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How to Solve the Pipeline Problem:

The SCO as institutional bridge-builder in the Eurasian energy sector

Energy security is an essential consideration for the Shanghai Cooperation Organization. Energy production and transit are driving forces behind the Russian and Kazakh economies, while securing energy supply is one of the major challenges China faces in the coming decades. Uzbekistan has significant gas resources which could represent an economic and geopolitical bargaining tool to promote its presence in Eurasia with sufficient investment. Kyrgyzstan has increasing potential to act as a key transit state for Chinese overland energy supply. Of the SCO observer states, India must compete with China to secure energy resources to fuel its own economic growth and Iran seeks to expand its role as energy supplier eastward. Energy plays a decisive role in the economic considerations of many of the SCO states, and yet the institution has not produced a coordinated energy security policy. Member states have preferred to pursue their respective energy strategies through bilateral negotiations, often subordinating the terms of energy supply contracts to broader diplomatic agendas. I will argue in this paper that this politicizing of the Eurasian energy sector by the SCO states is in fact a suboptimal strategy from the perspective of Eurasian energy supplier states, energy transit states, and energy consumer states, and that the confluence and competition of the energy interests of the various member states and the unique institutional structure of the SCO make it the ideal starting point for a new institutional approach to conflict mitigation in the Eurasian energy sector. I will focus my analysis on the challenges posed by transnational oil and gas pipelines in the region.

The January 2009 gas dispute between Russia and Ukraine was a high-profile example of the lack of institutional mechanisms for coping with transnational pipeline conflict. It 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 brought a sense of urgency and high stakes to energy policy discussions throughout Eurasia. The eventual resolution saw Ukraine agree to switch to netback pricing for gas while receiving higher transit fees from Russia. A similar situation unfolded between Turkmenistan, Iran, and Turkey during the winter of 2008, demonstrating that cross-border pipeline disputes occur across Eurasia. The recent Russia-Ukraine and Turkmenistan-Iran conflicts are iterations of pervasive and recurring disputes in the region. Finding an effective way to prevent or manage such disputes is vital in order to mitigate the high economic, political and human costs associated. There are three main issues at the core of most transnational pipeline conflicts that have arisen in Eurasia in recent years:

- How to prevent defaults on gas payments or transit fees that lead to supply cutoffs;
- How to develop standardized, stable, equitable pricing mechanisms; and
- How to de-politicize the Eurasian gas sector.

The 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 was 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 such as Russia. It is also very broad in its mission. Russia has repeatedly signaled that it does not view the ECT as a satisfactory solution to the problems posed by Eurasian transnational pipelines, essentially removing the teeth of the institution.

A posting on the official web portal of the President of Russia dated April 2009 stated "the existing bilateral arrangements and multilateral legally binding norms governing international energy relations have failed to prevent and resolve conflict situations..."[1] The principles outlined below this statement advocate for a "universal international legally binding instrument... [that would] cover all aspects of global energy cooperation." Rather than repeat the error of generality and ineffectiveness found in the ECT, however, a new institution should address a specific and complex energy issue without losing the capacity to please all involved parties. Transnational oil and gas pipelines generate specific types of conflict and involve actors who are physically linked to one another through the infrastructure of the pipeline. Why not therefore focus on developing an institution that establishes principles and mechanisms specific to this conflict and these actors?

The actors involved in transnational oil and gas pipeline conflicts in Eurasia fall primarily into three groups: the SCO member and observer states (and Turkmenistan), the EU and EU aspirant states (such as Turkey and Ukraine), and the countries of the Caucasus. As discussed briefly in the introduction to this paper, the SCO incorporates suppliers, transit states, and consumers of energy who must prioritize energy security. The intra-Eurasian energy security discussion revolves around pipelines. There is therefore a very strong general incentive for the

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[1] "Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles). Available at http://eng.kremlin.ru/text/docs/2009/04/215305.shtml

member states of the SCO to participate in an institution that could prevent or mitigate the damage caused by Eurasian pipeline conflicts.

A general incentive for SCO member states to participate must be matched by particular incentives for each member state to engage in such an institution. I will here propose several possible mechanisms that an institution could use to address the three main issues of Eurasian pipeline conflicts mentioned earlier in this paper, and examine how these mechanisms could incentivize participation and compliance of SCO member states. The first issue relates to preventing supply cut-offs caused by payment defaults. Commercial disputes will be mitigated by the creation of escrow accounts upon the signing of supply contracts, into which perhaps 18 to 36 months worth of payments would be placed. In the event of a dispute over payment or insolvency of the purchasing state, funds would be drawn down from these escrow accounts to ensure uninterrupted supply of energy to consumers while the parties to the supply contract come to an agreement. In the case of the Russia-Ukraine conflict, one could imagine that the EU might choose to assist Ukraine in funding this “payment cushion”, viewing it as a relatively small price to pay to avoid supply cut-offs. Another mechanism of commercial dispute prevention that would specifically target is to provide ownership of gas stored on a state’s territory to that state (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.