// CURRENT PRACTICE

INTERNATIONAL BAR ASSOCIATION SECTION ON ENERGY, ENVIRONMENT, NATURAL RESOURCES AND INFRASTRUCTURE LAW

Editor: Sean Rush *Petro-Canada Centre, Calgary, Canada*

the global voice of the legal profession

Vol 5 No 1 **APRIL 2009**

CURRENT PRACTICE

IN THIS ISSUE

Contributions to this publication are always welcome and should be sent to the editor at the address below:

Sean Rush
Senior Counsel, Petro-Canada Centre
150 – 6th Avenue SW, Calgary, Alberta T2P 3E3, Canada
srush@petro-canada.ca

FROM THE EDITOR

Welcome to this edition of *Current Practice*. These are remarkable times in which we live! In the four or so years that I have edited *Current Practice*, oil prices have marched steadily skyward and host governments have adjusted their take through surtaxes, forced equity participation, royalty reviews or other mechanisms. With record earnings still burning in their pockets, IOCs are tightening the purse strings in order to ride out the times. Meanwhile, host governments that have taken equity positions banking on windfall revenues are having a rethink – how to pay for the capex associated with an equity position when revenues have dropped by two-thirds?

Even the alternative fuel lobby has quietened as oil price has reduced gasoline and diesel costs to the consumer and the financial crisis affects the ability to finance alternative fuel options. Times like these produce a different workscope for energy lawyers: project negotiations become renegotiations, financing becomes refinancing, A and D becomes, well, D and A, IPO floatations become insolvencies, all of which, where unsuccessful, become litigation. These are the times that you find out the quality of your drafting!

This issue contains a wide variety of contributions from all over the globe and touches upon a variety of topics. These testing times have created new industries, challenges and markets of interest to SEERIL members. While doom and gloom in the financial sector seems to be the order of the day, it is encouraging to see new opportunities and solutions being explored by members in novel locations.

I hope you enjoy reading this issue of *Current Practice.*

Sean Rush

International Bar Association
10th Floor, 1 Stephen Street, London W1T 1AT, United Kingdom
Tel: +44 (0)20 7691 6868. Fax: +44 (0)20 7691 6544
www.ibanet.org

ASIA

The growing Sino–Central Asia energy nexus

Sasha Freeman
Fulbright & Jaworski LLP
sfreeman@fulbright.com

Despite China's swiftly rising energy demand, in the wake of the global financial crisis some analysts argue that China's energy demand will decline along with the decrease of the rate of its economic growth, on the grounds that its main export markets (the United States and Europe) are both suffering from the current financial crisis and the demand for Chinese products is dwindling. Although China's demand for energy may eventually slow down in the near future as a result of the global economy, it remains to be seen whether such an adjustment will be significant.[1] Current statistics show only an insignificant drop in industrial production growth, and preliminary manufacturing production figures show a month-on-month rebound.[2] In addition, recent Chinese policy reactions (such as a reduction of interest rates to bring the yuan's appreciation to a halt) are now well under way in order to sustain domestic growth given the gradual slowdown in the export sector.[3] Therefore, even if global economic growth slows down, China's oil demand growth can arguably remain positive in the foreseeable future.[4] The International Energy Agency kept its forecast for China's oil demand largely unchanged for 2008 and 2009.[5]

China's insatiable appetite for energy has driven it to Central Asia, the region known for its abundant oil and gas reserves. China's interest in Central Asian countries[6] is not a recent phenomenon; the relationship between the countries goes back to the 'Silk Road' as early as the 2nd century BC.[7] The only change today is that the traders have replaced jade, tea and silk with oil and gas. In the near future, China's relationship with Central Asia will continue to strengthen for a number of reasons.

China's rising demand for energy

Over the last decade, China's energy demand has escalated. As one of the world's fastest-growing economies (with real gross domestic product growing at a rate of 10 to 11 per cent per year), China's need for energy is projected to considerably increase in order to sustain its growth.[8] China's rapidly developing economy is mainly fuelled by oil, and today the country is the world's second-largest consumer of oil after the United States and the third-largest net importer of oil after the United States and Japan.[9] However, China's ability to provide for its own need for oil is limited by the fact that its proven oil and gas reserves are small in relation to its consumption.[10] China became a net oil importer in 1993, and its dependence on foreign oil continues to grow.[11] China currently imports over 46 per cent of its oil, and this number is expected to increase to 60 per cent by 2020.[12] Historically, natural gas has not been a major fuel in China and accounted for only three per cent of China's energy consumption in 2004, but its share in the country's energy mix is increasing as a result of the strong encouragement by the Chinese central government.[13]

Central Asia's abundant energy resources

China's rising energy demand has set it on a global quest to secure supplies of oil and natural gas. Beijing's strategy of investing in equity stakes to obtain control of overseas energy assets began in the early 1990s.[14] Rich oil and gas reserves of Central Asian countries, many of which border China, have made them attractive candidates as suppliers of both crude oil and gas. Even though estimates for oil and gas reserves differ sharply between various countries due to the incomplete exploration on the Caspian Seabed and surrounding lands, Central Asia's potential to become a major oil and natural gas exporter over the next decade is very high.[15] [16] A good example is the discovery of the Kashaghan field in Kazakhstan in July 2000, the largest oilfield outside the Middle East and the fifth-largest in the world in terms of reserves.[17] Another illustration of the region's great untapped potential is the most recent independent certification of the Osman-Yoloton and Yashlar natural gas fields in eastern Turkmenistan which, if confirmed, would establish Turkmenistan to be the second-largest holder of gas reserves in the world.[18]

Energy security concerns

Another factor that spurred China's entry into Central Asia included a need to reduce the dependency on Middle East oil and sea lines of communication for oil transports.[19] The Middle East remains the most turbulent spot on the global map, as the region continues to be riddled with deepening ethnic and political tensions, terrorism, corruption and authoritarianism.[20] Along with the growing demand in oil, China's energy security problem is likely to intensify due to its reliance on major energy resources located in this volatile area. Approximately 60 per cent of China's oil imports currently come from the Middle East.[21] Since China lacks the naval power necessary to protect its sea lines, Beijing fears that during a national security crisis ships carrying energy resources could be interdicted by hostile naval forces.[22] China's heavy use of the Malacca Strait in south-east Asia is emblematic of this concern – oil from the Persian Gulf and Africa is shipped to China via the Strait.[23] Ongoing political tensions over the control of the Malacca Strait coupled with a recent upsurge in pirate attacks present grave issues for Chinese energy security.[24] Therefore, compared with the Middle East that is 'always in the center of storm', Central Asia is naturally a better choice for China's oil and gas supply.

All these factors apparently lead to the promotion of the strategic position of Central Asia and China's increasing interest in the region. This article will further examine China's energy ties with Kazakhstan, Turkmenistan and Uzbekistan – the three countries of Central Asia with the largest oil and gas resources – in more detail including the regulatory framework and investment climate of each country.

Kazakhstan petroleum investment regime

According to the Kazakhstan Constitution, subsoil resources such as oil and gas are the exclusive property of the state.[25] The government agency responsible for energy policy is the Ministry of Energy and Natural Resources.[26] However, rights to use the subsoil may be granted to international companies on the basis of a subsoil-use contract concluded with the Ministry of Energy and Mineral Resources following an investment tender.[27] The primary legislative acts regulating the oil and gas industry in Kazakhstan are the Subsoil Law,[28] the Oil Law,[29] and the PSA Law.[30] A number of other laws regulate specific aspects of subsoil use. The Subsoil Law sets out the basic framework for oil and mining operations in Kazakhstan, while the Oil Law addresses only oil operations. The PSA Law regulates production-sharing agreements with respect to offshore oilfields. International projects have taken the form of joint ventures with KazMunayGaz, the national oil company, as well as production-sharing agreements and exploration/field concessions.[31]

China appears to have a long-term plan in Kazakhstan, and aims to establish the country as a major source of oil for its domestic market. China's increasing interest in the country is not surprising considering Kazakhstan's significant oil and gas reserves and fairly open investment climate. Kazakhstan has the region's largest recoverable crude oil reserves, and its production accounts for over half of the roughly 2.8 million barrels per day currently being produced in the region.[32]

China has spent a significant amount of time and money in recent years acquiring upstream oil assets in Kazakhstan, as well as investing in the construction of the Kazakh–China oil pipeline. CNPC, China's largest state-owned oil company, acquired a 60 per cent stake in the Aktobe oilfield in western Kazahstan in 1997.[33] In 2003, CNPC bought a 65 per cent share of the North Buzachi oil and gas field in north-west Kazakhstan and acquired 100 per cent ownership after having purchased another 35 per cent stake in the field earlier.[34] CNPC followed up that success by acquiring PetroKazakhstan, a Canadian company that is one of Kazakhstan's major energy producers, for US$4.18 billion in 2005.[35] This move was CNPC's biggest foreign acquisition to date and greatly expanded China's operations in Kazakhstan, particularly after the second section of the Kazakhstan–China oil pipeline was completed in December 2005.[36] The 613-mile-long pipeline was an important manifestation of the long-term nature of Sino–Kazakh cooperation and connected an existing pipeline network in central Kazakhstan with China's bordering province of Xinjiang supplying Caspian oil to serve China's growing energy needs.

Kazakhstan has made notable progress towards creating a market economy since its independence in 1991 and has attracted significant foreign investments from Chinese national oil companies and other investors.[37] Despite increasing international investment into Kazakhstan's energy sector, concerns remain with regard to the Government's tendency to challenge contractual rights, to legislate preferences for domestic companies, and to create mechanisms for government intervention in foreign companies' operations.[38] During 2007, for instance, Kazakh authorities announced that they would review all energy and mineral resources contracts in a bid to generate more revenue and diversify the sources of investment.[39] To that end, a new law came into effect allowing the Government to unilaterally break contracts with oil companies.[40] The new law gives Kazakhstan two paths to terminate contracts with energy companies.[41] One option forces the company into negotiations with the Government, and the other option allows for the repudiation of the contract with a notice period of only two months.[42] In response to concerns about Kazakhstan's investment climate, the Tax Ministry proposed a reformation of the foreign investment structure.[43] Within one month, however, the Government decided to abandon a proposal that would have turned the production-sharing agreement regimes into a concession-type system, allowing the country to change tax rates and contract terms more easily.[44]

Together with vague and contradictory legal provisions that are often arbitrarily and inconsistently enforced, these negative tendencies feed an enduring perception that Kazakhstan is becoming less open to investment.[45] China, along with investors from other countries, is keeping a watchful eye on Kazakhstan's investment climate and considers protection mechanisms for its present and future investments.

Turkmenistan petroleum investment regime

Pursuant to the Turkmenistan Constitution, oil, gas and other subsoil resources are the exclusive property of the state.[46] The responsible government agency for energy policy is the Cabinet of Ministers. Implementation of these decisions is delegated to the Ministry of Oil and Gas Industry and Mineral Resources.[47] Another government agency overseeing the hydrocarbon sector is the State Agency for the Management and Use of Hydrocarbon Resources, an independent legal and economic entity which reports directly to the President of Turkmenistan.[48] There are two primary legislative acts regulating the oil and gas industry in Turkmenistan. The Petroleum Law[49] regulates offshore and onshore petroleum operations in Turkmenistan, including petroleum licensing, taxation, accounting and other rights and obligations of state agencies and foreign partners. The Law on Foreign Concessions[50] permits the state to transfer natural resources to the concessionaire on the basis of a contract for a definite period of time. Foreign investment is limited to joint ventures and production-sharing agreements with Turkmenneft, the state-owned oil company.[51]

Despite its abundant oil and gas reserves and geographical proximity to China, Turkmenistan has generally played a weak role in Chinese international relations. Historically, Beijing kept Turkmenistan at arm's length and invested moderately in Turkmenistan's oil and gas sector.[52] The Turkmen leadership was notoriously unpredictable and appeared to have seriously over-committed the country's future gas exports.[53] The country has proven oil reserves of roughly 600 million barrels and natural gas reserves of approximately 2.83 trillion cubic metres at the end of 2007,[54] but a recent survey indicates that Turkmenistan's gas reserves might have been greatly underestimated. An independent audit of the country's gas reserves by Gaffney, Cline & Associates (GCA) showed an estimate of 28 trillion cubic metres of gas reserves.[55] If the GCA results are confirmed, Turkmenistan will have the second-largest proven gas reserves in the world after Russia, enabling it to fulfil its future gas export commitments.[56]

The most recent political shift in the region, the death of former President Niyazov and the election of President Berdymukhammedov in early 2007, has sparked new interest and hope for a stable environment for foreign investors in Turkmenistan's oil and gas sector.[57] Due to these changes, the past stranded relationship between China and Turkmenistan has taken a steep turn towards long-term cooperation. The new Government renewed the 2006 gas export agreement that former President Niyazov had made with China.[58] Despite uncertainty regarding Turkmenistan's proven gas reserves and possibly over-committed future gas exports, CNPC signed an agreement to transport 30 billion cubic metres of gas annually for 30 years in July 2007.[59] This gas import deal is linked to a production-sharing agreement allowing CNPC to develop a gas field in the north-east of the country, as well as construct a 7,000-kilometre gas pipeline across Central Asia via Kazakhstan and Uzbekistan linking Turkmenistan with China.[60]

The relations between China and Turkmenistan registered a sharp upward trend and the landmark gas and pipeline deals have sealed the vows to further energy cooperation. Turkmenistan's new Government is taking steps to improve the legal policies and institutional capacity to facilitate investment in the hydrocarbon industry. To that end, the Government has established a hydrocarbon regulatory authority separate from the central Government in order to provide greater revenue transparency and initiate more foreign investment.[61] Also, in August 2008 the Government proposed a draft of a new hydrocarbon law in an attempt to create a more favourable climate for foreign investments.[62] However, it is still too early to determine how much progress the new regime will make towards opening its hydrocarbon market and increasing transparency related to information and reserve audits.[63] Despite many uncertainties, the Chinese Government has placed a far-sighted strategic bet on what may soon prove to have the second-largest gas reserves in the world, and to be a major source of gas supply that may help to meet the country's growing energy needs.

Uzbekistan petroleum investment regime

The Uzbekistan Constitution vests ownership of the subsoil in the state.[64] The President of the Republic of Uzbekistan and the Council of Ministers are the decision-makers for energy policy.[65] Implementation of these decisions is delegated to the Fuel Energy Complex headed by a deputy prime minister and the individual agencies.[66] Operational responsibilities for the hydrocarbon sector are vested with UzbekNefteGaz, the country's national oil company.[67] In addition, many decisions of an operational or commercial nature affecting industry players are administratively regulated and/or subject to approval by the Ministry of Finance, the Anti-Monopoly Committee or the Council of Ministers.[68] There are three primary legislative acts regulating the oil and gas industry in Uzbekistan. The Subsoil Law[69] is the framework statute governing the exploration and development of all subsoil resources. The Concession Law[70] provides the legislative basis for this contractual form of mineral resource development. The PSA Law[71] provides the legislative regime for subsoil projects, including all mineral and hydrocarbon exploration, extraction, and production. Foreign investment is limited to joint ventures and production-sharing agreements with the state-owned UzbekNefteGaz.[72]

China's relationship with Uzbekistan has been developing at a much slower pace than those with Kazakhstan and Turkmenistan. Although Uzbekistan has plentiful oil and gas reserves comparable to its neighbours (594 million barrels of proven oil reserves and 65 trillion cubic metres of proven gas reserves[73]), its closed investment climate has drastically reduced the influx of foreign investments in the country's hydrocarbon industry. Since it gained independence, Uzbekistan has made little progress in market reforms and privatisation. [74] In order to boost foreign investment, Uzbekistan has recently taken various steps such as reversing its previous tax level increases on subsoil hydrocarbon production in 2007 (now 20 and 30 per cent tax for crude and gas production, respectively) and modifying its regulations for production-sharing agreement developments.[75] In addition, Uzbekistan has attempted to privatise UzbekNefteGaz several times since 2003, but its desire to maintain majority control over the company is thwarting its plans to attract foreign investors.[76]

Despite gradual steps to improve its foreign investment climate, Uzbekistan still faces serious hurdles to develop its hydrocarbon sector.[77] Sinopec, the Chinese state-owned oil company, rescinded a US$106 million deal to rehabilitate existing oilfields with UzbekNefteGaz in 2007 on account of high investment costs and resource taxes.[78] CNPC, another Chinese state-owned oil company, has only been moderately involved in oil and gas operations in Uzbekistan since 2006, and operates two oil and gas cooperation projects in addition to having a stake in a consortium operating a product-sharing contract on the exploration and development of oil and gas deposits in the Aral Sea.[79] The future of Sino–Uzbek cooperation in energy resources is still uncertain. Uzbekistan's political instability and unfavourable investment climate have been major deterrents for Chinese investments.

Conclusion

China's presence and influence in Central Asia are likely to continue to grow based on established relationships and clearly defined interests. Strong ties with Central Asia are instrumental to advancing the Chinese Government's objectives of satisfying its rising energy demand, reducing its strategic vulnerabilities and diversifying sources of energy imports. However, China must have a clear knowledge of its advantages and disadvantages in the region. While Central Asia's abundant energy resources and geographical proximity to China make it a strategic region for Chinese outbound oil and gas investments, the countries' closed investment climate, slow adjustments in market reforms, corruption, underdeveloped petroleum laws and government instability create challenges for furthering the energy nexus between the countries.

Notes

1 *Oil Market Report*, International Energy Agency (10 October 2008), available at http://omrpublic.iea.org/indexpublic.asp (accessed 29 November 2008).
2 *Ibid*
3 *Ibid*
4 *Ibid*
5 *Ibid*
6 Central Asia is defined as including the countries of Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.
7 James Millward, *Beyond the Pass: Economy, Ethnicity and Empire in Qing Central Asia* (Standford: Standford University Press, 1998), pp1,759–1,864.
8 *China Energy Profile*, Energy Information Administration (14 October 2008), available at **http://tonto.eia.doe.gov/country/country_energy_data.cfm?fips=CH** (accessed 29 November 2008);
Gal Luft, *Fueling the Dragon: China's Race into the Oil Market*, Institute for the Analysis of Global Security (2004), available at **www.iags.org/china.htm** (accessed 29 November 2008).
9 See *supra* n 8, *China Energy Profile*.
10 *Ibid.*
11 *Ibid.*
12 *China's Crude Oil Imports Report*, China Customs Administration (2007), available at **www1.customs.gov.cn/Default.aspx?TabID=5290&InfoID=100893&ctl=InfoDetail&mid=14685** (the website is in Chinese) (accessed 29 November 2008).
13 *China County Analysis Brief*, Energy Information Administration (August 2006), available at **www.eia.doe.gov/emeu/cabs/China/NaturalGas.html** (accessed 29 November 2008).
14 *China's Overseas Investments in Oil and Gas Production*, Eurasia Group (the report prepared for the US–China Economic and Security Review Commission) (16 October 2006), available at **www.uscc.gov/researchpapers/2006/oil_gas.pdf** (accessed 29 November 2008).
15 The Caspian Sea is a 700-mile-long body of water in Central Asia bordered by Azerbaijan, Iran, Kazakhstan, Russia and Turkmenistan. The Caspian Sea region has historically been an oil and natural gas producer, but many believe that the region contains large resources of oil and gas capable of much greater production than at present.
16 *Caspian Sea Country Analysis Brief*, Energy Information Administration (January 2007) available at www.eia.doe.gov/emeu/cabs/Caspian/pdf (accessed 29 November 2008);
Yu Jianhua, *Competition for Caspian Energy Development and Its Relationship with China*, Foreign Ministry Studies Office, US, pp 137–156 (this report is a part of proceedings of the Central Asia Symposium sponsored by the Foreign Ministry Studies Office, 7–11 August 2005) available at http://leav-www.army.mil/fmso/documents/New-Great-Game.pdf (accessed 29 November 2008).
17 *Kazakhstan Country Analysis Brief*, Energy Information Administration (February 2008) available at **www.eia.doe.gov/emeu/cabs/Kazakhstan/Background.html** (accessed 29 November 2008).
18 *Turkmenistan: The World's Largest Holder of Gas Reserves*, News Central Asia (24 October 2008) available at **www.newscentralasia.net/Articles-and-Reports/386.html** (accessed 29 November 2008).
19 Xuali Liao, 'Central Asia and China's Energy Security', *China and Eurasia Forum Quarterly*, vol 4, no 4 (2006), pp61–69, available at **www.silkroadstudies.org/new/docs/CEF/Quarterly/November_2006/Liao.pdf** (accessed 29 November 2008).
20 Gal Luft, *Dependence on Middle East Energy and Its Impact on Global Security*, Institute for the Analysis of Global Security (2007) available at **www.iags.org/luft_dependence_on_middle_east_energy.pdf** (accessed 29 November 2008).
21 *China's Crude Oil Imports*, China Customs Statistics Department (2007) available at **www.customs.gov.cn/publish/portal0/tab4370/module3758/info100562.htm** (the website is in Chinese) (accessed 29 November 2008).
22 Ian Storey, 'China's Malacca Dilemma', *China Brief*, vol 6, issue 8 (12 April 2006) available at **www.jamestown.org/publications_details.php?volume_id=415&issue_id=3686&article_id=2370974** (accessed 29 November 2008).
23 *Ibid*
24 *Ibid*
25 The Ministry of the Energetic and Mineral Resources of the Republic of Kazakhstan, official website: **www.memr.gov.kz/?lng=eng&mod=min** (accessed 29 November 2008).
26 *Ibid*
27 *Ibid*
28 The Law on the Subsoil and Subsoil Use of the Republic of Kazakhstan No 2828, dated 27 January 1996, as amended.
29 The Law on Oil of the Republic of Kazakhstan, dated 28 June 1995, as amended.
30 The Law on Production Sharing Agreements for Conducting Offshore Petroleum Operations of the Republic of Kazakhstan, dated 8 July 2005.
31 See *supra* n 17, *Kazakhstan Country Analysis Brief*.
32 *Ibid*
33 Xiaojie Xu, *Chinese NOCs' Overseas Strategies: Background, Comparison and Remarks*, CNPC Research Academy of Economic and Technology (March 2007) available at **www.rice.edu/energy/personnel/staff/Master_CV_XiaojieXu.pdf** (accessed 29 November 2008).
34 *Ibid*
35 *Ibid*
36 *Ibid*
37 *Kazakhstan Investment Climate Statement*, US Department of State (2008) available at **www.state.gov/e/eeb/ifd/2008/100888.htm** (accessed 29 November 2008).
38 *Ibid*
39 See *supra* n 17, *Kazakhstan Country Analysis Brief*.
40 *Ibid*
41 *Ibid*
42 *Ibid*
43 *Ibid*
44 *Ibid*
45 See *supra* n 37, *Kazakhstan Investment Climate Statement*.
46 Ministry of Oil and Gas of Turkmenistan, official website: **www.oilgas.gov.tm/** (the website is in Russian) (accessed 29 November 2008).
47 *Ibid*
48 *Ibid*
49 The Law on Hydrocarbon Resources of the Republic of Turkmenistan, as amended on 6 December 2005.
50 The Law of the Republic of Turkmenistan on Foreign Concessions, dated 1 October 1993.
51 *Central Asia Country Analysis Briefs*, Energy Information Administration (February 2008) available at **www.eia.doe.gov/emeu/cabs/Centasia/Background.html** (accessed 29 November 2008).
52 Kathleen Hancock, 'Escaping Russia, Looking to China: Turkmenistan Pins Hopes on China's Thirst for Natural Gas', *China and Eurasia Forum Quarterly*, vol 4, no 3 (2006), pp 67–87, available at **www.silkroadstudies.org/new/docs/CEF/Quarterly/August_2006/Hancock.pdf** (accessed 10 November 2008).
53 *Ibid*
54 See *supra* n 51, *Central Asia Country Analysis Briefs*.
55 'Turkmenistan: World's Second Largest Holder of Gas Reserves', *News Central Asia* (24 October 2008) available at **www.newscentralasia.net/Articles-and-Reports/386.html** (accessed 29 November 2008).
56 *Ibid*
57 *Ibid*
58 'China, Turkmenistan Sign Landmark Gas Deal', *News Central Asia* (18 July 2007) available at **www.newscentralasia.net/Regional-News/129.html** (accessed 29 November 2008).
59 See *supra* n 51, *Central Asia Country Analysis Briefs*.
60 *Ibid*
61 *Ibid*
62 'Turkmenistan Drafts New Law On Hydrocarbon Resources', *News Central Asia* (16 August 2008) available at **www.newscentralasia.net/Regional-News/295.html** (accessed 29 November 2008).
63 *Turkmenistan Investment Climate Statement*, US Embassy Ashgabat (2008) available at **http://turkmenistan.usembassy.gov/ic_report.html** (accessed 29 November 2008).
64 Official Uzbekistan Government website: **www.gov.uz/** (accessed 29 November 2008).
65 'The Energy Base of Uzbekistan', *Entrepreneur Connect* (6 October 2008) available at **www.entrepreneur.com/tradejournals/article/186836158.html** (accessed 29 November 2008).
66 *Ibid*
67 *Ibid*

68 *Ibid*
69 The Law of the Republic of Uzbekistan on the Subsoil, dated January 2003 as amended.
70 The Law of the Republic of Uzbekistan on Concessions, dated 30 August 1995.
71 The Law of the Republic of Uzbekistan on Production Sharing Agreements, dated 7 December 2001.
72 See *supra* n 51, *Central Asia Country Analysis Briefs*.
73 *Ibid*
74 *Uzbekistan Investment Climate Statement*, US Department of State (2007) available at **www.state.gov/e/eeb/ifd/2007/80761.htm** (accessed 29 November 2008).
75 See *supra* n 51, *Central Asia Country Analysis Briefs*.
76 *Ibid*
77 *Ibid*
78 *Ibid*
79 *CNPC in Uzbekistan*, CNPC official website: **www.cnpc.com.cn/eng/cnpcworldwide/euro-asia/Uzbekistan/** (accessed 29 November 2008).

CROATIA

Legal framework and practice of incentive system of electricity production from renewable energy resources

Karmen Stupin
Energy Institute Hrvoje Pozar, Zagreb
kstupin@eihp.hr

Introduction

General legal acts, which regulate rights of land use, physical planning, facilities construction and environment protection, to name but a few, are competent for planning, preparation and construction facilities using renewable energy resources ('renewables') for electricity production in the Republic of Croatia.

But the norms which govern the issues of preparation and realisation of renewable energy resource projects, potential measurement, facilities construction, connection to the grid and the gaining of financial incentives are contained in provisions of special legal acts relevant to energy. This regulation governs specific legal relations for incentivising electricity production from renewable energy resources between energy subjects and customers. It also regulates administrative procedures, the collection of incentive fees and the allocation of incentive prices to electricity producers.

Generally speaking, laws on energy and electricity determine the basic rules and principles of renewables regulation and promotion in the Republic of Croatia. However, specific procedure is detailed in secondary legislation issued by executive government bodies.

Incentive system in general

According to the Croatian Energy Act, an eligible producer is an energy undertaking which produces both electrical and thermal energy in a single generating facility and uses waste or renewable energy resources in an economically appropriate way in harmony with environmental protection.

The status of eligible producer can be gained via a decision made by the Croatian Energy Regulatory Agency[1] in accordance with the special rules. An eligible producer, apart from hydropower plants larger than 10MW, can acquire the right to an incentive through the special tariff system for generating electricity from renewable energy resources and cogeneration.

Eligible producers enter into buy-back contracts with the Croatian market operator[2], which pays them the incentivised price for their electricity delivered to the power system.

The incentive fee (electricity price supplement) has been collected from all electricity customers in Croatia since 1 July 2007. The incentive fee is specified on the electricity bill and each customer can easily calculate the amount he/she will pay for incentivising electricity production from renewables.

All suppliers of electricity[3] have to deduct a minimal share of electricity produced by eligible producers (prescribed by a Government Ordinance in accordance with the relevant EU Directive[4]).

Therefore, the market operator enters into contracts with all suppliers (to ensure they deduct a minimal share of electricity produced by eligible producers), collects from suppliers the incentive fees paid by customers and finally allocates the incentive price to eligible producers.

Legal framework of the incentive system[5]

The legal framework of the incentive system is constituted as follows:

Energy Act

The basic act for underlying matters is the Energy Act prescribing issues of energy strategy and planning, licensing for performing of energy activities, energy tariffs and conditions of energy supply.

According to the Act, the usage of renewable energy resources is in the interest of the Republic of Croatia. The detailed renewable and cogeneration usage for electricity generation is regulated by a special act.

Electricity Market Act

This Act regulates legal institutes defined by the relevant EU directive[6] and harmonised with the Croatian legal system such as unbundling, authorisation/tender for new facilities construction, eligible producer status, eligible consumer status, third party access and public service obligation.

The Act defines electricity market participants (producers, the market operator, systems operators, suppliers and customers) and prescribes their rights and obligations in the electricity market.

Ordinance on a minimal share of incentivised electricity production from renewable energy resources and cogeneration

By this Ordinance, through the minimal share of electricity produced from renewable energy resources and cogeneration in total energy consumption, the Croatian Government sets out goals in renewable and cogeneration use, based on the strategic determination of the Republic of Croatia[7] and the Croatian legal framework, according to the obligation of legislation harmonisation with relevant EU documents. The Ordinance defines that the market operator shall enter into contracts with eligible producers, which have a right to the incentive price, until electricity production from their facilities does not achieve the prescribed minimal share.

Ordinance on fees for incentivising electricity production from renewable energy resources and cogeneration

This Ordinance determines the manner of usage, amount, collection, allocation and payment fee for incentivising electricity production from renewable energy resources and cogeneration according to strategic goals of the Republic of Croatia Government-defined regulation through share renewables in total electricity consumption. The Ordinance prescribes the fee amount for the period 2007–2010.

Tariff system for generating the electricity from renewable energy resources and cogeneration

The tariff system determines the way and conditions under which eligible producers can gain the incentive price, the tariff item and their rate for each type of facility. Electricity producers can gain the incentive price by fulfilling two cumulative conditions: obtaining eligible producer status and entering into buy-back contracts, with incentives for electricity produced from renewable energy resources and cogeneration. Buy-back contracts will be concluded at the request of the electricity producer for the period of 12 years with a possibility of correction depending on the age of the facilities. The methods and elements of incentive pricing defined by the tariff system, which is effective at the time of the entering into contract, shall not be changed during the contract validity. The tariff system also regulates accounting, payment and allocation of financial resources collected by the market operator.

Rule Book on using renewable energy resources and cogeneration

This Rule Book defines groups of facilities using renewables and cogeneration for electricity generation, conditions for potential exploration and facilities construction and also keeps a registry of renewables and cogeneration projects, facilities and eligible producers[8], as well as prescribing the procedure in order to gain energy approval for renewables and cogeneration facilities construction.

Rule Book on gaining qualified producer status

This Rule Book determines conditions for obtaining eligible electricity producer status. Such status can be acquired by entities that produce both electrical and thermal energy in a single generating facility, use waste or renewable energy resources in an economically appropriate way in harmony with environmental protection. The Rule Book also defines groups of facilities and assumptions for acquiring, prolonging and losing electricity producer status which is based on an Agency decision.

Institutional framework of the incentive system

The institutions competent to establish, operate and supervise this system are: the Croatian Parliament, the Government, the Ministry of Economy, Labour and Entrepreneurship and the Regulatory Agency. Relevant energy undertakings are the market operator, transmission and distribution systems operators, electricity producers and electricity suppliers. The Croatian Parliament lays down relevant energy laws and the Energy Sector Development Strategy. The Government lays down the tariff system, determines the minimal share of electricity produced from renewable energy resources and cogeneration of total electricity consumption and prescribes the incentive fee amount.

The Ministry lays down secondary legislation and keeps the registry of renewable projects. The Regulatory Agency supervises tariff system implementation and issues licences for performing energy activities and eligible producer status decisions.

The market operator enters into buy-back contracts with eligible electricity producers, enters into contracts with all the suppliers for the purpose of insuring a minimal share of electricity produced by incentivised eligible producers, collects from all electricity suppliers the incentive fees paid by electricity customers and settles the incentivised price to eligible producers. The transmission system operator[9] and the distribution system operator[10] (TSO and DSO) are obliged to deduct all electricity produced from renewable energy resources and cogeneration. They also inform the market operator about total delivered and calculated electricity for all suppliers.

Obstacles and barriers to incentive system implementation

Due to the great number of regulations, the short period of their implementation and the novelty that they import to the energy sector regulation, it is not possible to identify all the obstacles and barriers of incentive system implementation. For the purpose of this review, the author will highlight some of them:

Administrative and professional task complexity

During the issuing of administrative acts based on special regulations, the administrative and professional service of the competent institution has to take account of administrative procedure principles and complex technical criteria and requests defined by special energy legislation.

Particularity of contractual relationships between incentive system participants

Contractual relationships between energy undertakings and customers end energy undertakings mutual are increasingly common in the electricity market. The General Condition of Electricity Supply regulates items of relationships regarding network connection, usage and supply. Incentive system regulations specify obligations of contract entered into between the market operator and eligible producers, and the market operator and suppliers, and contain the basic elements of these contracts – the market operator publishes some examples of contracts on its website. The authorities protect the weak party, mitigate the negotiation process and contribute to legal safety. However, only in concrete cases can problems arising from failure to contract or party insolvency be identified.

Relations to another legal domain

The described domain is regulated by a great number of acts relevant to energy and also other legal areas such as proprietary relations, spatial planning, concessions, building, environmental and consumer protection, for example. Thereby, amendments and modification of these regulations can influence the steps of legal procedure at project preparation and realisation which presents additional requests for competent institutions and investors.

Conclusion

The field of renewable energy resources usage for electricity production is regulated by a great number of acts from different legal areas. In addition, energy legislation has established a complicated and long-term legal procedure. There is no doubt that the enacting of legislation respective to the determination of rights and obligations of entities, pricing and deadlines has contributed to the legal safety of investors.

Only through further implementation of the regulations will the functionality and efficiency of the incentive system be shown.

Because the incentive fee is contained in the electricity price and is paid by all the customers, the established incentive system has to be based on objective, transparent and verifiable law for relevant institutions, energy undertakings and customers or their protection association.

Notes

1 The Croatian Energy Regulatory Agency (HERA) is an autonomous, independent and non-profit public institution, which regulates energy activities in the Republic of Croatia. HERA's obligations, authorities and responsibilities are based on the Act on the Regulation of Energy Activities, the Energy Act and other acts regulating specific energy activities.

2 The Croatian Energy Market Operator (HROTE) started to operate in April 2005. HROTE performs activities concerning the organisation of the electricity market as a public service, under the supervision of the Croatian Energy Regulatory Agency.

3 All suppliers need HERA's licence for performing a supply activity.

4 Directive 2001/77/EC of the European Parliament and of the Council of 27 September 2001 on the promotion of electricity produced from renewable energy resources in the internal electricity market.

5 Source: *Official Gazette of the Republic of Croatia*, available at **www.nn.hr/**

6 Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC.

7 Energy Sector Development Strategy (*Official Gazette* no 38/02) is adopted by the Croatian Parliament. A new strategy is under the drafting procedure.

8 The registry is kept by the Ministry of Economy, Labour and Entrepreneurship.

9 TSO (HEP-OPS) is a member of HEP Group as a daughter company of Hrvatska elektroprivreda d.d. (Croatian national power company). It is the sole transmission system operator (TSO) in the Republic of Croatia and has the licence to carry out electricity transmission as a public service.

10 Distribution system operator (DSO) is a member of HEP Group as a daughter company of Hrvatska elektroprivreda d.d. (Croatian national power company) and is responsible for the maintenance, replacement, reconstruction and development of distribution networks and plants.

MEXICO

Oil reform in Mexico: final assessment

Claudio Rodríguez-Galán
Chadbourne & Parke SC, Mexico City
crodriguez@chadbourne.com

In April 2008, the Mexican President, Felipe Calderón, submitted a reform package which looked to be the most important and politically aggressive reform of Mexican laws of the past few decades. After several months of discussion in the Mexican Senate Chamber and political movements from strong left-wing radical groups, the final product was indeed a reform to the Mexican oil company administration bodies and principles. Even though some areas were banned from private investment, transnational oil-related services companies may find business opportunities. This article describes the background, development and outcome of this proposal.

President Calderón's oil reform proposal

Considering the status of *Petróleos Mexicanos* (Pemex) within the Mexican legal system, and its importance for the Mexican macroeconomic figures, after several months of speculation President Felipe Calderón sent an oil-industry reform proposal (then called 'energy reform') to the Mexican Congress ('proposal') on 8 April 2008, containing the following legislative initiatives:

(i) reforms to the Administrative Law of Pemex (*Ley Orgánica de Petróleos Mexicanos*);

(ii) the creation of the Oil and Gas Commission Law (*Ley de la Comisión de Hidrocarburos*);

(iii) reforms to the Statutory Law of Article 27 of the Constitution on Oil Matters (*Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo*);

(iv) reforms to the Administrative Law of the Public Federal Administration (*Ley Orgánica de la Administración Pública Federal*);
(v) reforms to the Energy Regulatory Commission Law (*Ley de la Comisión Reguladora de Energía*); and
(vi) the creation of the Renewable Energies and Energy Transition Law (*Ley de Energías Renovables y Transición Energética*).

The main idea of the proposal was: to strengthen Pemex through financial and administrative independence; to allow the execution of contracts with specialised companies for the construction of new refineries and deep water exploration services; to create a clearer framework with regard to transparency and modern management standards; and to strengthen the faculties of existing or new regulatory bodies.

In summary, the proposal originally sought to attack and face the following problems with the following actions and solutions:

	Topic	Problem	Original proposal
1	Transportation, storage and distribution of oil products	'PEMEX Refinación' subsidiary has no construction projects and existing infrastructure is not sufficient.	Renew and expand oil pipeline network, as well as renew and expand all transportation, distribution and storage facilities.
2	Refinery capacity	Mexico imports four out of ten litres of gasoline. If no refinery infrastructure is created, in 2015 gasoline imports will reach 489,000 barrels per day, that is, half the national consumption rate.	Allow private firms to build new refineries in Mexico.
3	Corporate governance	Corporate governance shall be created or enhanced where already existing. This will force Pemex to transform itself into an efficient and transparent entity.	Strengthen the structure of the Board of Directors through the appointment of four new independent professional members.
4	Tax regime	Under the numbers of proven reservoirs, the increasing production costs and the decrease in oil revenue, the current tax regime will not be sustainable within the coming years.	Create a new tax regime for Pemex where new schemes for the collection of taxes are created in accordance with the rationales of the specific project and the factual/real development of oil fields.
5	Budget	Pemex has no freedom whatsoever in deciding its own budget. Thus, the use of resources is highly inefficient. The regulatory constraint on decision-making leads to loss of opportunities and time.	Create more resources for Pemex through additional oil revenues, and provide the sufficient administrative autonomy to decide its use in existing authorised maintenance and operation projects.
6	Financing	Pemex requires access to new financing sources and more transparency in budget administration.	Issuance of 'citizen paper' as a new source of financing Pemex, as well as better transparency mechanisms.
7	Ad hoc contract	Pemex is constrained by the (General) Public Works Law when contracting large-scale and complex projects, which causes delays and inefficiency when contracting such very specific oil industry projects under a general 'catch-all' law.	Design an ad hoc oil industry public works framework in accordance with international oil industry standards and needs, which would bring more flexibility and efficiency to Pemex contracting schemes.
8	Execution capabilities	The current Mexican oil industry framework is inconsistent with modern needs and facts. The restrictions imposed on procurement, acquisitions and public works laws create a lack of efficiency, causing delays in the response capabilities of the entity.	Create a specific legal framework in procurement, acquisitions and public works activities, allowing better response capabilities and more trust while contracting services and allowing important savings, which would create a better scenario for the use of better tecnology.
9	Debt	The actual framework does not allow a modern and flexible decision-making process with regard to external debt.	Allow Pemex to hire external financial schemes as may be required and to place debt in accordance with the terms and conditions imposed by the new Board of Directors.
10	Transparency, control and surveillance	Pemex is considered a corrupt and inefficient entity. Currently, surveillance schemes are focused on procedures, and not on attacking real corruption cases. Ironically, surveillance programmes are excessive and inefficient.	Strengthen control and surveillance programmes and bodies, and create better controls for transparency and corporate governance. Incorporate an audit and transparency committee formed by three independent members.

Outcome: Congress' seven Laws

After several months of discussion over President Calderón's proposal in the Mexican Senate, two major counter-proposals were submitted: one by the PRI party (right-centred) and another by the PRD party (left). Also, serious technical, operative and legal constitutional interpretation and financial debates were held for 70 days and, finally, on 28 November 2008, the Mexican Congress approved seven bills of oil reform ('Laws').

Below is a comparison of the final Laws and the original presidential proposals:

	Topic	Original proposal	Final laws
1	Transportation, storage and distribution of oil products	Renew and expand in a master fashion the oil pipeline network, as well as the transportation, distribution and storage facilities.	This proposal was *not* accepted. In the end, private firms will not be allowed to build or operate such facilities.
2	Refinery capacity	Support Pemex in the creation of new refinery facilities by private and social firms. President Calderón proposed these works to be executed under in-bond contracts.	This proposal was *not* accepted. The laws do not allow private firms to build or operate new refineries under any contractual scheme.
3	Corporate governance	Strengthen the Board of Directors through the appointment of four new independent professionals.	This proposal was accepted. A new Board of Directors scheme has been proposed with the inclusion of four new independent professional members. New committees are created in order to provide better surveillance mechanisms to the operations and finance of Pemex.
4	Tax regime	Create a new tax regime for Pemex, generating new schemes for rights and tax collection in accordance with the project or factual development of oil fields.	This proposal was accepted. A new tax regime is imposed and, more importantly, new independence rulings are created before the Ministry of Finance. That is, the tax burdens will not be unilaterally imposed by the Ministry of Finance.
5	Budget	Pemex shall have more resources from additional oil revenues, and have the sufficient administrative autonomy to decide on their use in already authorised projects, maintenance and operation.	This proposal was accepted. Independence rules are created before the Ministry of Finance. The Board of Directors will approve budget changes for Pemex and its subsidiaries without prior authorisation from the Ministry of Finance.
6	Financing	Create 'citizen papers' as a new source of financing Pemex, as well as better transparency mechanisms.	This proposal was accepted. The so-called 'citizen papers' (*bonos ciudadanos*) are created as a mechanism to obtain new financing and provide an audit/transparency tool for citizens.
7	Ad hoc contracts	Design an ad hoc oil industry public works legal framework in accordance with oil industry standards and needs, which should generate more flexibility and efficiency.	This proposal was accepted. An ad hoc scheme has been agreed on, through which Pemex or the new subsidiaries may enter into works or services agreements. Due to the relevance of this topic, it shall be explained in the section on 'Opportunities: works and services contracts' below.
8	Execution capabilities	Create a specific legal framework in procurement, acquisitions and public works activities, allowing better response capacity and generating more trust in the contracting of services, allowing important savings which will create a better scenario for the use of better technology.	*Ibid*
9	Debt	Propose new powers for Pemex to hire external financial schemes as may be required and placing debt in accordance with the terms and conditions imposed by the new Board of Directors.	The proposal was accepted. Pemex shall send a financing proposal to the Ministry of Finance and may enter into official negotiations regarding the external money market and even contract external funding as may be required in foreign currency. All this can be made without prior authorisation from the Ministry of Finance.
10	Transparency, control and surveillance	Strengthen control and surveillance programmes and bodies and create better controls for transparency and corporate governance. Incorporate an audit and transparency committee formed by three independent members.	The proposal was accepted. New audit and surveillance committees are created (audit, investment strategy, compensations, acquisitions and public works, environment, transparency and technological R&D).

Opportunities: works and services contracts

The oil reform effort is, without any doubt, the most politically complex reform that has been discussed in the Mexican Congress in the past two or three decades. Notwithstanding radical opposition from minorities, even the leftist PRD party was aware that new schemes and new rules were needed for the most important company in the Mexican economy.

Some important original proposals, such as the construction and operation by private firms of refinery infrastructure and transportation and storage services through in-bond contracts, were completely banned during discussions in the Senate and, consequently, important businesses opportunities for private and social sectors were automatically lost.

However, the following new potential areas of business opportunities have been identified:

(i) Public works and services related to Pemex's oil industry activities will be governed by the newly created Pemex Law (*Ley de Petróleos Mexicanos*).

(ii) Public works and services related to Pemex's administrative non-oil industrial activities will be governed by existing public works and acquisitions laws.

Therefore, oil industry activities may be bid to tender by Pemex or its new subsidiaries under the already explained ad hoc rules, as follows:

(i) information regarding compensation and payment conditions will be clearly contained within bidding documents;

(ii) price negotiation stages may be included in the contracts as may be proposed by the general rules to be issued by the newly created Board of Directors; and

(iii) depending on the need for a specific (that is, irregular oil spills, expert witness services, spare parts and technological enhancement services, among others), Pemex and its subsidiaries may choose not to bid under an open tender proceeding but to issue a restricted invitation to only three parties (*invitación a tres partes*) or contract under a direct contracting proceeding (*adjudicación directa*).

Even more importantly, new Article 60 of the Pemex Law states that Pemex and its subsidiaries may enter into works and 'services contracts' with private firms for 'the best execution that its activities may require', if the following 'restrictions' are honoured:

(i) the Nation shall keep the direct ownership over oil at all times;

(ii) no title or right will be granted over oil reservoirs to private firms. Therefore, services providers may not register such assets as their own;

(iii) the control and management of the oil industry shall be kept in favour of Pemex;

(iv) compensation related to such contracts will be in cash. Therefore, no percentage of the production or sale value of oil or its derivatives, nor the revenues of Pemex or its subsidiaries may be agreed;

(v) no rights of first refusal may be granted over oil or its derivatives;

(vi) neither share-production agreements nor associations with regard to exclusive or strategic activities shall be granted; and

(vii) in no case may Pemex's contracts be governed by foreign courts. However, they may include arbitral clauses in accordance with Mexican law and international treaties.

Notwithstanding such restrictions,[1] new Article 60 of the Pemex Law states that such services contracts:

(i) May include flexible clauses where parties may execute modifications to the projects if technological advances, new equipment or the increase in global prices of certain products arises during execution, or due to the acquisition of new information obtained during the execution of works that may improve the efficiency of the project itself.

(ii) Compensation will be fixed through pre-agreed formulas or fixed schemes in order to obtain a fixed and certain price in accordance with civil law.

(iii) Plural-annual services contracts may contain review clauses if technological advances, new equipment or the increase in global prices of certain products occurs during execution, or due to the acquisition of new information obtained during the execution of works that may improve the efficiency of the project itself.

(iv) Compensation shall be clearly stated at the signing of the contract.

(v) Additional compensation may be agreed upon if:
   - (i) Pemex achieves better economic results due to better execution timeframes;
   - (ii) Pemex obtains new technologies from contractors;
   - (iii) Pemex obtains better revenues due to circumstances created by contractors and a better service or work is so obtained; and
   - (iv) such additional compensation is expressly stated on the contract execution date.

Services contracts as described in Article 60 of the Pemex Law, taking into account the restrictions, may be executed in the following activities:

   - (i) exploration, exploitation, refinery, transportation, storage, distribution and first-hand sale of oil;
   - (ii) exploration, exploitation, production and first-hand sale of gas as well as transportation and necessary storage for the inter-connection between its exploitation and production; and
   - (iii) production, transportation, storage, distribution and first-hand sale of any products needed as raw industrial materials considered to be basic petrochemicals.

Conclusions

The originally entitled 'energy reform' is indeed now a reform of the way the state-owned oil company Pemex is managed which will lead to significant improvements to Pemex itself, thus allowing a more efficient operation. The debates within the Senate banned some of the original proposals from the presidential office such as to allow private firms to build refineries or to operate storage and transportation infrastructure on behalf of Pemex. Risk contracts and production-sharing agreements were also banned.

Fortunately, Pemex is now allowed to bypass onerous and inefficient general public works and services laws, which historically prevented Pemex from signing services contracts under fast and efficient scenarios, thus preventing access to better technology.

All the above-described measures will introduce greater legal security for services contracts, thus attracting private companies that were once deterred by the fear of a legal debate.

Although the reforms make important strides towards improving Pemex, they would not attract major oil firms. However, it is clear that the reform will be a boon to oil-related services companies.

Notes

1 Such restrictions are imposed by Article 27 of the Mexican Constitution and this was the main discussion between right-wing and left-wing Mexican parties, that is, whether or not to allow private investment and risk- and production-sharing agreements in Pemex. In the end, the spirit of Article 27 prevailed as hereby explained. This restriction clearly means that the biggest oil companies of the world would not be interested in exploration and exploitation activities with Pemex if risk- and production-sharing schemes are not allowed.

PORTUGAL

Energy Efficiency 2015

Ana Oliveira Rocha
A M Pereira Sáragga Leal Oliveira Martins Júdice e Associados, Lisbon
aor@plmj.pt

The European Union's (EU) policy on energy efficiency, and thus on the energy sector, goes hand-in-hand with its policy on climate change and originated, predominantly, due to the latter. Pursuant to the European Commission's 2006 paper 'EU Against Climate Change: Reducing Emission from the Energy and Transport Sectors', more than 80 per cent of EU greenhouse gas (GHG) emissions are due to the production of energy and its use in households, industry, transport and elsewhere. Efficiency targets have been established at 20 per cent of energy saving in consumption until 2020.

Thus, policies pursued by the EU (and consequently by its Member States) envisage cutting down on the use of fossil fuels and reducing GHG emissions, while relying on an improvement in the efficiency of the energy industry as well as on the increased market share of renewable energy sources.

Portugal is highly dependent on imported energy sources, amounting to 85 per cent of its primary energy (mostly fossil fuels), well above the EU average and also one of the highest GDP energy intensities of the EU.

Therefore, the Portuguese Energy Strategy (approved by Resolution of the Council of Ministers no 169/2005 of 25 October 2005) foresees the approval of an action plan for energy efficiency, intertwining the techno-economic viability factor with environmental conditions in its quest for a sustainable development of the country – one of the three main objectives of the national Energy Strategy.

Recently, on 20 May 2008, the Government approved the Resolution of the Council of Ministers no 80/2008, which approves the National Action Plan for Energy Efficiency (PNAEE) for the 2008–2015 period: Portugal Efficiency 2015.

The scope of the PNAEE, pursuant to its preamble, is to integrate the policies and energy efficiency measures to be put in place, with the aim of saving, until 2015, energy representing circa 1,792 million tonnes of petroleum equivalent. Implementation of the PNAEE will represent 9.8 per cent of energy savings during the said period; a far greater amount (20 per cent greater) than the one per cent of energy savings per annum limit until 2016 set out under Directive 2006/32/EC of the European Parliament and of the Council, dated 5 April 2006, on energy end-use efficiency and energy services. Under this Directive, the first domestic energy efficiency action plan was to be submitted to the European Commission no later than June 2007.

Had Portugal not been granted a 27 per cent GHG emission limit – within the EU 15, measured as per 1990 levels under the influence of the 1997 Kyoto Protocol – which had already been surpassed by the end of 2005, the foreseen high-savings percentage and goal would be impressive. This actually implies that the country needs an accrued effort for reducing its carbon intensity.

The monitoring duty regarding the implementation of the PNAEE is to be attributed to the Ministry for Economy and Innovation following an annual report issued by the Directorate-General for Energy and Geology (DGEG). The main guidelines of the PNAEE foresee its articulation with the National Climate Change Action Plan (PNAC), which was revised in 2007, setting out additional goals and measures for the reduction of GHG emissions; all of these additional goals and ambitious numbers result mainly from the verification of an existing deficit as to the previously defined objectives.

The PNAEE's scope foresees an implementation of 12 different, new programmes affecting four specific areas (transport, residential and services, industry, and the state) which include the improvement of energy efficiency of vehicles, urban (public) transportation, buildings, lighting and domestic appliances. The PNAEE's industrial and state energy efficiency programmes foresee, respectively, the implementation of a management system for the intensive consumption of energy, and the energy certification of Government buildings as well as a 'green procurement' policy, altogether providing for the installation of micro-generation systems in pools, sports centres and schools as well as cogeneration in hospitals which, alone, will represent an induced energy saving of 12 per cent.

Consumer behaviour is to be changed through awareness campaigns and tax measures, such as the creation of accelerated amortisation regimes for efficient equipment and interconnection of the IRS (the national income tax for physical persons) benefits regime with the system of energy certification in buildings and renewable energies.

Arguably the most unpopular measures, are: (i) the envisaged incorporation of a carbon tax on the Tax on Vehicles (ISV) and on the Sole Vehicles Circulation Tax – although a reduction of the car tax in the purchase of a new 'light' car (50 per cent of the ISV if it is a hybrid) is to be taken into consideration; (ii) a tax on inefficient equipment; and (iii) a mandatory mobility plan to be implemented in industrial parks with more than 500 workers which will have to include, among others, a shuttle/minibus service with modal connection points and a mail office (and/or connected services).

In line with EU guidelines, additional incentives are foreseen such as the creation of the Energy Efficiency Fund and Economy Service Companies (ESCOs – to be hired to introduce improvements in existing buildings in view of economy in the energy bill, and to be paid as per the economy brought by the consumption reduction), as well as the incentive for urban rehabilitation and the acquisition and renewal of household appliances.

The PNAEE includes other incentives such as a reduction of 2.5 per cent of the electricity tariff for consumers with reduced energy consumption and a tariff incentive to the less efficient; the creation of a benefited line of credit with €250,000 per year for investment in energy efficiency measures with a strong focus on urban rehabilitation and the creation of a depreciation regime for investment in energy efficiency in the industry and services sectors.

As per the consumption scenario included in the Annex to Resolution 80/2008, in case the currently proposed energy efficiency measures are not implemented, it is estimated that energy consumption will increase to a level higher than the one seen during the last five years. Considering the country's energy intensity, this increase would mean that it would take Portugal 15 years to converge with the present EU average at current levels (stabilisation being largely contrary to EU expectations and efforts).

Should the Ministry for Economy and Innovation be so proud to declare that 'We have the 5th more ambitious EU and, possibly, World objective'? This ranking clearly refers to the Portuguese successful renewable energies generation, but how can Portuguese nationals, in their everyday life, cope with such ambitious policies and aims regarding climate change and energy (efficiency)? Demand side management is being used, and there is an effort to inform the Portuguese people of ways to save energy. The national Regulatory Entity for Energy Services has, by Order no 15546/2008 of 4 June 2008, set the rules of the Plan for Promotion of Efficiency in Consumption (PPEC) to be applied by market segments, industry and agriculture, commerce and services, and residential. The PPEC provides for incentives attributed by means of tenders to bidding eligible measures (as defined) up to a maximum participation of 80 per cent of the costs of the measure proposed by the promoter and/or participating consumer. However, at present, the main interest and eventual reduction in domestic consumption is felt more due to the economic crisis and need to save money than due to the awareness of the inescapable need to save energy.

Sustainable development and these policies bring costs, not only expressed in hard currency to be spent but also at a socio-economic level, possibly impairing (even further) Portuguese competitiveness when compared to the rest of the EU and, on a larger scale, with the rest of the world. Who is to pick up the tab for such costs and how? How is the balancing and sustainability to be obtained?

Resolution 80/2008 gives us some hints, but not a definite answer. Other policies and aims are being put in place but it is not reassuring to hear the Portuguese Minister for Economy and Innovation declare, as happened recently, that Government incentives are to be reduced: the question is in what term (short, medium or long?) taking into account: (i) the above-mentioned new incentive measures included in the PNAEE; (ii) how expensive the new efficient technologies still are and, especially; (iii) the difficulty felt in translating into actions the energy consumption worries when lifestyles are to be limited or altered.

UKRAINE

Upstream activities and legislation framework update

Irina Paliashvili
RULG – Ukrainian Legal Group PA, Kiev
irinap@rulg.com

In 2008, all branches of the Government of Ukraine actively declared the need to reform and modernise the use of subsoil in the fuel and energy sector, as this process is vital to the energy security and energy independence of Ukraine. In particular, on 16 January 2008, the Cabinet of Ministers of Ukraine (CMU) adopted a programme of activity entitled 'Ukrainian Breakthrough: for People and not for Politicians' (CMU Programme), which includes an action plan in the sphere of fuel and energy complex (Clause 3.3). This action plan contains the following important aspects.

Ukraine's strategy during the next five to seven years will be aimed at achieving the goal of creating an attractive investment climate for the private sector in the exploration and production of oil and gas. According to the CMU Programme, achieving this goal requires that the regulatory framework must be stable, the CMU's actions must be predictable, the energy policy must comply with the purposes of the Energy Charter Treaty, and the regulatory framework must be brought into compliance with EU standards. The CMU declared the following tasks:

- step-by-step introduction of the market-based procedure for developing prices of natural gas and simultaneous introduction of target subsidies to low-income population for gas;
- establishing a transparent, tender-based procedure for granting subsoil licences and strengthening oversight by the state of the observance of licensing conditions by licence holders;
- increasing the financing of geological exploration;
- ensuring the achievement by state-owned companies of exploration drilling targets for oil and gas in accordance with the power sector strategy of Ukraine until 2030; and
- creation of favourable conditions for exploration in new territories, including the Black Sea and Azov Sea shelves.

The CMU undertook the obligations to amend the Law of Ukraine on Rental Payments for Oil, Natural Gas and Condensed Gas concerning the establishment of effective rates and payment procedures that would promote increased production, and to ensure stability of the legislative framework regarding the taxation of production and trade in oil and natural gas.

Following the adoption of the CMU Programme, the President of Ukraine expressed his views on the development of the oil and gas sector in his Decree on Certain Measures Aimed at Improving the Regulation of Mining Relations of 28 February 2008. He instructed the CMU to develop a number of laws and regulations, to adopt and implement certain programmes, to develop and implement effective mechanisms for attracting domestic and foreign investments into the development of mineral raw materials, and to monitor and enforce compliance with the legal requirements for granting subsoil licences and the compliance by subsoil users with the terms and conditions thereof.

Looking back at 2008 it must be admitted that, from the point of view of both legal regime and practical implementation, very little progress was achieved in the oil and gas sector and, indeed, it was one of the least attractive years for investment in this sector. Most of the goals and tasks declared by the CMU Programme and the instructions to the CMU set in the presidential Decree have not been implemented. In practice, a number of existing projects with the participation of foreign investors were either frozen or cancelled, and no new oil and gas subsoil areas were offered at subsoil auctions.

The specifics of the licensing regime for the use of subsoil in Ukraine were already described in detail in our article published in the *Russian Petroleum Investor* (RPI), volume XVII, issue 2 in February 2008, and so in this article we will only outline the main developments and trends of 2008.

The flawed ad hoc regulation-based system governing subsoil licensing continued in 2008, but there was much uncertainty in the first half of the year concerning the two key regulations: the Licensing Procedure and the Auction Procedure. The Licensing Procedure was reported to be adopted on 27 February, but it was not published until early April and took effect on 11 April, and the Auction Procedure was adopted as late as 4 June (and took effect on 17 June). Most of the comments and amendments to the drafts of these regulations, suggested by the industry (through the European Business Association) to the CMU, were not taken into account.

The CMU strongly favoured the state sector, to the disadvantage of the private sector, in exploration and production of oil and gas. For example, in 2008 virtually no oil and gas subsoil areas were offered at subsoil auctions (only one area was offered and then withdrawn from the auction that took place on 16 December), thereby depriving the private sector from any opportunity to invest in new oil and gas exploration and production projects. At the same time, a large number of oil and gas subsoil areas were granted to the state-owned NJSC Naftogaz Ukrayiny (for example by the CMU Ordinance of 17 September 2008) without an auction and without apparent legal grounds.

In addition, further severe restrictions were introduced for cooperation of state-owned companies with the private sector. The main vehicle for such cooperation, a Joint Activity Agreement (JAA), which has been used for years, became virtually unavailable. In particular, the CMU Ordinance of 7 May 2008 required that an individual permit of the CMU be obtained for any JAA that involves a state-owned company ('state-owned' means any company in which the state's stake exceeds 50 per cent). No procedure for obtaining such a permit was adopted. Moreover, the Ordinance called for early termination of previously concluded JAAs. Further, when a large number of oil and gas subsoil areas were granted to the state-owned NJSC Naftogaz Ukrayiny by the CMU Ordinance of 17 September 2008, this Ordinance contained a direct prohibition to develop these areas on the JAA basis.

On 30 October 2008 the CMU issued a Resolution requiring that the granting of subsoil licences for strategically important natural resources could be made by the Ministry of Environment Protection only upon prior permission of the CMU, without even specifying the criteria and procedure for such a permit.

We offer a very brief review of the 2008 Licensing Regulations – the Licensing Procedure (CMU Resolution No 273) and the Auction Procedure (CMU Resolution No 525). Without going into detail, the picture appears to be very mixed and non-transparent. Some of the positive trends of 2007 found their way into the 2008 Licensing Regulations, and some of them did not. On the other hand, some of the negative aspects of Licensing Regulations in 2007 were repeated and some new negative aspects appeared in the 2008 Licensing Regulations. The following are a few examples of *negative aspects* of the 2008 Licensing Regulations:

- The possibility of transfer (reformulation) of a licence in favour of a joint venture (JV) or a subsidiary, or a parent company, which was present in the Licensing Regulations in 2007, was removed, and moreover such transfer was directly banned.
- The very short deadlines for announcement of an auction (30 days) and submission of applications (15 days), which were present in the Licensing Regulations in 2007 (in the 2007 Auction Procedure), and which directly contradict the relevant EU Directive, were preserved in the Auction Procedure in 2008.

- No possibility to challenge the decision of the Auction Committee was provided in the Auction Procedure in 2008. Moreover, the auction organiser was granted the right to withdraw selected areas from the announced auction, or even cancel the announced auction without any explanation.

Below are a few examples of *positive aspects* of the 2008 Licensing Regulations:

- A single (exploration and production) licence is explicitly allowed by the Licensing Procedures for 2008.
- Foreign legal entities are directly mentioned a few times in the 2008 Auction Procedure. They are also mentioned in the Licensing Procedure for 2008, but only in a footnote. A conclusion can be made that in 2008 foreign legal entities could directly participate in auctions and, moreover, obtain licences through a non-auction procedure (it should be noted that no such opportunity was given to them in practice).
- The Auction Procedure for 2008 removed a notorious provision, which was present in the 2007 Auction Procedure, allowing, in the event of failure to pay for the licence purchased at the auction by the auction winner, the subsequent transfer of the right to purchase the licence to the next bidder.
- A single unified format was introduced for the subsoil licence.

For 2009, the new Budget Law once again confirmed that subsoil licensing will be governed by the ad hoc regulation-based system and, therefore, this system will again be based on the Licensing Regulations (the Licensing Procedure and the Auction Procedure) to be adopted by the CMU for 2009 only for the current year. In other words, the oil and gas sector will again depend on the goodwill and competence of the CMU. The drafts of the Licensing Regulations became available for public discussion on the Ministry of Environment Protection's website on 15 January 2009 and, thus, it appears that in 2009 they will again be adopted with substantive delay.

At the same time, despite all the negative trends in 2008, the CMU will have no choice but to improve the licensing regime in 2009 and to make the oil and gas sector much more attractive for investment. It appears that the economic crisis, the exodus of investors from Ukraine, the gas dispute with Russia, various threats to energy independence and other dramatic events of 2008 have taught the CMU some powerful lessons on the vital need to create an attractive investment regime, particularly in the oil and gas sector.

UNITED KINGDOM

Carbon Reduction Commitments: putting the heat on contractors

Paul Perry
White & Case LLP
pperry@whitecase.com

From October 2009, the Carbon Reduction Commitment will potentially impact facilities management companies acting as counterparties to energy supply contracts and Private Finance Initiative/Public Private Partnership (PFI/PPP) bidders or other persons entering into long-term contracts.

Background

The Climate Change Bill, introduced in Parliament on 14 November 2007, completed its passage through the House of Lords on 31 March 2008.

The intention of the legislation is to move the United Kingdom to a low-carbon economy and society. It introduces a long-term legally binding framework to tackle the dangers of climate change.

The key component of the legislation is implementing the United Kingdom's targets to reduce carbon dioxide emissions through domestic and international action by at least 60 per cent by 2050 and by at least 26 per cent by 2020, against a 1990 baseline, making the United Kingdom one of the first countries to enact such a long-range, binding carbon reduction target.

Under the Bill, (i) a committee on climate change will be established as an independent expert body to advise the Government on the pathway to the 2050 target; (ii) there will be a power to pilot local authority incentive schemes for household waste minimisation and recycling; (iii) the Government will produce five-year carbon budgets, which will set binding limits on carbon dioxide emissions; and most importantly (iv) the Bill contains enabling powers to introduce new trading schemes, such as the Carbon Reduction Commitment, through secondary legislation. The Bill is currently with the House of Commons and was amended in Public Bill Committee on 10 July 2008. No date has yet been set for the third reading of the Bill in the House of Commons, and, as such, it has not received Royal Assent – although it is intended that the Regulations effecting the Carbon Reduction Commitment will pass into law in October 2009.

The Scheme

As part of its overall targets to reduce carbon dioxide emissions, the Carbon Trust and the Government have identified that the Carbon Reduction Commitment target sector accounts for around ten per cent of the United Kingdom's emissions – around 51Mt CO_2 per year. As such, the Government wants to help spread responsibility for reducing carbon emissions across the economy through the introduction of a Carbon Reduction Commitment Scheme (the 'Scheme').

As part of the legislative package making up the Climate Change Bill, regulations are to be published (which are not yet available) to establish the Scheme.

Under those regulations, any organisation which (a) has at least one meter settled on the half-hourly market, and (b) has a total half-hourly metered electricity use greater than 6,000 megawatt-hours (MWh) between 1 January 2008 and 31 December 2008 (ie, if the organisation, including any parent company and its subsidiaries, spends more than £500,000 a year in the United Kingdom on electricity) will most likely be included in the new Scheme.

It is anticipated that half-hourly metering will be defined as using:

- half-hourly meters (Code of Practice 5 meters) used for billing purposes;
- Voluntary Automatic Meter Reading (AMR) meters that produce half-hourly data (irrespective of whether the half-hourly metered electricity is settled on the half-hourly or non-half hourly market); and
- pseudo half-hourly meters (commonly used to measure electricity consumption of street furniture, eg, street lights, traffic lights, etc).

Generally, if unsure, your electricity supplier should be able to tell you if you qualify.

Qualification for the Scheme is based solely on half-hourly electricity usage. However, once the Scheme starts, organisations will need to monitor and report all energy use emissions from all sources (electricity, gas and other fuels) except for transport emissions, emissions covered by the European Union Emissions Trading Scheme and emissions covered by climate change agreements.

Organisations will be required to monitor and report their total energy use emissions from October 2009; however, earlier in that year, the Environment Agency is proposing to contact all UK billing addresses with half-hourly meters.

Organisations receiving a letter from the Environment Agency – which will be the administrator for the Scheme – must provide information on half-hourly electricity consumption in 2008 and a list of their half-hourly meters to determine whether they are required to participate in the Scheme.

More than 10,000 organisations are expected to be covered by the Scheme – which expressly includes state-funded schools (they will be included in the Scheme but would not participate in it individually, as their emissions will be included under the umbrella of their local authority), and may also include hospitals and other National Health Service organisations).

From 2009, participants in the Scheme will be required to submit annual data statements via an online registry to the Environment Agency (or the Scottish Environment Protection Agency or the Northern Ireland Department of the Environment) on a self-certified basis.

Participants will need to monitor, assess and manage emissions throughout the emissions year and, at the start of each year, purchase enough allowances, either through Government auction or through buying allowances on the secondary market, to cover the amount of their emissions.

At the start of the Scheme, allowances will be sold to participants at a fixed price of £12/tCO_2. The first sale will take place in April 2011. This may represent a significant additional cost for any organisation covered by the Scheme.

The impact on outsourcing and PFI/PPP

As part of the consultation process on the Scheme, the Department for Environment, Food and Rural Affairs (Defra) has published the 'Carbon Reduction Commitment – Organisational Structures' paper, dated March 2008. In that paper, Defra addresses the issue of the Scheme's application to outsourcings, third party purchasers, and PFI/PPP transactions.

In each case, Defra indicates that it would take the approach that emissions responsibility should be allocated to the outsourcer or the outsourcee, to the consumer or third party purchaser, or to the public authority or PFI/PPP project company on the basis of whichever body is the effective 'counterparty to the energy supply contract'.

In the case of a third party purchasing electricity on behalf of another body, Defra looks specifically at the example of Kent County Council, which operates the LASER Energy Buying Group, a third party organisation which buys energy for around 70 other councils and other public bodies. LASER is responsible for placing supply contracts for gas, electricity, heating oil and roads fuels and paying energy bills worth around £200 million per annum. Under the arrangements, the energy suppliers bill LASER centrally, LASER validates the billing and pays correct bills, and LASER then bills the end-users. Defra concludes that the application of the 'counterparty to the energy supply contract' principle means that in most scenarios the actual consumer of the energy (ie, the council or public body) will be responsible for Scheme compliance, not LASER itself.

Under PFI/PPP arrangements, Defra again takes the approach that the 'counterparty to the energy supply contract' is to be responsible for compliance with the Scheme, and finds no good reason to change this approach. This may mean that either the authority, the private sector provider, or the special purpose vehicle (SPV) (where it is a 'thick' SPV) is responsible for compliance with the Scheme, depending on the arrangements of the PFI/PPP. Defra expressly considers and rejects the possibility of simply making the local authority responsible for compliance with the Scheme for each of its PFI/PPP arrangements. It should be noted that, where a 'thin' SPV is used and that 'thin' SPV is given responsibility for energy purchase, the energy use of the majority shareholder of the SPV will be regarded for the purposes of determining whether compliance with the Scheme is required, meaning that, even if the SPV itself does not purchase enough energy to be caught by the minimum requirements, the parent company of the majority shareholder may still be caught.

Defra mentions in its paper that the Scheme is likely to be caught as a 'Change in Law' under the provisions of a PFI/PPP contract and so adjustments to the pricings of existing contracts may be necessitated by the new Scheme. However, the 'Change in Law' provisions may not apply to save an arrangement where the relevant party ought to have been aware of the existence of the new Scheme when negotiating the PFI/PPP contract. Where organisations are currently bidding for PFI/PPP projects or are negotiating PFI/PPP arrangements with local authorities as the preferred bidder, they should consider including an allowance for the additional costs of compliance with the Scheme in their bid/project costs, to be on the safe side.

The enforceability of take-or-pay provisions in English law contracts

Ben Holland and Phillip Ashley
CMS Cameron McKenna LLP, London
ben.holland@cms-cmck.com • phillip.ashley@cms-cmck.com

In a recent case, the Commercial Court considered, for the first time, whether a claim based on a 'take-or-pay' provision in a sale and purchase agreement should fail because the take-or-pay provision was a 'penalty clause'. This article considers the impact of this judgment on the interpretation and drafting of contracts containing take-or-pay provisions.

What are take-or-pay provisions?

Take-or-pay provisions are a very familiar feature in many energy sector contracts. They require a buyer to take a minimum quantity of the product or service to which the contract relates. The buyer is required to pay for this minimum quantity, whether or not taken. Take-or-pay provisions are most commonly found in the energy industry, in gas sales contracts, power purchase contracts and many other common industry contracts. Similarly, 'send-or-pay' provisions are commonly found in energy sector transportation contracts. Take-or-pay provisions are also often found in contracts in other industry sectors.

What is the English law rule against penalty clauses?

The rule against penalties prevents the enforcement of clauses that operate as a penalty against the party in default. For example, where a contract stipulates that a specified sum is payable upon breach of an obligation by a party to that contract, but the sum stipulated is not a genuine pre-estimate of loss suffered due to that breach, the clause will not be enforceable.

The rule against penalties reflects the principle that, in English law, a party is normally free to breach its contractual obligations upon payment of damages, the value of which is to be determined by the court applying established principles. A penalty clause operates in a way that attempts to fix a higher measure of damages. As this may have the purpose of deterring a party's freedom to breach its contractual obligations (for example, an attempt to tie in a customer to a hire-purchase contract) such provisions may be considered unenforceable.

However, because the rule against penalties is an anomaly within the English law of contract, which generally allows commercial parties freedom to contract at will, the courts are predisposed to enforce such clauses and only rarely find that they are a penalty. This predisposition is particularly strong in commercial contracts freely entered into between commercial parties of comparable bargaining power.[1]

What was the case about?

In *M & J Polymers Ltd v Imerys Minerals Ltd*,[2] the Commercial Court considered the application of the rule against penalties in the context of take-or-pay provisions in a commercial contract. M & J Polymers Ltd ('M & J Polymers') supplied chemical dispersants to Imerys Minerals Ltd ('Imerys') under a long-term supply contract. The contract contained a provision requiring the buyer to order a minimum quantity of chemicals and a take-or-pay provision.

The recitals of the supply contract stated that: 'The Buyers want to ensure a regular and reliable supply of the Products and the Supplier agrees to guarantee such supply under the terms and conditions of this Agreement.'

The supply contract had a three-year minimum term and contained a take-or-pay provision as follows:

> 'Article 5: Stock Level and minimum purchase
> 5.3 During the term of this Agreement the Buyer will order the following minimum quantities of Products
> …
> 5.5 Take-or-pay: the Buyers collectively will pay for the minimum quantities of Products as indicated in this Article at 5.3… even if they together have not ordered the indicated quantities during the relevant monthly period.'

In the High Court, Burton J was asked, among other things, to resolve whether the sum owing under the take-or-pay provision was unenforceable as it offended the rule against penalties. To resolve this question Burton J considered two separate issues: first, did the take-or-pay provision give rise to a debt rather than damages and, secondly, if the take-or-pay provision gave rise to damages rather than a debt, was the provision in question a penalty or was it an enforceable liquidated damages provision?

It was common ground between the parties that any take-or-pay payments that would have fallen due after termination of the supply contract could only be claimed in damages. The dispute was limited to the take-or-pay payments that had fallen due prior to termination of the supply contract.

M&J Polymers argued that the claim under the take-or-pay provision was a debt and referred Burton J to the citation in *Chitty on Contracts*[3] discussing the principle in *White & Carter (Councils) Ltd v McGregor*[4] that states: 'The law on penalties… is not relevant where the claimant claims an agreed sum (a debt) which is due from the defendant in return for the claimant's performance of his obligations.'

In support of its contention that the take-or-pay provision created a debt and not damages, M&J Polymers referred Burton J to *Export Credits Guarantee Dept v Universal Oil Products Co*,[5] in which the contract provided for a payment to take place upon a specified event. In Lord Roskill's opinion: 'The clause was not a penalty clause because it provided for payment of money upon the happening of a specified event other than a breach of a contractual duty owed by the contemplated payor to the contemplated payee.'

The House of Lords held that a payment provided to take place upon a specified event was not susceptible to the rule against penalties. M & J Polymers drew an analogy with the take-or-pay provision in the supply contract, which, it was argued, also fell due upon the happening of a specified event. M&J Polymers argued that the sum was due irrespective of whether Imerys had ordered the minimum quantities – or as it might alternatively be stated, that the amount was due 'whether or not they have ordered the quantities' or indeed 'whether or not there has been a breach of Clause 5.3'. Therefore, M & J Polymers argued that the amount was due as a debt, not as damages, and so the rule against penalties did not apply.

Burton J did not agree with M & J Polymers' arguments and decided that take-or-pay provisions could, in certain circumstances, amount to a penalty clause. The judge held that the sum due under the take-or-pay provision arose as damages for failure to order the minimum quantity. It was not a claim for a debt. Burton J distinguished *Export Credits Guarantee Dept v Universal Oil Products Co* by deciding that:

> 'I do not see how a payment obligation can arise under Article 5.5 [the take-or-pay provision] in a case other than where there has been a breach of the obligation to order under Clause 5.3 [the minimum quantity provision]. If the goods are in fact ordered, then they will be delivered, and the price will be due quite irrespective of Article 5.3 or 5.5.'
> 'There may be an option for a claimant to pursue its claim either for damages for breach of Article 5.3 or for the price in respect of Article 5.5, but on the face of it the "specified event" in Article 5.5 is the same event as amounts to a breach of duty under Article 5.3.'

From this analysis, Burton J was 'satisfied therefore that, as a matter of principle, the rule against penalties may apply'. However, he found that in this case the take-or-pay provision did not offend the rule against penalties, since:

- contractual provisions are rarely struck down as a penalty;
- the take-or-pay provision was commercially justifiable and did not amount to oppression; and
- the take-or-pay provision was negotiated and freely entered into between parties of comparable bargaining power, and did not have the predominant purpose of deterring a breach of contract.

Why is the case important?

Two aspects of the judgment are of interest to energy companies, their investors and the lawyers advising them. The first is the finding that a breach of any take-or-pay provision, drafted in a similar manner to the one considered by the judge, gives rise to an action in damages not debt. The second is the judge's comments as to when take-or-pay clauses are likely to be treated as penalty provisions and held to be unenforceable.

Take-or-pay provisions – debt or damages?

Burton J first considered M&J Polymers' submission that its claim under the take-or-pay provisions was a debt as it arose out of a 'specified event' and not out of any breach of contract by the buyer.

To analyse the impact of this judgment, it is necessary to distinguish between a claim for a debt and a claim for damages. 'A debt is a definite sum of money fixed by the agreement of the parties as a payment by one party in return for the performance of a specified obligation by the other party or upon the occurrence of some specified event or condition; damages may be claimed from a party who has broken his contractual obligation in some way other than a failure to pay such debt.'[6]

Addressing this point, Burton J stated that he did not see 'how a payment obligation can arise under [the take-or-pay provision] in a case other than where there has been a breach of the obligation to order under [the minimum order provision]. If the goods are in fact ordered, then they will be delivered, and the price will be due quite irrespective of [either provision]'. In the judge's analysis, the obligation of the buyer to pay under the take-or-pay provision arose due to a breach of its obligation to order the minimum quantity. Therefore, the seller's claim was a damages claim, which was subject to the rule on penalties. Many take-or-pay provisions are coupled with an obligation on the buyer to order a certain quantity and would fall within the scope of the judge's reasoning.

With respect to the judge, it does not follow that it is a sound approach to construe the take-or-pay provision as a clause that only operates because of a breach of the obligation to order the minimum quantity. Nor is it necessary to construe the interrelation of the minimum order provision and the take-or-pay provision in a way that makes a claim by a seller under the take-or-pay provision a damages claim.

There are two separate obligations in most take-or-pay contracts. First, there is the obligation on the seller to make the goods available for delivery to the buyer. Secondly, there is the obligation on the buyer to take up and/or pay for the goods. Both of these obligations create a benefit for the other party in security of purchase and/or supply.

In the *M&J Polymers* case, it was not denied by the buyer that the seller had made the chemicals available for purchase. The seller had therefore performed the service to the buyer that was required by the supply contract. Normally, a seller that has performed the contractually agreed service to the buyer becomes entitled to be paid. This right to payment is a debt, it is not a damages claim. Compliance by the seller with its obligation to make the goods available to the buyer creates a debt. This happens regardless of whether the buyer complies with its obligation to take up the minimum quantity or not. The buyer still benefits from the seller performing its obligation and having the option of taking up the goods if it wishes to do so.

It may be that Burton J was not assisted by M&J Polymers focusing its arguments in favour of the sum owing being a debt due to the happening of a 'specified event'. The 'specified event' on which M&J Polymers sought to rely, as Burton J found, was 'the same event as amounts to a breach of duty' (the ordering by the buyer of the chemicals). If M&J Polymers had argued that the sum was due because M&J Polymers had performed 'a specified obligation' (the seller making the chemicals available for order) it is conceivable that Burton J may have found differently.

At least two send-or-pay provisions, which are in all essential respects analogous to take-or-pay provisions, have been referred to the House of Lords. In both *Total Gas Marketing Ltd v Arco British Ltd and others*[7] and in *Amoco (UK) Exploration Company v Teesside Gas Transportation Limited and Another*,[8] no issue was raised as to these provisions acting as a penalty.

Lord Hoffmann, in his speech in the House of Lords in *Amoco v Teesside Gas*, referred to '*the income stream from the send-or-pay payments*'. Although it was not in issue in that case whether the send-or-pay payments were damages or debt, Lord Hoffmann's reference to the sum as an '*income stream*' was a clear reference to the sum being a debt. Lord Hoffmann also alluded to the commercial purpose of creating such an income stream, as probably forming '*part of [the sellers'] financing arrangements*', under which the sellers' project finance lending was to be repaid.

At no point in *Amoco v Teesside Gas* did the party liable to pay the send-or-pay payments raise the issue of whether the send-or-pay provision was a penalty, even though by the time that it challenged the provisions it had paid £45 million in send-or-pay payments with no prospect of having any product to send down the pipeline (as it had none at the time to send).

A sum due to a seller under take-or-pay provisions has the essential hallmarks of a debt. Namely, the payments are a definite sum of money fixed by the agreement of the parties as a payment by one party in return for the performance of a specified obligation by the other party. This construction is consistent with Lord Hoffmann's speech in the House of Lords in *Amoco v Teesside Gas*,[9] where he referred to '*the income stream from the send-or-pay payments*'.[10]

In drafting take-or-pay provisions there may be two simple ways to avoid payments being construed as damages, rather than a debt, in accordance with Burton J's judgment. First, where there is no commercial imperative for the buyer to be compelled to take the product, it may be advisable for contracts to make clear that the buyer 'may' order quantities of the product, rather than imposing any obligation on the buyer that it 'will' or 'shall' place minimum orders. If the contract states 'may' it should not be a breach of contract to fail to order the quantity. Therefore the 'specified event' of not ordering the minimum quantity would not be a breach of contract in the manner that Burton J found.

Secondly, Burton J's construction of the provision would be unlikely to apply if a '*make-up*' provision were included in the agreement. Where a party has made a payment under a take-or-pay provision, having not taken the goods but is entitled, through '*make-up*' provisions, to take the goods at a later date, it would be extremely difficult to construe the sum paid as damages rather than debt, since the paying party is simply making a payment for the future performance of an obligation.

Take-or-pay provisions – when are they reasonable?

As a matter of practice, take-or-pay provisions in energy contracts will almost always be negotiated between commercial parties and will be commercially justified. Consequently, they are highly unlikely to be found to be a penalty, even if the rule on penalties could apply. This is because, as set out in *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd*,[11] 'the courts are predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power'. In that case Jackson J surveyed the law on penalties and came to the following conclusions:

- a damages provision is not a penalty if it is a genuine pre-estimate of damages;
- the process of considering whether a pre-estimate is genuine is primarily objective; however, the courts have some regard for the thought process of the parties;
- a pre-estimate will not be unreasonable, and therefore will be enforceable, unless there is a 'substantial discrepancy between the level of damages stipulated in the contract and the level of damages which is likely to be suffered';
- the courts are predisposed to upholding fixed levels of damages agreed between parties; and
- there are very few recent cases where a provision was found to be a penalty and in these cases there was a wide discrepancy between the level of damages stipulated in the contract and the level of damages suffered.

In *M&J Polymers*, Burton J held that the parties agreed the take-or-pay provision as the 'Buyers want[ed] to ensure a regular and reliable supply of the Products and the Supplier [to]… guarantee such supply under the terms and conditions of [the] Agreement'.[12] From the evidence, it also appears that M&J Polymers' suppliers of acrylic, a product necessary for the manufacture of the chemicals which was in short supply at the time that the supply contract was entered into, insisted that M&J Polymers entered into a long-term supply contract with them. M&J Polymers was therefore exposed to make payments to its own suppliers that it sought to hedge through the take-or-pay provision. M&J Polymers was not prepared to produce and store the chemical without knowing that Imerys would take or alternatively pay for an agreed quantity. Burton J agreed that it was reasonable for it to take this approach and the provision was therefore enforceable and not a penalty. This analysis is pertinent in relation to agreements in the energy industry where parties regularly enter into take-or-pay obligations either to hedge quantity risks to which they are exposed under upstream contracts or for reasons of project finance.

It is evident that 'long-term take-or-pay contracts contribute to the realization of upstream investments, especially in the case of non-EC gas producers. Without these contracts the huge amount of finance of [sic] new gas investments may not become available and the security of supply could be jeopardized'.[13] Take-or-pay provisions are often passed downstream through contracts, back-to-back, ensuring security and certainty of supply through the supply chain, making it easier to gain project finance upstream, but exposing each party to a quantity risk unless it negotiates an enforceable back-to-back take-or-pay obligation with its downstream customer(s).

The importance of take-or-pay provisions in protecting parties from quantity risks, or in order to project finance an investment, supports the proposition that, in the energy industry, such provisions are usually reasonable. In these or similar circumstances, it would be extremely difficult to suggest that a take-or-pay obligation in the energy industry was not a genuine pre-estimate of loss. For this reason, take-or-pay provisions in most standard energy sector contracts are unlikely to be held to be unenforceable as a penalty.

Notes

1 *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] EWHC 281 (TCC); [2005] BLR 271(QBD) (TCC).
2 *M&J Polymers Ltd v Imerys Minerals Ltd* [2008] EWHC 344 (Comm).
3 29th edn (2004), vol 1 at para 26-118.
4 [1962] AC 413.
5 [1983] 1 WLR 399.
6 *Chitty on Contracts*, 29th edn (2004), vol 1 at para 26-009.
7 [1998] 2 Lloyd's Rep 209.
8 [2001] UKHL 18.
9 *Ibid*.
10 *Ibid*, at 24.
11 [2005] EWHC 281 (TCC); [2005] BLR 271 (QBD (TCC)).
12 Paragraph 3 of the judgment quoting from the recitals of the supply contract.
13 Eugene D Cross, Bram Delvaux, Leigh Hacher, Piet Jan Slot, Geert Van Calster and Wim Vandenberghe, 'EU Energy Law', paragraph 5.71, in Roggenkamp, Ronne, Redgwell and Guayo, *Energy Law in Europe: National, EU and International Law and Institutions* (2007).

UNITED STATES

Climate change litigation against private defendants in the United States

Steven F Napolitano and Lincoln Davis Wilson
Skadden Arps Slate Meagher & Flom LLP
steven.napolitano@skadden.com • lincoln.davis@skadden.com

Tort litigation trends in the United States often follow the discussion of major events or ideas in the public forum. For instance, when health warnings are issued about a particular food item, class action lawsuits seeking damages may be expected to follow soon thereafter, and as books and documentary films have drawn national attention to the health effects of eating too much fast food, plaintiffs have filed suit alleging that such restaurants are liable for causing their obesity. Not unexpectedly, as awareness of and concerns about climate change have grown steadily in the public consciousness, plaintiffs in the United States have filed suits seeking to hold corporations liable for injuries caused by global warming. This article will address the current status of these civil suits and examine some of the procedural and substantive barriers to their success so far.

Only a half dozen or so suits alleging harms caused by global warming have been filed in US courts against private parties.[1] Plaintiffs have filed suits against defendants who emit compounds that allegedly cause or contribute to global warming, including utility companies, auto manufacturers and oil companies. Some of these suits have primarily sought injunctive relief, while others have sought money damages. For instance, in one case several states (including New York and California) sued utility companies for the alleged effect of their emissions on global warming, seeking an injunction that the defendants be required to reduce their emissions by certain increments annually.[2] In another case, plaintiffs whose property had been damaged by Hurricane Katrina sued oil and chemical companies for damages, alleging that the defendants' emissions had contributed to global warming, thereby making catastrophic meteorological events such as hurricanes more frequent.[3]

Thus far, these suits have not succeeded. Three of the suits have been dismissed by courts before discovery, one has settled, and a motion to dismiss is pending in the other. Several prominent procedural and substantive barriers stand in the way of these suits, including: (i) the political question doctrine; (ii) constitutional limitations on standing; (iii) the law of nuisance; and (iv) the First Amendment of the United States Constitution. This article will address each of these issues in turn.

The political question doctrine

The political question doctrine protects the separation of powers set forth in the United States Constitution by preventing the judiciary from deciding matters within the province of other branches of government. The Supreme Court of the United States has held that political questions may be present in a variety of circumstances, including where there is a 'textually demonstrable constitutional commitment of the issue to a coordinate political department;… a lack of judicially discoverable and manageable standards for resolving it; [or] the impossibility of deciding without an initial policy determination of a kind clearly for nonjudicial discretion… '[4]

Two global warming suits have been dismissed thus far under the political question doctrine. These suits, *Connecticut v American Electric Power*[5] and *California v General Motors Corp*,[6] were brought by states against corporations who were major emitters of greenhouse gases. In *American Electric Power*, certain US states sought an injunction requiring the companies to reduce their emissions by specified percentages, while in *General Motors*, the state of California sought damages for harms caused by global warming. In both cases, the defendants argued that the suits presented non-justiciable political questions, and in both cases the court agreed.

In *American Electric Power*, the first global warming suit against private defendants, the court prefaced its political question analysis with a detailed history of the actions taken with respect to climate change by Congress and the US Environmental Protection Agency (EPA), an Executive agency. In determining whether a political question was present, the court found one indicator particularly relevant: 'the impossibility of deciding without an initial policy determination of a kind clearly for nonjudicial discretion.' The court held that it could not conduct the balancing required of such a broad public nuisance claim – weighing the interests of reducing pollution against the interests of economic freedom – without an initial policy determination from Congress or the Executive. The court held that adjudicating the dispute would require several prior determinations by the legislature, including the scope and degree of liability of utilities and other companies, the economic implications of imposing liability, and the implications of a ruling on energy independence and national security. The court concluded that it should not interfere with the EPA's continuing determinations about climate change, and accordingly dismissed the case as a non-justiciable political question.

In *General Motors*, the court relied heavily on *American Electric Power* in determining that the case likewise presented a non-justiciable political question requiring an initial policy determination by another branch of government. The court also relied on the Supreme Court's decision in *Massachusetts v EPA*[7] for the proposition that sovereignty over certain global environmental concerns was given exclusively to the EPA, leaving the states limited procedural rights to challenge EPA rule-making. The court reasoned that this case presented a political question because adjudicating California's suit would require the court to make policy determinations that would interfere with the EPA's exclusive authority over such issues.

The *General Motors* court also held that other indicators demonstrated that California's suit presented a political question. First, the suit would transgress the 'textually demonstrable constitutional commitment' of the issue to the political branches; namely, it would transgress Congress' constitutional authority over commerce and the authority of Congress and the Executive over foreign policy. Secondly, the court found a 'lack of judicially discoverable or manageable standards' to adjudicate the dispute – there was no way of determining in a nuisance suit what was a reasonable amount of carbon emissions without a policy determination from the political branches. Accordingly, the court dismissed California's claims as non-justiciable.

Constitutional limitations on standing

The United States Supreme Court has held that plaintiffs must meet certain constitutional requirements to possess 'standing' to sue in federal courts. In order to possess standing, a plaintiff must allege an injury that is fairly traceable to the defendant's wrongful conduct and that may be redressed by a judicial decision. The two courts that have addressed the standing question in global warming suits against private defendants have split on the issue. In *Northwest Environmental Defense Center v Owens Corning Corp*,[8] the District of Oregon held in a published decision that the plaintiffs had standing – the case settled on the same day of the decision. Conversely, in *Comer v Nationwide Insurance*, the court held that the plaintiffs injured in Hurricane Katrina lacked standing to bring claims against oil and chemical companies and accordingly dismissed the case.[9] That decision is on appeal.

In *Northwest Environmental Defense Center*, the District of Oregon held that the plaintiffs possessed standing. There, the plaintiffs, environmental public interest organisations, alleged that the defendant fibreglass manufacturer was building a new facility without a preconstruction permit in violation of the federal Clean Air Act and the new source review provisions in Oregon's State Implementation Plan. The plaintiffs sued on the basis of their members' risk of disease and damage to their environment caused by the depletion of stratospheric ozone and by global warming, to which the emissions from the defendant's new facility would allegedly contribute. The plaintiffs sought declaratory and injunctive relief with respect to construction of the proposed facility, as well as civil penalties and attorneys' fees. The defendant moved to dismiss for lack of standing.

Denying the defendant's motion to dismiss for lack of standing, the court held that the plaintiffs' fear of suffering harm was sufficient to constitute an injury. Because the plaintiffs lived near the defendant's plant, there was sufficient likelihood that their local environment would be affected by the defendant's emissions. With respect to the 'fairly traceable' component of standing doctrine, the court held that '[i]t is sufficient for Plaintiffs to assert that emissions from Defendant's facility will contribute to the pollution', and denied the relevance of the defendant's assertion that its emissions were neither the only nor even a significant cause of the plaintiffs' injury. The court further held that the plaintiffs' suit did not violate the prohibition of generalised grievances – the court held that the plaintiffs' injury, though widely shared, was sufficiently concrete to support standing. The court therefore denied the defendant's motion to dismiss. On the same day, the parties settled the case for a payment of US$300,000 to various environmental organisations plus US$250,000 for the plaintiffs' attorneys' fees, as well as a promise by the defendant not to use certain chemicals in its manufacturing activities.[10]

In contrast, the court in *Comer v Nationwide Insurance* dismissed for lack of standing, but there is little guidance as to the grounds of the decision, because the reasoning was in an unavailable record of a hearing. Other cases, however, provide some insight into why a dismissal for lack of standing may be warranted in global warming cases. Defendants have moved to dismiss for lack of standing in *Native Village of Kivalina v ExxonMobil*,[11] a suit brought by Alaskan Eskimos who allege that damage to their coastal village was caused by global warming to which the defendant energy companies contributed. There, the defendants do not deny that the plaintiffs have suffered an injury (because their coastline has unquestionably eroded), but instead argue that the injury is not fairly traceable to the defendants' alleged wrongful conduct. Specifically, the defendants contend that the plaintiffs cannot show that their harm was caused by the emissions of the defendants rather than those of other third parties. They also argue that the plaintiffs' theory of causation is too attenuated to support standing.[12] The motion is pending before the court.

The law of nuisance

To make a claim for the tort of public nuisance, a plaintiff must allege that the defendant's conduct was a substantial factor in harming him and a substantial number of other people, and that the seriousness of the harm outweighs its utility. Elements of the law of nuisance may be an important bar to the success of future global warming claims. For instance, in *Kivalina*, the defendants argue that because the plaintiffs' injury was caused by CO_2 emissions from everyone on the planet over the last two centuries, of which the defendants represent only a fraction, the plaintiffs fail to sufficiently allege that the defendants' conduct was a substantial factor in causing their harm and thus do not properly allege a state-law nuisance claim. Further, the defendants argue that the federal common-law nuisance claims must fail because such claims are limited to states seeking injunctive relief, and that Congress has displaced courts' authority to regulate emissions standards.[13] The plaintiffs respond by noting that the defendants' emissions constitute a significant portion of all emissions that have caused global warming and, therefore, that their emissions are a substantial factor in causing the plaintiffs' harm. Further, the plaintiffs argue that federal common law nuisance claims are not limited to suits by states for injunctive relief.[14]

The First Amendment

Finally, in *Kivalina*, the plaintiffs allege that the energy companies are liable for civil conspiracy and concert of action in that they conspired to deceive the public by funding organisations that deny the scientific consensus on global warming.[15] In moving to dismiss for failure to state a claim, the defendants have argued that imposing liability on defendants for such expressive activity would violate the freedom of speech guarantees of the First Amendment to the United States Constitution.[16] In response, the plaintiffs argued that there is no First Amendment protection for fraud – that is, for intentional or reckless misstatements of fact – and that the defendants have committed fraud.[17] Thus, the plaintiffs' claims could turn in part on whether the global warming hypothesis is deemed a fact, and whether the defendants are deemed to have intentionally or recklessly disregarded it. *Kivalina* is an important case, and the court's rulings on these arguments will be important to the future viability of such claims.

Conclusion

While global warming litigation against private defendants in the United States is in its early stages, the procedural and substantive issues discussed above have thus far proved daunting hurdles to succeeding on such a claim. In the meantime, the disposition of the motion to dismiss in *Kivalina* may determine whether plaintiffs continue to pursue such claims against private defendants in the face of such hurdles.

Notes

1 Instead of suing private parties, other plaintiffs have sued the Government to force agencies to take action with respect to global warming. See, for example, *Massachusetts v EPA*, 549 US 497 (2007).
2 *Connecticut v American Electric Power*, 406 F Supp 2d 265 (SDNY 2005).
3 *Comer v Nationwide Mutual Ins Co*, no 1:05-cv-436, 2006 US Dist LEXIS 33123 (SD Miss, 23 February 2006).
4 *Baker v Carr*, 369 US 186, 217 (1962).
5 406 F Supp 2d 265 (SDNY 2005).
6 No C06-05755, 2007 US Dist LEXIS 68547 (ND Cal, 17 September 2007).
7 549 US 497 (2007).
8 434 F Supp 2d 957 (D Or 2006).
9 Order of Dismissal, *Comer v Nationwide Ins Co*, no 1:05-cv-436 (SD Miss, 30 August 2007) (dismissing for lack of standing and pursuant to the political question doctrine for reasons stated in an unavailable record of hearing).
10 Stipulated Order of Dismissal, *Nw Environmental Defense Ctr v Owens Corning Corp*, no 04-1727 (D Or, 8 June 2006).
11 No 4:08-cv-01138 (ND Cal 2008).
12 Brief of Oil Defendants in Support of Motion to Dismiss Under Rule 12(b)(1), *Native Village of Kivalina v ExxonMobil Corp*, no 4:08-cv-01138 (ND Cal, 30 June 2008).
13 Brief of Oil Defendants in Support of Motion to Dismiss Under Rule 12(b)(6), *Native Village of Kivalina v ExxonMobil Corp*, no 4:08-cv-01138 (ND Cal, 30 June 2008).
14 Corrected Brief of Plaintiffs in Opposition to Motion to Dismiss, *Native Village of Kivalina v ExxonMobil Corp*, no 4:08-cv-01138 (ND Cal, 8 October 2008).
15 Complaint 189-248, *Native Village of Kivalina v ExxonMobil Corp*, no 4:08-cv-01138 (ND Cal, 26 February 2008).
16 Brief of Utility Defendants, *Native Village of Kivalina v ExxonMobil Corp*, no 4:08-cv-01138 (ND Cal, 30 June 2008).
17 Corrected Brief of Plaintiffs in Opposition to Motion to Dismiss, *Native Village of Kivalina v ExxonMobil Corp*, no 4:08-cv-01138 (ND Cal, 8 October 2008).