

CHAPTER-6

ISSUES & OBSTACLES INVOLVED IN AGG

6.1 TRANSIT THROUGH THIRD COUNTRIES

Cross border trade is an age old concept. In earlier days when currency notes had not been introduced, trade was established through barter system. After establishment of the East India Company in India, British traders used to come to India and sell their goods and in lieu of the same, they took back spices, gold etc. Similarly, in this era when all development is based on energy, cross-border transport of energy in the form of piped natural gas is inevitable. Today, it may be a dream, but by 2025 it will become reality. Every giant leap has its first stride which faces different obstacles either in the form of inner resistance or external opposition.

A joint UNDP/World Bank study has reported that:

“Cross-border oil and gas pipelines have a history of vulnerability to disruption and of generating conflict. While it is true that most operating pipelines have avoided such problems, the minority that has such a history have cast a much greater shadow than their actual numbers might justify. This negative perception inhibits both the operation of existing lines and the building of new ones.”

Governments can only enact domestic laws, although much of energy trade is global. However, governments can enter into multilateral treaties, which they can put into effect as domestic laws.

Numerous intergovernmental organizations (IGOs) have been created to facilitate international energy trade and its environmental impacts. The Energy Charter Conference stands out as one such IGO that has significantly increased its global influence.

Where cross-border pipelines need to transit third countries, transit arrangements must be settled before development is able to commence. These arrangements include transit fees, off take and input arrangements, taxation and regulation. Treaty-based transit protection reduces political risks, while at the same time leaving it to the parties and the transit country to work out their detailed contractual arrangements. The Energy Charter Treaty (ECT) provides a ready-made mechanism by which transit rights can be entrenched.

Under the ECT, negotiations for a detailed Protocol on Transit have been going on for some years. It is hoped they will soon conclude successfully. If the AGG goes ahead, opportunities may emerge for the transit countries to install local power generation and cogeneration plants in coastal towns adjacent to the pipeline route.

6.2 COMPLEXITY OF NEGOTIATIONS

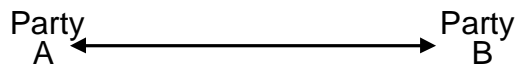
The negotiation of investment agreements for infrastructure projects is a complex, lengthy and expensive process. It is only the most substantial investors who can afford the time and cost to see these negotiations through to the end. In international negotiations involving projects for the private development of infrastructure, there can be an unequal understanding of the “rules of the game” and confusion about total trade flows versus values created from the various stake holders. There is often great tension in public-private sector deals, especially if a developing economy is involved, and its officials are participating in project negotiations for the first time.

In projects that involve multiple parties, it is essential for the parties to test their preconceptions, to re-evaluate their goals and to redesign their proposed dealings so as to either reduce the number of contracting parties or minimize the level of contractual complexity.

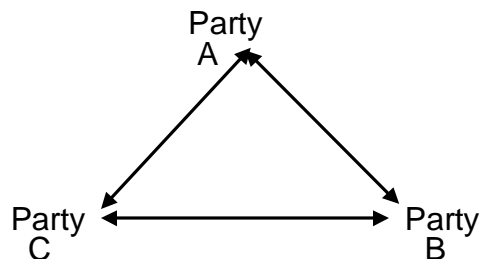
Negotiating sound and durable investment agreements for cross-border projects does not involve special science, but it often requires special facilitation and guidance. To begin with, such projects normally bring together in an international transaction various participants, including public officials, who would otherwise have had little to do with each other. In their negotiations these people need to transcend national and cultural boundaries and establish an overriding mutuality of purpose. Public officials, for their part, may need to contend with competing or unsympathetic constituents within their own government.

Most trilateral or quadrilateral deals involve contractual complexity to a degree well beyond the level to which parties and their lawyers have been trained to cope with or may have ever encountered. This is illustrated in figures below.

Complexity of Multi-Party Contractual Relationship



A bilateral relationship depends on two sets of rights and obligations



A trilateral relationship has three times the complexity of a bilateral relationship

because it depends on six sets of rights and obligations.

A quadrilateral relationship has six times the complexity of a bilateral relationship because it depends on 12 sets of rights and obligations. A five-party relationship involves 10 times the complexity of a bilateral relationship and easily outstrips the capacity of the parties and their lawyers to stabilize their relationship by orthodox contractual means. In case of AGG it would involve multilateral negotiations not only with participating countries, but other influencing countries are also required to be taken in the boat.

From the start of negotiations, it is important to strive to minimize contractual complexity. One technique of achieving this in the case of jointly-owned projects, is to utilize incorporation laws to establish joint ventures, in preference to contractual structures. This process requires substantial work to allow effective tax planning and expense-offsetting.

Parties who succeed in putting others into legal strait-jackets can unwittingly sow the seeds of instability in the real relationship, if they fail to appreciate that the legal issues are inseparable from the surrounding political, financial, policy and social issues.

The real glue to hold cross-border projects together is not the legal framework so much as mutual benefit.

6.3 REGULATION

Need for Effective, Stable and Fair Domestic Regulation

Each country needs to establish an effective, stable and fair scheme of domestic regulation on gas pipelines. The role of government is to design and put in place the regulatory scheme; the role of the independent regulator is to implement it. The regulator does not, or certainly should not, make its own regulatory rules.

Principles of Effective Regulation

- The regulator should be legally and organizationally separate from the government and the utilities.
- The objectives of the regulator should be specified in clear and unambiguous terms.
- The scope for the regulator to exercise personal discretion should be limited, in order to maintain confidence in the impartiality of the regulatory process.

- Regulatory procedures should be transparent and easy to administer
- Regulatory procedures should be carried out promptly.
- A method of review of network pricing should be specified. This should enable network operators to benefit from efficiency improvements and lead to simple, automatic adjustments.
- The regulator should be able to obtain direct access to information about service quality and user satisfaction, with mechanisms to consult the public.
- The regulatory system should function free from political interference.
- The regulatory system should be legally accountable for its actions by a prompt and effective appeal process.

There are two broad options by which the establishment of an effective regulatory scheme can be achieved:

- The first is by the enactment of legislation to establish an independent regulatory scheme applicable to the entire industry.
- The second is “regulation by contract”, by the negotiation of contractual regulatory arrangements with the energy facility operator on an individual basis.

In the case of governments in economies which are not accustomed to independent regulatory systems, it may be more palatable for political reasons to have regulatory controls negotiated and set out in particular contractual arrangements. These may be easier for some governments to implement than the establishment of an independent regulatory agency at the outset, and may be seen by investors as offering more certainty, security and stability for their investment. Such contractual arrangements must however be enforceable against governments.

The approach taken for “economic regulation” or pricing regulation is often more complex because a gas user pays for two components:

- The energy value of the gas, and
- The cost of transporting the gas from the source of supply.

In the early life of projects, typically for the first 15 years or so, investors strongly prefer pipelines to enjoy a regulation-free period, or at least have clarity about regulation for its project term and envisaged expansions. This

enables investors to negotiate freely with the gas suppliers and customers for use of the pipeline, and enables the investors to establish a secure revenue stream to service and retire debt. Heavy handed or uncertain regulation has a chilling effect on pipeline investment.

It should be in the normal commercial interest of the pipeline operator to maximize throughput.

The “use-it-or-lose-it” principle should apply. That is, if a customer contracts for pipeline capacity but does not intend to use it, the pipeline operator must be informed, so that this capacity could be made available to others in the market.

Approaches to Regulatory Harmonization

Regulatory harmonization does not mean that each economy involved with a cross border project, whether as exporting, importing or transit nation, will necessarily adopt a uniform or standardized regulatory regime. The goal of harmonization is to remove the uncertainty of local law and regulatory regimes. The process of regulatory harmonization depends on the legal, commercial and cultural similarities of the exporting and importing countries.

Possible approaches include:

- multiparty project agreements between the respective governments and the commercial sponsors
- project specific agreements or framework treaties between sovereign states
- special purpose enabling legislation and regulations.

A combination of the above approaches could be necessary where there are serious political and commercial risks.

Multi-party project agreements raise concerns about the extent that respective governments are willing to give undertakings regarding:

- waiver of sovereign immunity
- whether foreign law will control the interpretation of the agreement
- performance guarantees and credit support for state-owned enterprises
- consent to participate in, and be bound by, international arbitration and dispute resolution procedures rather than invoking the jurisdiction of its

courts.

Project agreements or framework treaties have been used successfully to promote cross-border natural gas trade. Typically, they have recognized the right of the respective states to assert regulatory authority over the portion of the pipeline system that is within their jurisdiction rather than adopt uniform rules.

Special legislation may be necessary when contracts and trade agreements are not sufficiently robust for the project participants and their financial backers. Regulatory exemptions, waivers of law, and tax holidays have also been used to underwrite governmental support for cross-border gas projects.

Critical issues to consider in regulatory harmonization are

- whether the project will have an exclusive right to serve the market
- non-discriminatory treatment for all projects that either export or import natural gas
- market-based pricing, including the ability to pass through contractual price adjustments and take-or-pay payments
- recognition of a tax-efficient project entity that owns, finances and operates the project and ensures that income will flow to the sponsors
- simplification of project construction permitting and licensing in coordination with project milestones
- coordination of environmental base-line studies, permits and public involvement processes
- the extent and time frame for third parties to have access to project facilities
- regulatory bodies in each jurisdiction to avoid the disruption of contractual relationships to the maximum extent
- a single layer of taxation with a mechanism agreed between the participating states for the distribution of revenue
- elimination of separate excise (VAT) taxes, withholding taxes, customs duties and transit fees.

Tendency to Regional Regulation

For cross-border gas pipelines, there is an emerging need for, and there is

already a tendency to move towards, regional regulation.

The regional initiatives which have been seen to date have been relatively informal cooperative initiatives taken by domestic regulators with the approval of domestic governments and were not required to be supported by international legal regimes.

Within the EU, there is an emerging model of a regional regulatory framework and consistent standards between its member countries which have evolved since the EU initiated the annual Madrid Gas Regulation Forum.

Regional trade agreements have also served as platforms for securing access to both supplies and markets. In terms of regulatory harmonization, the signatory states agree to limit regulatory measures that discriminate against its nationals, or impose restrictions on imports and exports and export taxes.

6.4 INTERNATIONAL ENVIRONMENTAL STANDARDS

Agreement on applicable environmental standards for pipeline construction and operation is of pivotal importance.

In an era when the principle of sustainable development is globally acknowledged, reliance on internationally recognized environmental standards offers a more reliable basis for investment than domestic standards. A particularly sensitive issue for investors is the risk of any subsequent tightening of environmental regulation in excess of recognized international standards.

6.5 HARMONIZATION OF TAXATION REGIMES

Harmonization of taxation regimes primarily requires a single method for assessing income and capital allowances. It is preferable to grant the project exemptions from excise taxes, withholding taxes on dividends, customs duties and transit fees. Often these issues are dealt with in bilateral investment treaties.

Once the taxation regime is established, there are three variations for apportioning tax revenues from cross-border gas projects, when there are facilities located in more than one economy:

- (i) the value of facilities or length of pipeline located in each economy
- (ii) the quantity of natural gas delivered in each economy or
- (iii) a combination of (i) and (ii).

Harmonized taxation regimes provide support for financing, as revenue flows and tax obligations are easier to forecast. Financiers will always have more confidence in a project whose fiscal structure is transparent.

Like other commercial sectors, the natural gas industry is subject to imposition of taxes on company income and shareholder dividends. Corporate tax rates can vary substantially, making business structures important in determining 'tax domicile'. Many countries have adopted income tax provisions specifically for the petroleum industry that provides for accelerated write-off of development expenditures or depletion allowances for both domestic and foreign oil and gas.

Further liberalization and adjustment in the taxing of energy projects is required. In particular, when complex joint ventures are established for different parts of an energy project, the ability of proponents to efficiently structure or restructure their projects is hampered by inflexible tax laws.

The facilities and infrastructure required for efficient and reliable production and marketing of natural gas are supported by complex contractual and financing provisions that specify delivery rates and mechanisms for price adjustment for several years into the future. These provisions, such as take-or-pay obligations, can have tax implications as well.

In a world of higher energy prices, gas exporters can face a potential dilemma of higher netback prices for export gas over those available in the domestic market. While this might not be a problem in economies where the government controls or owns the energy-producing assets, a free market environment will see the resource developer striving to secure the highest returns for its shareholders.

6.6 INVESTMENT PROTECTION

Most investors will carry out their investment decision-making process in three stages:

- first, they will evaluate the potential economic return
- second, they will assess the investment risks and
- third, if the potential risk-adjusted economic return is considered to outweigh all of the risks, and the requirements of "bankability" are satisfied, they will decide whether or not to go ahead.

Generally speaking, if a host economy does not provide a secure and stable

legal framework for infrastructure investment, most investors are likely to balk. The project's attractiveness would not make any difference to investors in the absence of an adequate legal framework, nor would taxation or other financial inducements the government might offer.

When gas pipeline tariffs are capped at low levels or are vulnerable to regulatory intervention, investors will be less likely to accept an inadequate legal framework. Recently there have been some widely noted failures in energy infrastructure investment projects, notably in Indonesia, Pakistan, India and Argentina. These as a rule had followed an economic and financial crisis.

Sometimes, the constitutional and legislative safeguards offered by a particular host jurisdiction would not by themselves be sufficient to satisfy the needs of investors. Apart from seeking improved legislation, other measures to overcome legal inadequacies, such as investment agreements with the host government, and equity participation by the host government, can be considered. "Investment agreement" in this context means either an agreement, a license or a concession, or a combination of any of these, entered into with, or granted by, the host government to underpin an infrastructure investment.

Investment agreements can make appropriate provision for approvals processes, regulation of prices, technical and operational issues and environmental and other matters. Such agreements may overcome some of the other legal problems inherent in the lack of legislation.

If there is no existing regulatory regime, or if it is considered to be inadequate, investment agreements can establish a legally secure regulatory framework under which an investment can be made.

6.7 ISSUES & OBSTACLES IN VARIOUS PHASES OF PROJECT

Asian Gas Grid being an international project, wherein many countries of Asian region will participate, may have much obstruction from start to end. Probable obstructions in various phases of the project are as under:

a) Pre-Project Approval Phase

- Rules of the game are required to be clearly defined as many countries will participate in the construction of the pipeline as well as operation thereof. This is essential, for creating an environment in which the commercial issues of cross-border pipelines are amicably resolved.
- Different gas prices of different source.
- Fixation of gas prices may be important obstruction.

- Assurance of firm gas availability throughout the project life. Change of government should not have any impact on this.
- Relationship of countries with each other.
- More number of countries for one limb may be one of the obstructions.
- Supply countries may pose their own tantrums.
- Energy security strategies of participating countries may be different.
- Conflict of interest between buyer and seller.
- Large investments in cross-border pipelines and investors may like to ensure their return. Confidence building measures for investors are required.
- Private sector financing may not be available at the initial stage.
- Super powers of the world may not like AGG to be implemented.
- LNG lobby may not allow implementation of AGG.
- Unstable governments and threat from terrorism.
- Cross-border connections require harmonization of national, legal and regulatory frameworks, as well as gas pricing schedules. Transportation tariff may be a major obstacle.
- Sharing of profits, etc by participating countries.
- The benefits to different countries are of asymptotic nature, thus agreement on cost to be incurred by different countries will have to be agreed upon. Economic and financial viability and distributional consequences are therefore required to be studied carefully.
- Evolving of dispute resolution system. Difficulty in agreement of arbitration clause.
- Common technical standards for design and construction, operation and maintenance, safety, etc.
- Non-availability of down stream consumer's network: the main obstacle in use of natural gas is lack of terminals, long distance pipelines and

local network for transmission of NG for households as well as for industries.

b) Project Execution Phase

- Technical expertise to deal such a mammoth project.
- Different quality of gas.
- Large requirement of competent manpower of client, contractor and consultant.
- Cross-border pipelines have long history, and are vulnerable to disruption and conflict where transit is associated.
- Right of Way (ROW) related problems: As this line will pass through many countries having different rules and regulations in acquisition of land for execution of the pipeline.
- Approximate length of the pipeline will be around 14,000 km, probably having pipeline size of 56"/ 48". Thus the total steel requirement will be of the order of 70 lakh tones. This means almost all the steel mills will be busy for 2 to 3 years for supply of steel.
- Non-availability of contractors having adequate experience in the construction , operation and maintenance of pipelines
- Terrain of the pipeline may pose difficulty in laying the line, therefore route selection is required to be done cautiously.
- Custody transfer of gas: Provision of adequate metering system while entering into the country and leaving the country will have to be provided and gas balancing will be a problem. Metering system should be of the same type having the same accuracy level.
- Design related issues; availability of line pipe of such a large quantity will be cause of concern for this project.

c) Operation Phase

- Cross-Border lines are susceptible to disruption and conflict, which may be a cause of concern during operation phase.
- Gas reconciliation and balancing.

- Capacity utilization needs to be ensured, as low capacity utilization will have an impact on project profitability.
- Safety and security of pipeline in respective countries.
- Synchronization of maintenance schedule of compressors and pipeline.

d) Others

- Since this project will have many countries on board, coordinating agencies will have to ensure that all parties continue in the project till its completion and also thereafter. If all the countries benefit from the project, they will have the incentive to stay and resolve the conflicts amicably.
- This project is fraught with the risk of conflicts among participating countries, thus it is necessary to work out a sound disputes resolution before start of the project.
- Gas distribution is a monopoly held by state-owned petroleum companies in many ASEAN countries. This limits private sector participation and investment. For example, Indonesia hopes to open up the entire downstream sector with the passage of an oil and gas bill now before Parliament.
- Individual governments must also move towards market-based pricing system and away from practices, such as price intervention and tax distortions, that lead to inefficient pricing of natural gas and gas-related products and services. Proponents in Indonesia complain that natural gas cannot compete on price until diesel oil and other fuel subsidies are removed.

6.8 CONCLUSION

AGG will encounter many technical as well as commercial issues, but energy requirement will resolve all the issues. Given the large investments required, the main challenge is to design financing schemes that work. The World Bank can play a key transitional role in such projects. But there needs to be demonstrable commitment by all the participating countries for establishing sound regulatory and pricing policies.

Apart from the above, other obstacles will be encountered during execution of the project. These need to be identified in advance by experts so that timely and adequate action can be taken.