



# **European Energy Security and Large Infrastructure Projects**

**An International Energy Litigation Lawyer and M&A Banker's Perspective**

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On 27 March 2018, Germany approved the construction and operation of the Russian Nord Stream 2 gas pipeline. The Nord Stream operator said that it expected that other four countries along the route of the undersea pipeline - Russia, Finland, Sweden and Denmark – will issue permits in the coming months <sup>1</sup>. With the significant technological advances in recent times, there has been a significant improvement in the distances that pipelines can carry oil and gas, both offshore and on land. This, together with, very often, geopolitical factors has improved the possibilities for exporting oil and gas from isolated locations and significantly increased the number of long-distance and transboundary pipelines. The global energy industry has become increasingly dependent on the transportation of oil and gas through these pipelines. It is estimated that more than 50% of world's oil production is traded across at least one border. Historically, Gazprom's piped gas has supplied 35% of European gas.

With a long-standing and consistent push to bring more LNG supply to Europe, and US Shale in particular, Russian gas may be taking a defensive position, resulting in lower gas prices for European consumers? Gazprom's opex is amongst the lowest globally, its estimated average production costs are only US\$0.15/mcf, maintenance capex amongst the lowest in Europe at US\$0.35/mcf, taxes at US\$0.5/mcf, and transportation costs of US\$1.5/mcf. Russia's pre-tax operating cash break-even point at the point of delivery in Europe is just US\$1.5/mcf versus US\$4.5/mcf for marginal (Australian and US) LNG. Ergo, while the aggressive excess LNG

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<sup>1</sup> Reuters, 2018

supplies to Europe coupled with spare regasification capacity in Europe and switching from gas-fired to coal-fire power plants in Europe, may lower European gas prices, the trends are unlikely to reduce Gazprom's market share significantly in the near term. The side effect is that US and other overseas LNG producers may well suffer in case of a gas price below US\$4.0/mcf. Goldman Sach's recent report explaining the "Story of Europe's New Gas Order" compares the price of Russian gas at US\$1.5/mcf versus US\$2-3/mcf of other pipeline gas, US\$3-3.5/mcf of low cost LNG producers and US\$4.4.5/mcf of marginal LNG (US and Australia).<sup>2</sup> The implications are obvious, Russia's cost position is strong enough to compete effectively against all other gas players and sustain its market share, with lower gas price bound to hurt most other producers, not just Gazprom, in the process.

### **Transboundary Pipelines and International Law**

The legal regime which is applicable to transboundary pipelines is in constant development in order to match the needs caused by commercial practice. Two fundamental models under public international law that can be used as the framework for a transboundary pipeline project are the Interconnector model and the Unified Project model.<sup>2</sup> The Interconnector model is in fact two individual pipelines that are connected together at the common boundary between two States. Each State retains separate and distinct sovereignty over that part of the pipeline that lies within its territory.<sup>3</sup> National laws are applied separately to the relevant part of the pipeline. There is no obligation for an interstate agreement for an Interconnector model pipeline, although the commercial execution of such a project will be very much

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<sup>2</sup> John J. Galleher and Michael K. Kenny, Pipelines 2009: Infrastructure's Hidden Assets, 2009

<sup>3</sup> Goldman Sach, LNG vs. pipeline gas: Europe's New Gas Order, 2017; Russian oil: Is the rally over? 2018; Russian energy: What we hear from investors, 2018

simplified by a creating such an agreement. The applicable legal regime applicable will be the domestic laws of the relevant States, and any coordination can be accomplished by way of a host government agreement.<sup>4</sup> The Unified Project model is a proper international pipeline. It is a single pipeline that crosses one or more boundaries. A single legal regime is created between the relevant States that applies to the entire length of the pipeline and all coordination issues are resolved by way of an IGA.<sup>5</sup> This model has many other advantages for commercial actors and governments in simplifying the rules to be applied to the construction and maintenance of the pipeline. The most significant difference between the two models is the issue of national jurisdiction over the pipeline. In the Interconnector model, there must be a prior agreement as to the location of the common boundary. On the other hand, the Unified Project model enables countries to by-pass sovereignty issues and isolate territorial and boundary disputes, without prejudicing a State's territorial or boundary claims.<sup>6</sup>

A distinction needs to be drawn in the international law applied to transboundary pipelines which are located off-shore and those which are land-based. The United Nations Convention on the Law of the Sea<sup>7</sup> (UNCLOS) has a number of provisions that deal with transboundary pipelines. Article 79 of UNCLOS<sup>8</sup> states that, subject to certain conditions all States are entitled to lay submarine pipelines on the continental shelf (i.e., beyond the usually 12-mile territorial sea limit) and that a coastal State may not impede the laying or maintenance of such pipelines<sup>9</sup> The consent of the coastal State is therefore required for the delineation of

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<sup>4</sup> Energy Charter - Workshop on Recent Developments in the Model Agreements for Cross-border Pipelines, Brussels, 17-18 October 2006

<sup>5</sup> John J. Galleher and Michael K. Kenny, Pipelines 2009: Infrastructure's Hidden Assets, 2009

<sup>6</sup> Ibid

<sup>7</sup> United Nation Convention of the Law of the Sea

<sup>8</sup> Ibid, Article 79

<sup>9</sup> Ibid

the particular course of a seabed pipeline, but not for the actual construction of the pipeline. Intra-field pipelines connecting the sub-sea well to the production installation, or bringing oil and gas onshore, are often regulated by interstate agreement. For example, Agreement between UK and Belgium relating to the transmission of natural gas through a pipeline 1998<sup>10</sup> which provides for a split jurisdiction between boundaries of the states, the operator has to be given approval by both States, safety measures to be determined by each State. As land-based transboundary pipelines, generally, do not have an international legal regime equivalent to UNCLOS, each particular project depends on the its particular circumstances including: commercial tariffs, government fees, safety inspection, environmental protection, quality control etc.

The EU has adopted a directive (EC Council Directive 91/296/EEC (1991))<sup>11</sup> which allows for the free and unimpeded transit through the EU. Although the primary aim of this was to establish a single energy market, still, it was a significant step forward. Energy Charter Treaty<sup>12</sup> is an important element in the discussion of transboundary pipelines. The ECT is the only multilateral instrument of general application that creates a general legal framework for securing unimpeded transport of energy products through pipelines. 46 States have ratified the ECT and, although it is Euro-focused, it has members outside Europe. The ECT deals with a several aspects of transboundary pipelines. It imposes an obligation on all member States to facilitate the transit of energy materials and products without distinguishing as to the origin, destination or ownership of products and without any unreasonable delays, restrictions or charges. It also imposes a minimum standard on transit States by providing that they must impose the same treatment and conditions to their own imports and exports. (IBID)

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<sup>10</sup> UK - Belgium Agreement, 1998

<sup>11</sup> EC Council Directive 91/296/EEC (1991)

<sup>12</sup> Energy Charter Treaty

One of most important provision of the ECT is Article 7,<sup>13</sup> which deals specifically with the issue of energy transit. Article 7(6) of the ECT imposes an obligation on the State parties not to interrupt or reduce the existing flow of energy in the event that a dispute arises over such transit prior to the conclusion of the dispute resolution procedures set out in article 7(7).<sup>14</sup> This issue is perhaps best illustrated by the infamous dispute between Russia and Ukraine in transporting Russian gas to the European market which reoccurs almost every winter and affect energy security of a large part of Eastern Europe, as well as it affects gas prices in Europe as a whole. The dispute, Industry literature suggest, has also resulted in the Ukrainian Court imprisoning the former Ukrainian PM Yulia Tymoshenko for the signing of gas agreements with Russia in 2009, in which national energy company Naftogaz Ukrainy sustained 1.5-billion-hryvnia (\$187 million) of losses. In October 2011, the European Union expressed consternation at the result of the Court case, and a spokesperson for the European Foreign Policy Service said that the EU could revise its policy with regards to Ukraine in connection with the verdict handed down to Tymoshenko.<sup>15</sup>

### **Nord Stream 1 pipeline and transboundary EIA under Espoo Convention**

To, among other reasons, avoid the problem in communication with Ukraine, Russia has built the Nord Stream 1 - a long-distance gas pipeline, 1224 km long. It provides for the export of natural gas from the Russian Arctic to the increasing European Union market demand.<sup>16</sup> Apart from land-based pipelines in Russia and Germany, the project includes underwater gas lines

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<sup>13</sup> Ibid, Article 7

<sup>14</sup> Ibid

<sup>15</sup> Interfax Global Energy Services, 11th of October 2011

<sup>16</sup> R Götz, 'The Nord Stream Pipeline: The Energy Policy Background' (2009) 52 German Yearbook of International Law 233

from Vyborg to Greifswald.<sup>17</sup> This project has raised a number of issues relating to its impact on the region's energy security and geopolitics. Several treaties are relevant relating to the Nord Stream project from the perspective of environmental protection.<sup>18</sup> Also, there is an obligation to undertake an environmental impact assessment where certain activities are likely to have a significant adverse effect on the environment. These are contained in the Voluntary Guidelines on Biodiversity-inclusive Impact Assessment<sup>19</sup> of the Convention on Biological Diversity and Principle 17 of the Rio Declaration.<sup>20</sup> These instruments are non-binding and they reflect the customary nature of obligations to undertake the environmental impact assessment.

An important Convention is the 1991 Convention on Environmental Impact Assessment in a Transboundary Context (Espoo Convention).<sup>21</sup> All Baltic Sea States have ratified the Espoo Convention, except Russia which is a signatory State and in 2006 agreed to act as a party of origin to the extent possible under its legislation in relation to Nord Stream.<sup>22</sup> This was very important as other applicable Conventions, for example, 1992 Helsinki Convention are does not contain specific obligations that are appropriate for undertaking a transboundary environmental impact assessment.<sup>23</sup> Under the Espoo Convention, regarding the environmental impact assessment, the Nord Stream project has five parties of origin (Russia, Finland, Sweden, Denmark and Germany) and nine affected parties (Poland, Lithuania, Latvia and Estonia).<sup>24</sup> Compared with the previous examples, the approach adopted in connection

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<sup>17</sup> Ibid

<sup>18</sup> C Redgwel, 'Fundamental International Environmental Law Questions relating to the Baltic Sea Pipeline' (The Nord Stream Pipeline: Legal, Economic and Environmental Issues conference, Kiel, 21 February 2009)

<sup>19</sup> UNEP/CBD/COP/8/27/Add.2 (2006)

<sup>20</sup> A/CONF.151/26(Vol I) (1992))

<sup>21</sup> Convention on Environmental Impact Assessment in a Transboundary Context (Espoo, 1991)

<sup>22</sup> 'Chapter 3: Legal Framework and Public Consultation' in 'Nord Stream Espoo Report' (2009) 62

<sup>23</sup> Energy Networks and the Law: Innovative Solutions in Changing Markets. Martha M. Roggenkamp, Lila Barrera-Hernandez, Donald N. Zillman, Inigo Del Guayo, p 114

<sup>24</sup> 'Chapter 3: Legal Framework and Public Consultation' in 'Nord Stream Espoo Report' (2009) 62

with the Nord Stream project is innovative. It has been ensured that the Nord Stream consortium conducts an environmental impact statement for the entire Nord Stream pipeline in addition to the traditional assessment of the individual sectors on the basis of national EIA legislation.<sup>25</sup> Still, only the domestic authorities of the five parties of origin had the right to decide whether to grant or withhold their permission for the project in regard to their territorial sea and EEZ. The judgment was dependant on whether the environmental impact assessment concerning the sector of the pipeline under the jurisdiction of the particular State was in accordance with its national environmental impact assessment legislation and the corresponding rules.<sup>26</sup> Nevertheless, it is not a strict obligation to consider all locational alternatives as the Appendix II(b) of the Espoo Convention is limited to reasonable alternatives.<sup>27</sup> Therefore, consistent with the Espoo Convention, each party of origin has to conclude which alternatives are to be examined within its jurisdiction, including land-based alternatives. However, no such requests were made during the scoping phase of the assessment. Hence, subsequently it became difficult to argue for the States concerned that the environmental impact statement for the entire Nord Stream pipeline was incomplete because it did not take into account land-based alternatives.<sup>28</sup> Nonetheless, the European Parliament criticised the transboundary environmental impact assessment because the alternatives for the project's route were apparently not studied adequately.<sup>29</sup>

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<sup>25</sup> Energy Networks and the Law: Innovative Solutions in Changing Markets. Martha M. Roggenkamp, Lila Barrera-Hernandez, Donald N. Zillman, Inigo Del Guayo

<sup>26</sup> Fact Sheet: The Nord Stream Pipeline Project

<sup>27</sup> *Convention on Environmental Impact Assessment in a Transboundary Context (Espoo, 1991)*, Appendix II(b)

<sup>28</sup> Energy Networks and the Law: Innovative Solutions in Changing Markets. Martha M. Roggenkamp, Lila Barrera-Hernandez, Donald N. Zillman, Inigo Del Guayo

<sup>29</sup> European Parliament, Resolution A6-0225/2008

## **Nord Stream 2 approval by the German Federal Maritime and Hydrographic Agency, and European Commission's anti-trust case against Gazprom**

Russia, Algeria and Libya have access gas export capacities, which could be utilized if the countries could increase its production levels. Russia is trying to further expand its export capacity through Nord Stream 2 (to increase exports to Germany and North West of Europe) and Turkish Stream (to increase exports to Turkey and Central and Eastern Europe), which would increase Russia's gas exports to Europe by >30%. Gazprom's desire is to complete the pipeline projects by 2019 or 2020. This deadline is in line with Russia's inability to redirect its gas exports to China earlier than 2020-2022, due to lack of export infrastructure in the East.

On 27 March 2018, Germany approved the construction and operation of the Russian Nord Stream 2 gas pipeline. According to Deutsche Welle article dated the same day, "the US and EU's Eastern members fear the gas pipeline will empower Russia"<sup>30</sup>. The German Federal Maritime and Hydrographic Agency's approval of the 31-kilometer section of the pipeline in Germany's exclusive economic zone means that all legal obstacles have been cleared. "We are pleased that all necessary permits are now in place for the German route section", said Jens Lange, permits manager Germany at Nord Stream 2, a subsidiary of Russian gas export monopoly Gazprom. Construction of the German Section of the North Stream 2 pipeline is to start this Spring. Germany, the largest consumer of Russian gas in Europe, views the pipeline as an economic issue financed by five Western firms and has dismissed geo-political objections by US and certain EU countries. Two German companies, Uniper and Wintershall, financially back the Nord Stream project 2.<sup>31</sup>

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<sup>30</sup> Deutsche Welle, 27 March 2018

<sup>31</sup> Deutsche Welle, 27 March 2018

The European Commission is facing a dilemma of how to deal with Russia as it handles an ongoing anti-trust case against Gazprom, while also expressing disapproval of Moscow's foreign policy. Brussels is likely to announce a final settlement on the case soon. The mainstream press expects a contentious decision, but no fines imposed.<sup>32</sup>

### **BTC pipeline project - legal regime and its implications**

The Baku-Tbilisi-Ceyhan (BTC) oil pipeline is 1,760 kilometre long and runs from the offshore oil fields in the Caspian Sea near Baku in Azerbaijan, through Georgia's national park close to Tbilisi, finishing south of Ceyhan on the southern shores of Turkey on the Mediterranean at a tanker terminal, where the oil is loaded on to tankers that transport the oil to Western Europe. The legal regime of the project consists of a number of agreements, which govern the construction, development and operation of the pipeline, and the social and environmental standards which have to be complied with.<sup>33</sup> When it comes to compliance with the OECD Guidelines on Multinational Enterprises,<sup>34</sup> the most important agreements are: The Intergovernmental Agreement (IGA)<sup>35</sup> which is a trilateral agreement between Azerbaijan, Turkey and Georgia and was signed on 18 November 1999. The IGA affirms each country's support for the pipeline and sets down several mutual undertakings to ensure the project's construction and operation. The IGA has the status of an international treaty. The next important agreements are The Host Government Agreements (HGAs).<sup>36</sup> Those are individual agreements between BTC Co and each of the countries. They define the capital and

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<sup>32</sup> Ibid

<sup>33</sup> BTC Co, "Baku-Tbilisi-Ceyhan Pipeline: Environmental and Social Action Plan", p.5

<sup>34</sup> OECD Guidelines on Multinational Enterprises, 2011 edition

<sup>35</sup> <http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632>

<sup>36</sup> Ibid

resources that each signatory is to provide to the project, the timetable by which this project would be developed, the standards that it must meet, and the domestic legislation, both current and future, to which the project is subject.<sup>37</sup> The HGAs are incorporated into domestic law in all three host countries and override all domestic law apart from the constitutions where such law conflicts with the terms of the HGAs and the IGAs.<sup>38</sup>

In April 2003, six environment and human rights groups lodged a Complaint against BP in relation to the BTC project under the OECD Guidelines for Multinational Enterprises.<sup>39</sup> The complaint alleged that BTC Co failed to consult satisfactorily with affected communities on relevant matters.<sup>40</sup> In its revised Final Statement, the OECD NCP finds BP/BTC Co in breach of Chapter V paragraph 2(b) of the OECD Guidelines (OECD Guidelines, Chapter IV), which recommends adequate and timely consultation by multinationals with local communities impacted by corporate operations. It also questioned the competence of the due diligence undertaken by BP/BTC Co in relation to human rights, noting that *“concerns over potential human rights abuses by local security forces had been identified in the negotiation of the overall BTC framework”* and that *“the company’s due diligence preparations could have identified and mitigated an additional risk of intimidation by local partners”*, particularly in the northeast of Turkey, where the pipeline passes through an area *“characterised by a significant Kurdish population and ethnic tensions”*.<sup>41</sup> Also, the NCP ruled that the company’s response to allegations of intimidation *“does not seem to accord”*<sup>42</sup> with its legally binding

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<sup>37</sup> BTC Co, “Baku-Tbilisi-Ceyhan Pipeline: Environmental and Social Action Plan”, p.5

<sup>38</sup> Ibid

<sup>39</sup> Ibid, Chapter 5.2

<sup>40</sup> <http://www.thecornerhouse.org.uk/resource/bp-violated-international-corporate-social-responsibility-rules-says-ukgovernmenthttp>

<sup>41</sup> Ibid, par. 54,62

<sup>42</sup> Ibid

commitment to implement the Voluntary Principles on Security and Human Rights.<sup>43</sup> Although both the OECD Guidelines and the Voluntary Principles on Human Rights and Security are not legally binding instruments, BTC Co is under contractual obligation to comply with them under the Joint Statement that the company signed in 2003 with Azerbaijan, Georgia and Turkey.<sup>44</sup> The BTC Co. and the governments also committed to implement the Voluntary Principles on Security and Human Rights<sup>45</sup> and Paragraph 9 of the Joint Statement affirms that it “constitutes a Project Agreement as defined under the BTC IGA and HGAs.” It is “binding on all parties”<sup>46</sup> and as “the status of national law”.<sup>47</sup> The breach of the OECD Guidelines upheld by the NCP is material and also constitutes a clear breach of BTC Co’s obligation under the Joint Statement to ensure that all project activities are “consistent with the Guidelines in all material respects”.<sup>48</sup> The breach of the OECD Guidelines also constitutes a breach of the Host Government Agreement in Turkey, the country where the breach occurred, since “the Joint Statement is a Project Agreement under the Host Government Agreements (HGAs)”.<sup>49</sup> BTC Co confirmed that such a breach would render it liable to “any third party for breach of standards set forth in the HGA”.<sup>50</sup> Those who were intimidated by security forces and whose allegations of intimidation were not investigated, or who felt unable to challenge agreed compensation terms because of the company’s failure to

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<sup>43</sup> [http://www.voluntaryprinciples.org/files/voluntary\\_principles\\_english.pdf](http://www.voluntaryprinciples.org/files/voluntary_principles_english.pdf)

<sup>44</sup> Joint Statement on the Baku-Tbilisi-Ceyhan Pipeline Project, 16 May 2003

<sup>45</sup> [http://www.voluntaryprinciples.org/files/voluntary\\_principles\\_english.pdf](http://www.voluntaryprinciples.org/files/voluntary_principles_english.pdf)

<sup>46</sup> Ibid, par.9

<sup>47</sup> BTC Co, “Baku-Tbilisi-Ceyhan – BTC Briefing Note on Environmental Standards, Applicability and Enforcement”, June 2003, “Enforcement”

<sup>48</sup> Joint Statement on the Baku-Tbilisi-Ceyhan Pipeline Project, 16 May 2003, par.5

<sup>49</sup> Ibid, Chapter 5.2, p.24

<sup>50</sup> Baku-Tbilisi-Ceyhan: BTC Briefing Note on Environmental Standards, Applicability and Enforcement, June 2003, Annex A

adequately safeguard “against the risk of local partners undermining the overall consultation and grievance process”,<sup>51</sup> may be in a position to pursue tort claims against BTC Co.

### **Energy Charter Treaty**

Energy Charter Treaty<sup>52</sup> has its origins in the 1990 Lubbers Plan, named after the Prime Minister of Netherlands who took the early initiative. There were two main concerns: the first was to secure the long term energy needs of Western Europe, and the second to assist the countries of Eastern Europe in their transition to market economies. Another important concern was environmental problems associated with energy supply which extended beyond national boundaries.<sup>53</sup> The final signatories to the Treaty included more or less all of the countries of Europe, all of the republics of the former Soviet Union, Japan and Australia. Firstly, a European initiative, eventually evolved into a multilateral investment and trade treaty with implications well beyond Europe. Wälde states that liberalisation, privatisation, deregulation and national competitiveness are now the key paradigms of the currently dominant view in economic policy and legislation.<sup>54</sup> The Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects<sup>55</sup> was negotiated, opened for signature and entered into force concurrently as the Energy Charter Treaty. PEEREA requires its participating states to formulate clear policy aims for improving energy efficiency and reducing the energy cycle’s negative environmental impact. It has an aim of strengthening the

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<sup>51</sup> UK National Contact Point, “Revised Final Statement on BTC pipeline Specific Instance”, 9 March 2011, p.2

<sup>52</sup> Energy Charter Treaty

<sup>53</sup> "THE ENERGY CHARTER TREATY – AN EAST-WEST GATEWAY FOR INVESTMENT AND TRADE" by Thomas Wälde (Ed), Kluwer Law International, London 1996

<sup>54</sup> Ibid

<sup>55</sup> The Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects 1994

rule of law internationally in relation between member states and investors, and domestically by signalling 'good governance' in member states.<sup>56</sup> It provides for a more legally ordered institutional international environment. However, it does not provide any particular method to force countries which are not interested in developing such rule of law and it does not force energy flows between unwilling suppliers or consumers. It does, to a certain extent, facilitate transactions, investment and trade flows which are desired by providing a more favourable legal environment – but it cannot compel or steer such transactions. In essence, it is facilitative for investment and transactions, but no more.<sup>57</sup> Latest incidents of direct or creeping expropriations in various countries have raised concerns about investments in this sector which may go further than the borders of the countries involved. Moreover, the economics of many sustainable clean energy projects are based in part on local governmental subsidies and incentives and oblige that those are kept in the form determined at investment commencement. There is significant concern in the investment community about the stability of the relevant rules and regulations in many of the developing countries.<sup>58</sup>

## Conclusions

Firstly, adequacy of regulation varies significantly between states, and not only between developed and underdeveloped economies and legal systems, but also between states that are both generally regarded as sophisticated in bringing about and implementing the rule of law. Secondly, technological advances have increased the complexity of such large energy projects and made them intrinsically more complex for regulators to grasp and regulate.

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<sup>56</sup> Energy Charter Treaty and its Role in International Energy, Andrei Konoplyanik & Thomas Wälde

<sup>57</sup> Ibid

<sup>58</sup> (Noah D. Rubins & N. Stephan Kinsella, *International Investment, Political Risk, and Dispute Resolution: A Practitioner's Guide* (OXFORD UNIVERSITY PRESS 2005))

Overall, it appears that the relevant regulation seems to be lagging the Energy Sector's development, creating regulatory "gaps". Furthermore, it is important to suggest caution in avoiding any pollution of legislative and legal processes by political agendas of various states and political forces at play as illustrated by the Russia – Ukraine gas transmission disputes, the Kurdish issue in Turkey affecting complaints on BTC and so on. On the other hand, the BTC case also illustrates an example where a foreign Oil & Gas consortium may have fallen accountable for gaps in the local legislation and its enforcement or lack of it. Finally, the Energy Charter Treaty does not alleviate the concern in the investment community about the stability of the relevant rules and regulations in many of the developing countries. However, it is unclear if a potential supra-national frameworks that would not only transcend national borders responding to globalisation, but would also account for the ever increasing complexities of new technologies in the Energy sector, would provide an adequate solution.

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