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Investing in the Energy Sector: An Issue of Governance

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Introduction

Of all economic sectors, energy is among those where the issue of investments is the most urgent. Because of its technological structure and significant fixed costs, the energy sector is by nature heavily capital intensive. With growing demand and increasingly difficult access to resources, the amounts needed become enormous. The International Energy Agency (IEA) estimates in its *World Energy Outlook 2008* that total energy investment needs between now and 2030 will stand at $26 trillion, or close to $1 trillion per year. This is just for energy supply. Half of these investments will be needed in the electricity sector (see below for more details on these estimations).

Even after putting these figures into perspective in terms of total worldwide investments over the next 25 years, the amount of money is still significant. All types of energy are involved – oil, gas, coal, nuclear and renewables. In addition, all steps in the supply chain are included – exploration, production, transformation and transportation. The stakes are high. Without the necessary investments, security of supply, global economic growth and environmental integrity are put at risk. The most important challenge for the energy sector in the years to come is thus to pave the way for realising timely and appropriate investments.

The current economic recession that is threatening to curb global economic growth will not change this fact. Even if global energy demand slows down in the next two or three years, the world will return to its long term growth path. An energy facility lasts between 20 and 60 years. Thus, the structure of energy production in 2050, when the current economic crisis has been forgotten, will be determined now and over the next years. Even if global energy demand remains stable between now and 2050 (which is highly improbable), the replacement of existing facilities that have reached the end of their lifecycle will still require considerable efforts.

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Six Reasons for the Shortage of Investments

The energy sector has experienced some of the largest upheavals in its history over the past five years and even more so in the second half of 2008. After an increase from $30 to $147, the price for a barrel of crude oil (which remains the energy market's price setter) has fallen back to below $40. The price hikes were due to increasing demand, insufficient growth in supply and relative insensitivity to price among consumers. Although investment flows have increased following record prices for energy products over the last years, their real effect has been insufficient to satisfy the high level of demand. The lack of energy investments can be attributed to six sources:

- 1. The hesitancy of large energy groups. As they remembered periods of overcapacity in each of the past three decades, the big energy companies wanted to be reassured of the sustainability of the price increase. Project hurdle rates progressed cautiously. Companies preferred to give money back to shareholders or consolidate ownership rather than risk new investments.

- 2. The new nationalism of energy producing countries. In recent years as prices have increased, producing countries have increasingly preferred to exploit resources themselves, primarily in the hope of retaining more of the rent in the country. In a broader perspective, one has to acknowledge that the "end of history" and a smooth transition to globalisation, that were evoked even several years ago, did not work out. Not surprisingly, energy policies continue to be strongly influenced by national interests.

- 3. The hesitations by political decision makers. The on-going fluctuations between environmental, security and economic objectives that characterise domestic energy policies prevent the creation of a stable investment framework in the energy sector. In Europe for example, the changing policies concerning biofuels or the ambitious yet not credible announ-cements concerning energy efficiency create a climate of uncertainty for investors, making it difficult to develop a coherent vision of the evolution of demand.

- 4. The lack of a stable framework for international energy policy. Over the last years, any ambition of international co-operation, and *a fortiori* for governance, has been abandoned in favour of individual or bilateral approaches. Europeans, who are far from being the only countries at

fault for this, concentrate on bilateral and regional policies for guaranteeing their energy supply: policies like the European Neighbourhood Policy or the Baku Initiative lead Europe to China's western border. Such regional or sub-regional initiatives slow the creation of multilateral and stable rules of the game that everyone could accept.

- 5. Local resistance to any new investment project in industrialised countries. The NIMBY ('not in my backyard') phenomenon has made it nearly impossible for political decision makers to impose the necessary arbitration at the regional and national levels to make infrastructure projects possible. This can concern a high tension line, a refinery, a drilling site, a LNG terminal, a nuclear power plant or in the future will complicate siting for CO2 storage.

- 6. Increasing difficulty in accessing resources. In real terms, the production of a barrel of oil, a cubic meter of natural gas, or a kilowatt hour of electricity is more expensive today than ten or twenty years ago. Reserves that are more difficult to reach (deep sea, arctic region or oil shale), the lack of skilled workers and stricter regulations, notably in terms of security and the environment, make it so that the investments needed for constant production increase. This is aggravated by the cost escalation in all the factor inputs for energy projects.

These different points, notably 2, 3, and 4, highlight the importance of national and international governance of energy investments.[1] Our detailed analysis of the structures that govern investments in the energy sector will show the limits and shortfalls of the different approaches and the lack of convergence between them. Of course, many of these limits exist for good reasons. The absence of an accepted set of international institutions and practices encourages each actor to chart its own course, often to the detriment of others and leading to suboptimal solutions that can endure for quite some time.

Another reason for this highly unsatisfactory situation is the fractious nature of the energy policy debate. Today, the problems of security of supply and access to energy resources can no longer be discussed without referring to discussions on the post-Kyoto regime in the fight against climate change. Yet, no matter how closely linked these themes are in practice, they are dealt with separately in international negotiations, leading to predictable tensions and

[1] For a detailed analysis of global energy governance, see C. Kérébel's contributions in J. H. Keppler and C. Kérébel (eds.) , *La Gouvernance mondiale de l'énergie,* "Les études de l'Ifri," 2009 (forthcoming).

inevitable inefficiencies. Some proposals for better governance of energy investments are presented in the conclusion of this chapter. Such perspectives can only be structured around increased transparency, consultation and co-ordination between all of the actors in the marketplace. The necessary debates must take place in a non-restrictive and multilateral spirit that allows the different actors to improve the governance of the energy sector through collective ownership of its institutions.

The Financial Crisis and the Energy Crisis: What are the Connections Between Them?

It was already noted that the current economic crisis does not change the need for a stable framework to encourage energy investments at the national, European and global levels. However, the financial crisis and the energy crisis interact on several levels. The energy sector is certainly not the only one contributing to the financial crisis. The latter was born, inter alia, out of a poorly managed and regulated liberalisation of the financial sector (notably by allowing for companies to be highly leveraged), lax monetary policies, and global imbalances (unsustainable trade and budget deficits). But the energy sector, like commodities in general, played its own role.

In the finance-energy relationship, overabundant liquidity facilitated the untenable expansion of the global economy, stimulating demand and energy prices in its wake. Real growth in China and India and their progressive insertion into the global economy supported and amplified the financial changes. Ex post, it seems clear that the exceedingly low interest rates allowed for overly fast expansion, the creation of speculative bubbles and the development of macroeconomic imbalances all at the same time. China's trade surplus and the US trade deficit, which resulted to a large extent from the Chinese surplus and enabled American consumers to live on increasing debt, should have been recognised earlier. It is also important to note the arrival of new financial instruments that were helped by powerful computer technologies. Those allowed for financial risk to be created, shared and diversified. This "securitisation" led us to believe, wrongly, that lenders were conducting the normal due diligence in checking on the solvency of their borrowers. In brief, this extremely fast growth, partly real, largely virtual, contributed to soaring energy prices and led energy companies to make investments, some of which could not be made at today's prices.

But the links between a lack of energy investments and the current economic crisis do not end there. Although the crisis was originally financial, energy markets had contributed to it through their own dynamic. Limited access to resources and the lack of investments contributed to skyrocketing prices and thus to surpluses

for producers, of between $1 and $2 trillion per year. A priori, a $62 trillion global economy undergoing strong growth can certainly generate such large amounts of money.[2] It is useful to recall that world trade flows amounted to more than $20 trillion in 2008, and that China's trade surplus alone was around $700 billion the same year.[3]

Nonetheless, the transfer of around 2% of global GDP is not a small affair. In order to evaluate its impact on the global economy, it is necessary to understand the "recycling" impact of this amount of money. Does it matter whether the $1.5 trillion is spent by consumers in industrialised countries or by consumers and governments of energy producer countries? In other words, is money as productive when it is invested via a sovereign wealth fund of a producer country, as it is when it is put into a savings account in an OECD country?

The answer is not simple and must be based, at least initially, on anecdotal evidence. For a historical example that shows the importance of this issue, we look to the 1980s. During this period, the surpluses of producer countries after the second oil crisis were not well recycled. The overabundant liquidity of the global financial system was to a large extent absorbed by lending to Latin American countries to finance their growth. The insufficient verification of the solvency of borrowers resulted in the Latin American debt crisis once interest rates rose. Only the creation of the "Brady Bonds", which set new prices for the debt, was able to settle the crisis. Today's situation lends itself to certain analogies, with American homeowners being the imprudent borrowers and the US Treasury's Emergency Economic Stabilization Act, worth $700 billion, aimed at neutralising the "toxic" debt of the banks and setting again generally accepted market prices. No conclusions can be reached in this paper as the US and other countries around the world are discovering that what was triggered by sub-prime debt has exposed much deeper malaises in the financial world.

The recycling of funds by countries with a trade surplus (energy exporting countries and countries that export industrial goods such as China) has become much more professional since the 1980s. The creation of sovereign wealth funds, which are aimed at making the most of the money earned from exporting resources, is an important phenomenon here, as the surplus is spent less on fruitless consumption. The initial desire of these funds to invest directly in the capital of banks in industrialised countries by buying stakes rather than passive investments was at first an important signal, but recently, sovereign funds have become more cautious about taking financial positions in financial institutions.

Doubt however remains. For example, it is hard to imagine Dubai's recent boom as a global financial centre if the Gulf countries

[2] IMF estimation for 2008. Source: World Economic Outlook Database, October 2008, *Imf.org*.
[3] *Ibidem*.

did not have the ability to invest heavily, given their trade and budget surpluses. But recent events are raising questions about the commercial sustainability of this project. In brief, it is too early to formulate a definitive opinion on the energy sector's role in the current global crisis – was it a catalyst, a victim or both? It is possible that the imperfect recycling of revenues contributed to a wave of liquidity that set about indiscriminately seeking borrowers. However, this contribution is only partial, as the value of all outstanding residential mortgages in the US was at $10.6 trillion as of midyear 2008.[4]

The Real Threats to Investments: The Role of Governance

Lastly, what impact will the financial crisis have on investments in the energy sector? It was noted above that medium- and long-term needs will require significant investments even if demand growth temporarily eases. Despite the crisis, the amount of investments in oil and gas will not be limited by difficulties in obtaining financing, as the energy sector traditionally secures financing rather easily. The size and professionalism of companies as well as the relative stability of demand make it so that even in periods when credit freezes up, large energy projects find financing provided that they are put forth by serious consortiums. After all, as energy is an essential good, global energy consumption is more stable than economic growth: in the short term, the elasticity of energy demand in relation to revenue is clearly below 1. We cannot be as optimistic about the availability of financing for power infrastructure, in particular in the third world.

The danger of insufficient energy investments comes from two different sources. The first is what the French hydrocarbon expert Denis Babusiaux calls "self-destructive expectations". When everyone believes that current production capacity is sufficient or too high, all actors are careful not to invest. It is precisely at this moment that capacity will prove to be insufficient and investments are the most profitable. The current slowing down of demand risks creating exactly such a situation in the mid-term. This paradoxical effect is due to very long investment cycles – often called the "hog cycle".

In order to exploit a new oil field or construct a new power plant or gas pipeline, producers must commit to the project for decades with costs in the billions of dollars. This explains both their caution when faced with high nominal costs and long delays between an investment decision and the time when energy actually arrives on the market. The latest oil rush went poorly: the increase in prices during the second oil shock led to investments that were so massive

[4] US Federal Reserve, 11 December 2008, <www.federalreserve.gov/releases/z1/Current/z1r-4.pdf>.

that at the end of the 1990s, the world found itself with an overcapacity in the means of production at the moment the Asian crisis hit. We all know the result: oil prices dropped below $10 per barrel. “Too cheap to meter” was *The Economist’s* headline on March 4, 1999, under the picture of an overflowing oil well. This was only ten years ago. Investors remember this all too well and will again wait a little while longer before making major commitments.

The second threat that hangs over energy investments is obviously the absence of governance capable of creating a stable and transparent framework. Inadequate governance signifies an increased risk for investors. There are at least three areas where the global energy market would benefit from improved governance:

- Risks in exporting countries. Access conditions in large exporting countries are becoming increasingly uncertain. In Iran, Iraq, Russia, Algeria, Venezuela and Nigeria, large hydrocarbon reserves and political instability at various levels go hand in hand. Helping producer countries with the long-term management of their surplus by using lessons learned from success stories could be a major contribution to the world economy’s stability. A subset of this is engaging them in the creation of stable and predictable conditions for both foreign and domestic investors. Consumer countries will not be able to impose their solutions on producer countries: each country’s solution will necessarily have to respect its national sovereignty on natural resources. But beyond national solutions, the creation of platforms and processes that promote a multilateral exchange on investment rules is needed. In a second step, internationally recognised mechanisms that allow reconciling different interpretations of previously agreed rules must be strengthened.

- Risks in importing countries. Carrying out a large energy project in an industrialised country is increasingly difficult. Take for example the electric interconnection line between France and Spain through the Pyrenees, which turned into a 30-year saga. Between mutual distrust, exploitation for political reasons, trade issues and local resistance, a project whose industrial usefulness was never doubted and whose environmental impact was limited, never saw the light of day. The latest decision to bury the line underground at a price five times higher is perhaps the right one, but that’s not the real issue. The problem is the inability of the states to formulate and lead arbitration between national and local interests. These interests are all certainly legitimate. But in the absence of clear priorities, honest evaluations and transparent procedures, it is impossible to establish the necessary

responsibilities and concessions that each party deserves. In this respect, industrialised countries have a duty to improve their decision-making procedures to permit large national or international energy investments.

- Transportation risks. At the end of 2008 and the beginning of 2009, the general public has become conscious of these risks with the wave of pirate attacks in the Gulf of Aden and the gas conflict between Russia and Ukraine. Energy experts have known and warned for some time that transport infrastructure is the weakest link in the global energy supply system. Looking at the Strait of Hormuz, the Strait of Malacca, the Suez Canal, as well as the major gas and oil pipelines connecting Russia and Central Asia to Turkey and Europe, it becomes clear that transport infrastructure security demands more international attention and co-ordination. It is probable that this is an issue where global governance in the energy sector can make considerable progress in the coming years. Given that it is in everyone's interest to arrive at mutual arrangements, and that there are no major differences between the respective interests in producer and consumer countries, an international initiative to secure energy transport routes will have a good chance for success.

In the following, we will concentrate on the first of these three major issues for the governance of energy investments. After a short discussion of the energy sector investment needs in the coming years, we will explore the question of foreign direct investment (FDI) in producer countries.[5] How does the governance of foreign investments at the global level work? How are energy investments different? Next, we will analyse the current state of global governance of energy investments and notably the treaties and means of dispute settlement that define the framework of these investments. The next chapter deals with two recent attempts in creating a multilateral framework for international investments that were undertaken in the 1990s, as the problems that they have encountered serve as valuable lessons for any future initiative. Our conclusion makes some proposals aimed at improving global governance of energy investments.

[5] According to the OECD (2003, p. 157), "FDI is an activity in which an investor resident in one country obtains a lasting interest in, and a significant influence on the management of, an entity resident in another country. This may involve either creating an entirely new enterprise (so-called 'greenfield' investment) or, more typically, changing the ownership of existing enterprises (via mergers and acquisitions). Other types of financial transactions between related enterprises, like reinvesting the earnings of the FDI enterprise or other capital transfers, are also defined as foreign direct investment."

Energy Sector Investment Needs

It is obvious that very important investments are needed in order to guarantee a sufficient level of energy supplies in the future. But as the current economic situation does not encourage investments, the risk of under-investment now grows even bigger today, especially as the period of under-investment in the 1990s has not been completely caught up yet. It is not easy to quantify with exact figures the energy sector's investment needs, given the uncertainty concerning economic growth, energy prices, production costs and conditions for access to resources, but we will cite those published annually by the IEA. These estimates have grown considerably: in 2003, the IEA estimated that $16 trillion would be needed for the period 2001-2030.[6] The *World Energy Outlook (WEO) 2006* put investment needs at $20 trillion, the WEO 2007 at $22 trillion and the WEO 2008 forecasted $26 trillion for the period 2007-2030 (which means around $1.1 trillion per year or around 1.8% of global GDP in 2008).

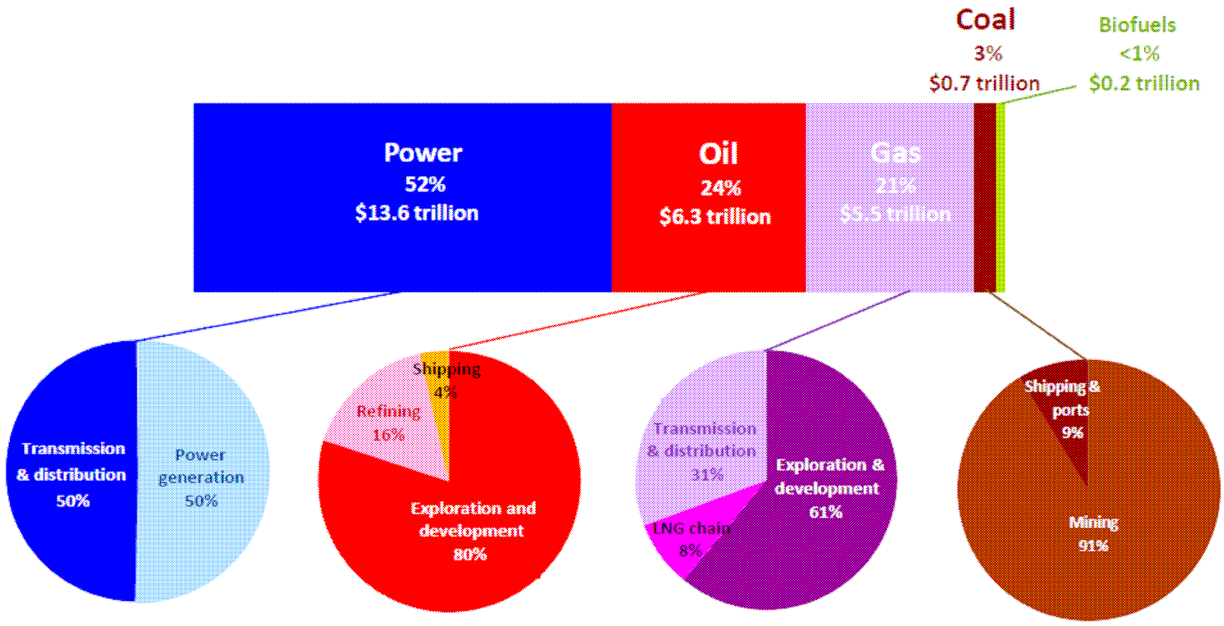
The $26 trillion represent the investments needs for the supply side of the reference scenario – which, as the IEA says itself, is not sustainable, notably because this scenario would increase the average global temperature by at least 6°C. The WEO 2008 thus proposes alternative scenarios: the "550 Policy scenario", which would limit the increase in global temperature to 3°C, and the "450 Policy scenario", which would limit it to 2°C.[7] These scenarios would require even greater investments: $4 trillion more for the 550 scenario compared to the reference scenario ($30 trillion in total), and $9 trillion more for the 450 scenario ($35 trillion in total). The additional investments needed compared to the reference scenario are respectively equivalent to 0.24% and 0.55% of global GDP according to the IEA's estimates. However, some of these additional investments would improve energy efficiency and thus reduce consumption: the related savings would add up to more than $7 trillion in the 550 scenario and to $5.8 trillion in the 450 scenario.[8]

Investment needs for the reference scenario are divided up in a quite unequal manner between the different energy sectors: $13.6 trillion are required by the electricity sector (52% of the total), $6.3 trillion by the oil sector (24% of the total), and $5.5 trillion by the

[6] IEA (2003, p. 25).
[7] The numbers 550 and 450 refer to the parts per million (ppm) CO2 equivalent.
[8] The savings are less in the 550 scenario, since the higher electricity prices partly cancel out the increased energy savings.

natural gas sector (21% of the total). Investments in coal and biofuels are much smaller (see graph 1 for more details).

Graph 1: Energy Investment Needs for the Period 2007-2030 (Reference Scenario)



Source: IEA (2008a, p. 89)

It is important to note that more than half of investments, in all sectors, are needed simply to maintain the current level of supply. This is due to the fact that a lot of infrastructure will have to be replaced between now and 2030. In the oil and gas sectors, the natural rates of decline for fields already producing are increasing. It will thus be necessary to invest more in the upstream sector[9] in the coming years, in existing and in new fields. Between 2000 and 2007, annual upstream investments (for oil and gas) had already more than tripled to reach $390 billion. It should continue to increase and reach a little over $600 billion by 2012. This figure of $600 billion, which was calculated at a time when the real impact of the economic crisis was not yet visible, has however been put into question by the latest developments on energy markets and in the broader world economy.

In the medium-term, i.e. between 2007 and 2030, the IEA estimates the combined upstream investment needs for oil and gas to be at $8.4 trillion, or $350 billion per year on average. This number is thus slightly lower than the average spending between 2000 and

[9] One usually divides the oil and gas industry into two sectors: “upstream” (exploration, development) and “downstream” (refining, transportation, distribution).

2007, which had been pushed up by oil prices at record levels. The difference between current and future spending is also due to the fact that the geography of investments is changing in the medium-term: it will be necessary to invest much more in regions that are rich in resources, notably the Middle East, where production costs are the lowest. But according to the IEA, these investments are not necessarily guaranteed. On one hand, one must consider whether or not producer countries will themselves be able or willing to invest enough. On the other hand, it is not certain that they will allow more foreign investments in their upstream sectors, considered to be highly strategic. Given the clear need for greater investment in this domain, this issue represents a major challenge in terms of energy governance. Oil and gas industries as well as the governments of importing countries should thus increase dialogue with political leaders from producing countries who decide on the legal framework for investment – both foreign and domestic.

Despite investment restrictions, the mining and petroleum sector currently accounts for a large portion of foreign direct investment. According to UNCTAD, FDI flows in this sector amounted to $134 billion between 2004 and 2006 and represented around 13% of total FDI flows in the world. However, the largest part of these investments (more than $100 billion) were invested in developed countries and not in those countries that are rich in natural resources and where oil and gas production is cheap – in particular Russia and the countries of the Middle East. The part of the mining and petroleum sector in total FDI stocks is however lower than its part in recent FDI flows: UNCTAD estimates that FDI stocks in the energy sector amounted to $954 billion in 2006 and represented 7.7% of the total FDI stock in the world.[10] It is interesting to note in this context that the volume of FDI stocks has greatly increased since 1990, and especially since 2000: worldwide FDI stocks (all industrial sectors combined) amounted to $1.9 trillion in 1990, $5.8 trillion in 2000 and $15.2 trillion in 2007.[11] One can thus be surprised that this steep increase has happened despite the deficiencies of global investment governance. We will see in the following pages that there is no governance framework for FDI at the global level. It is clear that the poor level of global investment governance does not prevent FDIs to be made, but without doubt, it reduces the opportunities in a number of countries with important energy producing potential.

[10] UNCTAD (2008b, p. 207 and 209).
[11] UNCTAD figures, *Unctad.org*.

The Current Framework of Energy Investment Regulation

We need to reiterate that no harmonized legal framework regulating FDI at the global level currently exists. The situation of FDI is hence clearly different from that of international trade, as the WTO rules constitute a widely respected global legal framework for international trade.[12] This difference in the degree of regulation is above all explained by the fact that FDI affects national sovereignty in a more direct way than reductions in customs and tariffs do.[13] However, there have been several attempts to create multilateral structures to govern FDI in the past. Negotiations on this issue, from the Havana Conference of 1948 to the negotiations of the Multilateral Agreement on Investment (MAI), have had only very limited success. Lastly, the attempts to harmonise the investment framework in the energy sector through the Energy Charter have had little impact, since the most important exporting countries have not signed it, or in the case of Russia and Norway, have not ratified it. It is thus necessary to note that the current regulation of FDI is a patchwork of international rules, which is primarily based on bilateral and regional treaties.[14] Foreign investments therefore lack an adequate governance structure.

In the energy sector, the absence of global governance for investments prevents the realisation of some necessary investments. This notably concerns foreign investments, since the opportunities for upstream foreign investment in resource-rich countries are very limited. Access to resources is increasingly difficult for foreign investors. Some countries like Saudi Arabia, Kuwait and Mexico even ban by laws any foreign investment in the upstream sector. At the global level, 77% of oil reserves are controlled by state companies in which no foreign participation is allowed.[15] Many national governments prefer to have, as much as possible, national investors in upstream gas and oil projects. If they decide however, due to a lack of capital and technological capabilities in the country, to open the market up to foreign investors, investors are not necessarily chosen for their technical and financial capabilities. On the contrary, the nationality of the

[12] For the application of WTO rules in the energy sector, see O. Louis' contribution in J. H. Keppler and C. Kérébel (eds.). op. cit. [1].
[13] Kurtz (2002, p. 49).
[14] Kurtz (2002, p. 10).
[15] Figure from 2005, according to the Baker Institute (2007, p. 1).

investor and the political relations with the country in question often play a major role. A good example of this is Venezuela, who announced that in the future they would favour Chinese and Russian investors over North American or European ones.[16]

Moreover, problems can crop up once investments have already been made. Several recent examples in the energy sector show that the commitments on national treatment or most favoured nation treatment are not always interpreted in a consistent manner. Notably after the increase in oil prices and in the power of producer countries, some of them began to discriminate between foreign investors and domestic ones. In several cases, foreign investors were made to accept increased control over their activities by political powers. Thus, there has been a general trend towards exploration-production gas and oil markets being more closed to foreign investors over the last few years. Because of this, the percentage of global oil reserves open to all investors has been reduced over the last few decades.[17] Nonetheless, these evolutions not only limit the possibilities for financing in producing countries (even if this factor has lost importance over the last few years), but it also affects their technical capabilities: without cooperating with big international oil companies (IOCs), some national oil companies lack the techno-logical, commercial and logistical know-how to explore fields that are difficult to access. This in turn leads to additional investments delays.[18] These observations and recent developments underline the fact that the regulation of FDIs in the energy sector needs multilateral governance.

Discrimination against foreign investors can take many forms. Concretely, the investor can face different and less favourable tax regimes or discriminatory administrative practices. Several governments for example impose higher environmental norms on foreign investors than on national ones. In addition, foreign investors are sometimes inspected more frequently and more stringently (as it was the case with Sakhalin-2 before the entry of Gazprom into the project: see box 1 for more details). Lastly, certain foreign investors are confronted with visa restrictions on foreign personnel. Some of these measures can be considered as creeping expropriation, since some governments are aiming to regain national control over their oil and gas resources. In most of the cases, these measures are in contradiction with the obligations taken in the initial investment contract. Nonetheless, they also result from the lack of clarity regar-ding certain principles figuring in investment treaties (as it is the case for example with “fair and equal treatment”) and the procedural difficulties in proving the existence of discriminatory practices. This general

[16] P. Lesova, “Exxon pursues arbitration against Venezuela over seizure of oil assets,” *Market Watch*, 13 September 2007. Despite this type of declarations, which indeed do not facilitate foreign investments, one must still distinguish between rhetoric and the reality on the ground, which often tends to be very complex.
[17] World Bank (2008, p. 2).
[18] Geden and Fischer (2008, p. 83).

uncertainty concerning the institutional and legal situation, rather than one specific discriminatory treatment, is often the main reason for investments not being made. This points to a major issue for multilateral governance: the creation of transparency and medium-term visibility, which are both needed for energy projects that will last between 20 and 60 years.

Box 1. Shell, Mitsui and Mitsubishi, and the Forced Entry of Gazprom into Sakhalin-2

In 1994, the Russian government signed an agreement with Sakhalin Energy, a consortium formed by Shell (55%) and the Japanese groups Mitsui (25%) and Mitsubishi (20%), about the development of oil and gas reserves in the Russian Far East, within a project called Sakhalin-2. In the following, the three companies have invested around $12 billion in the project. Oil production started in 1999, whereas gas production has been delayed several times

The 1994 agreement, a so-called Production Sharing Agreement (PSA), had one disadvantage for Russia: a government that signs a PSA does not benefit from the project's earnings before the foreign investtors have not got back their investment. But at that time, this kind of contract was the only way to attract foreign investors. Some eight years later, the situation had changed and the Russian government affirmed its objective of renegotiating the existing agreement on Sakhalin-2: it wanted to make the terms of the contract more favourable to Russia.

This assertion was soon followed by complaints about the project's environmental impact. Although a more diligent assessment and control of the environ-mental impact had also been requested earlier by many Non-Governmental Organisations and the European Bank of Reconstruction and Development (EBRD), most of the observers concluded that the sudden interest in favour of the environment by the Russian authorities was directly linked to the wish of a renegotiation of the production agreement: the Russian government wanted Gazprom to enter into the project consortium. In the course of the negotiations, the Russian Ministry of natural resources de facto cancelled the permission to develop the second phase of the project, which Sakhalin Energy had received earlier.

Instead of starting an arbitration procedure, which could have been based on the violation of the non-discrimination principle that applies to foreign investors, Shell, Mitsui and Mitsubishi accepted to renegotiate the PSA with the Russian authorities. After two years of negotiations, the consortium accepted, despite its initial reluctance, the entry of Gazprom into the project: Gazprom paid $7.45 billion for 50% of the shares, plus one vote. This ad hoc solution underlines the uncer-

tainty concerning some investments in the energy sector, as there are no clear agreements on the appropriate governance of investments.[1]

1. See Bradshaw (2006) and other publications by M. Bradshaw on Sakhalin: <www.geog.le.ac.uk/staff/mjb41/articles/sakhalinarticles.html>, and several articles by E. Studer on *Leblogfinance.com*.

Regional and Bilateral Investment Treaties

Given the lack of a global framework, the number of bilateral investment treaties (BIT) has increased over the last twenty years. In 1989 there were 385, and 2,608 by the end of 2007. 179 states today are part of at least one bilateral investment treaty.[19] In addition, some regional free trade agreements have clauses related to investments, as is the case with the EU, NAFTA, and ASEAN. Nonetheless, only 60% of FDI stocks invested by OECD countries in non-OECD countries are currently covered by international investment agree-ments.[20]

Bilateral and regional investment treaties define investment conditions for individuals and companies from the states that are party to the agreement, by setting norms for the promotion and legal protection of foreign investments. Likewise, they typically contain national treatment or most favoured nation treatment clauses, that is to say that the host state guarantees that it will apply to foreign investors conditions that are equal (if not more favourable) to those applied to national or third country investors. In most cases, the parties also guarantee investors “fair and equal” treatment and compensation in case of war. BITs also forbid expropriation (direct or indirect), except when expropriations are taken for public purposes, in a non-discriminatory manner, in conformity with the law, and on payment of an appropriate compensation to the investor. These clauses have their origin in the era of decolonization, when numerous direct expropriations took place in former colonies that had become independent. Today, mainly indirect expropriation is of concern in the energy sector: most problems arise from attempts to renegotiate agreements and reduce the part of foreign investors.

Lastly, BITs include mechanisms for dispute settlement; in most cases they offer alternatives to the national legal system, so as to depoliticize the dispute. Investors often prefer appealing to international institutions, since they believe national courts lack objectivity, or in developing countries, that the courts are not competent and efficient. A BIT thus gives investors direct access to an international dispute resolution institution (the investor thus does

[19] UNCTAD figures, *Unctad.org*.
[20] Brunner and Folly (2007, p. 9).

not have to ask for diplomatic protection from its home country). These rules concerning dispute settlements are of prime importance for investment decisions since, once the investment has been made, pulling assets out is very difficult to do: through its assets, the investor is tied to the host country for the long-term. This is especially true for investments in the gas and oil sector, which by nature are very capital intensive and long-term. The host state also has an interest in investors not pulling out, since such a decision would strongly deter all other investors in the future.

Different Ways to Dispute Settlement

There a several ways and procedures to settle an investment related dispute. Mediation is the most discreet and flexible of these methods: the two parties ask a mediator to help them find the most satisfying settlement to their dispute. Conciliation differs from mediation, because a conciliator also makes a practical proposition for resolving the conflict, without however providing a legally binding decision. Arbitration finally consists of appealing to one (or more) arbitrators outside of the traditional legal system, who are asked by the involved parties to handle the case, listen to the two sides and come up with a legally binding decision (arbitration award). Compared to traditional legal systems, arbitration has the advantage of being quick and efficient, because the possibilities of appeal are very limited once the arbitration award is taken. In addition, arbitration allows, if the parties wish, to preserve the secrecy of the dispute. This helps to continue the co-operation after the settlement of the dispute, which seems vital in the energy sector.

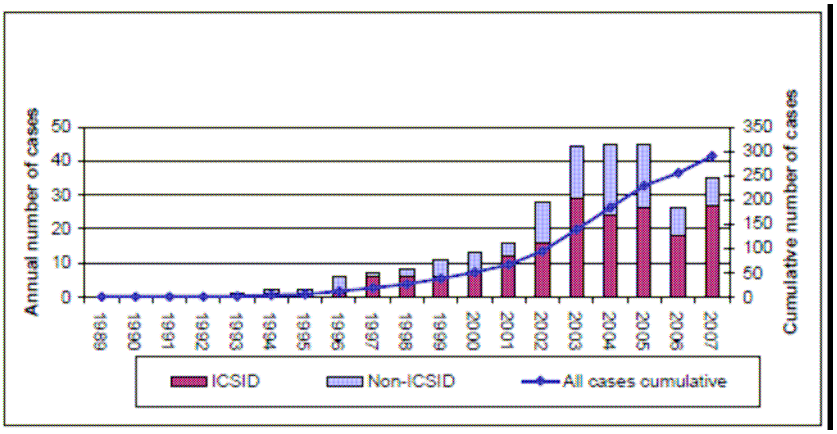
There are several international dispute settlement institutions, of which the International Centre for Settlement of Investment Disputes (ICSID), which is part of the World Bank Group, is without doubt the most important and the only one that solely deals with disputes tied to investments.[21] In November 2007, 143 countries had ratified the Washington Convention of 1965 related to the creation of the ICSID.[22] But also disputes where either the state party or the home state of the foreign investor has not ratified the Washington Convention can be brought to the ICSID, through the “ICSID Additional Facility Rules”. A large number of BITs give the investor the opportunity to use the ICSID, but many also allow for the use of other arbitration institutions like the Permanent Court of Arbitration in The

[21] For more information on the ICSID, see Alcabas (2003), and *Icsid.worldbank.org*.
[22] A number of important large gas and oil exporting countries have not ratified the Washington Convention. This is the case for example with Russia, Iran, Iraq, Mexico, and Libya. Saudi Arabia, the world’s largest oil producer, ratified the Washington Convention, but issued an exception which excludes the ICSID from having any jurisdiction over oil disputes.

Hague, the Arbitration Institute of the Stockholm Chamber of Commerce, the London Court of International Arbitration, and the International Court of Arbitration of the International Chamber of Commerce in Paris.[23] Moreover, ad hoc arbitration can also occur, which leads to an even more flexible solution. To organize this type of arbitration, the United Nations Commission on International Trade Law (UNCITRAL) developed a set of arbitration rules in 1976.[24]

As most of the disputes and their resolutions are not, or only partly, known to the public, it is difficult to establish the number of arbitration, conciliation or mediation cases. Indeed, an obligation to publish all registered cases only exists for cases brought to the ICSID. Thus, we do not know the real number of cases brought to arbitration courts. We know even less about the number of disputes settled amicably and following more flexible procedures like mediation and conciliation. According to UNCITRAL, at least 35 arbitration procedures concerning a dispute about foreign investment (in all sectors of the economy) have been initiated in 2007. Of them, 27 have been brought to the ICSID (see graph 2 for the historical evolution of arbitration cases). The cumulated number of arbitrations linked to foreign investment and known to the public (again for all sectors of the industry) was 290 at the end of 2007. They have been brought to the following arbitration institutions: ICSID (or ICSID supplementary mechanism) 182, arbitration following UNCITRAL rules 80, Arbitration Institute of the Stockholm Chamber of Commerce 14, International Chamber of Commerce 5, ad-hoc arbitration 5, other institutions 4. In view of our earlier remarks, the actual number of arbitrations is certainly higher than that.[25]

Graph 2: Known Investment Treaty Arbitrations
(Cumulative and Newly Instituted Cases, 1987-2007)



Source: UNCTAD (2008a, p. 1).

[23] For more information on these courts, see *Pca-cpa.org*, *Sccinstitute.com, Lcia-arbitration.com*, *Iccwbo.org*.
[24] These rules can be consulted at *Uncitral.org*.
[25] UNCTAD (2008a, p. 1-2).

About 24% of international investment arbitrations are disputes related to mining or oil and gas exploration activities.[26] Precisely, 23 of the cases registered with the ICSID between 1972 and 2004, were linked to the oil and gas sector. In view of the important volume of FDI in this sector, the number of cases is stunningly low. This shows, once again, the specific nature of the energy sector when compared to other sectors of the economy. Furthermore, in only two of the cases registered with the ICSID arbitration decisions have been rendered. All other cases have been settled amicably in the course of deliberations or withdrawn at the request of the parties. It is indeed one of the strengths of the ICSID procedure that it facilitates negotiated solutions between the parties while the arbitration deliberations are ongoing.

We can also conclude from historical evidence that dispute settlements other than arbitration, like more informal negotiations, mediation or conciliation, seem to impose themselves as settlement mechanisms that fit better to the needs of the energy sector. As energy investments are often very large and long-lasting, the investor has an interest in continuing the co-operation even in the case of a dispute. In some cases, it is difficult to imagine that co-operation will continue after arbitration, as arbitration procedures are often costly and may last for several years. Many investors hence prefer not to go to arbitration, or at least not to pursue an arbitration procedure to its end, because this could have negative consequences for the co-operation with the host country (see box 2 for an example of different reactions by foreign investors in a dispute with the host government).

Moreover, experience shows that it is not always certain that an investor can assert the rights granted to him by an arbitration decision, i.e. get back the compensation payment which he has been entitled to. To do so, he always needs to go to a national court, because arbitration courts do not have any enforcement capacities. Nevertheless, it should not be forgotten that the mere existence of arbitration procedures is an important deterrent: the possibility to bring a case to arbitration can prevent governments from irresponsible and unlawful behaviour. Thanks to this, arbitration is a significant element of the global governance of energy investments.[27]

[26] UNCTAD (2008a, p. 2-3).
[27] Onwuamaegbu (2004, p. 12-14), Alcabas (2003).

Box 2. The Nationalisation of the Venezuelan Orinoco Belt Heavy Oil Projects and the Reactions by Foreign Investors

Since May 2007, the president of Venezuela Hugo Chávez tries to renegotiate the "strategic associations" with six international oil companies that have invested in the Orinoco Belt, which has one of world's largest reserves in extra-heavy crude oil. The Venezuelan Congress then voted a law saying that PDVSA, the National Venezuelan oil company, should take majority stakes of the Orinoco production. Venezuela hence forced foreign investors to sell parts of their assets, so that PDVSA gets at least 60% of the shares of each project. The negotiations about renewed conditions of co-operation and the price PDVSA had to pay have proven to be difficult, but four out of the six international companies active in the Orinoco Belt (Chevron, BP, Total, Statoil) have finally agreed to continue the co-operation as minority shareholders. Total and Statoil have then sold parts of their shares.

On the other hand, ExxonMobil et ConocoPhillips, the two other international investors in the Orinoco Belt, have not accepted the Venezuelan proposals, as it proved impossible to find amicably an agreement on the due compensation payment. The two US companies then decided to leave their projects and bring the case to the ICSID. They deposed their requests for the institution of arbitration proceedings in October and December 2007 respectively. Arbitration tribunals have been constituted in 2008 and they are charged to decide on the amount of the compensation payments. Given the historical experiences with arbitration procedures, one could imagine that deliberations will last for three or four years. Nevertheless, the two companies have repeatedly stressed their readiness to continue negotiations with Venezuelan authorities in order to resume co-operation in the future, if Venezuela is ready to change the conditions. This could be a realistic solution, given that settlements of investment disputes are often found in the course of an arbitration procedure, but without a formal arbitration decision.[1]

1. EIA Country Analysis Briefs Venezuela (October 2007). P. Lesova, "Exxon pursues arbitration against Venezuela over seizure of oil assets," *Market Watch*, 13 September 2007. S. Gelsi, "Exxon Mobil's hard line on expropriation," *Market Watch*, 14 February 2008. B. Ellsworth, "Exxon-Venezuela dispute to intensify after ruling," Reuters, 19 March 2008.

Recent Attempts to "Multilateralise" the Legal Framework of Foreign Investments

It is clear that the current legal framework regarding foreign investments has many disadvantages. As there is no governance of foreign investments at the global level, the fragmentation of the regulation is in particular creating additional transaction costs for companies investing abroad. This means that the current system favours big multinational groups, as they are the only companies able to afford these additional costs that are due to the need of legal advice, for example. This situation creates important market distortions and it contributes to the concentration of power in the hands of multinationals.[28] These problems have been known for a long time and some national governments and international organisations have repeatedly tried to define a multilateral framework of foreign direct investment in the past. Among the recent initiatives, those undertaken at the WTO following the request by several developed countries have only had a very limited success. The agreement on "Trade-Related Investment Measures" (TRIMs) is included in the GATT 1994, but its impact is marginal. The question of investments has again been included in the agenda of WTO negotiations at the 1996 Singapore conference. But developing countries were still hostile to the opening of negotiations on an investment agreement. The issue has finally been withdrawn from the Doha programme at the Cancún conference in July 2004. In view of the slow progress of the Doha round, a resumption of the question at the WTO looks rather unrealistic today.

The issue of foreign investment has also been discussed at recent G8 meetings. For instance, the importance of the liberty to invest was underlined in the final declaration of the Heiligendamm summit in 2007. At his occasion, the G8 countries have renewed their commitment to minimise national restrictions on foreign investment and called upon emerging countries to liberalise their investment regimes too.[29] At the G8 summit in Hokkaido in July 2008, the IEA presented an evaluation of the St. Petersburg Plan of Action on

[28] Brunner and Folly (2007, p. 1-2).
[29] G8 (2007, p. 4-8).

Global Energy Security, which had previously been agreed in 2006. In this document, the IEA identifies restrictions on foreign investment as a major problem:

"In general, limits on foreign ownership of energy assets hinders investment and should be avoided – the IEA does not see the current trend toward creation of national champions as helpful to investment as they crowd out other options and deters market integration. Many G8 countries are creating rules that detail the limits on foreign investment. We urge these rules to be clear and transparent – and limited to truly strategic assets".[30]

Two other attempts to "multilateralise" the rules of FDI have gone further and are hence worth a more in-depth analysis: the Multilateral Agreement on Investment and the Energy Charter.

The Multilateral Agreement on Investment at the OECD

The Multilateral Agreement on Investment (MAI) is the largest attempt ever undertaken to create multilateral investment rules. This agreement was negotiated at the OECD between 1995 and 1998, but the negotiations have not led to the signature of a final document, as the stopping of negotiations was declared in 1998.[31] The failure of the MAI negotiations was due to several reasons: the general design of the agreement, as it was considered being too favourable on the protection of investments and investors, and not restrictive enough concerning conditions that investors have to respect. The agreement would have greatly restricted the power of governments to control investors, which was difficult to accept for many countries that had been in favour of the agreement in the first place. Some changes of government in the course of negotiations did influence this change of position, too. The retreat of France in October 1998, after the Lalumière-Landau report,[32] marked the end of the MAI.

Moreover, many Non-Governmental Organisations (NGOs) criticised the MAI as a "neo-liberal aberration" that reinforces the power of big multinational companies, notably at the expense of national regulation favouring environmental protection. The way the negotiations were conducted was criticized too because the public was largely excluded and barely informed about the deliberations. The MAI was not considered being a political issue in the beginning and the negotiations took place mainly between government officials and experts. Political decision-makers hardly took part in the

[30] IEA (2008b, p. 10).
[31] The latest version of the agreement, the Draft Consolidated Text of April 1998, is online available at <www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf>.
[32] Lalumière and Landau (1998).

negotiations. In the end, the lack of political will to pursue the issue, especially after the hostile public reactions, was the main culprit for the failure of the negotiations.[33] The MAI and its failure are hence valuable lessons for every future negotiation on the governance of international investment, concerning both the content of the agreement and the way of conducting negotiations.

The initial motivation of OECD countries to draw up more coherent and transparent rules for foreign investment stemmed from the failure to integrate detailed rules governing investment in the Uruguay cycle. OECD members then decided to draw up a legal framework inside the organisation, as they hoped that it would be easier to find an agreement with a limited number of participating countries. Nonetheless, OECD countries hoped that an agreement worked out inside the OECD could become an example for the rest of the world; all non-OECD countries were invited to join the agreement at a later date. Some NGOs and developing countries however perceived the OECD countries' initiative as an attempt to impose on developing countries rules that favour the developed world. This perception was linked, at least partially, to the lack of dialogue between the concerned actors: the different political and economic actors and civil society were not able to communicate. Thus the MAI was not politically feasible in the end. This was a rather awkward situation, because the different actors could have been potential partners, as they all should have an interest in improving the governance of international investments.[34]

The MAI was based on the assumption that foreign investment is a driving force behind economic growth. Thus, the negotiations aimed to define high standards for investment liberalisation, investor protection and dispute settlement. Negotiations were based on a very large definition of investment (including portfolio investments) and followed a top-down approach, which means that the agreement applies to all economic sectors with the exception of those that are explicitly excluded by the participating countries and mentioned as such in the agreement's annexe. If a country wanted such an exception, it however needed to justify it by "essential security interests". Moreover, the MAI applies fundamental principles like national treatment, most-favoured nation treatment and transparency to foreign investors at all investment phases (including the pre-investment phase, i.e. market access).

After three years of negotiations, the MAI became the victim of its own excessive ambitions: it became clear that national delegations were not able to find compromises on an important number of questions. The most contentious issue was about environmental and social standards, but this topic was just one of many bones of contention. There were also controversies on the very definition of

[33] Muchlinski (2000), Tieleman (2000, p. 5-6).
[34] Tieleman (2000, p. 18).

investment and hence the agreement's range, the exceptions from national treatment and most favoured nation treatment (especially concerning the pre-investment phase and a general exclusion of culture), investment incentives, foreign investment taxation, intellectual property, performance requirements, and dispute settlement (no-tably the possibility for investors to file an arbitration procedure directly against a host state, without making the case known to the public).[35]

As the MAI has not been signed, it is difficult to asses if MAI rules had been fully applied to the energy sector. In its latest version, the MAI does not foresee specific rules for energy, but it is highly likely that some OECD countries wanted to exclude energy from the MAI's scope. Two national delegations proposed to reaffirm national sovereignty on natural resources in the MAI's preamble.[36] Moreover, it is open to discussion in how far the MAI could have been a model for multilateral investment governance in the energy sector that also includes the principal oil producing countries.

Despite its failure, the MAI remains the first attempt to create a general governance of foreign investments and many important conclusions for any future project can be drawn from this attempt. In the current context, the "OECD Declaration on International Investment and Multinational Enterprises", signed in 1976 and amended for the last time in 2000, still constitutes the key OECD document on international investment.[37] This declaration is a political commitment to improve the investment climate for FDI and eleven countries outside the OECD have joined it. It however remains much less legally binding than the MAI would have been. More generally, the OECD Investment Committee continues to work towards a harmonisation of foreign investment rules. Therefore, the "Policy Framework for Investment" has been adopted in 2006.[38] This document does not contain any legally binding obligations, but it proposes specific measures that help improving investment conditions instead. It is mainly directed towards developing countries.

Given the difficulties to set up a binding multilateral framework for FDIs, the current situation remains dominated by bilateral treaties. It however needs to be stressed that a global regulation framework, which applies to all sectors of the economy, would not necessarily respond to the often specific needs of the energy sector. The characteristics of energy investments, especially in the area of oil and gas production, do demand adapted rules. This need has been recognized by the Energy Charter, as it puts forward a legal framework for foreign investments that is adapted to the energy sector.

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[35] Brunner/Folly (2007, p. 3, 26), UNCTAD (1999, p. 1).
[36] OECD (1998, p. 7).
[37] OECD (2000).
[38] OECD (2006).

The Energy Charter

Initiated by the European Communities, the Energy Charter is the first practical attempt to develop multilateral governance in the energy sector. Its main mission is to create and improve the legal framework of international co-operation in this field. The Charter has been developed at the beginning of the 1990s, and hence in the heyday of post-Cold war euphoria. It tries to bring together the countries of the former Eastern bloc, some of them possessing a huge amount of natural resources, and the Western, mainly European, markets. The Charter notably aims to facilitate energy investments in the successor countries of the USSR, which lacked at that time the means to develop their oil and gas production and transport infrastructure. Beside investments, the Charter also includes common rules for energy trade and transit, as well as energy efficiency. In general, the Charter has an all-encompassing approach also in terms of proceeding: the Energy Charter Treaty (ECT) is certainly its key piece, but the Charter is also meant to be a dynamic process and a permanent forum. It includes the annual Energy Charter Conference, which brings together all signatories, and the Brussels-based Energy Charter Secretariat.

The ECT was signed by 51 countries in 1994 and it entered into force in 1998, after the ratification by 30 countries.[39] Five signatories have not ratified the treaty; the two most important exporter countries among the signatories, Norway and Russia, are among them.[40] Russia and Belarus however apply the ECT on a provisional basis, which means that only those of the ECT articles that are in compliance with domestic law are in force. The arbitration filed by former Yukos shareholders against the Russian Federation, which is currently ongoing, could clarify what this provisional application means in practice, notably in terms of investment protection.[41]

Moreover, the ECT is the first multilateral agreement ever covering investment. It hence stands for the existence of common rules in energy investment and substitutes 1275 bilateral investment treaties that would be needed to guarantee the same level of protection between the 51 members of the ECT.[42] The treaty hence improves investment transparency and visibility in the energy sector and reduces non-commercial risks. More precisely, the ECT protects

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[39] The ECT was signed by all EU members, the European Communities as such, many other European countries, all successor states of the USSR, Australia, Japan and Mongolia. 20 countries are observers (e.g. Algeria, China, Iran, Saudi Arabia, the United States). Several international organizations are also observers, such as the ASEAN, the IEA, the OECD, the World Bank and the WTO. See <www.encharter.org/index.php?id=61>.

[40] The three others being Australia, Belarus, and Iceland.

[41] "Former Yukos owners begin $50bn claim against Russia," *Times Online*, 17 November 2008.

[42] Konoplyanik (2006, p. 19).

all investors based in one member state that invest in an "economic activity in the energy sector"[43] in the territory of another ECT party. Governments are notably obliged to treat foreign investors at least as good as national investors (national treatment clause) or as good as the most favoured foreign investor (most-favoured nation clause), depending on what is more advantageous for foreign investors. There is however one important exception to this obligation: it does not apply in the pre-investment phase, i.e. the signatories have the right to prefer national investors when it comes to the attribution of investment licences. This clause mainly addresses exploration and production investments, and it allows limiting the access of foreign investors to the resources. So the ECT makes a difference between the pre- and post-investment phases: once a foreign investor has realised an investment, any form of discrimination compared to national investors is forbidden.

The ECT investment regime also includes the payment of compensations for any loss in the case of war or civil unrest, as well as the payment of "prompt, adequate and effective compensation" in case of expropriation (Art. 13 of the ECT). So the ECT does not generally exclude expropriation, but it needs to be justified by a public interest purpose. It also must happen in a non discriminatory manner and be carried out under due process of law. It was originally planned to clarify the investment regime in an additional treaty on this topic, but the negotiations relative to this additional treaty have been suspended in 1998.

The ECT finally addresses the issue of dispute settlement. Part V of the treaty gives foreign investors the right to file an investment dispute to an international arbitration or conciliation procedure, in the case that an amicable resolution has proved to be impossible. The ECT gives the investor the choice to bring the case to the ICSID,[44] the Arbitration Institute of the Stockholm Chamber of Commerce or an ad-hoc arbitration following UNCITRAL rules. Since the ECT entered into force in 1998, the Energy Charter Secretariat has been notified of 20 cases that have been brought to arbitration under the provisions of the ECT.[45] Until now, four arbitration awards have been rendered (see box 3 for an example of an arbitration award rendered under ECT provisions). In other disputes, settlements have been agreed by the parties in the course of the deliberations and hearings. So on the one hand, the arbitration rules provided by the ECT facilitate the settlement of disputes. But on the other hand,

[43] The ECT (article 1) defines energy widely: its definition covers exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing, and sale of energy materials and products. Energy services are also included.

[44] Or to the ICSID Additional Facility, if one of the parties has not ratified the Washington Convention of 1965.

[45] See *Encharter.org*. There is no obligation to notify the secretariat of the beginning of an arbitration procedure. So one can think that the real number of procedures is still higher.

they also have an important deterrence function: given that the foreign investor who has suffered a prejudice has the right to bring the case to international arbitration, ECT members will think twice before breaking their obligations vis-à-vis any foreign investor.

In sum, the Energy Charter contributes to better investment governance in the energy sector, even if this contribution has remained rather limited until now. In those countries that have ratified the ECT, the treaty makes the legal conditions for foreign investment more transparent and stable. One may however question the effective application of the ECT investment rules by its members: it would be judicious to do a transparent and critical evaluation of the application of these rules, as this has already been done for the Charter's principles concerning energy efficiency. Despite the deficiencies of the Charter, its ratification by further countries would, at least in principle, improve the governance of energy investments. Though, the Charter's difficult past – marked by often complicated negotiations, which look never-ending on certain aspects – heavily reduces the possibility of additional ratifications. Up to now, few exporter countries have signed the ECT. Among those who did, the two most important ones, Russia and Norway, have not ratified it. As it is barely realistic that this situation will change in the future, the Charter's impact will remain limited. For this reason, we propose multiplying the approaches to improve the governance of foreign investments in the energy sector.

Box 3. Nykomb Synergetics Technology Holding vs. the Republic of Latvia

It is interesting to analyse this case because it is the first arbitration decision awarded under the investment regime of the Energy Charter Treaty (ECT). Moreover, this case is a good example of a rather limited dispute that has been settled rather quickly. It concerns an investment by Nykomb, a Swedish company, which has built, from 1997 onwards, a gas power station in Latvia. The beginning of electricity production was delayed, following a dispute on the price that Latvenergo, the state company responsible for electricity production, distribution and transport in Latvia, should pay for the excess quantities produced by Nykomb's power plant. After the start of production, Latvenergo indeed paid a lower price for the electricity produced by Nykomb than for the electricity produced by other, Latvian, companies.

Nykomb then decided, in 2001, to bring the case to an arbitration court, because it estimated that Latvia did not respect its national treatment obligations under the ECT, as it paid domestic producers higher prices than foreign ones. According to Nykomb, this measure also had to be considered a measure of expropriation. In its arbitration decision on 16 December 2003, the arbitration tribunal rejected this expropriation claim. But the tribunal, formed according to

the rules of the Arbitration Institute of the Stockholm Chamber of Commerce, found that Nykomb had suffered a discriminatory treatment, which is forbidden under the ECT. The tribunal hence ordered a compensation payment of 1.6 million Latvian Lats (around 2.4 million Euro) in favour of Nykomb. In addition, Latvenergo was ordered to pay a double price for the electricity produced by Nykomb up to 2007. Latvia finally had to pay 2 million Swedish Krona (around 220,000 Euro) to Nykomb for arbitration fees. Both parties then had to pay, in equal parts, 253,000 Euro of administration fees to the Stockholm Chamber of Commerce. Latvia did not appeal the decision and paid the compensation in time.[1]

1. Wetterfors; Ildze Slanke, Latvia loses arbitration to Nykomb Synergetics Technology Holding AB, 23/12/2003, <www.balticbusinessnews.com/Default2.aspx?ArticleID=c6e5dd53-6e12-47d5-88dc-43b9e374ec90; Smith (2004).

Conclusions and Proposals

As we have seen in this article, recent attempts to establish a multilateral and legally binding framework for foreign investments have resulted in limited success. This is especially true for the initiatives that addressed foreign investments in all sectors of the economy (the MAI and the negotiations at the WTO), but also, to a lesser extent, for the Energy Charter. Investment governance hence remains partial and incomplete. This is a big challenge for the energy sector, as uncertainties about the legal framework for foreign investments jeopardize the realisation of investments that are necessary in order to guarantee a sufficient level of energy production.

Adopt a Modest and Open Procedure

Given the problems of past attempts, we propose a procedure that is both, broader and less restrictive. Unlike the Energy Charter, it will be limited to the question of foreign investments in the energy sector. This attempt will not aim at the establishment of a legally-binding treaty. On the contrary, the main goal will be the drafting of principles that can be accepted by all actors. In order to do so, the stakeholders in the energy sector, private and public, from the main exporting and importing countries, should engage in a process of information sharing. They should analyse together what kind of investment are needed, and compare investment plans brought forward by the different economic actors. It will be important to depoliticize as much as possible the issue of investments and bring it back to its economic fundamentals. Thus, the leitmotif of this initiative should consist in seeking a balanced position between the sovereignty of energy-rich countries and foreign investors' need of stability, transparency and fair treatment.

A first realistic goal would be the adoption of a set of principles that facilitate and frame foreign investment in the energy sector. In this context, the transparency of practices and procedures is an essential point. Based on an exchange of best practices, the set of principles should propose, in a second step, ways to avoid investment related disputes. At the same time, it will contain methods that facilitate the resolution of disputes. This set of principles could be based on the OECD's "Policy Framework for Investment" and adapt it to the needs of the energy sector. In terms of rules, the initial objective would clearly be more modest than the Energy Charter. But

it would be more ambitious in terms of information sharing and transparency in the area of investment.

Create Synergies Between Existing Initiatives

It is obvious that all international organisations and initiatives which are already working on energy governance must be involved as much as possible. Thus, it would advantageous to define an open working framework that could take the form of a series of conferences or dialogue forums. These should notably include two ongoing initiatives dealing with energy investments: a working group of the World Energy Council is dealing with energy trade and investment rules. A study on the issue, that will contain concrete reform proposals, will be presented in 2009.[46] Within the framework of the International Energy Forum (IEF), energy ministers have asked the IEF Secretariat to prepare a report on the issue, which will contain "recommendations and actions on how to remove the key uncertainty factors holding back energy investment".[47]

It will be essential that governments of exporting and importing countries support the conclusions and give them the necessary political weight. To make this happen, it would be advantageous to set up well balanced proposals that should, for example, contain a clear affirmation of the principle of national sovereignty over natural resources. These proposals could at the same time serve as a stepping stone for a long-term process, in the course of which the different parties, hopefully, will understand what is at stake and show their determination to continue the discussion on the issue. At best, a dynamic process will start. Therefore, the stakeholders should proceed by rather modest steps that are followed and respected by all actors. Thus, the different stakeholders will be able to realise the advantages of co-operation. Once the discussions on the topic will have reached a certain degree of mutual trust, the possibility to start negotiations about a binding treaty could become feasible – provided that these negotiations will take into account the interests of importing and exporting countries. Nonetheless, it will be important to take this step at the right time, i.e. not too early, and to proceed progressively.

Concerning the questions that must be dealt with more precisely, one needs to distinguish between two areas: the access to upstream oil and gas projects for foreign investors (the pre-investment phase) and the stability of the legal investment framework which includes revision procedures of investment agreements (the post-investment phase). In this context, the overarching and long-term goal is to convince exporter and consumer countries of the advantages that a more open investment regime would bring. A less

[46] Task Force on Rules of the Energy Trade & Investment, <www.worldenergy.org/documents/rulestradetor.pdf>.
[47] N. van Hulst, "Key Messages from the 11th IEF in Rome," 20-22 April 2008, <www2.iefs.org.sa/Articles/Pages/KEYMESSAGESFROM11thIEF.aspx>.

politicized approach, which would result from the involvement of many different actors, could in the end convince the producer countries that the opening of the production sector to foreign investors allows them to have more stable and reliable revenues. Thanks to the broadening of financing possibilities, investments would become more efficient and better adapted to the needs. This would, inter alia, reduce the risk of exaggerated price and demand fluctuations.

Intensify the Debate about Reciprocity of Investment Regimes

It would surely be advantageous to see the issue of foreign investment in the upstream sector in a larger context, and especially in relation to the question of foreign investments in the downstream sector of importing countries. Large producer countries are increasingly interested in downstream investments in consumer countries; thanks to the rise of energy prices, they also increasingly have the means to realise important investments abroad. Many consumer countries, however, mainly perceive these plans as a potential security risk. They seem to overlook that it is hardly credible to ask producer countries to unilaterally open the market if they themselves do not worry about the restrictions that are applied to foreign investors in their own domestic markets. We would hence propose that exporting and importing countries should develop a common vision of reciprocity of access, based on a set of shared principles. So all stakeholders should intensify their discussions about the reciprocity of investment regimes, with the goal of finding a solution that is well-balanced between their respective interests.

For importing countries, the offer to open the downstream sector could hence constitute an important item in the negotiation which may allow in return a larger opening of the upstream sector from exporting countries. A reciprocal regime would have advantages for both sides, notably concerning the security of supply: a supplier has no interest to cut off supplies to countries where it sells its products. Thanks to his presence in the distribution market, he will also have a better perception of demand. On the opposite, a company from an importing country that invests in the upstream sector of a foreign country will not be interested in suddenly changing its supplier: this improves the demand security of the exporting country. Nevertheless, it needs to be guaranteed that all partners have the same idea of reciprocity, and that they apply rules the same way. Thus, it would be important to make sure that a reciprocity regime is created in a multilateral perspective that does not hinder the free functioning of the market. Notably in the natural gas market, downstream investments by producers could have negative consequences on prices and competition. Competition authorities hence need to be particularly watchful, but without applying specific ad hoc rules. In this context, one could also think about extending to the

downstream sector a common practice in the upstream sector, that is the limitation of foreign participation to a certain threshold (to 49% for example).

Enforce Existing Treaties and Clarify Definitions

Apart from problems related to investment restrictions, the treatment and protection of existing investments also need clarification. The most important point here concerns guaranteeing and enforcing obligations taken at the signing of the investment agreement and conditions concerning the renegotiation of contracts. Improving investment protection is indeed a crucial aspect for giving foreign investors the necessary confidence. In addition, there is an urgent need to agree on a clearer definition of investment: the lack of a commonly accepted definition of the term “investment” is striking and poses significant problems. A couple of points hence need to be clarified. Notably the definition of indirect investments (i.e. work done by contractors) must be made clear, as their legal status is often lacking clarity. The different parties should equally agree on a better definition of investments made prior to the actual investment decision (like feasibility studies). As these investments can amount to important sums in the energy sector, a better regulation in this area is necessary.

Moreover, several key principles of investment treaties, like “fair and equitable treatment”, lack clear and univocal definition. That is why customary definitions, which are based on case law and arbitration awards, are used. But as case law is evolving and decisions are sometimes contradicting, the lack of clear rules, laid down in a reference document, often poses a problem. This is also true for the principle of “national treatment”, because difficulties in defining (e.g. concerning the expression “comparable circumstances”) impede transparency and visibility. It is thus important to define clear criteria to know if a measure must be considered discriminatory. Finally, the different actors need to agree on the definition of situations where expropriation is allowed. In fact, there are no clear criteria that would allow to determine if a “legitimate public interest” exists. It is hence difficult to know if a given expropriation is legal or not.

Establish Easier and Quicker Dispute Settlement Procedures

In order to improve the governance of energy investments, it would finally be useful to make arbitration procedures easier, quicker and less expansive. On the one hand, as problems related to arbitration go beyond the energy sector, it is more judicious to work out proposals on this issue in a larger framework that involves all sectors of the economy. On the other, given the specificities of the energy sector, it could nevertheless be worth thinking about the creation of an institution that specializes in the settlement of energy disputes. This organisation should not be limited to arbitration, but also offer

less coercive ways of dispute settlement. The uppermost goal of such an initiative would be to facilitate solutions that allow for the continuation of co-operation between foreign investors and host states after the settlement of a dispute.

Tackle the Question Now and Get Engaged in a Long-Term Dialogue

Overall, investment governance in the energy sector and its improvement will remain very important issues in the future. The best way to move forward is based on shared principles like multilateralism and reciprocity between producers and consumers. Although it may be unrealistic to hope for a definitive solution of the problem in the near future, first steps in the right direction should be made now. Even if the current sluggishness of energy markets seems to make the issue less urgent, it would be wrong to think that it will reduce the scope of the question: the calming down of the energy market will be rather brief. So it is better to seize the opportunity now and commit producer and consumer countries to a dialogue on multilateral investment governance that is beneficial to both parties.

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