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Memorandum
A New Institutional Model for Eurasian Energy Governance

This week's readings focused on the possible role international institutions of various kinds may be able to play in anti-corruption efforts in individual countries. They highlighted a) the challenge IFIs face of mediating between their own explicit and unstated goals, b) the difficulty IFIs have in building credibility with developing countries, and c) the importance of striking a balance between an ideal-world policy prescription and a contextualized policy prescription, unique to each nation. In this memo, I present a model of an intermediate level of global governance: a regional institution designed to combat a specific problem that is designed to have positive externalities on other challenges in the region it impacts. I argue that rather than asking what role traditional Bretton Woods IFIs can have in impacting global governance today, we should be looking to the rise of regional governance institutions that can overcome the three challenges listed above by virtue of their very nature.

The January 2009 gas dispute between Russia and Ukraine led to a supply cutoff to consumers in Eastern Europe unprecedented in its severity. Faltering price negotiations and mutual accusations of non-payment and theft led to a standoff that lasted nearly three weeks and that has sharpened energy policy discussions throughout Eurasia. Many consider the resolution of the dispute, which saw Ukraine agree to switch to netback pricing for gas while receiving higher transit fees from Russia, as a logical evolution of the prior 2006 agreement, which eliminated the barter trade for Central Asian gas.

It would be premature, though, to assume that the 2010 deal signals an end to future gas disputes. It is also unsatisfying to explain the dispute itself solely as a result of post-Soviet economic restructuring. There are a number of pressing issues in the Eurasian natural gas sector that still need to be addressed. First and foremost, these disputes are not limited to Russia and Ukraine (or, more accurately, Russia, Ukraine and the European Union). The winter of 2008 saw a parallel situation unfold between Turkmenistan, Iran, and Turkey, demonstrating that cross-border pipeline disputes happen **throughout Eurasia**. Finding an effective means to prevent or manage such disputes is vital, as the so-called "Great Game" intensifies and our definition of sovereignty continues to evolve.

Without playing any sort of blame game, we have identified several pressing issues in the natural gas sector, based on our understanding of the Russia-Ukraine dispute:

- Can we prevent defaults on **gas payments or transit fees** that lead to supply cutoffs?
- Is reform needed in existing **infrastructure management** regimes?
- How can we develop **standardized, stable, equitable pricing** mechanisms?
- Is there a way to **de-politicize** the Eurasian gas sector?

Our collective answer to these questions is yes, but it will not be easy. Our aim here is to initiate a creative discussion by presenting a possible new dispute resolution mechanism in the Eurasian gas sector. The basic idea is to create a new international institution that serves this very objective: not only to standardize pricing negotiations and to resolve disputes, but to bind its member states to their commitments. For the purposes of discussion, we will refer to this institution as the **Eurasian Agency for Cross-Border Pipelines.**

Such an institution is necessitated by the fact that existing dispute resolution mechanisms and institutional arrangements have proven to be inadequate and to possess major drawbacks. For example, although the Energy Charter Treaty's Transit Protocol obliges signatories to ensure transit of energy supplies on a non-discriminatory basis, it has been ineffective in preventing either the 2006 or the 2009 disputes between Russia and Ukraine, two signatory states. The Energy Charter contains weak incentives for compliance and has not been ratified by certain key players. It is also very broad in its mission; what is needed is an institution whose mission is to address the particularities of the Eurasian gas sector.

Geographic Scope and Incentives

The Agency for Cross-Border Pipelines must have a geographic scope that encompasses **key producers, consumers, and transit states**, while leaving the door open to accession by emerging players in the gas sector. For this reason, we propose that the agency unite two diverse groupings of states: **the Shanghai Cooperation Organization (SCO)** and its observer states, together with the European Union (EU) and its neighbors. In addition, such an Agency would include the states of the Caucasus as literally the physical 'bridge' that forms the fulcrum of Eurasia. We acknowledge that Energy is beyond the scope of these organizations per se, but the point is to bring together countries already engaged with each other on an international institutional level.

Before addressing the structure and mechanisms of the Agency, it is vital to identify what incentives states will have to buy into the Agency in the first place.

The first group of key players includes large producers, such as Russia. Russia has two clear incentives: securing **higher end-user prices and maintaining production levels**. To counteract the looming drop in production in existing fields and the delay as challenging new fields come on line, we advocate the **transfer of technology** from Agency member states with excess capacity to producer states, who would then commit to reliable supply at higher prices.

In addition to technology transfer, smaller producer states have a number of identifiable interests: **higher end-user prices, a consolidation of bargaining power (in terms of alternate export routes), and a disentanglement of energy policy from external political influences**. These states, such as the Caspian Sea littoral countries, will provide a significant portion of China's demand for gas in the future, for example.

A large **emerging consumer state** such as China is likely to accede to an international institution to govern cross-border pipelines once the producer states have signed on. By participating in the Agency, consumer states receive **reliable supply volumes at a nominally higher price**. What the higher price does not reflect, however, are the savings consumers states enjoy by foregoing capacity building and technical assistance in the transit and producer states, a function that will be transferred by the Agency.

Existing consumers may have the greatest interest in transit stability, and for this alone would opt-in to an Agency for Cross-Border Pipelines.

Finally, transit states, who need to be bound to their commitments in order to prevent supply cutoffs, will be drawn to the Agency by **stable transit fees and sovereign control of their domestic**

infrastructure, including gas storage. Just like for small producer states, transit states have a vital interest in the disentanglement of politics from energy policy.

Institutional Structure

The Eurasian Agency for Cross-Border Pipelines would be an **international body with signatory states**. Member states are expected to negotiate the terms of new and existing pipeline projects entirely within the framework of the Agency. Each individual pipeline project shall be managed under the umbrella of a **holding company**, with ownership shares given to each affected state as well as the corporate owners of pipeline infrastructure (the holding company has the authority to contract out pipeline servicing).

The Agency is responsible of maintaining a pool of pre-selected experts from its signatory states to serve on each **Independent Commission** established for the management of technical disputes related to cross-border pipelines.

One of the main functions of the Agency is to set guidelines for the pricing negotiations conducted by the holding company. Those guidelines will include minimum term length for transit agreements (at least five years), as well as further provisions discussed below under 'Pricing.'

Each member state is required to contribute funds to an **escrow account** that is accessible only in the case of a dispute (see below). This is a tool to bind member states to their commitments while simultaneously mitigating the consequences of non-payment.

Finally, new member states will have the option of entering a set-length **Transition Period** before the mandate of the Agency is fully applicable. This is designed to create a cushion of stability while individual states build up their technical capacity or their ability to meet their financial commitments. In this period, any other member state has the option to contribute to the transitioning state's escrow account, with a long-term return guaranteed.

Pricing

One of the legacies of Soviet economic integration has been the prevalence of opaque pricing mechanisms in the natural gas trade. In particular, there are debates about the merits of net-back pricing compared to cost-plus or net-forward pricing. We support the adoption of **net-back pricing** within the Eurasian gas trade as it offers greater transparency and predictability in contract negotiations and will be applicable even as alternate fuel sources (including LNG) come on line.

Additionally, we propose several changes to prevailing pricing norms:

- Transit fees should be **paid by end-users** based on a capacity-related distance charge
- Transit fees will be negotiated on a **long-term basis** with phased annual adjustments based on an index similar to the netback index for gas supply.
    - For member states in their transition period, these annual adjustments will be smoothed over time to prevent a drastic change in solvency.

Dispute Management

We have identified four levels of disputes over cross-border pipelines that can occur**: technical, legal,**

commercial, and political.

Technical disputes concern the **quantity and quality of gas** that is being supplied to and withdrawn from cross-border pipelines. The mechanism we propose is surprisingly underused throughout Eurasia: **monitoring stations** at entry and exit points along national boards, to be staffed by pre-selected technicians from an Independent Commission. The cost of monitoring stations is not excessive.

Legal disputes concern **contract violations**, such as re-export (if prohibited) or any perceived infringement that results in legal action. To resolve legal disputes, we propose the appointment of a **neutral expert** to arbitrate and, if necessary, facilitate new contract negotiations.

Commercial disputes will be mitigated by the existence of escrow accounts, filled regularly by each member state and then drawn down in the case of non-payment. Escrow accounts offer a depoliticized solution to payments as they are inaccessible except during a dispute. In the case of insolvency, there will be a **36-month "bridge" period** during which payments will be made out of the account and the non-paying country will be expected to begin refilling the account. Another mechanism of commercial disputes is to clearly delineate national sovereignty – we propose that storage of gas on a country's territory will belong exclusively to that country (implying that it has to pay for the gas), so that there can be no theft of one country's gas in another country's territory.

In the face of political disputes, such as security concerns, both parties should engage in consultations with the Eurasian Agency for Cross-Border Pipelines, serving as an honest broker, only to address those aspects of the conflict that relate to pipelines.

Finally, the same transition period provisions discussed above will be applied to disputes resolution.

Conclusion

If this Agency existed, how would its provisions apply to the Russia-Ukraine cross-border natural gas trade? First of all, there would be an immediate switch to netback prices to be paid to Russia, significantly higher than what Ukraine has paid in recent years. The mutual tradeoff would be a long-term commitment to a specified transit fee to replace the re-negotiations that take place on a nearly annual basis. Moreover, any gas stored on Ukraine's territory would belong to Ukraine after payment made to the holding company. In addition to the high price paid to Russian and Central Asian producers, producer states would benefit from the long-term commitment and the chance to work within a dispute resolution framework that puts commercial and institutional stability ahead of politics.