

**ENERGY CHARTER
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Related documents: CC 470

DECISION OF THE ENERGY CHARTER CONFERENCE

Subject: Report by the Chairman of the Investment Group

The Energy Charter Conference at its 24th Meeting held on 5th/6th December 2013 **took note** of the Report by the Chairman of the Investment Group as contained in document CC 470 (attached hereto).

Keywords: Report, Chairman, Investment Group

Report by the Chairman of the Investment Group

This report provides an overview of the activities of the Investment Group in 2013.

The Investment Group convened two times in 2013: on 15 May and on 22 October in Brussels.

The first meeting was chaired by Mr. George Shammass (Cyprus), Chairman of the Energy Charter's IG and the second meeting was chaired by Dr. Klara Rakhmetova (Kazakhstan) Vice-Chairman. Mr. Ramiz Rzaev (Azerbaijan) served in the capacity of second Vice-Chairman.

The Investment Group successfully implemented activities on investment promotion and protection in line with the Programme of Work 2013 including relevant activities of the Modernisation Road Map of the Energy Charter process.

Foreign Direct Investment (FDI) has the potential to support implementation of strategically important energy projects, generate employment, raise productivity, transfer skills and technology, enhance trade and contribute to the long-term economic development. The Energy Charter plays a major role to provide a favourable framework for FDI in the energy sector.

In 2013, the delegations of the Investment Group discussed following matters: Country Reviews of Investment Climate and Market Structure; Promotion of Low-Carbon Investments; Improving Entry Conditions for Foreign Investors; Improving Energy Sector Transparency; Promoting Investments in Regional Energy Markets. A short summary with conclusions and recommendations of all addressed topics, along with outlook for future activities is presented below.

1. Country Reviews of Investment Climate and Market Structure in the energy sector of Mongolia and Morocco / Accession Reports of Montenegro

In 2013 Mongolia (member country) and the Kingdom of Morocco (observer country) presented reviews on the Investment Climate and Market Structure (ICMS) in the energy sector. The reviews were prepared by the national authorities of those countries in close cooperation with the Energy Charter Secretariat. Austria and Turkey acted as peer review countries for the report of Mongolia. Germany and Italy acted as peer review countries for the report of Morocco. It is observed that member states are actively taking part in the peer review process on the reports which is a positive development to strengthen cooperation among the Charter constituency.

The in-depth review of Mongolia concluded that the government is facilitating market-based reforms of the energy sector at all levels: institutional, legislative and industrial.

Mongolia has undertaken a comprehensive reform of the investment climate in the energy sector in a direction more favourable to foreign investors.

The territory of Mongolia is rich of abundant mineral resources and is ranked among the top 10 mineral richest countries. Currently the energy sector of Mongolia relies on coal for electricity generation. The conducted reviews shows that there are tremendous opportunities for the production of energy from renewable sources such as: wind, hydro and solar however the share of renewable energy in the total energy production is the lowest among the regional countries. The development of the vast resources of wind, hydro, solar and geothermal power is a key in the government's energy plan aiming at reaching a 20 percent share of national energy in 2020.

The Gobi Desert of Mongolia is estimated to be the third largest potential source of solar energy in the world and also blessed with steady, strong wind speeds making it ideal for both technologies. However, this attractive geographic zone for development of renewable energy sources is very isolated and requires investment on transmission infrastructure and connection to the regional energy markets. Combined with modern power transmission technologies, renewable energy can support the long-term economic prosperity of Mongolia and the region.

Among key recommendations the Charter Conference invited the Mongolian Government to facilitate measures aimed at reducing carbon emissions, reducing energy intensity and introduction of policies aimed at a more rapid transition to a low carbon economy.

The in-depth review of the Kingdom of Morocco concluded that the investment legislation provides a stable framework for foreign investment. The renewable energy has very strong potential for the national and regional energy markets. Morocco is in a strategic position for energy integration with neighbouring countries.

The reviews outlines that the recent reform of the fossil-fuel subsidies through the indexation to the international oil prices is an appropriate instrument to reduce public debt and to reduce fossil fuel subsidies which may cause distortions to competition in the energy sector. The electricity system of Morocco is undergoing a full-scale transition towards a competitive market for production and transmission at the high and medium voltage. The further market reforms would require more investments from the private sector.

The Government is invited to consider accession to the Energy Charter Treaty as a means to promote foreign investment and create stable, equitable, favourable and transparent conditions for foreign investors.

The Investment Group welcomed two investment reviews which will be published by the Secretariat.

Draft Accession Reports of Montenegro namely Report on harmonisation of laws and regulations with the provisions of the ECT and Report on Investment Climate and Exceptions to national treatment were discussed by the Investment Group.

It should be noted that the Energy Policy defines objectives of the energy development in Montenegro up to 2030, along with the main priorities and key strategic directions. Main objectives of the energy policy include: security of energy supply; development of a competitive energy market; and sustainable energy development.

The reports demonstrate that the Government of Montenegro has developed comprehensive legislation and policies for the regulation of its energy sector. The legislation is in line with the principles of open and competitive energy markets based on non-discrimination. The presented reports and follow up discussions did not identify any non-conforming measures preventing Montenegro from progressing further towards full membership in the Energy Charter Conference.

The Investment Group encouraged the Government of Montenegro to continue comprehensive cooperation with the Energy Charter.

2. Promotion of Low-Carbon Investments

In 2013, the Investment Group conducted consultations on benefits of a non-binding Declaration and/or interpretative notes on promoting low-carbon investment within the framework of the ECT.

The analysis shows that energy projects normally entail large-scale capital investments. Moreover, low-carbon investment projects, due to their condition of non-mature technologies, tend to be very dependent on public support. As a result, investors face substantial political and regulatory risk.

The Investment Group discussed recent increase of ECT arbitration cases initiated against developed countries and economies in transition related to the withdrawal of support to low-carbon investment by host states.

It may be considered that adoption of a non-binding Declaration and/or interpretative notes on promoting low-carbon investment would allow the Contracting Parties to improve legal certainty in the application of international investment protection mechanisms, which would in turn reduce the normative and political risk borne by investors and the amount of investment related litigation.

The delegates of the Investment Group noted that a non-binding Declaration would be more appropriate instrument to consider in the future. A Declaration on low carbon investments by the Energy Charter Conference would send important signal to the international community and to investors about its commitment to sustainable development and to mitigation of the climate change.

In addition, a Declaration would provide guidance to investment arbitration tribunals as a clarification of the provisions on investment promotion and protection under the ECT and thus contribute to legal certainty. This would in turn reaffirm the sovereignty of the ECT Contracting Parties and on the other hand it would reduce the risk borne by investors (and consequently the amount of investment related litigation). The result would be a more balanced relationship between host states and investors.

The Investment Group requested the Secretariat to continue analysis and facilitate consultations in accordance with the decision (cc 440) of the Charter Conference:

- (a) Conduct further analysis and consultations on benefits of a non-binding Declaration and/or interpretative notes on promoting low-carbon investment within the framework of the ECT;
- (b) Conduct further analysis and consultations on benefits of adding new low-carbon energy materials and products to Annex EM I of the ECT.
- (c) Develop further proposals on the reduction of inefficient fossil fuel subsidies within the ECT constituency based on the discussion of this issue in the Investment Group, the Trade and Transit Group and the PEEREA Working Group.

The Investment Group will continue consultations on promoting low-carbon investments with the overall aim to protect and to balance both the interest of the Energy Charter members and of the international investors.

3. Improving Entry Conditions for Foreign Investors

The attraction of foreign investment to promote energy production in a sustainable manner, and the development of secure and diversified sources of energy imports, are pressing issues in many countries. The Energy Charter Treaty is the first binding multilateral agreement on the promotion and protection of foreign investment, covering all important investment issues and providing high standards of protection, including a fully developed dispute settlement mechanism.

One of the key challenges for the parties to the Treaty is to ensure full implementation of all commitments. The Charter process plays a key role in translating the aim of a truly open non-discriminatory energy market into reality. One of key objectives of the Energy Charter Treaty is to eliminate barriers to investment in the energy sector.

Under the Energy Charter Treaty, "National and MFN Treatment" is the commitment by a Contracting Party to treat foreign investors of another Contracting Party no less favourably than domestic investors or than any other foreign investor.

In 2013, the Investment Group made preparations towards the comprehensive review of the Energy Charter Blue Book (transparency document) which is a register of exceptions to the principle of non-discriminatory treatment.

The purpose of the comprehensive review of all exceptions is to identify existing instances of non-compliance with the National and MFN Treatment principle and to urge signatories to abolish non-conforming measures which infringe upon their obligations under the ECT. Supported by the Secretariat the delegates of the Investment Group agreed upon questionnaire for the comprehensive review of the Blue Book in the course of 2014.

Depending on the results of the comprehensive review process the Investment Group will discuss the results of the review and if required formulate policy recommendations for endorsement by the Charter Conference in 2014 or in 2015. Reducing number of exceptions to National and MFN Treatment would improve entry conditions for foreign investors and contribute to establishment of a level playing field in the energy sector.

4. Improving Energy Sector Transparency

With the increasing globalisation of the world economy, the interdependence of the energy sector, and the long term and highly capital intensive nature of energy projects, multilateral rules for international cooperation are needed. The ECT was negotiated to meet that need. The ECT principles include: competitive markets; investment protection; assurance of reliable cross-border energy flows; dispute settlement; energy efficiency. The fundamental aim of the ECT is to strengthen the rule of law on energy issues, by creating a level playing field of rules to be observed by all participating governments, thus minimizing the risks associated with energy-related investments and trade.

The perceived degree of political risks in the host country considerably affects the decision of foreign companies whether to make an investment in the first place or not, and what level of return it would require. By reducing the political risks that foreign investors face in the host country, the ECT seeks to boost investor confidence and to contribute to an increase in international investment flows.

Ensuring adequate global energy supply will require significant and timely investment and international cooperation along the entire supply chain. Many national and international energy companies that operate across the borders develop new tactics and strategies to address challenges and to satisfy complex criteria of energy security for both energy consuming and energy producing countries. In recent years many companies implemented exchange of assets (swaps), a process which gained attention of the Energy Charter Investment Group. In recent years many companies implemented exchange of assets (swaps), a process which gained attention of the Energy Charter Investment Group.

The Investment Group discussed the study “Analysis of mutual exchanges of the business assets within investment activities in the energy sector” conducted by the Secretariat and the Energy Research Institute of the Russian Academy of Sciences in the course of 2013. The study investigated how asset swaps relate to various measures in the sphere of energy security enhancement; contribute to the development of open and competitive markets; are treated by anti-trust and national approval processes in different jurisdictions; are implemented in light of challenges with business assets and portfolio evaluation; relate to investment protection provisions under the ECT regime.

In order to diversify assets, companies undertake transactions of asset acquisition and asset sale. One of the possibilities to acquire needed assets for companies working in different sectors, especially in the markets where it is extremely hard to enter and develop new assets, is to conduct a deal of an assets exchange.

The conducted study shows that assets exchange can serve as a mechanism of risk mitigation for (1) investment activities; (2) energy companies internationalisation/globalisation strategies implementation; (3) solving the difficult issues of reciprocity access to market segments. Moreover, asset swaps allow overcoming such difficulties in full compliance with national legislations. The mechanism is used by energy companies worldwide.

The Investment Group took note of the study to be published by the Secretariat.

5. Promoting Investments in Regional Energy Markets

In the context of global financial crisis there is increasing global demand for investments in infrastructure, making competition for investment among many countries around the world. Many countries are seeking to create a favourable business environment for investors and some countries are actively promoting foreign investment in infrastructure.

In general, infrastructure investments tend to be highly capital intensive, have long gestation periods and strong government involvement. For this reason, the potential risks associated with such investments are a matter of concern for foreign investors. The combination of high commercial risk and a weak regulatory and institutional environment in a host country can effectively block the inflow of foreign investment, especially in countries with relatively small domestic markets.

Many regions around the world are interested in new regional, bilateral, or multilateral approaches that emphasise better coordination of their efforts to create more robust regional power grids with the potential of lowering capital investment requirements across time and reducing system operational costs. The Government of Mongolia promotes regional cooperation for development of renewable energy sources and electricity grid infrastructure in the region of Northeast Asia.

The Investment Group welcomed the draft study of the regional study "Gobitec and Asian Super Grid" for renewable energies in North East Asia which was prepared by the Secretariat on close cooperation with international partners. The study outlines an innovative and ambitious proposal of connecting the electricity grids of Russian Federation, Mongolia, China, the Republic of Korea, Japan and possibly North Korea into a vast electric power system.

Among other important considerations the study concludes that a large interconnection system including a high share of renewable energies will decrease CO₂ emissions and the cost of electricity for the Northeast Asian countries due to the fact that renewable energy potential is large in the Gobi desert. Regional cooperation needs to ensure the equal distribution of project benefits to all participating countries. It further noted that more countries in Northeast Asia joining the Energy Charter Treaty would facilitate the implementation of large-scale cross-border energy infrastructure projects.

The reduction of investment risk and the creation of a stable and transparent investment climate is one of the major challenges. The ECT assists in this respect by offering binding protection for energy investors against key non-commercial risks, such as discriminatory

treatment, direct or indirect expropriation, or breach of individual investment contracts. Once an energy investment is made, the ECT is designed to provide a stable interface between the investment and the host government. This stability is particularly important in the energy sector, where investments are highly strategic and capital-intensive, and where risks have to be assessed over the long-term.

It should be stressed that regional cooperation will play a key role in the establishing the Gobitec and Asian Super Grid initiatives. An international platform for facilitating energy dialog and an improved investment climate in the region will be important.

The Investment Group welcomed the study which will be published by the Secretariat.