russia is being called upon to give access to its pipelines to independent producers and other countries, such as Kazakhstan and Turkmenistan. This is an issue of serious contention for Russia, which does not want to become a gas transit country or liberalize Gazprom's export gas pipelines.

Industry and Energy Minister Viktor Khristenko has said Russia would ratify the treaty upon reaching a mutually acceptable agreement on transit with the EU. "Russia is conducting intensive, but difficult negotiations on the transit protocol," the minister said.

Another point of contention is the responsibility for under-deliveries of gas to Europe because of Russia's conflicts with post-Soviet transit countries, notably Ukraine. According to the EU, its member states, which buy Russian gas on the western border of the former Soviet Union, should not be affected by post-Soviet contradictions. The treaty stipulates the arbitration of price disputes and would prohibit Russia from stopping gas deliveries to any country.

Gas prices on the Russian domestic market are another problem. So far, Moscow and Brussels have not found common ground concerning Russia's domestic gas prices. EU officials say they are unjustifiably low, which gives Russian exporters advantages over European producers. But Russian government experts say that low domestic prices are a natural advantage of the country, just as a milder climate is an advantage of Europe.

Russia cannot agree to adjust domestic gas prices to global ones and the EU does not demand this categorically either because a rapid growth of gas prices in Russia would change all price proportions in the national economy. And given the low volume of the export of finished goods, the thesis about unjustified privileges granted to Russian producers sounds strange too.

Another issue on the agenda is the leveling off of prices of Russian and Central Asian gas, which would not benefit Russia. According to Gazprom's data, accession to the charter would cost the gas holding \$4.5-\$5 billion in annual losses owing to price adjustment.

Russia is still coordinating the gas provision business in the former Soviet territory. Central Asian states sell their gas not to consumers directly but to Gazprom, at prices that are lower than the market value. Theoretically, Russia could become an ordinary transit power, but this would disrupt

the whole system of economic and political relations in the former Soviet territory where many former Soviet republics receive Russian gas at half the market prices.

At the same time, accession to the charter may also benefit Russia. Some experts say that it would help Russia attract \$480-\$600 billion for its fuel and energy sector and increase energy exports to 600 million metric tons of conventional fuel by 2010.

Leonid Grigoryev, President of Russia's Institute of Energy and Finance, said Russia would ratify the charter in time for the July 2006 G8 summit in St. Petersburg. He said oil consumption could dwindle, increasing political risks related to hydrocarbons production and distribution, in 20-30 years because of the transition to hydrogen technologies and renewal energy sources. Therefore, Russia should ratify the charter, he said.

So far, Russia's stand is very harsh: the state (Gazprom) will retain control of the gas transportation network and domestic gas prices will not be adjusted to global ones. According to a Gazprom spokesman, the Energy Charter provides for unilateral advantages for the EU over producers concerning access to mineral resources and their delivery to the international market. The gas holding's management contends that the treaty in its present form would considerably lower the competitiveness of Russian gas on the world market.

However, this position of principle is unlikely to prevent the ratification by Russia of the Energy Charter, but rather will be used as a bargaining chip in relations with the EU. The problem will likely be solved eventually on the basis of mutual consensus.

2). Russia backs Energy Charter principles but has concerns.

ST. PETERSBURG, June 10 (RIA Novosti) - Russia backs the principles of the Energy Charter but is concerned that certain important provisions are lacking in the document, the country's finance minister said Saturday.

"Russia has shared and will continue to share the principles of the Energy Charter, but we are not happy with certain things contained in agreements to the Energy Charter," Alexei Kudrin told a news conference after a G8 finance ministers' meeting in St. Petersburg.

First of all, Kudrin said, the charter did not touch upon nuclear power development; Russia as a nuclear energy supplier would like this issue to be addressed in the document.

Also, the minister said, the charter does not mention energy resource transit, which is of particular importance since transit principles have changed, and EU states are no longer transit countries.

Kudrin said that Ukraine, which ratified the charter, was a transit country, but that it siphoned off natural gas from transit pipelines. "Such gas tapping is a violation of the Energy Charter, but somehow the West says nothing about it," he said.

In view of the interdependence of Russia and the EU in the field of energy, an energy dialog is becoming one of the major areas of sectoral cooperation. This derives from the real economic needs of our countries, from our common interest in the consolidation of political and economic stability in the Eurasian space. The European Union nations currently account for about 90 percent of Russia's export of energy carriers. By all appearances, this market will remain a priority one for us in the next 20-25 years, too. And in the long run the energy dialog could develop into the creation of a European Energy Community, based on the principles of equality and encompassing all the kinds of energy.

2.3 GAZPROM LAUNCHES CONSTRUCTION OF ONSHORE SECTION OF NORTH EUROPEAN GAS PIPELINE

The North European gas pipeline will open a new chapter in the history of cooperation with European gas consumers. It will begin to deliver Russian natural gas.

Attachment 1 gas to Western Europe avoiding transit states along its route.

It is expected that that by 2010 the European gas market will need about 100 bcm of gas in excess of the existing long-term contracts. The existing export gas pipelines from Russia to Europe will not be able to quench the growing gas thirst. To solve this problem and raise the safety of Russian gas supplies for export, development of the North European gas pipeline (NEGP) project was begun a few years ago.

The North European gas pipeline project will inaugurate a brand new route to export Russian gas to Europe. Its implementation will diversify export routes, make supplies more flexible and directly connect gas transport networks of Russia and other countries in the Baltic Sea area to the European

gas grid. The NEGP will bypass transit states reducing sovereign risks and costs of Russian gas delivery and enhancing reliability of export supplies.

The NEGP will run under the waters of the Baltic Sea from Portovaya bay (near Vyborg) to the coast of Germany (near Greifswald). The plan is to build two parallel gas pipeline legs each about 1,200 km long. Total annual NEGP capacity will be 55 bcm. The pipeline will have a spur to deliver gas to consumers in Sweden.

The gas pipeline construction will help expand gas supplies to Scandinavian countries as well as provide reliable gas supplies to consumers in Western Europe, North-Western region of Russia and Kaliningrad Region as gas consumption continues to grow in these areas.

The first pipeline of NEGP will be put into operation in 2010.

The first joint of the Russian onshore section of the North European Gas Pipeline has been welded today in the town of Babayevo (Vologda region).

Attending the event were Mikhail Fradkov, Chairman of the Government of the Russian Federation, Michael Glos, Economy Minister of Germany, Alexey Miller, Chairman of Gazprom's Management Committee, Jurgen Hambrecht, Chairman of the Board of Executive Directors of BASF AG and Wulf Bernotat, Chairman of the Board of Management & CEO of E.ON AG.

NEGP's offshore section will be engineered, constructed and operated by North European Gas Pipeline Company incorporated on 30 November 2005 in the canton of Zug (Switzerland) by Gazprom (51%), BASF AG (24.5%) and E.ON AG (24.5%).

“Today we've started establishing a cardinally new route for natural gas transmission. Projected over a long term and aimed at meeting the united Europe's soaring needs in Russian gas, the North European Gas Pipeline will substantially enhance the reliability and flexibility of gas deliveries from Russia. Gazprom's long-lasting experience of operations in the gas business as well as our alliance with the prominent German companies BASF and E.ON are the keystones for our success, with the foundation of a special purpose Gazprom, BASF and E.ON joint venture being undoubtedly a landmark event in this regard,” maintained Alexey Miller.

“For so far 15 years BASF and Gazprom have been successfully working as a team in the gas trading sector. In 2003 we launched joint business in the geological exploration and production sectors. By now intensifying our partnership ties, we’re making another contribution into prospective natural gas supply of Europe along the entire value chain, from a Siberian drilling well to a European end-user,” said Jurgen Hambrecht.

“Welding the first joint of a gas pipeline from Russia to Germany is a symbolically meaningful event. Our reliable partnership ties in the energy sector have been a connecting bridge between Russia and Germany over many decades. Our countries have close relationships and have managed to find the best way to understand each other. The North European Gas Pipeline construction under the Baltic Sea will be another crucial step towards promoting our cooperation,” stated Wulf Bernotat.

Reference:

The North European Gas Pipeline (NEGP) is a fundamentally new route for Russian gas exports to Europe. Targeting at Germany, the Great Britain, the Netherlands, France and Denmark, NEGP is of great significance for meeting Europe’s soaring gas demand.

Back in December 2000 the European Commission resolved to award the NEGP Project with the TEN (Trans European Networks) Status.

With no transiting countries along its route, which excludes any potential political risks, NEGP will directly link the United Gas Transmission System (UGTS) of Russia with the European gas network and will ensure the utmost in reliable gas deliveries to West European consumers. Additionally NEGP will play a special role in providing abundant gas supply to the Kaliningrad region.

To link NEGP with UGTS of Russia, a 917-km-long Gryazovets-Vyborg gas pipeline will be built through the Vologda and Leningrad regions. Commissioning this pipeline will also help meet growing gas requirements of St. Petersburg and the Leningrad region.

To be built in the Portovaya Bay (near the town of Vyborg, Leningrad region), an onshore

compressor station will be a starting point for NEGP's offshore section (1,198 km) that will run under the Baltic Sea to Greifswald (Germany) with a potential gas lateral to Sweden and then will go across Germany and the Netherlands to Bacton (the Great Britain).

NEGP's working pressure will account for 210 Ata. With its nominal capacity to reach 27.5 bcm/y, the first line of NEGP is slated for 2010. Upon construction of the second line, NEGP's design capacity will double to 55 bcm per annum.

NEGP will carry gas to be withdrawn from UGTS.

An eight-member Shareholders Committee has been set up to operate the North European Gas Pipeline Company joint venture.

The construction of NEGP will meet the most rigid environmental standards and won't disrupt the Baltic Sea ecosystem.

2.4 Building of energy policy in EU

1). EU-energy policy

Some 80% of the energy the EU consumes is from fossil fuels – oil, natural gas and coal. A significant and increasing proportion of this comes from outside the EU. Dependence on imported oil and gas, which is currently 50%, could rise to 70% by 2030. This will increase the EU's vulnerability to supply cuts or higher prices resulting from international crises. The EU also needs to burn less fossil fuel in order to reverse global warming.

The way forward is a combination of:

energy savings through more efficient energy use,

alternative sources (particularly renewables within the EU), more efficient use of gas-fired co-generation plants, which also produce steam and heat, more use of biomass from organic matter in energy production and biofuels in transport, better integration of EU energy markets, better

integration of EU energy policy with other policies, such as agriculture and trade, and more international cooperation.

Imports remain essential, long-term security of supply also means not being over-dependent on a few countries for supplies, or compensating for that dependence by close cooperation, with countries such as Russia (a major source of fossil fuels and potentially of electricity), and with the countries of the Gulf region. Cooperation with developing or emerging economies includes investment and transfer of know-how in production and transport in the interests of both sides.

The EU, Bulgaria, Romania, and seven countries of southeast Europe have set up a single Energy Community across the 34 countries, so that in due course energy market rules will be the same across the whole zone. The EU will benefit in particular from greater security for the supply of gas and power transiting these countries. The non-EU countries' energy markets will operate more efficiently by applying EU rules and their consumers will benefit from more competitive markets and the targeting of subsidies where they are most needed.

Changing the fuel mix.

None of this will be enough. Ultimately, the EU must become a low-carbon economy using less fossil fuel in industry, transport and the home, and making use of renewable energy sources to generate electricity, heat or cool buildings, and fuel transport, particularly cars. This presupposes an ambitious switch to wind (particularly offshore wind), biomass, hydro and solar power and bio-fuels from organic matter. The following step could be to become a hydrogen-based economy.

Caring for the environment.

Caps on the amount of emissions of carbon dioxide (CO₂) EU industry can spew into the atmosphere now apply in order to halt global warming. Companies exceeding their emissions allowance trade with others who have not used up all their allowance. This encourages more efficient energy use, cuts pollution and keeps the promises the EU has made in the Kyoto Protocol on climate change.

The European Commission has proposed extending these rules to airlines. The growth in emissions from planes threatens to cancel out more than a quarter of the 8% reduction in total greenhouse gas emissions compared to 1990 levels that the Kyoto Protocol imposes on EU-15 energy-intensive industries by 2012.

Saving energy by using it more efficiently

In order to cut fossil fuel use, the EU is committed to obtaining 15% of its energy from renewables by 2015. Member states have also undertaken to save 1% of their final energy consumption each year for nine years from 2007 by expanding the use of energy-efficient and cost-effective lighting, heating, hot water, ventilation and transportation.

Road transport is a heavy fuel user. In addition, traffic jams and commuting waste fuel, and vehicle exhausts pollute, so more efficient use of transport (thanks to better traffic management and urban planning), and a faster switch to greater use of public transport and bio-fuels are crucial. The EU has set a target of 8% for biofuels of total energy consumption by 2015.

Moreover, the EU has agreed energy performance standards and certification requirements for buildings, compulsory regular inspections of boilers and air-conditioning systems, and standards for energy-using equipment, such as household appliances - all of which help save energy.

Using energy more intelligently

Technology will play a key role in using energy more rationally. The EU's framework programmes for research and technological development fund energy research, and the EU's Intelligent Energy Executive Agency is spending €200 million from its *Intelligent Energy for Europe* programme between 2003 and 2006 to support research into energy saving, energy efficiency, renewable energies and the energy-related aspects of transport in the EU, Bulgaria, Croatia and Romania.

The single energy market.

A competitive energy market helps efficient energy use. In the past, national gas and electricity markets were separate 'islands' within the EU, where supply and distribution were in the hands of monopolies. Now, markets have been opened up to competition and national borders in energy markets are disappearing.

The EU facilitates competition with funding to connect isolated networks and improve cross-border interconnections, both within the EU and with supplier countries. For their part, all suppliers have guarantees under single energy market rules that they can have access to the distribution grid and pipeline networks of other EU countries, and that access charges will be fair.

All businesses and many consumers are already free to choose their own supplier of gas and electricity. All other consumers will be by mid-2007. The additional competition comes with additional protection. There are safeguards to protect consumers against their lights going out or their heating going cold. These ensure that cost-cutting by competing suppliers does not result in

under-investment, that consumers in remote areas or on low incomes are not regarded as too small or too far away to bother about, and that there will always be someone to step in immediately if a supplier goes out of business.

2). The intelligent Energy-Europe: WORK PROGRAMME-2006

The Intelligent Energy - Europe (IEE) Programme¹ is intended to support the European Union's policies in the field of energy as laid down in the Green Paper on the Security of Energy Supply², the White Paper on Transport and related Community legislation. Its aim is to support sustainable development in the energy field, making a balanced contribution to achieving the general objectives of security of energy supply, competitiveness, and environmental protection (Article 1 of Decision 1230/2003/EC).

Under this Decision, the programme is structured into four specific fields:

- (a) "SAVE", which concerns the improvement of energy efficiency and the rational use of energy, in particular in the building and industry sectors (with the exception of actions under STEER), including the preparation of legislative measures and their application;
 - (b) "ALTENER", which concerns the promotion of new and renewable energy sources for the centralised and decentralised production of electricity and heat and their integration into the local environment and energy systems (with the exception of actions under STEER), including the preparation of legislative measures and their application;
 - (c) "STEER", which concerns support for initiatives relating to all energy aspects of transport, the diversification of fuels, such as through new developing and renewable energy sources, and the promotion of renewable fuels and energy efficiency in transport, including the preparation of legislative measures and their application;
 - (d) "COOPENER", which concerns support for initiatives relating to the promotion of renewable energy sources and energy efficiency in the developing countries, in particular as part of Community cooperation with developing countries in Africa, Asia, Latin America and the Pacific.
- According to Article 5(1) of Decision 1230/2003/EC, the implementation of the programme is based on a work programme established by the Commission in consultation with the committee referred to in Article 8 of the Decision. A global work programme established for the period 2003-2006 determines the priorities of the programme and details the funding arrangements as well as the

selection and award criteria. In addition, annual work programmes are established to specify the annual priorities and the annual budget available.

The annual work programme for 2006 is based on the global work programme for 2003-2006. It details the annual priorities for 2006, the means of implementation and the estimated budget for its implementation.

Actions or projects supported under the IEE programme should aim to remove market barriers to the increased use of energy efficiency and renewable energy sources (RES). They should also have a significant impact at European level, a high profile and the broadest possible relevance to European citizens and policies. In this context, preference will be given to proposals of outstanding quality that provide cost-effective arrangements and a significant scale.

Generally, the actions will be promotional activities in the very broad sense. They complement the Sixth Framework Programme for Research and Technological Development (FP6). However, as the IEE programme addresses non-technological barriers, it will not support costs related to research, demonstration and investment in technologies. Nonetheless, many of the actions, especially those concerned with social, economic, legal and institutional issues, will have a link to one or more energy-efficiency and/or renewable-energy technologies.

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2.5 RUSSIA/EU ENERGY PARTNERSHIP PROJECTS OF COMMON INTEREST

In accordance with the instruction of Deputy Prime Minister of the Russian Federation Mr.

Khristenko and Director General Energy and Transport of the European Commission Mr. Lamoureux the joint group of experts under the leadership of Mr. A.Y. Voronin and Mr. Guy de Selliers have held four working sessions for the discussion of the projects of common interest within the framework of the EU-Russia Energy Dialog.

The joint group of experts has carried out consultations with representatives of the major Russian and EU companies involved in the fuel and energy field as well as with legal, financial, insurance and technical specialists.

A number of conclusions have emerged from this work:

1. The projects of common interest already identified by the Energy Dialog partners are still of mutual interest and strategic importance and are thus worthy of the support of EU and Russia authorities.
2. The joint group of experts underlines that there is a whole number of other projects that would contribute to the objectives of the EU/Russia Energy Partnership and that could also benefit from the support of the EU and Russian authorities.
3. Most major Russian and European oil and gas companies believe that the EU import requirements for oil and gas from Russia will increase. In its turn Europe remains one of the most important energy resources export markets for Russia.

Therefore they fully support the objectives pursued in the context of the Energy Dialog. Some of the private sector interlocutors are however not yet convinced that this Energy Dialog will lead to concrete results with a positive impact on the activities of the private sector.

4. It is feasible and highly advisable to create a practical scheme to mitigate against certain residual non-commercial risks as is envisaged by the EU and Russian authorities. A preliminary concept for such scheme has been developed.

I. Methodological approaches for selecting the Projects of Common Interest

Because of the long lead time of most of the projects of common interest identified so far by the Energy Dialog partners the experts recommend to expand that list by including other projects and initiatives which contribute to the fundamental objectives of the EU/Russian partnerships.

While the current focus has been on major integrated field development and/or gas pipeline infrastructure projects, the experts recommend broadening this focus to include other initiatives aimed at strengthening relationships and partnerships between European and Russian companies including not only investments by European companies in Russia but also investments

The indicated conclusions as well as the text of this report reflect the ideas of the joint group of experts and do not represent the official position of the Energy Dialog parties. by Russian companies in the EU.

Expanding the focus and the list of projects of common interest would yield a number of other benefits:

- It is likely to lead to the identification of projects and other initiatives with shorter leadtime that would demonstrate some immediate concrete results from the EU/Russian energy partnership thereby increasing the credibility of the entire approach.
- It would increase the commitment of the private sector to a successful Energy Dialogue and Partnership.
- It will make it possible to create a more resilient and useful scheme for the guarantee of non-commercial risk because the more projects are included in the scheme the better the risks are diversified and the sounder is the scheme itself.

The experts thus recommend pursuing further the identification of other projects of common interest in consultation with the private sector. As it is clear that the initiative and responsibility for developing these projects lies with the Russian and European companies, identification of these projects can only be done through consultation with these companies enquiring as to what are their plans and which are the projects and other initiatives which they wish to pursue.

The experts thus propose a two step approach involving, in a first step, a pre-screening of projects followed at a later stage by a formal selection process of those projects which will benefit from the official support of the Russian and EU authorities.

For the pre-screening of "Candidate Projects" the selection criteria would be limited to the following:

- The Candidate Project should contribute directly or indirectly to the export of energy resources from Russia and the security of energy supplies to Europe.
- It should be of sufficient significance to justify the involvement of Russian and EU authorities.
- There should be a preliminary project concept with estimates of all key parameters of the project including order of magnitude estimates of capital costs.
- There should be some initial indication of the potential viability of each candidate project.
- There should be no significant environmental, social, technical, legal or other impediment that could jeopardize the implementation of the proposed candidate project.

While these criteria appear clear there is still room for interpretation, in particular as to the first criteria about the contribution of a given project to the exports of Russian energy and the security of European energy supplies. For the pre-screening, the experts recommend however to interpret this criteria with flexibility in order to have the broadest portfolio of projects to choose from when carrying out the formal selection of projects.

For the formal selection of projects that would be officially endorsed by the Russian and EU authorities as projects of common interest and would enjoy the general support of the authorities and benefit from the proposed risk mitigation guarantee scheme which is proposed, the selection process would be more stringent and the analysis to be undertaken would be much more extensive. This formal selection would only take place once the projects are fully prepared and the project sponsors have completed detailed feasibility studies, financing plans, environmental impact studies and other relevant analysis.

In line with the general approach outlined above, the experts have launched a formal consultation process with about 25 of the major EU and Russian companies in the oil and gas sector.

One question that remains open is the inclusion of electricity projects in the process of identification and selection of projects described above. In the conclusions of the EU-Russia Summit Meeting held in October 2001, the Electricity Interconnection Project had been explicitly mentioned as one of the Projects of Common Interest. In the report prepared for the Summit Meeting held in May 2002, this project was treated under the heading "Other Areas of Mutual Interest". The experts believe that such a project should be able to meet all the criteria articulated above and could thus become a Project of Common Interest that should benefit also from the risk mitigation guarantee scheme that is proposed.

The Russian experts have expressed their desire not to limit the list of projects of common interest to the oil and gas sector but to broaden it to include energy saving, power generation and power distribution projects and possibly other types of energy projects.

As this question goes beyond the scope of the expert's terms of reference, the Independent International experts refrained from commenting on this point.

The final question is the treatment, within the context of the Energy Dialogue, of other private sector initiatives, which, while not directly project related, would contribute directly to the strengthening of relationships between Russian and EU energy companies. These could include investments by EU companies in Russian companies and, vice versa, investment by Russian companies in the EU and in EU Accession countries.

Such initiatives would contribute directly to a true Energy partnership between the EU and Russia and ultimately would also translate into additional flows of investments and increased energy export capacity from Russia to Europe. Explicit support for such initiatives within the context of the EU/Russia energy Dialogue and, in particular, access to the support that the proposed Guarantee Fund would provide would be a powerful and positive signal for industry participants from both sides.

II. Analysis of the implementation status of the previously agreed

Projects of Common Interest

1. The Adria/Druzhba Integration Project will provide an outlet of the existing pipeline system to the Mediterranean Sea. The Project provides for a stepwise increase of the oil export through the Omishal port (Republic of Croatia) by 5, 10 and 15 million ton a year. On September 24, 2002, a meeting of the international working group of experts was held at the Ministry of Energy of the Russian Federation where the representatives of the Republic of Belarus, Republic of Hungary, Russian Federation, Slovak Republic, Ukraine and the Republic of Croatia discussed the project of intergovernmental agreement "About cooperation on integration project of the "Druzhba" and "Adria" pipelines" proposed by the Russian party, agreed on an expert level the text of the Agreement and made an agreement to commence in the shortest possible period the internal national procedures for its final concordance in order to sign it as soon as possible.

The two first phases of this project would require very limited financing most of which will be needed in Croatia for the reversal of flows of the current pipeline. It is the view of some of the companies interested in this project that such financing, which amounts to less than Euros 100 million, could readily be mobilized from the own cash resources of the companies involved.

Phase three of this project, which would involve an increase in the capacity of the existing pipelines, would require more significant investment. We understand that this phase three is only at the very initial stages of its development and that there is no clear consensus among the various companies and countries that would be involved in such a project about its exact design or about the capital costs involved.

2. The Shtokman project remains of great interest to most of the companies that have been sponsoring it so far. This could be one of the first large integrated new gas field development and infrastructure project to be implemented. The Shtokman gas-condensate field is included in the list of the depths areas for which the right of use can be obtained on

PSA terms.

The field was discovered in 1998 on the Barents Sea shelf. The feasibility study for the development of the field was prepared in 1993. Presumably, during the preparation phase of the PSA the development of the field will be financed by the mother companies of closedtype JSC Sevmorneftgaz, while during the implementation of the PSA the 100% financing shall be secured by the attracted funds.

The first phase, which will cost close to Euros 10 billion, poses technical, financial and economic challenges, the resolution of which will take significant time, effort and commitment. There are still open questions about the project design and in particular about which option to choose for the new export pipeline routes to Europe.

The experts have been able to gather some information about this project although no detailed feasibility analysis has been made available. While it is impossible to have a firm view as to the timing of this project, industry sources believe that the implementation of this project could start within 3-5 years and could be completed around the year 2010.

For this to happen within this time frame, however, concrete progress should be achieved soon in the negotiations between Foreign and Russian partners and Government.

To this effect a formal working group involving the main interested parties, including key lending institutions, could be convened under the sponsorship of the official Russian and Commission interlocutors responsible for the EU/Russia Dialogue.

3. The North European Gas Pipeline Project

The North European gas pipeline will allow to present to the EU members a new possibility of Russian natural gas supplies and will connect the EU countries' gas networks with the Unified Gas Supply System of Russia. This will lower the political risks, which at present significantly affect the security of gas supplies to Western Europe.

The implementation of the North European gas pipeline project is an integral part of the EU political initiative (Northern Dimension) the central issue of which lies in creation of new transportation routes for energy supplies from Russia to Western Europe.

The gas pipeline will allow to:

- provide the diversification of export gas supplies and the ability of their maneuvering;
- connect Russian gas suppliers with the EU consumers;

- link the Scandinavian region to the common European gas network;
- present to the EU members a new possibility for gas imports.

On January 2001, “Gazprom” and “Fortum” came to a conclusion that it is expedient to implement the project choosing the “sea” variant, i.e. from Russia through the Gulf of Finland and the Baltic Sea to the German coast.

According to the elaborated schedule for the implementation of the North European gas pipeline project the period of its realization till the start-up will be 6 years.

The project is extremely capital-intensive and the key task will be to resolve matters regarding its financing.

4. The various Yamal Pipeline Projects are of great significance and remain a priority.

Yamal 1, which is already in operation, still requires additional investment to bring it to its full capacity of 28 bcm.

The Yamal Link (or Southern Connector), which links the Yamal pipeline to the Slovakian pipeline infrastructure is still under consideration although the degree of priority of this project at this time is unclear.

The project to increase the capacity of the existing Yamal pipeline through Belarus to Poland remains an important priority. This project, which would cost in the range of Euros 1-2 billion, would allow for an increase in the export capacity from the existing Gazprom fields and would thus contribute directly to the objectives pursued in the context of the EU/Russia Energy Dialogue.

As regards the financing for these projects, the challenge will be to finance these without further burdening Gazprom's balance sheet. Creative structures to that effect can be envisaged. These will require however the involvement of new industrial partners and possibly some radical changes to the way these infrastructures have been owned and financed in the past.

5. Finally, there is the full scale Integrated Yamal project, including both the development of the Yamal fields and the construction of a new pipeline for the export of the natural gas from this field to Europe.

Its cost is estimated to be in excess of Euros 20 billion. There is little doubt that in view of the substantial potential for energy savings in Russia as well as the potential production capacity of the various of smaller fields being developed by independent oil companies, Russia will be able to increase substantially its exports of natural gas

to Europe without the full development of the Yamal field, at least within the foreseeable future. The financability of the full scale Yamal project thus remains at this stage somewhat in doubt.

III. New Projects proposed for consideration

The experts propose that certain other projects be given priority consideration for possible inclusion in the list of projects of Common Interest.

1. The projects of the fuel and energy complex of Kaliningrad city and Kaliningrad Oblast (the proposals of the Administration of Kaliningrad Oblast are set forth in the Attachment 1).

- Kaliningrad TES 2 Power Station. The Russian Co-Chairman of the joint group of experts has stressed that the Russian Government has taken final decision on the construction of TES 2 Power Station in Kaliningrad Oblast. It will become the main source of energy supply for the region resulting in prospect in an energy surplus. Two 450MW blocks of the station will be put into operation in 2005 and 2010. According to the studies carried out by the Russian experts the pay-back period of the project from the moment the construction commences will be 8,5 years if the energy is sold at the domestic market and one year less if the energy is partially exported. According to estimates, the overall investment costs for the project implementation will amount to 453,3 million US\$. The prime cost of the generated electricity will be significantly lower compared to that of the neighboring countries' stations because the basic fuel will be natural gas. The Russian Co-Chairman of the joint group of experts has stressed the importance of attracting investors for implementing this project, which will make it possible to sell significant amounts of electricity to EU members at favorable prices. In this connection there was a desire to include TES 2 into the list of projects of common interest.

- Construction of the TES-2 heating main in the city of Kaliningrad. This project is linked to the implementation of the TES-2 project in Kaliningrad. TES-2 includes a starting-up and reserve boiler-room (construction readiness 90%) which is equipped with two boilers with an output of 50 tons of steam per hour. The project provides for the construction of a heating main running from the boiler-room to the city of Kaliningrad. The distance of the heating main is 8 km. The construction period is 2 years.

The amount of investments equals to 8 million US\$.

- Switching the boiler rooms to the local fuel. The Kaliningrad Oblast has significant reserves of fuel peat, which is a renewable raw material. The purpose of implementing

this project is to replace costly black oil and coal delivered from outside of the Oblast with peat. Using peat in boiler rooms of small and medium capacity will significantly improve the environment in the Oblast and in the bordering regions of contiguous states. The period of implementation is 2003-2005. The amount of investments equals to 1.9 million US\$.

2. Rehabilitation of the Gas Transportation System of the Ukraine oriented for transit.

On October 7, 2002, the Government of the Russian Federation and the Cabinet of Ministers of the Ukraine signed the Agreement on strategic cooperation in the gas sector. On the basis of this Agreement JSC “Gazprom” and National Joint-Stock Company “Naftagaz Ukraina” signed a contract for creating an enterprise called “International Consortium on Management and Development of the Gas Transportation System of the Ukraine”. When all the procedural issues between the parties will be settled, the inclusion of this project in the list of project of Common Interest might be appropriate as this might facilitate the mobilization of the financing required for implementing such project.

IV. Creating a risk mitigation Guarantee Scheme - The Arbitral Award Guarantee Fund

In order for the Energy Dialogue to have a real impact on investment flows in the energy sector, it is highly advisable, if not essential, to develop a scheme to protect investors against certain risks of a non-commercial nature which otherwise could deter them from increasing their investments. Such a scheme, to the extent it is practical and effective and addresses the true concern of private sector participants, could be the linchpin of a true energy partnership that would involve not only the EU and Russia authorities but would also lead to the effective mobilization of the private sector, both in Russia and in Europe.

Any such scheme needs to satisfy a number of criteria:

- It must address the real concern of investors and focus on the residual risks that investors couldn't otherwise cover.
- It must have the potential to help mobilize a very large flow of investment amounting to several billion Euros per year for the foreseeable future.
- Yet, it should be affordable in terms of the amount of financial resources that the authorities of Russia and the EU can allocate to such a scheme.
- Finally, it should be easy to implement without the need to create a new burdensome bureaucracy.

Traditional approaches to covering non-commercial risks would not be compatible with all of

the above criteria as they would require vast amounts of capital and would only be able to cover a small proportion of the planned projects. New approaches had to be developed, and the experts are pleased to report that they have developed an innovative scheme that meets all of the requirements outlined above.

The Arbitral Award Guarantee Fund

The purpose of this Fund is to help protect investors, and other parties to contracts concluded in the context of the development of projects of common interest, against the risk of nonenforceability of their contractual rights.

V. Proposed Next Steps

The joint Co-Chairmen of the Experts Group working on the Projects of Common Interest are convinced of the soundness of the approach launched by the EU and Russia authorities in the context of the Energy Dialogue and recommend the following next steps:

- Propose to the Russian and EU authorities to render support for the new projects proposed by the experts.
- Continue and liven up the work already begun, in particular to attract private sector participants more actively to this work;
- Pursue the consultations with representatives of oil and gas companies including private sector participants and work with them to identify other projects and initiatives that could be granted the status of "Projects of Common Interest";
- Propose to the Russian and EU authorities to broaden the field of cooperation by including into the proposed list the energy projects as well as projects in the field of energy saving, electricity generation and distribution;
- Organize ad-hoc project specific working groups involving the leading Russian and EU companies involved in these projects together with the key lending institutions such as the EBRD. The purpose of these working groups would be to facilitate the dialogue among the various parties involved, in particular with the relevant public authorities, and to help in the process of mobilizing financing for these projects.
- Undertake a full feasibility study of the proposed Arbitral Award Guarantee Fund and complete it within 4 months;
- Initiate discussions with the relevant EU and Russian authorities to determine the amount of capital that the Governments of Russia and the EU will be willing to contribute to the Fund. In that context preliminary contacts have been made with the

European Bank for Reconstruction and Development (EBRD) which has expressed an interest in participating in the proposed Fund (subject to confirmation of the viability of the concept) and with the European Investment Bank (EIB) Group which also appears open to consider a possible participation;

- Start exploring with Governments of transit countries their willingness to participate in the proposed scheme.

Fuel and Energy Complex Projects proposed by
the Administration of the Kaliningrad Oblast

Construction of the Kaliningrad TES-2 Power Station

TES-2 will be the basic source of power supply for the region. It consists of two energy blocks of equal capacity using the steam and gas technology. The total electrical output is 900 MW, the thermal output is 680 giga-calories per hour. Main fuel is natural gas with an annual consumption of 1260 million cubic meters.

The lead-in of the first 450 MW energy block is scheduled for 2005. The second block of the same output is to be put into operation in 2010. The overall cost for implementing the project is 395 million US\$. The pay-back period of the project from the moment the construction commences will be 8.5 years if the energy is sold at the domestic market and 7.5 years if the energy is sold both at the domestic and foreign market. The first block put into operation will annually generate 2.9 billion kilowatt per hour of electricity for covering the domestic needs of the region. After the station reaches its planned production capacity the annual generation of electricity will be 5.8 billion kilowatt per hour making it possible to partially export it (up to 1.9 billion kilowatt per hour). The prime cost of the generated electricity will be 0.65 US cent/kilowatt per hour. Capital cost per 1 kilowatt of the installed capacity will make 440 US\$.

There is an approved feasibility study of the project on hand. The construction is carried out by RAO "UES of Russia" which on July 22, 2002 held a tender to select the general contractor and suppliers of the energy equipment for constructing the thermoelectric power station.

Construction of gas pipe-bends running to large inhabited localities and gasification of districts and cities of the region

The project provides for the construction of high pressure gas pipe-bends running to the cities of Sovetsk, Neman, Chernyakhovsk and Svetly. At the same time the

indicated inhabited localities as well as cities and districts of the region will see works on construction of low pressure gas pipelines and internal house gas networks.

The implementation of this project will allow to resolve problems of heat supply and meet population's domestic needs of natural gas and will make it possible to develop new works and modernize the existing ones. The environmental conditions of the Kaliningrad Oblast and bordering regions of contiguous states will significantly improve.

The overall costs for implementing the project will be 60-65 million US\$. The work completion date is 2010.

Construction of the second gas-main pipeline to the Kaliningrad Oblast

The construction of the gas pipeline will allow to increase the amounts of natural gas supplies to the region what will significantly improve the stability and reliability of its energy supply. The implementation of this project will give an additional boost to the social and economic development of the Kaliningrad Oblast, will satisfy the prospective gas needs of economy, housing and communal services and population of the region.

At present three options for possible gas piping to the Kaliningrad Oblast are being considered:

- In the technological corridor of the existing gas pipeline running through the territory of the Republic of Lithuania.

At meetings of any level JSC "Gazprom" refuses to consider the construction of this gas pipeline.

- Constructing on the territory of Poland a gas pipe-bend from the Yamal – Western Europe gas main. This option is stipulated in the Article 3 of the Agreement between the Government of the Russian Federation and the Government of the Republic of Poland on creating a system of gas pipelines for transiting the Russian gas through the territory of the Republic of Poland and for supplying the Russian gas to the Republic of Poland dated August 25, 1993. The gas pipe-bend route will run through the territory of the Varminsk-Mazursk province of Poland with an outlet to the Kaliningrad Oblast.

The authorities of the Varminsk-Mazursk province of Poland show great interest for the construction of this gas pipeline. Currently there have been prepared a relevant draft of the protocol of intentions between the Head of the

Administration (Governor) of the Kaliningrad Oblast and the Governor of the Varminsk-Mazursk province of the Republic of Poland.

- The gas pipe-bend to the Kaliningrad Oblast from the North European gas pipeline which is planned to be laid at the bottom of the Baltic Sea.

Arbitral Award Guarantee Fund

Summary Concept, proposed by the EU Co-Chairman of the Expert Group

The purpose of the proposed Arbitral Award Guarantee Fund is to help protect investors, and other parties to contracts concluded in the context of the development of projects of common interest, against the risk of non-enforceability of their contractual rights. It would do so by guaranteeing the payment of amounts due to an injured party in the context of a dispute, as awarded to them by an international arbitral court which would have been called upon to rule on the dispute. By guaranteeing such payment, it will give confidence to all parties that, in the case of a dispute, they will be adequately compensated for any damage they would have suffered. It addresses not only a fundamental concern of foreign investors in Russia but also a concern of Russian companies that have experienced difficulties in enforcing their contractual rights in Russia or in other countries.

Creating this scheme would require a strong political commitment of the authorities of Russia and of the EU including a commitment to make a capital commitment of about Euros 500 million for the capital of the proposed Fund (including both the Russian and EU share). This capital commitment, all of which would not need to be paid upfront, would have a tremendous catalytic impact on investment flows. The EU experts estimate that, with Euros 500 million of capital, the Fund would be able to carry Euros 3 to 5 billion worth of risks which would, in turn, correspond to investments 5 to 10 times larger than that. The capital committed by the Governments and EU institutions to this scheme could thus help mobilize investments in the energy sector worth 30 to 50 times the capital they would have committed and in excess of 100 times the capital actually paid in.

Other key features of the proposed Fund are:

- The rights, responsibilities and commitments of both the Russian and EU Governments, institutions and companies in the context of this scheme are equally balanced.

□ Both Russian companies and EU companies and investors would equally benefit from the coverage provided by the Fund.

□ The concept of this Fund is built on the principles embodied in the EU/Russia Partnership and Cooperation Agreement and other treaties to which the EU countries and Russia are party and is in line with one of the main objectives stated by the EU and Russia authorities which is to promote, throughout the region, the rule of law and the respect for contractual rights.

□ The proposed concept is compatible with the provisions of the Energy Charter Treaty relating to the protection of investments but is not dependent on the ratification of the Charter for its implementation. The proposed concept is also fully compatible with the PSA (Production Sharing Agreements) regime but could also be effective in supporting projects that do not benefit from a PSA treatment.

□ The Fund, which would charge market based premiums to those parties for whom it provides coverage, would be managed in such a way that it would be profitable and, under normal circumstances, would earn a reasonable return on the capital provided.

The establishment of such a Fund will require, from both sides, a strong political commitment at the highest level and a willingness on the part of the authorities concerned to commit to the following:

□ Contribute about Euros 400-500 million of capital including both the EU and Russia contributions.

□ Confirm the commitment of the Russian and of the EU Member States to enforce international arbitral awards on their territories, which principle is already well established and explicitly acknowledged in the EU/Russia Partnership and Cooperation Agreement.

□ In line with such a commitment, agree to indemnify the Fund for any payments it would have made for the compensation of an injured party as a result of a failure by a State to execute an international arbitral award on its territory (in the same way as the Russian Government has agreed to do so in the context of the recent World Bank sponsored Russian Coal and Forestry Sector Guarantee Facility).

Because of the multinational nature of most of the projects to be supported, in particular the transportation projects that transit through other countries, it would be advisable to extend the coverage provided by the Fund to enforcement of international arbitral awards in transit countries. This will require the Governments of these countries to agree to make similar commitments to those outlined above although it would not necessarily require a capital contribution on their part.

The establishment of the proposed Arbitral Award Guarantee Fund is undoubtedly an ambitious undertaking, which will require strong political commitment. The experts are nevertheless confident that, with such a commitment, it is technically and financially feasible to establish this Fund within 6 to 9 months of a political decision to proceed.

Establishing the proposed Fund will have a significant catalytic impact on energy industry participants as it would be a vivid demonstration of the commitment of both the EU and the Russian States to the development of a truly effective Energy Partnership and to the broader objectives of strengthening the ties and increasing investment flows between Russia and the EU.

1. Background

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

The growing demand for energy in the European Union calls for the implementation of new strategic projects of common interest integrating the development of new energy production and transportation projects in Russia. While such projects are the responsibility of the companies involved, both the EU and Russia are desirous to facilitate the financing and implementation of these projects. In that context it was decided by the EU and Russian authorities to explore, among other things, the possibility of creating a new and practicable scheme for the mitigation of residual noncommercial risks associated with projects of common interest. It is in response to this decision that the following concept has been developed by a group of experts appointed jointly by the EU and Russian authorities.

2. Purpose

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

3. Eligible Contracts

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

Eligible projects should meet the following criteria:

- i. They should contribute directly or indirectly to the export of energy resources from Russia and to the imports into the EU.
- ii. They should be of sufficient size to justify the involvement of Russian and EU authorities, i.e. requiring in excess of 100 million Euros of financing.
- iii. The primary partners in such projects should be either European or Russian.
- iv. Projects should be economically and financially viable, with a fully underwritten financing plan (including both debt and equity).
- v. The projects should not violate any of the applicable laws either in Russia or in the EU, including in areas such as the environment, competition law and market access.

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

It is anticipated that loan and other credit agreements, which are usually not subject to international arbitration, would not be eligible for direct coverage by the proposed Fund as this Fund is not meant to be a loan guarantee scheme duplicating the type of support provided by Export Credit Agencies and other multilateral organisations but is meant to provide a type of support which is complementary to what is already available. The lenders are nevertheless likely to benefit directly

from the coverage provided by the Fund as it is expected that, in the context of typical project financing arrangements, the benefits of the coverage of the Fund and the proceeds of any payment by the Fund in relation to a dispute which has affected a borrower's ability to service its debt would be assigned in whole or in part to the lenders.

4. Coverage and Term Provided

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

It is anticipated that there will be some limited exclusions: "Genuine" insolvency of the defaulting party. Indeed, the purpose of the Fund is not to underwrite the credit worthiness of parties to a contract but to protect them against the risks of non-enforcement of international arbitral awards arising from the weakness of local judicial systems or other factors of a political nature.

Events of Force Majeure such as breakdown of relations between the EU and Russia or invalidation or cancellation of the EU/Russia Partnership and Cooperation Agreement (PCA) leading to wholesale renunciation/invalidity of contracts concluded previously between EU and Russian parties. Such "nonproject specific" event would need to be dealt with at a

State to State level with the recovery of awards and other damages on behalf of private parties being handled directly by the respective States as is customary in cases of international crises.

The Fund will pay once all the possibilities to appeal or challenge the international arbitral decision will have been exhausted, including any challenge to the enforceability of the award being made in accordance with the provisions of the New York Convention of 1958. In the agreements constituting the Fund, the respective Governments will not only have to commit to enforce international arbitral awards but they will also have to agree that any appeal or challenge will be dealt with by the relevant courts at the place of international arbitration and not by local courts where enforcement is sought so as to limit the role of the enforcement courts solely to the execution of the arbitral award without re-examination of the case or review of the award (as is already the case under the rules of the International Centre for Settlement of Investment Disputes). The Governments will also have to agree not to invoke Sovereign Immunity as a way of avoiding satisfaction of an international arbitral decision rendered against them.

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

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

5. Number of Projects and Contracts Insured

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

- i. Alternative One: Concentrate on a small number of big projects (e.g. four to five projects) recognizing that this might create risk concentration issues.
- ii. Alternative Two: Diversify risks over a larger number of projects or risks. From a risk management standpoint, this latter alternative would be preferable.

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

6. Amounts Insured

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

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

7. Premiums

Premiums would be payable on the amounts insured. The premium level will be determined following a detailed analysis of the financial viability of the Fund and of the costs of reinsurance or

other forms of risk sharing arrangements. The premiums should be sufficient to allow the Fund to cover its operating expenses and generate an acceptable return on capital.

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

8. Expected Aggregate Commitment and Exposure

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

9. Capital Structure

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

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

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

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

- i. Alternative One: The EU (through EU institutions) and Russian government with equal parts.
- ii. Alternative Two: The EU (through EU institutions) and Russian government and transit country governments.
- iii. Alternative Three: The EU institutions only.
- iv. Alternative Four: Any have of the above plus energy industry or financial sector participants.

10. Fund Legal Structure

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

11. Re-insurance

In order to increase its risk taking capacity and leverage up its own capital, the Fund will attempt to structure a comprehensive reinsurance program with the specialized insurance, reinsurance and financial markets. In the present context of the insurance industry, it is highly unlikely that any kind of support can be obtained from the private market on a “risk attaching” basis (providing

reinsurance protection on all policies issued during a given period and for the same duration as these), whether on proportional basis or on a non-proportional basis (excess of loss – XL). Certain government or multilateral backed agencies however might consider such an option. It might nevertheless be possible to organize a reinsurance program involving the private market so long as it is structured on a “loss occurring” basis (providing reinsurance protection for any loss declared during a given period).

While such program would be launched from the outset, it will have to be re-negotiated on an annual basis in accordance with industry practices.

Two alternative approaches could thus be envisaged for the structure of the reinsurance program:

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

2. Non-proportional reinsurance only.

If the above is not feasible or is not economical, the Fund would reinsure its exposure through an XL reinsurance program made up of several layers. The first layer would ideally be placed with government-backed agencies either on a risk attaching or loss occurring basis. The following layers would be placed in the private markets on a loss-occurring basis. In either case, depending on market availability, the Fund might seek to further protect its retained exposure through a portfolio protection program negotiated with the traditional reinsurance market or through the issuance of CAT bonds in the financial markets. Using the various techniques above it is estimated that the Fund should be able to reinsure, from the start, up to twice the amount of exposure it would retain (or 2 billion euro). The amount of reinsurance it would be able to purchase could gradually increase possibly up to 4 times the Fund’s net retained exposure, and even more, depending on the profile of its risk portfolio and its track record of losses and recoveries.

12. Loss Recovery

Once a loss has occurred and the Fund has made a payment, the Fund will be fully subrogated to the rights of the party to which the Fund has made the payment. In addition, any payment by the Fund will immediately give rise to a financial claim on the Government of the country in the jurisdiction of which the failure to execute the arbitral award has occurred. When constituting the Fund, an agreement to that effect will need to be entered into by the various Governments concerned by

which they make a commitment to compensate the Fund for any payments the Fund has made. In view of the multilateral nature of the Fund's backing, it would be justified to obtain for the Fund the benefit of 'preferred creditor status' similar to that of other multi-lateral agencies and to ensure that failure by the obligor Government to meet its financial obligation to the Fund would trigger cross-default clauses with other important official lenders such as EBRD, EIB, IBRD and possibly others.

Finally, as a last resort, such a default by the concerned Government to compensate the Fund could trigger sanctions in the context of the exiting treaty between Russia and the EU (see point 12 below).

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

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

A formal link should be established between the Fund, or more precisely between the agreements establishing the Fund, and the existing PCA. Such link will be established through a 'cross-default' clause to be incorporated in the agreements governing the Fund by which any payment made by the Fund, as a result of the nonenforcement of an international arbitral award within the jurisdiction of the country party to the PCA treaty, would be considered a violation of the terms of the PCA. The basis of such cross-default lies in the article 98 of the PCA by which the parties explicitly support the use of international arbitration for dispute resolution in the context of investment projects.

Additional support for such a link can be found in the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards, which is in force in EU countries as well as in the countries of the former Soviet Union. It would thus be clear that the obligation to enforce international arbitration awards is an international treaty obligation which takes precedence over the provisions of local law and that, therefore, provisions of local law which might be inconsistent with the basis upon which an international arbitral decision was reached, can not be grounds for non-enforcement of awards.

Furthermore, as a result of the link with the PCA through the proposed cross-default, any failure to execute an international arbitral award resulting in a payment by the Fund would immediately trigger the dispute resolution procedure envisaged in article 101 of the PCA as amended by the fast

track procedures currently being negotiated. In addition, if such procedure does not lead to a solution acceptable to both the Russian government and the EU and does not lead to full compensation of the Fund by the defaulting Government, article 107 of the PCA would allow the imposition of unilateral sanctions. It might be advisable to identify up front the type of sanctions that could be imposed in such a situation and specify them in the “cross-default” clause to be included in the agreements governing the Fund. Such ‘pre-programming’ of the sanctions could give more credence to the possibility of such sanctions being imposed in case of default thereby increasing the ‘deterrent’ effect. It might be possible, although it may not be advisable, to structure the cross default so that curing a default resulting from a non execution of an international arbitral award would require not only a full compensation for the amounts disbursed by the Fund but also full compensation to the injured party for any difference between the payments received from the Fund and the total arbitral award which had been granted.

14. Extension to other Countries

As a number of projects of common interest are likely to span several countries outside of Russia and the EU, the proposed scheme should also be designed to protect against the risk on non-enforcement of contractual rights in these other countries. For this, these countries should enter into agreements with the Fund by which they commit to enforce international arbitral awards on their territories and to compensate the Fund for any payments it has made as a result of a failure to do so. It will also require incorporating in such agreements cross-default clauses with the existing international treaties between these countries and the EU. Such countries would not necessarily have to participate in the capital of the Fund.

15. Governance and Management of the Fund

A Board of Directors representing the shareholders in the Fund would govern the Fund. Day to day management of the Fund could be entrusted to a small staff (or Permanent Secretariat) or could be delegated to one of the parent institutions. It should be noted that the burden of managing the Fund should be relatively light. The main task will be to manage the Fund’s exposure and to syndicate the risks in the broader insurance, reinsurance and financial markets.

This task could be contracted out to a small and specialized underwriting agent constituted for this purpose. This agent could be jointly owned by the Fund and by key energy industry participants as a means of involving the Fund’s beneficiaries in the management of the risk syndication process.

III. Russia-EU Energy Dialogue

3.1 ASPECTS OF ENERGY DIALOG

Since the previous report of Russian Minister of Energy and Industry Victor Khristenko and European Commission Director-General François Lamoureux November 2003, events have modified the context of the EU-Russia energy dialogue: ten new Member States have joined the European Union; the prices of raw materials have increased significantly on the international market; the European Union has given its support to Russian accession to the WTO; and the Russian Federation has made clear its intention to ratify the Kyoto protocol. These developments will favour the growing integration of the continent's energy markets and there by help facilitate investment.

The agreement of April 2004 to extend the EU-Russia Partnership and Cooperation Agreement to the enlarged Union, as was reflected in the Joint Statement on EU Enlargement and EU-Russia Relations, permitted a number of energy issues to be additionally clarified, notably the importance of long term gas contracts and the absence of quantitative restrictions on fossil fuel imports, the confirmation of the supply contracts for nuclear material concluded by Russia before enlargement with the new Member States and the free transit of energy products including electricity to the Kaliningrad Oblast.

Consultations on the issues related to the recent EU enlargement will continue, taking into the account the process of the new Member States' integration into the EU internal energy market. Close cooperation has enabled an agreement to be reached between the EU and Russia on the future accession of the Russian Federation to the World Trade Organisation, including in relation to certain energy trade issues.

Recognising the importance of sustainable development and in part building on the discussions held within the framework of the Energy Dialogue, the ratification of the Kyoto Protocol by the Russian Federation is welcomed. Ratification will permit the EU and the Russian Federation to engage in joint implementation projects and in emission trading. In the energy sector, it will encourage the additional efforts necessary to improve energy efficiency and to develop non-polluting energies, notably renewable energy sources.

The current situation on the international energy market underlines the importance for both the Russian Federation and the EU of further progress in the Energy Dialogue, recognising the damaging consequences that the sharp rise in oil prices can have on the world economy. In this context, it might be useful to jointly examine the contribution that strategic stocks can make to enhancing the stability of the oil market.

Further developing co-operation through the EU-Russia Energy Technology Centre created in 2002, Russia's association with the energy market observation system established by the European Commission in 2004, and the energy industry "steering group" will contribute to the continued improvement of the investment climate between the EU and Russia, and identify more clearly the issues to be tackled.

This latest report provides guidelines for the future development of the EURussia energy dialogue which will contribute to the practical implementation of the Common European Economic Space. Creation of investment support mechanisms, energy efficiency, maritime safety, the interconnection of electricity grids and Trans-European energy networks are among the priority themes for further progress.

1). ENERGY EFFICIENCY

Increasing energy efficiency offers significant opportunities for cooperation, particularly industrial co-operation with the exchange of good practices and technologies between Russian and EU companies.

The EU-Russia Energy Technology Centre is proving a valuable focal point, organising in October 2004 Round Tables in Moscow and Nizhny Novgorod on renewable energy and energy efficiency in buildings, and on sustainable regional energy policies and strategies respectively.

In addition, the TACIS technical assistance for the energy efficiency pilot projects in Archangelsk, Astrakhan and Kaliningrad will shortly become available.

Particular attention should be given to energy efficiency in Kaliningrad, which is 90% dependent upon transit of energy and where savings could reach as high as 35-40%.

The Parties note that their discussions on energy have embraced issues relating to transport, a sector with rapidly rising energy consumption.

Transport accounts for significant and rising emissions of CO₂ and greater efficiency, particularly of urban transport, could significantly improve the environmental impact of the sector. Closer cooperation on targeted projects could be profitable for both the EU and the Russian Federation.

A seminar on transport strategies in Moscow in May 2004 brought together representatives from the EU and the Russian Federation. The exchange of views helped to define areas for co-operation in the coming years, including the need to harmonise legislative and regulatory measures, the convergence of technical norms and standards in the oil maritime transport sector, the interoperability of the railway network, environmental concerns linked with the transport demand growth, particularly in urban transport, and energy efficiency.

With the objective of helping to foster a more favourable framework for developing renewable energies, the EU-Russia Energy Technology Centre organised a Round Table in Moscow on 22nd June 2004. Seminars have also been organised on fuel cells, CO₂ sequestration and biomass with a view to considering Russia's participation in the European Union's Research Framework Programme on these issues.

2). INVESTMENT SUPPORT MECHANISMS

Encouraging mutual investments into the Russian and EU energy sectors remains a key objective of the Energy Dialogue, with the view to ensuring both the security of supply and the security of demand in the context of increased energy interdependency. Significant reforms have been carried out within Russia to create a more competitive and attractive investment climate. However Russian companies active in certain energy sectors face hurdles in accessing international money markets, particularly very long term financing.

The Parties therefore welcome the work conducted with the help of the European Investment Fund to develop a scheme for mitigating noncommercial risks. They agree to work together to explore the proposal in greater detail. The European Party has transmitted a first document describing the principle of a guarantee mechanism. After reaching an agreement between the Parties on a guarantee mechanism, it would be possible to consider its development within the framework of the Partnership and Co-operation Agreement (PCA). A meeting of experts and representatives from the Russian and European industries will be held in Brussels (or Luxemburg) by the end of 2004 in order to prepare an orientation paper.

The Parties will also evaluate the opportunity of establishing an investment or guarantee fund for energy efficiency projects given the potential for energy savings in Russia.

3). ELECTRICITY INTERCONNECTIONS

In the context of integrating the EU and Russian electricity markets, both Parties recognise the importance of a level playing field, with equivalent basic rules with respect to the degree of market opening and other important market rules, such as regulation of network access and unbundling. It is also imperative to make further progress towards a common view on the extent to which current and planned EU and Russian market and environmental rules are equivalent. The Parties recognise that the participation of Russian representatives in the Florence Forum of electricity regulators is increasing co-operation and the convergence of the regulatory framework. The Parties welcome the feasibility study which will start in January 2005 to examine the synchronous interconnection of the systems of the Union for the Co-ordination of Transmission of Electricity (UCTE) and of the Integrated Power System/United Power System (IPS/UPS). This important study which will be funded on equal basis with 75% and 25% of the European costs covered by the European Commission and UCTE respectively, will be completed at the latest in 2006.

4). TRADE IN NUCLEAR MATERIALS

On 17 May 2004, the European Commission has presented a draft agreement on the trade in nuclear materials to the Russian Federation. The text is currently being analysed by the Russian authorities. The experts of the European Commission and of the Russian government are conducting discussions on this draft agreement.

5). INFRASTRUCTURE PROJECTS OF COMMON INTEREST

The Parties confirm the importance of the projects of common interest, defined in the framework of the Energy Dialogue at the October 2001 Summit, for enhancing the security of energy supplies across the European continent via an increased diversification of transportation routes. In

particular, for gas, they stress the priority of the Northern Trans-European Gas Pipeline. The Parties welcome the ongoing expansion of the Yamal-Europe pipeline.

The Parties underline the importance of further work to expand this list, in particular by including oil pipelines, to optimally operate the existing ones or even to develop the rail transportation of crude oil and oil products, including enhancing co-operation on railway interoperability, given the environmental risks and safety concerns posed by the increasing density of maritime traffic.

The reliable functioning of energy transport networks is another important field of cooperation. In 2004, technical assistance of up to 3 million euros for the state of infrastructures, entitled “Gas and Oil Transport Network observation system and modernisation plans”, was foreseen in the framework of TACIS.

6). GALILEO-GLONASS: AN INSTRUMENT TO STRENGTHEN INFRASTRUCTURE SAFETY

The Parties recognise the benefits satellite navigation can bring for the whole energy chain: exploration, construction, transport, and site monitoring.

Noting the ambitious national programme for the modernisation of the Russian global satellite navigation system (GSNS) GLONASS of double application, and the European GALILEO programme, which aims to establish the first global satellite navigation system specifically designed for civilian and commercial applications by 2008, the complementary use of the two networks could significantly reinforce the safety of energy transport infrastructures and energy production.

The Energy Dialogue has helped to revive the negotiations on preparing an intergovernmental agreement on compatibility and complementary use of the two GSNS systems: the existing GLONASS and planned GALILEO system

In addition to the discussions about the technical compatibility and complementary use of GLONASS and GALILEO, it is planned to initiate co-operation on joint development of GSNS signal receivers, as well as specific applications of GSNS to the energy field (exploration, construction and maintenance of transport infrastructure).

7). MARITIME SAFETY

With the increasing density of maritime traffic and the heightened risk of accidents and pollution, maritime safety is a very sensitive issue and an important area for EU-Russia co-operation. The European Party welcomes the undertaking given by Russia to strengthen its checks on tankers that discharge in its ports and the support given by Russia to the EU on the basis of the Russian position at the International Maritime Organisation (IMO). Both Parties recognise the importance of a rapid implementation of IMO standards.

8). EU-RUSSIA ENERGY TECHNOLOGY CENTRE

The Parties welcome the increasingly important practical role of the Centre in promoting the exchange of information about advanced energy technologies and encouraging contacts between EU and Russian energy sector actors. Among the numerous events the Centre has organised, specific mention should be made of the Round Tables held on modern technologies for the exploitation of hard-to-recover oil reserves, gas-to-liquids (GTL) technologies and their perspectives in Russia, oil refining in Russia with specific emphasis on EU fuel quality standards, implementing advanced coal preparation technologies in Russia, the technical regulation of power plants to assure the stability of the grid, the EU experience of promoting renewable energies and its relevance for Russia, and a Round Table on energy efficiency and renewable energies in buildings.

In parallel with the identification of a number of project proposals, the Parties welcome the work of the Centre with respect to investment promotion, where a workshop has been held with the European Bank for Reconstruction and Development (EBRD) on project financing with International Financial Institutions and another on bankable projects in the oil and gas sector.

The activities of the Centre are aimed at facilitating the creation of a more favourable climate for implementing joint projects in the priority fields of the Energy Dialogue, including identifying financial sources for such projects. The Parties will assist the Centre in accomplishing this important task.

CONCLUSIONS

The Parties recognise that the future priorities for the Dialogue should include:

- Continued efforts to encourage investments;
- Closer collaboration in promoting energy savings, energy efficiency and renewable energy;
- Improving the safety and security of the energy transportation infrastructure, including its expansion across the European continent;
- Renewed emphasis to the work on electricity market integration, including the issues of market and environment equivalent rules.

The Parties recognise the important contribution that the energy market observation system being developed within the services of the European Commission, to which Russian experts will be associated, will make in enhancing the transparency of energy markets.

Strengthening co-operation of the Russian and EU industry, in particular via the “steering group of the industry”, will contribute to the further development of the Energy Dialogue.

3.2 Energy in 21st Century: Effectiveness and Security

1). World Energy Market Trends and Energy Security

The global energy consumption may increase by a third within the next 15 years and by some 45% in the next two decades. The global demand for oil may grow by 35 million barrels a day (42%) and for gas by 1.7 trillion cubic meters a year (60%) by 2025.

The situation on the world market is influenced by four major factors: a rapid increase in energy demand on the emerging Asian markets (up to 45% of prospective growth in global oil demand); a growing gap between gas consumption and production in industrialized countries (by 2020, Europe will import 60% to 70% of its gas requirements); a shortage of oil processing and transportation systems and a limited amount of additional oil production facilities; and insufficient information transparency in global oil trade.

Taken together, these factors emphasize the issue of energy security. At the same time, the globalization processes that began in the 20th century directly bear on the global energy sector.

Russia, with its competitive positioning on the global market, regards the issue of energy security as primarily safe provision of energy resources to all countries and nations on the planet.

In our opinion, global energy security can be attained by the joint implementation of the following measures in three basic spheres: reliable provision of traditional energy resources to the global

economy; growing effectiveness of the use of energy resources and environmental protection and discovery and use of new energy sources.

Russia is contributing to global energy security by developing its fuel and energy complex and participating in growing international cooperation.

2). Russian Fuel and Energy Complex in Global Context

The area of 13% of the planet where less than 3% of the world's population lives has over 34% of natural gas and some 13% of the world's prospected oil reserves.

Russia is the world leader in international trade in natural gas and the second largest exporter of oil and petrochemicals.

Much has changed here in the past year, but not the above characteristics. Russia has one of the world's biggest fuel and energy reserves. Its energy sector is an inalienable part of the global energy market. And lastly, Russia is an active player on the international energy market.

The geographic location of Russia gives it a special role in the transit of energy resources in Eurasia, ensuring the most effective format of the West-East, South-North and South-North-West energy infrastructure. This facet of the Russian energy sector is crucial for the national economy and for the development of foreign energy markets and hence the global economy.

Our competitive advantages in the economy should work (and are working) primarily to the benefit and in the interests of Russia and its people. But the quality and reliability of exports, as well and the economic growth and prosperity of importer countries, hinge on the dynamic development and sustainable operation of Russia's fuel and energy complex, the quick development of new fields and efficient exploitation of old ones.

The priorities of the state energy policy were formulated in the Energy Strategy of Russia for a Period Until 2020. Figures may change but the long-term energy policy of Russia will remain sufficiently stable and predictable.

Our policy is based on:

Improvement of principles involved in the use of mineral resources;

Development of domestic fuel and energy markets and elaboration of a rational fuel and energy balance for the country;

Growth and diversification of energy export without any detriment to domestic demand.

In the past years, Russia's contribution to the domestic market has grown considerably. From 2002 to 2004, it posted the highest production growth among major oil producers.

You must be eager to learn about the outlook for the future decade.

We envisage the following developments in the Russian oil and gas sector:

Based on current estimates, oil production may reach 530 million tons and oil export 310 million tons by 2015. The West Siberian oil and gas province will be the main oil base of the country in this period. Oil production will continue to grow there until 2010-2015. At the same time, production will decline in the Volga-Urals province and the North Caucasus because of depletion of reserves there. New oil centers will develop in East Siberia and Sakha – Yakutia (oil production of up to 50 million tons in 2015), on the offshore Sakhalin fields (25-26 mln tons), the Barents Sea and the Russian sector of the Caspian Sea. Oil production in the Timano-Pechora province will also grow.

We are going to maintain the planned production and increase effectiveness by applying research and technical achievements, improving drilling methods, using better reservoir stimulation and increased recovery, and introducing new progressive production technologies to make the production of hard to recover reserves economically effective.

These issues will be discussed over the next two days at plenary sessions and roundtables attended by spokesmen of the Industry and Energy Ministry, researchers, and delegates from innovation-bound companies. This format of participants is the specific feature of the Oil & Gas Week. We hope that the results of its work will be used to the benefit of Russian and foreign oil companies.

We are going to diversify oil exports. Europe will remain the main market for Russian energy resources, but the share of Asia Pacific countries in the export of Russian oil will grow from the present level of 3% to 15-18% in 2015.

The transport infrastructure of Russia's oil sector will look as follows: the throughput capacity of trunk oil pipelines and sea terminals for the export and transit of oil to non-CIS countries may grow by 20% by 2010 and 40-50% by 2015 against the current figures. This will enable us to export some 70 million tons of oil to the West and Northwest, about 130 million tons via the Black Sea-Caspian infrastructure (with due regard for the potential extension of the Caspian Pipeline Concern), some 80 million tons to the East, and up to 25 million tons to the North.

Gas production may reach 740 billion cubic meters and gas export 290 billion cubic meters by 2015. Gas production in West Siberia in this period will stabilize, so that increment will be ensured by the commissioning of new fields in East Siberia and the Far East and on the shelf of the Northern and Far Eastern seas.

We must employ a comprehensive, systemic approach to energy exploration, production and transportation projects with due regard for the priorities and guidelines of the Energy Strategy. This approach is being applied in the Program of creating a joint gas production, transportation and supply system in East Siberia and the Far East, with the possibility of exporting to China and other Asia Pacific countries, as well as during the construction of the East Siberia – Pacific (ESP) oil pipeline, which is connected to the Program of geological exploration and concession of hydrocarbon deposits in East Siberia and the Far East.

The considerable gas reserves and prospective resources in East Siberia and the Far East are sufficient for creating new gas production centers in the region that would work for the domestic market and ensure export deliveries.

We expect gas production in the region to grow more than ten-fold by 2015 and 15-fold by 2020 as against 2005.

The decision on the first stage of another systemic project – the construction of East Siberia – Pacific oil pipeline, which is expected to be completed by 2008, has been made. Its capacity will be 30 million tons, to be provided mostly from West Siberian oilfields and partially East Siberian oilfields already at the first stage. A terminal will be built on the Pacific coast in 2008. The completion of the system with the capacity of 80 million tons will bring us to the Pacific coast. Contracts for the design and construction stage of the pipeline will be awarded by Transneft.

The blueprints of the project's first stage have been submitted for ecological examination, and we hope that strategic vision will take the upper hand over tactical differences regarding various aspects of the project. Ecological security in the fuel and energy sector is a highly respected value for every Russian department and company, as well as independent public organizations. It would be ludicrous to suspect anyone of a desire to damage the environment where you live and work. However, new effective technologies of environmental protection cannot progress in an atmosphere of bans and suspicion of unusual decisions that have been tried and tested elsewhere.

3). Internal Petroleum Market

I would like to say a few words here about our domestic market.

The basic proposition for our refining industry is the improvement of refining efficiency, with the target figure of 75% to 80%.

Also, to help stabilize energy market at home, we could do the following:

make changes to severance tax formulas to stimulate domestic supply and the development of deposits in new oil provinces and hard-to-recover reserves in old wells;

change petroleum excise taxes to motivate the production and use of higher-value fuels; further strengthen sanctions against oil companies and refiners that abuse their dominant market position ; regulate long-term consumer acquisitions – at least for a term of one year.

4). Energy Efficient Economy

Demand for energy at home depends to a great extent on the energy efficiency of the economy – an area where Russian economy still has much room for growth, estimated at 360 to 430 million tons of fuel equivalent, or 35% to 40% of current annual energy consumption.

Energy saving needs to be a dimension where the government should find common ground with the business community, notably through the Private-Public Partnership strategy. In fact, this approach is the basis of the draft concept of the federal target program Energy Efficient Economy for 2007-2010 and up to 2015. The program will be focused on more efficient use of Russia's energy resources to ensure high competitiveness of the national economy and provide decent living standards for Russian people. Hopefully, this program will successfully pass all coordination steps to enter into force as soon as possible and save us an estimated 100 million tons of fuel equivalent a year by 2015.

5). EU-Russia Energy Dialog

I also feel bound to look at some international and, importantly, bilateral cooperation aspects.

The first such issue is energy dialog between the Russian Federation and European Union. It emerged as an independent EU-Russia cooperation dimension in late 2000 as Russian and EU officials agreed to arrange first expert meetings to discuss energy.

A great deal has been done in the past five years. Quantitatively, our cooperation is now much more intensive than when it started, as oil and gas exports have risen considerably. Qualitatively, the supplies are now more diversified and reliable. Reliability and security of energy exports have always been a primary value between Russia and Europe that have a 30-year record of cooperation without a single default on either side. Europe's supplies have grown more reliable – hence higher energy security – due to geographic diversification and infrastructure enlargement. Important landmarks here are the Baltic Pipeline System, which will soon come fully on stream with 60 million tons a year; the first leg of the Yamal-Europe gas pipeline, which is going to pump up to 30

billion cubic meters annually from next year; increase in supplies through the Friendship Pipeline built back in the Soviet times; commissioning of the Caspian Pipeline Consortium; and building new and upgrading existing Black Sea terminals.

In an active debate on the nature and status of long-term gas contracts, nuclear and some other spheres, we have successfully resolved all our matters of concern.

The EU-Russia energy dialog has helped expand the global energy partnership agenda from its traditional focus on fossil fuels into infrastructure, new sources of energy, and legal implications of long-term energy risks.

Both the EU and Russia have always paid great attention to stability, reliability, and continuity of energy production, distribution, transportation and use and to such issues as energy efficiency, energy saving, environmental concerns, and development of alternative sources of energy.

Also, the Russian government is pushing ahead with the North European Gas Pipeline, a project that will make gas exports better diversified and more maneuverable; increase gas supplies for Western Europe and ensure the implementation of existing and future long-term gas contracts; and, in effect, will contribute to the integration of the Russian gas transport system with the gas network spanning the entire Europe.

Both sides of the energy dialog are continuing adjustment of their energy strategies and systems. One such job - drafting a feasibility study for uniting the Russia-CIS and European UCTE electricity networks - is to be completed later this year.

Surging global demand for crude oil and its products requires a concerted effort from producer and consumer nations who have to come up with credible schemes to ensure market stabilization and predictability. In this context, we are developing cooperation in energy market monitoring and forecasting and data sharing on reserves, taxes, and consumption management.

The EU-Russia energy dialog has led to a system of public/private working groups, an effective mechanism for consultations between government and businesses. These working groups look at priority issues in trade, infrastructure development, investment, and energy efficiency. Hopefully, they will not only analyze problems that Russian and EU energy industries are facing but also participate in decision making and major business projects across Russia and the European Union.

6). Russia's G8 Presidency

Last week could be rightfully called Russia-U.S. Energy Week. In this period we summed up a number of major achievements in our bilateral cooperation. Sakhalin-1 started shipping its first oil for the U.S. on October 1. In early September, Gazprom supplied the first batch of liquefied natural gas directly to the North-American market. During this period participation of American companies in Russian oil and gas business has changed substantially. Many of them have become more active on the Russian market.

We have discussed important aspects, which are relevant for the future. In 2005, the share of Russian oil and oil products in the U.S. market has more than doubled. Although it amounts to about four percent of this market, the dynamics is impressive. The prospects are also great, and they are mainly connected with the implementation of the large-scale Shtokman project. A list of participants will be finalized no later than next April. All documents and calculations for a final decision on investors should be ready before the year expires. This agenda of the Russia-U.S. Energy Week is closely connected with the issue of global energy security, and with the preparation of G8 summit in Moscow.

During its Presidency of the G8, Russia will give priority to energy security. The main goal is to guarantee long-term stability of energy markets, which is only possible if the following major tasks are fulfilled as a package:

Data on resources, demand, and reserves of hydrocarbons should be more transparent, and easier to receive;

Long-term contracts, and intensive dialogue between producers and consumers of energy should make the energy market more predictable;

The energy infrastructure should develop more effectively to meet the requirements of the market;

All energy resources, including hydro resources and other renewable sources, should be put to better use;

Intensified R&D should help generate new sources of energy (hydrogen, thermonuclear, renewable, etc).

We hope that the concept of global energy security, on which we have still to work with our colleagues, will help us find the ways of removing uncertainties for a long time to come. It should also determine the directions of work for both consumers and producers, and help us minimize mutual risks, which we sometimes encounter.

We have just finished our dialog with the United States. We will assume the G8 Presidency at a round table in Moscow in two hours from now. Representatives of departments and organizations

from dozens of countries will take part in round table discussions here today, tomorrow, and the day after tomorrow.

This is an important dialog between those who draft energy policy in their departments, and those who implement this policy in corporations. In practical terms, the interaction between scientific and business communities continues the political dialog, which has recently become intensive at the highest levels.

3.3 How we can built energy security system: important principles.

Russia and the European Union are connected not only by pipelines, but also by the experience of cooperation within the framework of the Energy Dialogue.

Unfortunately, the Russian-Ukrainian gas conflict has strengthened the stand of those Europeans who distrust Russia and see what they want to see rather than facts. According to them, Russia is using energy deliveries for blackmailing those who reject its imperial policies.

They refuse to see the economic essence of the conflict, or to admit that Ukraine had paid a quarter of the market price for Russian gas over the past ten years, and that it was Ukraine who started the unauthorized withdrawal of Russian gas transported to Europe.

This selective European vision promoted the transformation of the traditional thesis of energy security into "security from Russia." The official EU stand formulated by the Council of Europe in late March was more substantiated, yet it is difficult to accept some of its arguments.

First, the EU has again proclaimed the task of diversifying energy sources.

For the past few years, it has been trying to get the best of both worlds, pressing for guarantees of increased energy deliveries from Russia, while carrying on its energy diversification policy.

This reminds me of a bizarre declaration of love, when a man proposes to a girl but warns her that he would continue diversifying his private life. Moreover, Russia's attempts to diversify its gas export routes are regarded as anti-European.

It would be better to build energy security on a balance of the security of demand and offer. The security of the offer entails guarantees of stable demand for the supplier's energy and opens the door to large-scale investment in long-term projects.

Second, the EU has reaffirmed its intention to press Russia into ratifying the Energy Charter Treaty, though it is badly balanced and its ratification does not offer Russia any advantages. In particular, it does not cover issues of importance to Russia, such as marine transportation of oil and gas, trade in nuclear fuel, and the regime of foreign investment into distribution networks.

The only argument in favor of ratification is the potential inflow of foreign investment, which the ratification would allegedly guarantee. But foreigners have long been investing in the Russian energy sector, and the best examples of this are the Russian-British joint venture TNK-BP, the Shtokman gas condensate field, and the North European Gas Pipeline.

It is counterproductive to force unfavorable cooperation terms on a partner. Energy security that is based on the interests of only consumer states cannot be stable. It should also take into account the interests of producers and transit countries.

Third, the EU has promised to do its best to spread the rules of its common energy market to neighboring countries, including Russia. This promise should be assessed not from the angle of Russian specifics or falsely interpreted sovereignty, but in a purely pragmatic manner.

The goal of a common competitive gas market in the EU is to lower gas prices for the end users. However, Russia's policy is to increase prices in a controlled manner. The application of European rules to Russia would put an end to the export monopoly of state-owned energy giant Gazprom and to export control as such.

Most importantly, this will inevitably level off prices on the "common Russian-European market." Russia is aware of the potential economic consequences of increasing domestic gas prices to Finland's level (\$400 per 1,000 cu m).

In other words, the EU attempt to force its model of a market economy on Russia is not an export of values, but "realpolitik" aimed at lowering gas prices on the European market by undermining Russia's competitiveness.

It is impossible to ensure one's security at someone else's expense. A sustainable energy security system can be built only on equality and respect for the interests of all parties, and on asset swaps at all stages of energy production and supply. Russian energy supplies to Europe will be ensured most reliably if Russian and European companies jointly control and get profits along the entire gas route from the well in West Siberia to the gas stove in Scotland.

And lastly, energy security should not be limited to hydrocarbons. There is a huge potential for joint projects in nuclear power (the Russian initiative of creating a network of international uranium enrichment centers), energy efficiency, and the development of alternative energy sources in energy-hungry developing countries.

Moreover, an exchange of technologies could pave the way to joint research and educational projects. The Russian state concern for nuclear-generated electrical and thermal energy (Rosenergoatom) and British Nuclear Fuels Ltd. are implementing joint projects of training nuclear power plant personnel.

The Russian and European business is acting more constructively than diplomats, who should probably take the cue from business in this case.

3.4 G8 Summit: Russia prepares for constructive dialogue

Participants in the July G8 summit will come to St. Petersburg with different goals in mind, and this is natural, because industrialized countries have always had different goals.

It is another matter that they need to be balanced to produce acceptable results for all participants. This is possible if the G8 leaders are set to attain common results.

Unfortunately, the tone of the global press shows that in the past years differences, notably over Iran, Ukraine and Georgia, have invariably given way to accusations of Russia pursuing imperial or anti-American policies. And Russia strikes back, without sparing the feelings of its political opponents.

Dick Cheney's recent speech in Vilnius was a brilliant attempt to place Moscow in the defendant's seat. Vladimir Putin's reference to a wolf who "knows who to eat and is not about to listen to anyone" intrigued everyone. But the harsh tone of the exchange has left almost nothing unsaid: the Kremlin will not be forced into a defensive position but will voice its opinion as harshly as it deems necessary.

This has created a problem almost on the eve of the summit. The United States and Russia have talented speechwriters who can find a clever way of putting the fighting spirit of their leaders on paper. Cheney and Putin seem to be taking pleasure in fighting. But fever tends to go down when the battle is over, just as it has this time, when everyone is thinking about the St. Petersburg summit and nobody wants to turn it into a squabble. Otherwise why meet at all, let alone in the Russian president's home city?

There is nothing wrong with the Kremlin's decision to come clean; the steam has been let off; no more attempts to frame each other. Russian presidential aide and G8 Sherpa Igor Shuvalov has taken over the job of looking for silver linings. According to him, the Kremlin knows that the pre-summit atmosphere is not very good, to put it mildly.

According to the Financial Times, Shuvalov does not expect the situation to improve radically but has warned against throwing the baby out with the bathwater. In other words, he spotlighted the need to focus on one of the priority issues on the G8 agenda - energy security.

The New Year "present" to Ukraine, when Russian gas supplies to that former Soviet republic were cut short for economic reasons, turned the economic problem into a political one, nobody can deny that. The Kremlin is aware of this and is prepared to consider Western concerns.

Sharp rhetoric and overemotional criticism are one thing, and roundtable discussions of the world's leading industrialized states are quite another. Only amateurs can describe Moscow's actions on the gas scene as unwarranted. The future of the Russian power industry depends on the West almost as much as the West depends on Russian gas deliveries.

Russia cannot make a sharp turn towards Asia on the energy issue; given the current transportation infrastructure, the overwhelming part of Russian energy exports will continue to be directed westward. The trunk pipeline to the East, when it is built, will divert only 25% of Russian energy exports.

"A geopolitical drama is not in the scenario of global politics," German magazine *Internationale Politik* writes in a special edition devoted to energy in the 21st century.

Why kick each other then? I don't know who sent chief of the presidential staff Sergei Sobyenin to London, but it was a very timely and wise decision. The phlegmatic-looking Kremlin official with the calm eyes of a reasonable human being did better than anybody could in that situation. People like him usually avoid the political limelight.

"Our biggest problem is the rhetoric. We do have differences with our Western partners, but nothing of critical importance and certainly nothing that cannot be resolved through direct dialogue," Sobyenin told *The Times*, in his first interview with the foreign press on his first foreign visit. Those who know the Kremlin parlance immediately interpreted his statement as Moscow's desire to allay Western fears of unconstructive attitude to the G8 summit agenda.

3.5 Russia-EU energy cooperation: time for meaningful dialog

A regular Russia-EU summit scheduled for May 25 is a good opportunity to review the partners' relations. At present, Russia and the EU are revising the foundations of bilateral cooperation,

because the current 1994 agreement on partnership and cooperation expires in 2007. It does not reflect the changes that have taken place in Russia, the EU, and the rest of the world in recent years. Everyone agrees that the new agreement should promote closer relations between the EU and Russia. It should be based on today's realities, one of which is the energy dialog.

The recent summits largely ignored energy cooperation. The energy roadmap on the common economic space leaves much to be desired, although Russian-EU energy cooperation is making steady headway. The initiatives on the construction of the North European Gas Pipeline (NEGP), or the Yamal-Europe Gas Pipeline are vivid examples of that.

According to the data of the Russian Ministry of Industry and Energy, the scale of raw oil supplies from Russia to EU countries grew from 144 million tons in 2001 to 256 million tons in 2005, registering an increase of 77%. The potential of Russia-EU energy cooperation is enormous. It may produce very tangible results in such directions as energy saving, energy efficiency, the use of renewable energy sources, and atomic power engineering.

But at the present time its discussion is complicated and too politicized. After Ukraine's gas conflict with the Russian Gazprom last winter, the EU developed doubts about Russia's reliability as a gas supplier. It blamed Russia for using energy carriers as a political weapon to scare neighboring states. But renunciation of the Soviet practice of supplying neighbors with cheap energy was inevitable once Moscow decided to switch over to the market price formation. This is exactly what the European Union repeatedly called on Russia to do.

The other tangle of energy contradictions between Moscow and Brussels is linked with the Transit Protocol to the Energy Charter Treaty. In the early 1990s, Russia signed this Charter, but has not ratified it since. Now the EU is trying to persuade Moscow that it should ratify the Charter in its own interests. De facto this would oblige Gazprom to make its gas pipelines available to independent producers and third countries. Russia would only lose from that because its gas will be much less competitive on the world market.

In turn, Russia is urging the EU to secure equal access of companies from third countries to its markets. Until recently, the intentions of the Russian players to emerge on the European energy site were often resisted. For instance, Gazprom's intention to buy the British Centrica evoked an uproar in the Western press. Gazprom was blamed for trying to establish control over supplies to Western Europe. Some publications even urged the British authorities to change national legislation in order to avert this. Meanwhile, entry into a new market is a perfectly logical decision for a developing company, and is well in line with the civilized norms of a market economy.

Importantly, the energy dialog between the EU and Russia is complicated by the lack of consistent economic policy within the EU itself. Recently, the European Commission accused Madrid of protectionism regarding its energy market. Madrid was blamed for deliberately obstructing the German rivals, who wanted to buy the Spanish energy producer Endesa. Under the circumstances, it is not surprising that Russia is primarily developing a dialog with individual EU countries or companies, whereas energy cooperation with the EU as a whole is becoming less important.

As a result, both the EU and Russia have started leaning towards diversification. The EU has declared its intention to increase gas imports from Algeria, Libya, and Nigeria, and to enhance cooperation with Central Asia and Caspian countries. Russia has spoken about a possibility of upgrading its deliveries to the Asia-Pacific region. At the same time, it is obvious that the bulk of projects on alternative markets are much less effective economically than EU-Russian cooperation could be.

The generally negative coverage of Russia's policies in the past few months, and complications in dialog with Europe look in the context of the upcoming G8 summit as an attempt to exert pressure on Moscow to make it more pliable. International energy security is on the G8 agenda. The sides do not have a single approach to it, and heated debates on this issue are most likely.

At the same time, despite the discord of recent months, the EU has officially recognized Russia as a reliable gas supplier. EU Energy Commissioner Andris Piebalgs expressed this opinion in the Financial Times. He said that Europe needed Russian gas, and that there were no serious conflicts between Europe and Russia in the energy sector.

The sides will discuss Russia-EU energy cooperation as a major part of bilateral relations in Sochi. It is very important for the sides to avoid political declarations, considering such serious challenges to global energy security as the world's growing demand for energy carriers, negative impact on the environment, and shortage of energy. The interdependence of Russia and the EU in the energy sphere is as obvious as is the need to start, at long last, a meaningful dialog. It should facilitate the formation of a transparent system of relations between energy suppliers and consumers, and make predictable diversification in this sphere. If this happens, the Russia-EU summit in Sochi may become a major landmark on the road to energy security, and a sound prelude to the July G8 summit in St. Petersburg.

IV. CONCLUSION.

In view of the interdependence of Russia and the EU in the field of energy, an energy dialog is becoming one of the major areas of sectoral cooperation. This derives from the real economic needs of our countries, from our common interest in the consolidation of political and economic stability in the Eurasian space. The European Union nations currently account for about 90 percent of Russia's export of energy carriers. By all appearances, this market will remain a priority one for us in the next 20-25 years, too. And in the long run the energy dialog could develop into the creation of a European Energy Community, based on the principles of equality and encompassing all the kinds of energy.

It seems that now is the time for both Russian and European politicians to carefully review certain past mistakes, learn from them, and, in some sense, 'turn the page' in mutual energy relationships and take new steps in order to build a better common energy future.

Strategic solution for Russia and Europe in their energy relations lies in the direction of deeper market integration, mutual direct investments, establishment of common market structures and rules. Such an approach will make all parties interested in stability, reliability and efficiency of markets and energy security of supply.

How we can build energy security? In my view it would be better to build energy security on a balance of the security of demand and offer. The security of the offer entails guarantees of stable demand for the supplier's energy and opens the door to large-scale investment in long-term projects.

Also I wish to stress that sustainable energy security system can be built only on equality and respect for the interests of all parties, and on asset swaps at all stages of energy production and supply.

Russian energy supplies to Europe will be ensured most reliably if Russian and European companies jointly control and get profits along the entire gas route from the well in West Siberia to the gas stove in Scotland.

If we do follow these principles, that would only lead Russia and Europe to better energy security and mutual economic development benefits.

We need a mutually respectful dialogue addressing concerns and specific interests of both parties, Russia and the EU

