

**ENERGY CHARTER TREATY AND ITS ROLE  
FOR JAPANESE BUSINESS IN EURASIA, WITH  
PARTICULAR EMPHASIS ON RUSSIA**

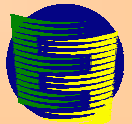
**Dr. Andrei A. Konoplyanik**  
**Deputy Secretary General,**  
**Energy Charter Secretariat**

**JETRO London / ECT Seminar, January 25, 2006,**  
**co-sponsored by:**

**Japan Chamber of Commerce and Industry (JCCI) in the UK**

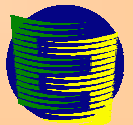
## OUTLINE:

- (1) What is the Energy Charter Treaty and the Energy Charter process**
- (2) How does the ECT work (what is its practical role for business, especially in reducing investment risks)**
- (3) Why Russia has not yet ratified the Treaty**
- (4) What are the prospects for and benefits of ECT ratification for Russia**
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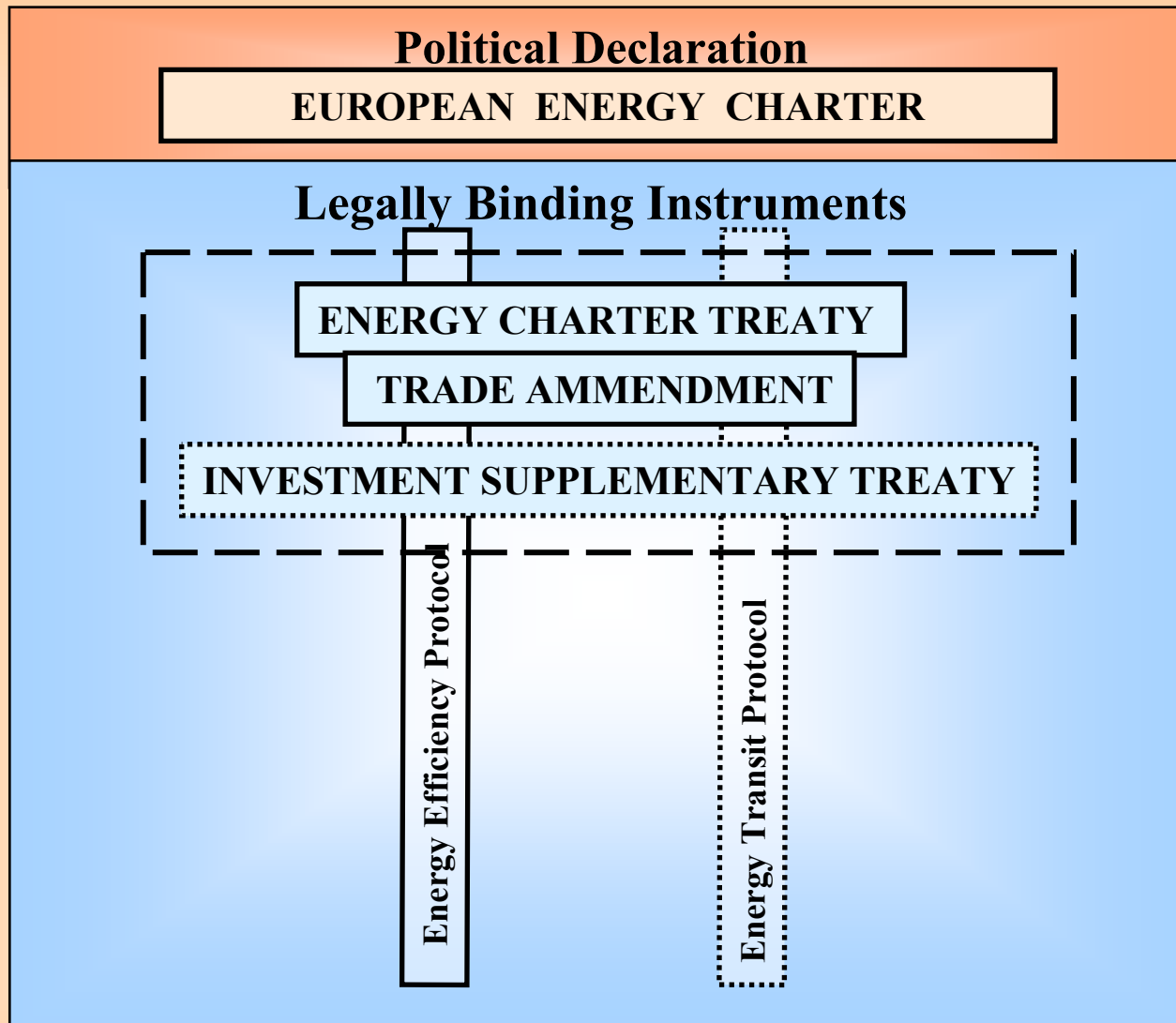


# ENERGY CHARTER HISTORY

<b>June 25, 1990</b>	<b>Lubbers' initiative on common broader European energy space presented to the European Council</b>
<b>December 17, 1991</b>	<b>European Energy Charter signed</b>
<b>December 17, 1994</b>	<b>Energy Charter Treaty (ECT) and Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) signed</b>
<b>16 April, 1998</b>	<b>ECT enters into force and became an integral part of international law</b>
<b>As of today</b>	<ul style="list-style-type: none"><li>• <b>ECT signed by 51 states + European Communities = 52 ECT signatories</b></li><li>• <b>ECT ratified by 46 states + EC (excl. 5 countries: Russia, Belarus, Iceland, Australia, Norway )</b></li><li>• <b>Russia and Belarus : provisional application of ECT</b></li></ul>

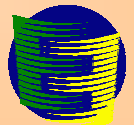


# ENERGY CHARTER AND RELATED DOCUMENTS



- in force

- negotiations continue



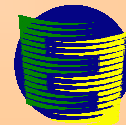
# ECT: A BALANCE OF PRODUCER-CONSUMER INTERESTS

## **ECT Article 2 “Purpose of the Treaty”:**

**“This Treaty establishes a legal framework in order to promote long-term cooperation in the energy field, based on complementarities and mutual benefits”**

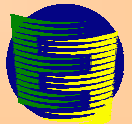
## **ECT Article 3 “International markets”:**

**“The Contracting Parties shall work to promote access to international markets on commercial terms, and generally to develop an open and competitive market, for Energy Materials and Products”**



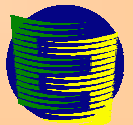
# ECT: THE FIRST MULTILATERAL INVESTMENT AGREEMENT (1)

- **Based on:**
  - well-established practice of BITs (about 500 BITs as of early 1990's - around 2400 BITs as of today)
  - investment chapter XI of NAFTA (US, Canada, Mexico)
  - some interaction with then proposed “Multilateral Agreement for Investment” (MAI – aborted in 1998)
- **Within 51 ECT member-states equal to (substitutes) 1275 BITs**
- **MFN and National Treatment for investors:**
  - binding guarantee of non-discriminatory treatment for *post-establishment* phase,
  - soft-law obligations for *pre-establishment* phase (stage of making investment)



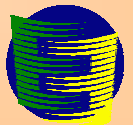
# ECT: THE FIRST MULTILATERAL INVESTMENT AGREEMENT (2)

- **Protection against key political/regulatory risk:**
  - expropriation and nationalisation,
  - breach of individual investment contracts,
  - unjustified restrictions on transfer of funds
- **Reinforced by access to binding international arbitration in case of dispute:**
  - State-to-state, and **(NOVELTY!)** investor-to-state: direct dispute settlement at investor's choice at ICSID, UNCITRAL or ICC Stockholm,
  - Awards:
    - ✓ final and enforceable under NY convention,
    - ✓ Usually as entitlement to payment (no risk of vicious circle for retaliating measures),
    - ✓ Retroactive to start of dispute, may include interest (no incentive to delay process)



# ECT SPECIFIC ROLE

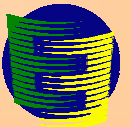
- **Unique coverage of different areas for energy cooperation:**
  - investment, trade, transit, energy efficiency, dispute settlement,
  - EMP, energy-related equipment
  - 51 member-states + 18 observer-states
- **First and only one multilateral investment agreement with high standard of investment protection, incl. dispute settlement**
- **Energy Charter process = Specialized forum for “advanced” discussion of energy-related problems that might create new risks for development of energy projects in ECT member-states = platform for preparation of new legally binding documents to diminish such risks in ECT member-states.**





## OUTLINE:

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# FINANCING ENERGY PROJECTS: FROM EQUITY TO DEBT FINANCING

## Equity/debt financing ratio:

Pre-1970's = ~ 100 / ~ 0

Nowadays = ~ 20-40 / ~ 60-80,

f.i. most recent:

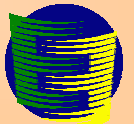
BTC pipeline = 30 / 70

Sakhalin-2 (PSA) = 20 / 80

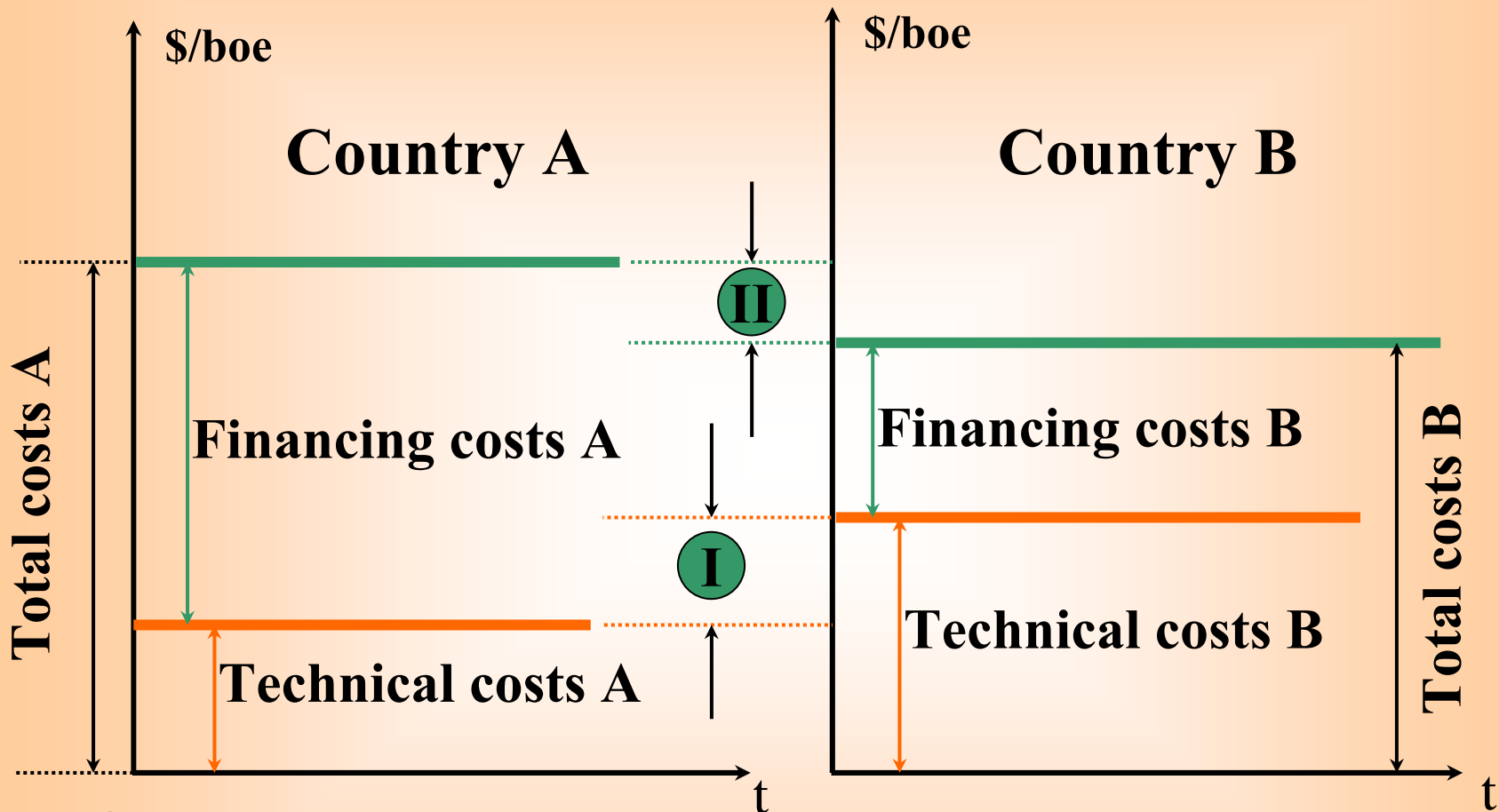
(2 fields+pipeline+LNG plant)

➔ Increased role of financial costs (cost of financing)  
of the energy projects

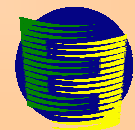
➔ Availability and cost of raising capital = one of major  
factors of competitiveness with growing importance  
in time



# “NATURAL” VS. FINAL COMPETITIVE ADVANTAGES OF ENERGY PROJECTS



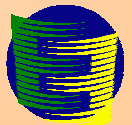
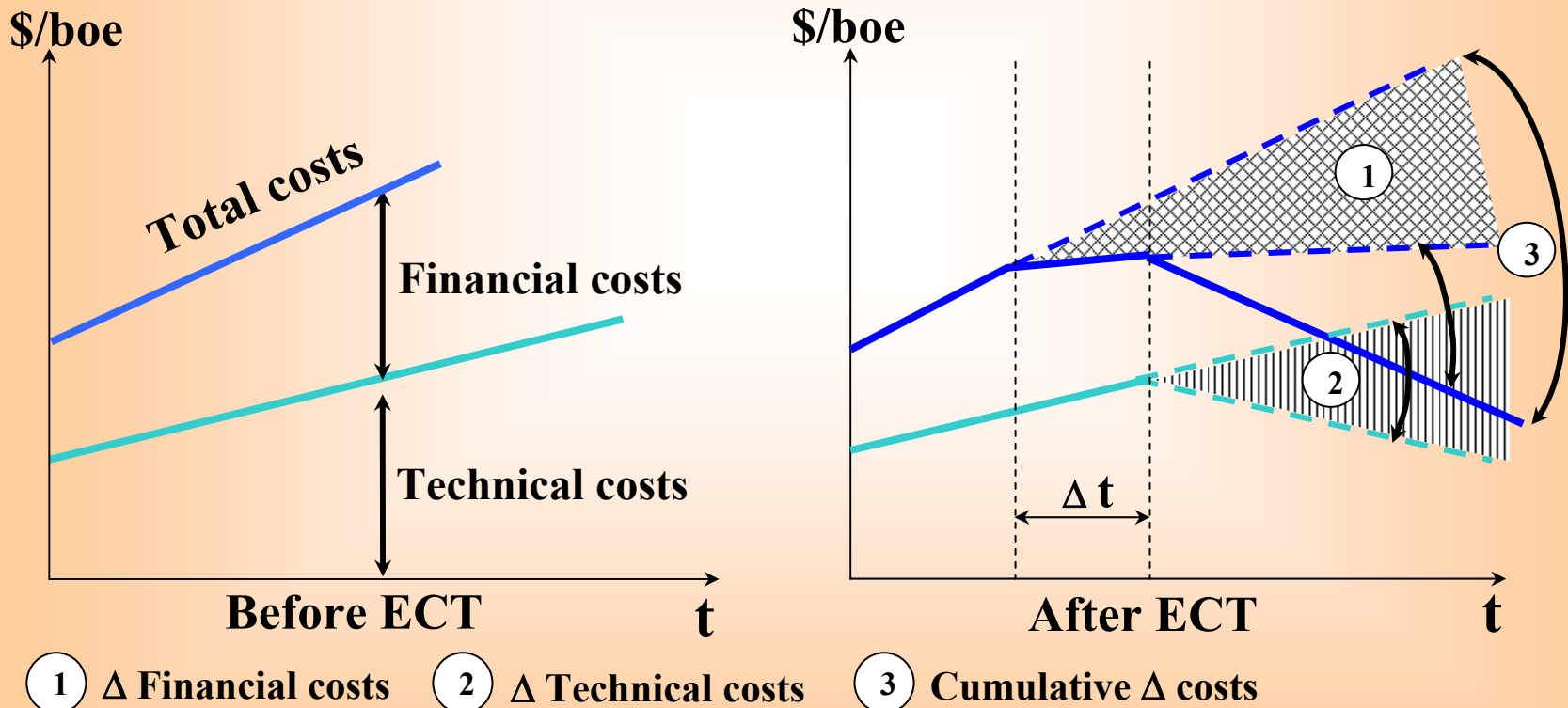
- I** “Natural advantage” of country A over country B
- II** Final competitive *disadvantage* of country A over country B



# ECT IS BUSINESS-ORIENTED TREATY (how it works)

ECT/Legislation → ↓ risks → ↓ financial costs (cost of capital) = ① →  
 ↑ inflow of investments (i.e. ↑ FDI, ↓ capital flight) → ↑ CAPEX → ↓ technical costs = ② →  
 ① + ② = ③ → ↑ pre-tax profit → ↑ IRR (if adequate tax system) → ↑ competitiveness →  
 ↑ market share → ↑ sales volumes → ↑ revenue volumes

ECT provides multiplier legal effect in diminishing risks with consequential economic results in cost reduction and increase of revenues and profits



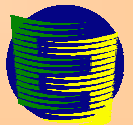
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# RUSSIA'S ECT RATIFICATION HISTORY

- **Russia started ratification procedure in 1996**
- **Evolution of RF State Duma position:**
  - **1997: No – but linked to WTO accession,**
  - **2001: Russia will ratify ECT, but not yet (depending on Transit Protocol)**
- **Major Russia's concerns regarding ECT ratification relates to gas transit issues or to the issues outside the scope of the ECT**
- **Successful finalisation of Transit Protocol = key to reopen ECT ratification issue**

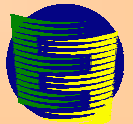


# KEY ARGUMENTS AGAINST ECT RATIFICATION IN RUSSIA

– related to the substance on ECT

## Opponents, as if:

- **ECT demands mandatory TPA to Gazprom's pipelines for cheap gas from Central Asia**
  - No such obligation. ECT excludes mandatory TPA (ECT Understanding IV.1(b)(i)). Transit is only one of the available options (+ on-border purchases, swaps)
- **Obligation to transit Central Asian gas through Russia at low (subsidised) domestic transportation tariffs**
  - No such obligations (ECT Article 7(3)). Transit and transportation are different in non-EU states (it being further clarified in draft Transit Protocol)
- **ECT will “kill” LTCs**
  - Not true. ECT documents do not deal with LTC as such at all. Economic niche for LTCs will become more narrow due to objective reasons, but they will continue to exist as a major instrument of financing Greenfield oil & gas projects. ECT supports LTC by diminishing political and regulatory risks.

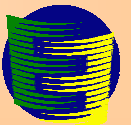


# KEY ARGUMENTS AGAINST ECT RATIFICATION IN RUSSIA

– *non*-related to the substance on ECT

**Opponents: ECT does *not* address/solve/regulate problems of:**

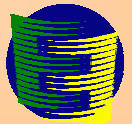
- **Bilateral RF-EU trade in nuclear materials**
  - Prior to ECT signing in Dec.1994, RF and EU has agreed in July 1994 to regulate nuclear trade on a bilateral basis (RUF-EU Partnership & Cooperation Agreement).
- **Black Sea straits**
  - 1936 Montreaux Convention on the regime of the Turkish Straits sets forth freedom of passage and navigation,
- **Maritime transit of oil & products**
  - Maritime transportation is covered by the UN Convention on the Law of the Sea





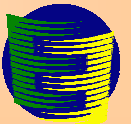
# ENERGY CHARTER PROTOCOL ON TRANSIT

- **Multilateral phase of negotiations finished December 2002**
- **Three outstanding issues are left between Russia and EU to be solved first on bilateral level:**
  - **Contractual mismatch (supply vs. transit arrangements),**
  - **Implementation of TP within the REIO (within EU),**
  - **Transit tariffs: correlation between cost-reflectiveness and auctions as congestion management mechanisms**
- **December 2005 Charter Conference + Chairman's letter to RF and EU, Jan'06: to provide before end-Febr'06 schedule for TP finalisation in 2006**

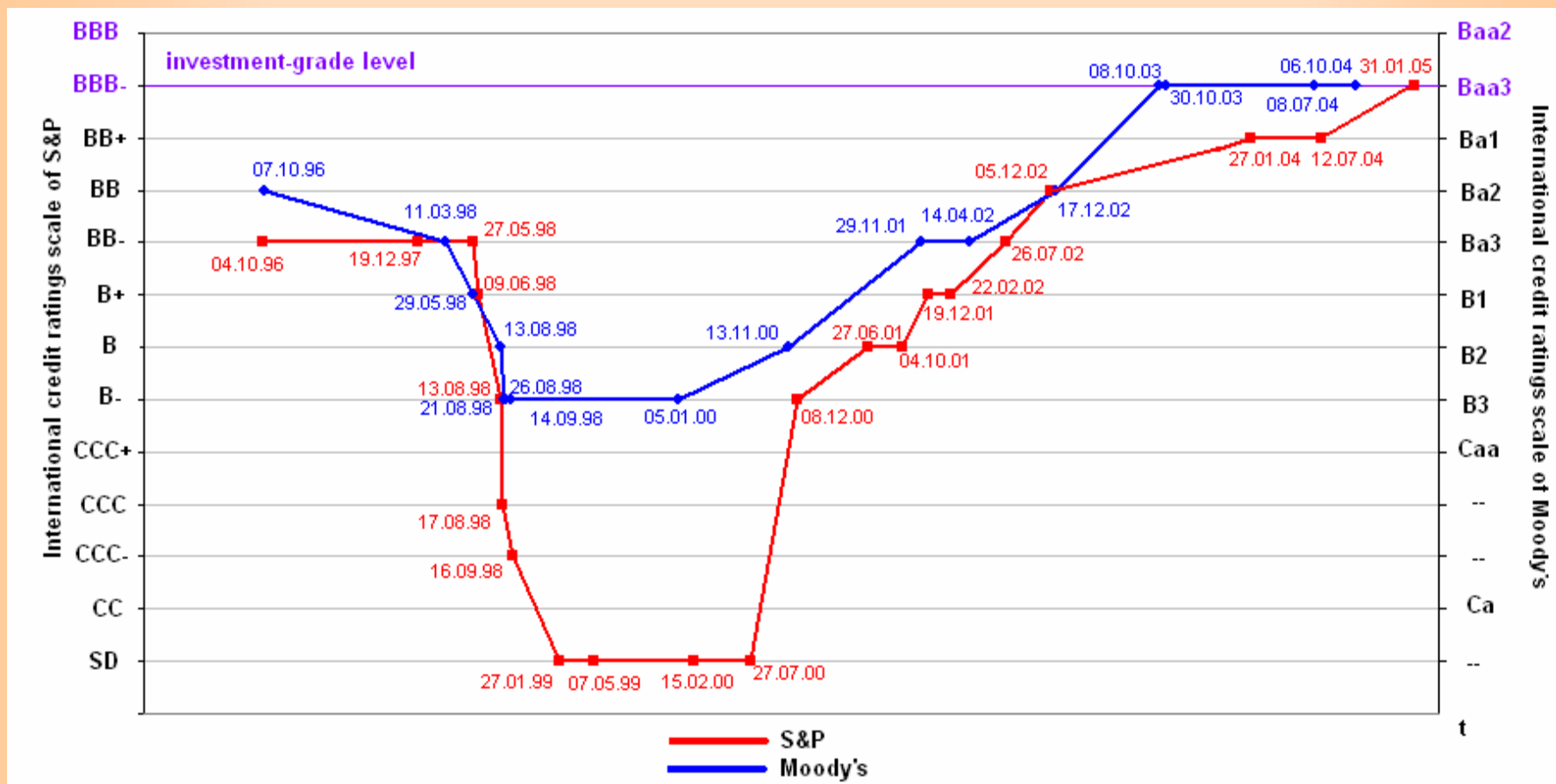


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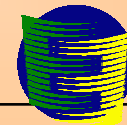
# COMPARATIVE RATING HISTORY OF RUSSIA (Standard & Poor's and Moody's)



# RUSSIA' LONG-TERM CREDIT RATINGS

	Moody's	Standard & Poor's	Fitch IBCA	Short description	LIBOR+	
<b>“Investment” ratings</b>	Aaa	AAA	AAA	Maximum security level	<b>Up to 4,25%</b>	
	Aa1	AA+	AA+	High security level		
	Aa2	AA	AA			
	Aa3	AA-	AA-			
	A1	A+	A+	Upper middle security level		
	A2	A	A			
	A3	A-	A-			
	Baa1	BBB+	BBB+	Lower middle security level		<b>Up to 6%</b>
	Baa2	BBB	BBB (Russia: rating was assigned 03.08.2005)			
	Baa3 (Russia: rating was assigned 08.10.2003)	BBB-(Russia: rating was assigned 31.01.2005)	BBB-			
<b>“Speculative” ratings</b>	Ba1	BB+	BB+	Non-investment, speculative level	<b>Up to 14%</b>	
	Ba2	BB	BB			
	Ba3	BB-	BB-			
	B1	B+	B+	High speculative level	<b>Up to 19%</b>	
	B2	B	B			
	B3	B-	B-			
	Caa	CCC+	CCC	Significant risk, issuer is facing hard difficulties		
	--	CCC	--			
	--	CCC-	--			
	Ca	CC	--	Highest speculative level, possibility of default		
	C	C	--			
	--	--	DDD	Default	<b>Up to 204%</b>	
	--	SD	DD			
	--	D	D			
--	--	--				

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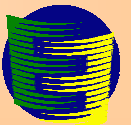
# **RUSSIA'S SOVEREIGN RATINGS ARE WITHIN "INVESTMENT RATINGS" ZONE, *BUT* CREDIT RATINGS OF RUSSIAN PROJECTS ARE WITHIN "SPECULATIVE RATINGS" ZONE**

## **Rule of project financing:**

**Cumulative long-term credit rating of the project = sovereign rating + company/investor rating + project rating;**

**Cumulative long-term credit rating of the project can not usually be better than the sovereign rating of the host state;**

**If Russia's long-term credit rating is at the bottom of "investment ratings" zone – that means that long-term credit ratings of Russian investment projects are placed within "speculative ratings" zone with corresponding LIBOR+ values for debt/project financing**



# **NON-RATIFICATION OF ECT BY RUSSIA = ITS COMPETITIVE DISADVANTAGE**

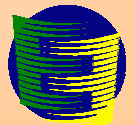
**Russia's objective competitive disadvantages: longest distances to markets + falling production at major fields + more complex geology (from Senoman gas of W.Siberia to Valanzhin, Achimov, offshore, Yamal gas) + harsh natural conditions of new areas**

**Russia: Highest stimuli to diminish technical and financial costs of production and transportation:**

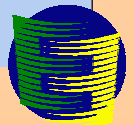
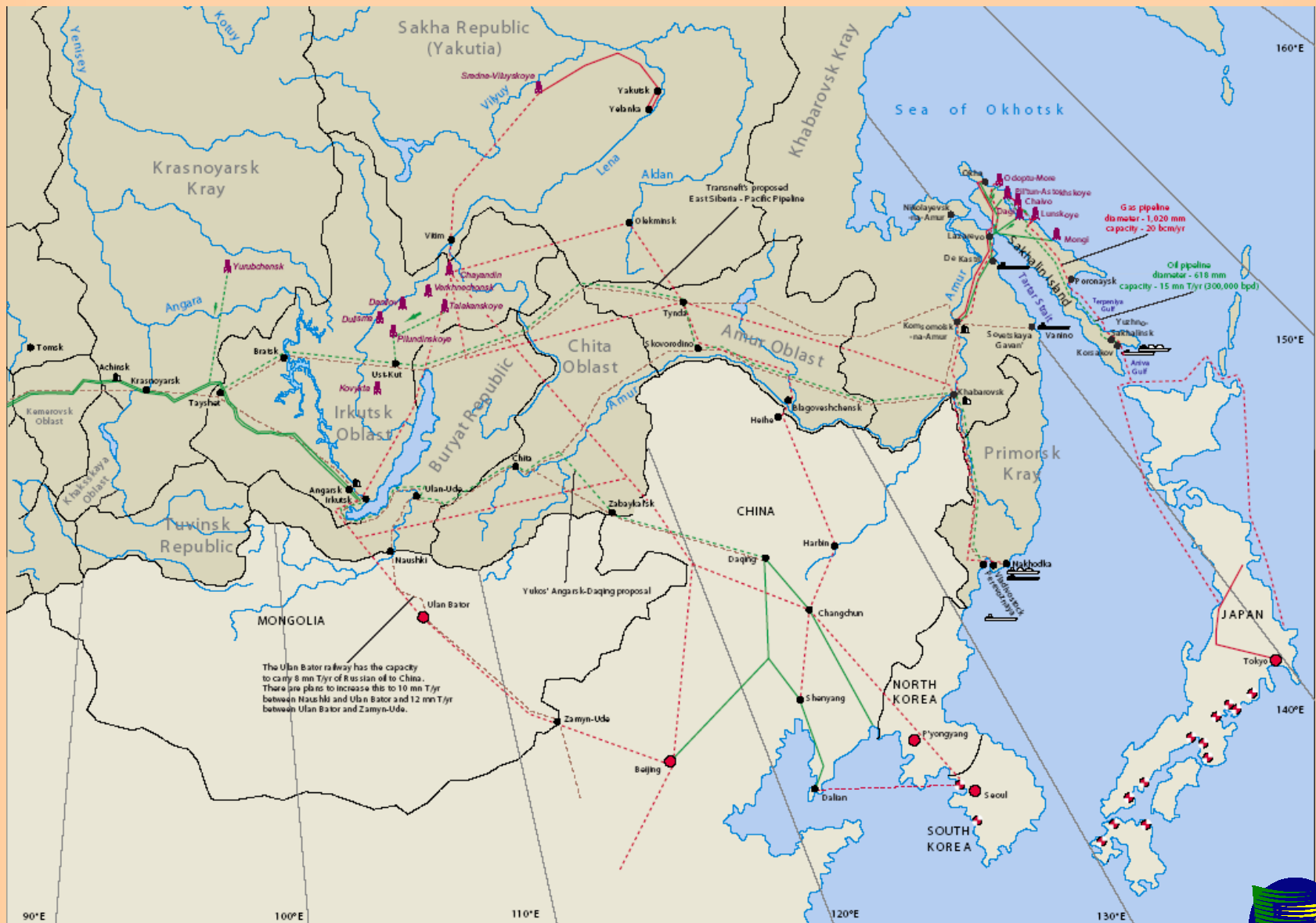
- (a) technical costs ← investments ← legal environment in host and transit countries (risks)**
- (b) financial costs ← cost of capital ← credit ratings (sovereign, corporate, project) ← legal environment in host and transit countries (risks)**

**ECT and related documents (when ratified) = common legal environment minimizing risks and technical & financial costs for investors from ECT member-states in ECT member-states**

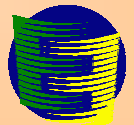
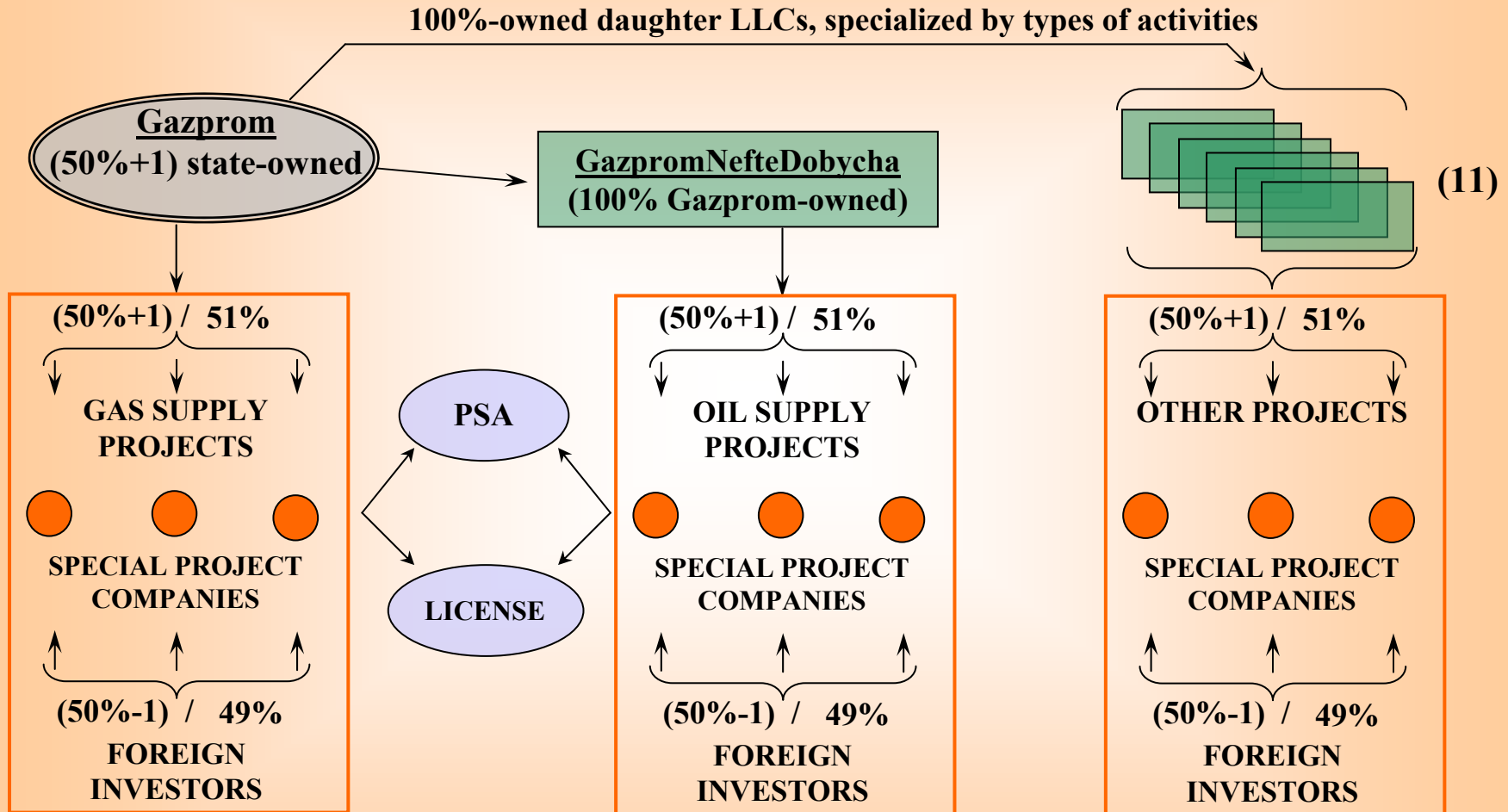
**Incremental stimuli for ECT ratification by Russia**



# EXISTING AND PROJECTED ENERGY INFRASTRUCTURE IN THE RUSSIAN EASTERN SIBERIA AND FAR EAST



# STATE-OWNED GASPROM AND FOREIGN INVESTORS: HOW IT WOULD WORK

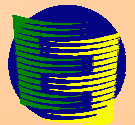




# INVESTMENTS SOURCES FOR RUSSIAN GAS SECTOR

	2005	2010	2015
<b>Investments</b> (bln USD)	<b>9.8-10.9</b>	<b>14.9-17.0</b>	<b>21.1-36.6</b>
<b>Equity</b> (net profit + depreciation) (bln USD)	<b>9.4-9.5</b>	<b>11.2-12.2</b>	<b>11.2-13.5</b>
<b>Debt</b> (bln USD)	<b>0.4-1.4</b>	<b>3.7-4.8</b>	<b>9.9-23.1</b>
<b>Debt/equity</b> (%/%)	$\frac{4-13}{96-87}$	$\frac{25-28}{75-72}$	$\frac{47-63}{53-37}$

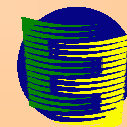
**Source:** Russia's oil & gas development strategy (2005), p.42 (calculations based on marginal parameters of "basic", "investment" and "target/innovation" scenarios, in current prices)



# INVESTMENTS IN GAS SECTOR OF RUSSIA: POSSIBLE ROLE OF THE ECT («cost» of the ECT non-ratification by Russia)

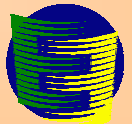
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<b>Debt (bln. USD)</b>	<b>0.4-1.4</b>	<b>3.7-4.8</b>	<b>9.9-23.1</b>
<b>Δ LIBOR = (mln.USD/year):</b>			
<b>1%</b>	<b>4-14</b>	<b>37-48</b>	<b>99-231</b>
<b>5%</b>	<b>20-70</b>	<b>185-240</b>	<b>495-1155</b>

- **Decisions for 2015 investments are to be taken & documentation to be drafted soon**
- **Due to the development of new fields of Yamal and East Siberia and access to the Asian market “gas interests” of Russia are now even more linked with tasks and objectives of the Energy Charter**

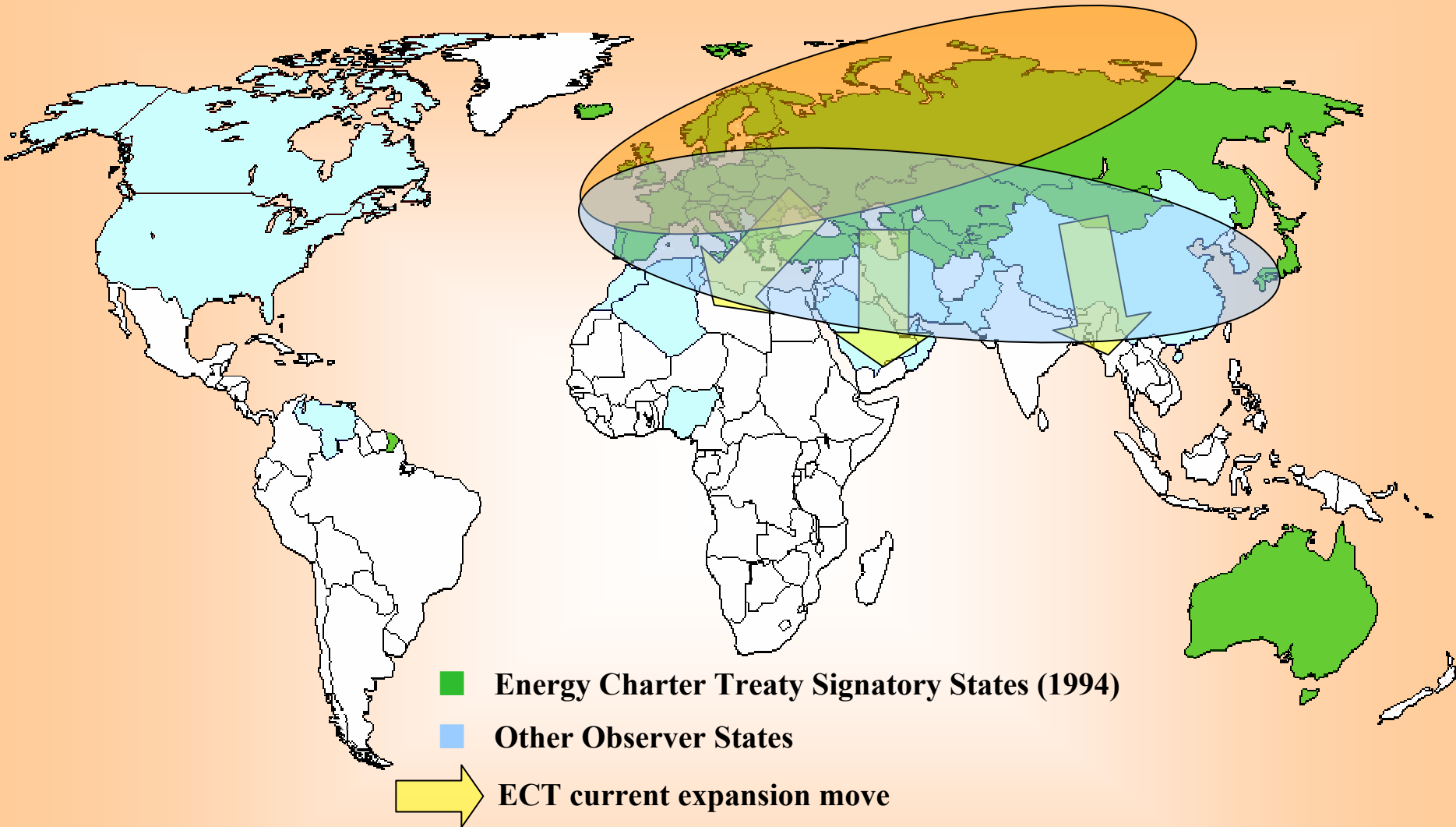


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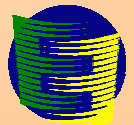
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# ENERGY CHARTER PROCESS: GEOGRAPHICAL DEVELOPMENT

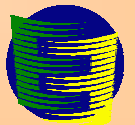


1. From trans-Atlantic political declaration to broader Eurasian single energy market
2. ECT expansion is an objective and logical process based on economic and financial reasons



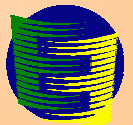
# **ECT EXPANSION PROCESS: ASIAN DIMENSION DOMINATES**

- **New ECT members:**  
**Mongolia - 1999**
- **New ECT observers:**  
**China – 2001**  
**Korea Rep. – 2002**  
**Iran – 2002**  
**Nigeria – 2003**  
**ASEAN – 2003**  
**Pakistan – 2005**



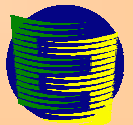
# ECT-RELATED INTERESTS FOR JAPANESE BUSINESS (1)

- **Energy imports (Japan = net-importer of energy) => diversification of supply origins: from dominance of Middle East supplies - shift towards Russia (Sakhalin, Eastern Siberia), other non-OPEC Asia, etc.:**
  - Trade in EMP (ECT: trade, transit, DS)
  - Investment in production & transportation of EMP (ECT: investment, trade, transit, DS)
- **Export of capital (Japan = net-exporter of capital) => direct & financial investment worldwide, major interest to Asia:**
  - Production of equipment for energy industries & end-users of energy (ECT: investment, trade, EE/PEEREA, DS),
  - Energy production in third countries for third countries (ECT: full package)



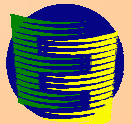
## **ECT-RELATED INTERESTS FOR JAPANESE BUSINESS (2)**

- **ECT ratification by Russia**
  - **Russia as key future energy supplier**
  - **Russia as future market for co-production (in cooperation with Russian companies) of high-tech energy efficient equipment**
- **ECT expansion – Asian dimension**
  - **Non-OPEC Asia as additional energy supplier**
  - **Asia as a market for energy-related equipment**
  - **Asia as market for energy-related financial investments**



## **RUSSIA'S 2006 G-8 PRESIDENCY AND ECT**

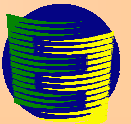
- **“Energy security” – key topic for Russia’s 2006 G-8 Presidency. ECT is effective (cost/benefit) instrument of providing “energy security” throughout all cross-border energy value chains,**
- **Energy Charter – the only international organisation dealing with energy issues which decisions are legally binding, where Russia is full member,**
- **All G-8 countries have signed Energy Charter political declaration. That is good basis for developing energy cooperation within G-8 states (common political fundament is already there),**
- **ECT ratification by Russia (or: new start of ratification procedure) may act as valuable input of my country in implementing “energy security” philosophy within Eurasia and as culmination of Russia’s G-8 Presidency.**





**Thank you for your attention!**

**[www.encharter.org](http://www.encharter.org)**



# **BACK-UP SLIDES**

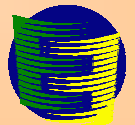
# MAIN CONTENT OF SELECTED INTERNATIONAL INVESTMENT-RELATED AGREEMENTS

Organisation (members)	Legal Status	Scope	Investment	Trade	Transit	Energy Efficiency	Dispute Settlement
<b>ECT (52)</b>	<b>LB</b>	<b>Energy</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>
<b>WTO (149)</b>	<b>LB</b>	<b>General</b>	<b>(Yes) Services</b>	<b>Yes</b>	<i>Yes/No*</i>	<i>No</i>	<b>Yes</b>
<b>NAFTA (3)</b>	<b>LB</b>	<b>General</b>	<b>Yes</b>	<b>Yes</b>	<i>No</i>	<i>No</i>	<b>Yes</b>
<b>MERCOSUR (4)</b>	<b>LB</b>	<b>General</b>	<b>Yes</b>	<b>Yes</b>	<i>No</i>	<i>No</i>	<b>Yes</b>
<b>OECD (30)</b>	<b>LB</b>	<b>General</b>	<b>Yes</b>	<i>No</i>	<i>No</i>	<i>No</i>	<i>No</i>
<b>APEC (21)</b>	<i>Non-LB</i>	<b>General</b>	<b>Yes</b>	<b>Yes</b>	<i>No</i>	<i>No</i>	<i>No</i>

\* application of GATT Art.V to grid-bound transportation systems is under debate

Plus specialised energy-related organisations: OPEC, IEA, IEF, UN ECE

Plus specialised “regional” organisations: BSEC, BASREC, ...

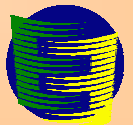


# **ENERGY CHARTER PROCESS: TO ADDRESS SPECIFIC ENERGY RISKS IN A GLOBAL CONTEXT**

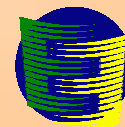
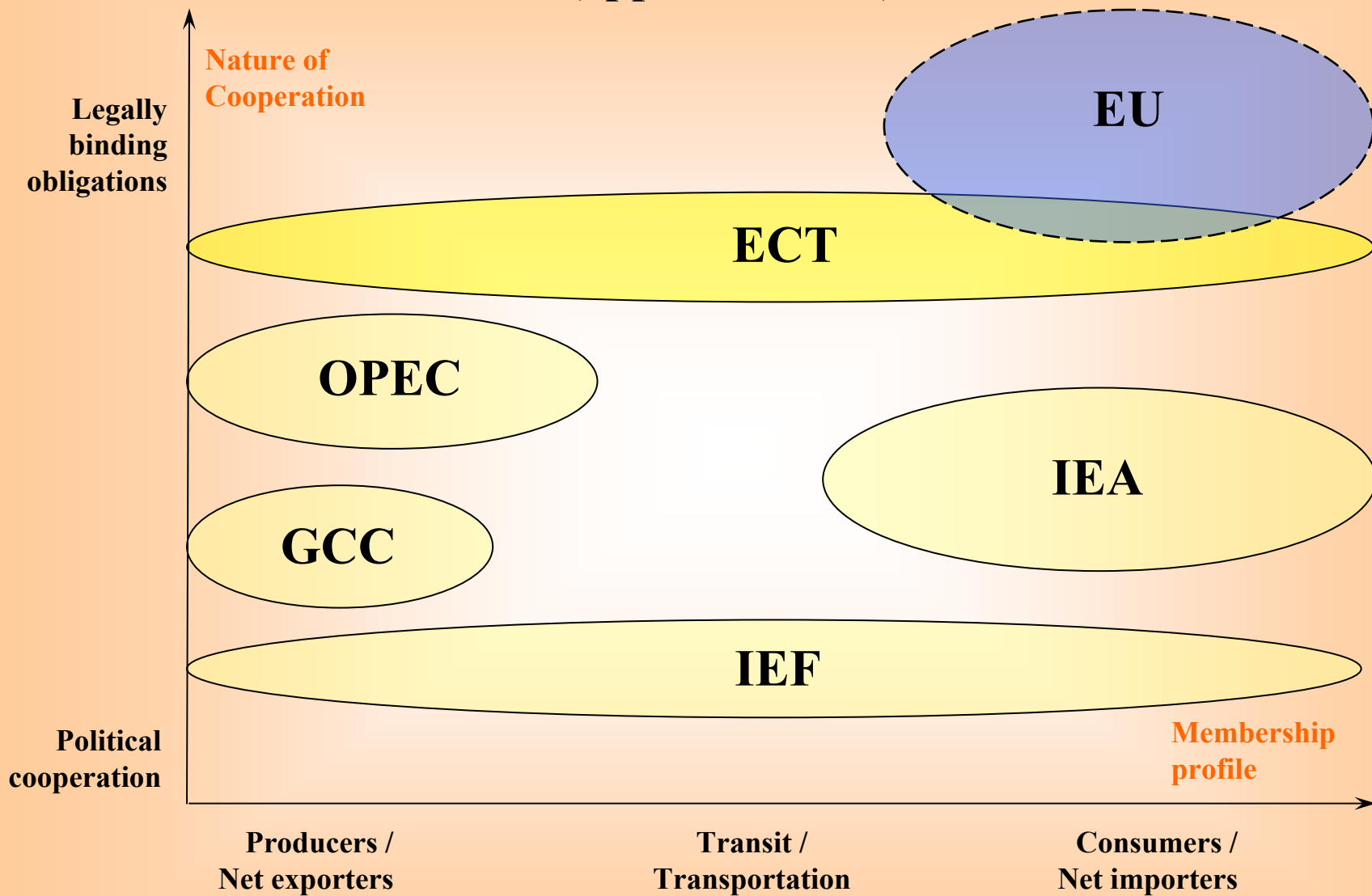
## **Energy projects (compared to other industries):**

- Highest capital intensity (absolute & unit CAPEX per project),**
- Longest project life-cycle,**
- Longest pay-back periods,**
- Geology risks (+ immobile infrastructure, etc.),**
- Highest demand for legal & tax stability,**
- Role of risk management.**

**A competitive niche exists for energy-related multilateral international organisations – at least to address specific character of energy risks.**



# SOME ENERGY-RELATED INTERNATIONAL ORGANISATIONS (approximation)



# INVESTMENTS ON IMPLEMENTATION OF RUSSIAN ENERGY STRATEGY UP TO 2020 (1)

- **Annual oil & gas investments (huge and upward trend with time):**

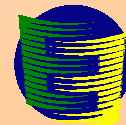
**RES, 2001 (2001-2020): \$ 16-18,5 bln**

**RES, 2003 (2001-2020): \$ 20-22 bln**

**IEA, 2004 (2003-2030): \$ 24 bln**

**RO&GS, 2005 (2005-2015): \$ 27-37 bln**

**Sources:** ЭС-2020 (2001), с.144-149; ЭС-2020 (2003), с. 193-196; IEA WEO (2004), р.325; Стратегия развития нефтегазового комплекса России на период до 2010-2015 гг. (2005), с.43



# INVESTMENTS ON IMPLEMENTATION OF RUSSIAN ENERGY STRATEGY UP TO 2020 (2)

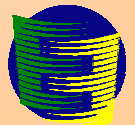
- **Investment sources acc. to RES-2020 (own sources of energy enterprises in investments into fixed assets of fuel & energy complex):**

**Today = 85%,**

**2001-2010 = 80-90%,**

**2010-2020 = 70-75%**

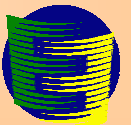
**Sources:** ЭС-2020 (2001), с.144-149; ЭС-2020 (2003), с. 193-196; Стратегия развития нефтегазового комплекса России на период до 2010-2015 гг. (2005), с.43



# **INVESTMENTS ON IMPLEMENTATION OF RUSSIAN ENERGY STRATEGY UP TO 2020: LEGAL ASSURANCE**

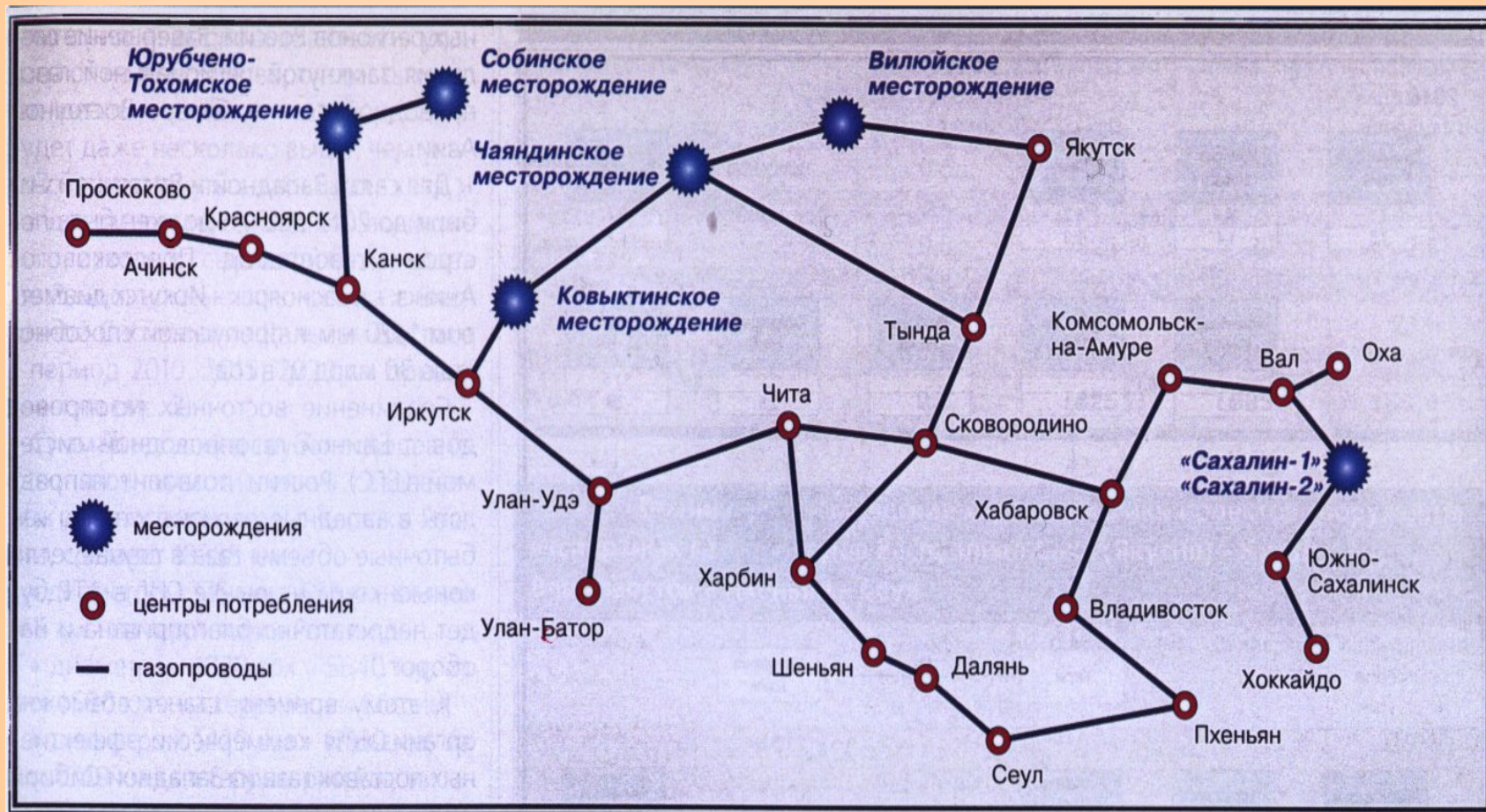
- **Investments in new big projects would be mostly made on project financing basis**
- **Creation of legislation acceptable for project financing in energy upstream industries aimed at improvement of both:**
  - **licensing system, and**
  - **PSA regime**
- **Improvement of legislation on concessions and foreign investment**

Source: ЭС-2020 (2001), c.144-149; ЭС-2020 (2003), c. 193-196

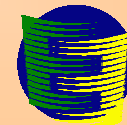




# OUTLINE OF THE GAS SUPPLY SYSTEM IN THE EAST OF RUSSIA AND NORTH-EAST OF ASIA (UP TO 2020)



According to the Institute of Oil and Gas Geology, Russian Academy of Sciences, Siberian Branch  
Source: "Oil of Russia", № 11, 2004, p.59

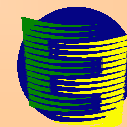


# TOTAL CAPEX IN DEVELOPMENT OF GAS-TRANSPORTATION SYSTEM IN THE RUSSIAN EASTERN SIBERIA AND FAR EAST

<b>Pipeline diameter, mm/inches</b>	<b>Up to 2010</b>	<b>2011-2015</b>	<b>2015-2020</b>	<b>Total up to 2020</b>
<b>325/...</b>	<b>0</b>	<b>166</b>	<b>0</b>	<b>166</b>
<b>1020/...</b>	<b>1605</b>	<b>885</b>	<b>4625</b>	<b>7115</b>
<b>1420/...</b>	<b>6011</b>	<b>12248</b>	<b>0</b>	<b>18259</b>
<b>Total</b>	<b>7616</b>	<b>13299</b>	<b>4625</b>	<b>25540</b>

According to Institute of Oil and Gas Geology, Russian Academy of Sciences, Siberian Branch

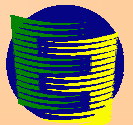
Source: "Oil of Russia", № 11, 2004, p.59



# **PRESIDENT V.PUTIN ON MAJOR ISSUES OF RUSSIAN ENERGY ECONOMY**

- **Radically improve business climate, quality of corporate governance, investment attractiveness**
- **Competent legal regulation, optimal taxation**
- **Stimulate Greenfield E&P and Brownfield O&G recovery**
- **Mineral resources transparency and reproduction (improve R/P ratio)**
- **Find a balanced development model (unite capacities and interests of the State, subsoil users, private investors)**
- **Speed-up technological modernization (domestic energy equipment)**
- **R&D, incl. environmentally-safe nuclear energy, energy-saving technologies, deep processing of energy resources**
- **More actively utilize potential of international cooperation, attract foreign experience and investments for technological modernization of Russian energy economy**

**From the speech at the RF Security Council meeting on “Role of Russia in providing for international energy security”, December 2005**



# RUSSIA, ENERGY, INVESTMENTS

- **“Russian energy economy has three major tasks for 2006 – investment, investment and once more investment”.**

From the speech of A.Chubais (CEO, RAO UES of Russia) on December 22, 2005, at the grand rally on the occasion of Russian energy economy professional red-day

- **“...the birth of new ascending trend, under which, most probably, the next five-year period of Russian economic development will take place. Large projects, large investments – with the huge participation and dominance of the State. The strategy of transforming Russia into the energy leader of the world economy, that was voiced by Vladimir Putin during the penultimate week of the year, demonstrates that determination for substantial investments has finally matured within the state power. We may not like such dominance of the State in the economic sphere, but for all that we can not disagree that without its participation the implementation of such large-scale strategic projects is in principle impossible.”**

“Expert”, № 49, 26 December – 1 January 2006, p.13.

