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from : General Secretariat of the Council
dated : 23 October 2006
to : COREPER / COUNCIL

Subject : RELATIONS WITH AZERBAIJAN
– Memorandum of Understanding on a Strategic Partnership between the
European Union and the Republic of Azerbaijan in the field of energy

Subject to confirmation by COREPER, the Council is invited to endorse the Memorandum of Understanding on a Strategic Partnership between the European Union and the Republic of Azerbaijan in the field of energy.

**Memomrandum of Understanding on a Strategic Partnership between the European Union
and the Republic of Azerbaijan in the field of energy**

PREAMBLE

Having regard to the Communication of the Commission to the Council and the European Parliament on the Development of Energy Policy for the Enlarged European Union its neighbours and partner countries;

Having regard to the Commission's Green Paper on "A European Strategy for Sustainable, Competitive and Secure Energy" and the conclusions of the 23-24 March and 15-16 June, 2006, European Councils which underlined the importance for the EU to enhance relations in the energy sector with its main suppliers and transit countries,

Having regard to Azerbaijan's State Programme for the Development of the Fuel and Energy Sector in Azerbaijan that was approved by Presidential Decree in February 2005 (in Annex) and Azerbaijan's State Programme for the Utilization of Alternative and Renewable Energy Sources that was approved by Presidential Decree in October 2004 (in Annex).

Recognizing that, in the field of energy, the EU and Azerbaijan share convergent interests and both could benefit from the integration of their respective energy markets, thereby enhancing the energy security of both sides. In this context, the gradual harmonisation by Azerbaijan to the EU energy acquis would constitute a significant step towards Azerbaijan's objective of gradual economic integration and deepening of political cooperation with the EU.

Considering that in the framework of the European Neighbourhood Policy (ENP), the EU and Azerbaijan have decided to step up their energy co-operation and that the EU-Azerbaijan Action Plan (AP) includes energy-related actions and objectives aimed at the gradual convergence of EU and Azerbaijan's energy legislation and integration of their respective energy markets;

Considering that the EU and Azerbaijan are determined to advance rapidly in realizing these objectives, as was confirmed during high-level meetings, and also through the creation in 2005 of a Sub-committee on Energy and Transport within the framework of the EU-Azerbaijan Partnership and Cooperation Agreement;

Emphasizing the importance of ensuring the sovereignty, territorial integrity and inviolability of internationally recognized borders of the States of the region, particularly with a view of elimination of threats and risks in strengthening the European energy security;

Taking note of the new EU initiative in energy efficiency, detailed in the recent Green Paper,

Considering, in connection to the above, that the EIB and the EBRD should be closely involved in the implementation of this Strategic Partnership;

Recalling that the energy sector remains one of the important elements in EU-Azerbaijan bilateral relations and both sides have benefited from cooperation in the framework of the Community assistance under Tacis National Programme and Inogate Programme

Whereas:

1. The Azerbaijani energy sector is, and will remain, one of the major factors for the economic and social development of Azerbaijan through the exploitation and export of natural oil and gas resources, and the potential rapid development of transport and of transit of oil and natural gas. The gradual convergence with the EU's internal energy market, aiming ultimately at its integration, remains a shared priority for the EU and Azerbaijan;
2. The EU and Azerbaijan face common energy policy challenges. The diversification and security of energy supplies, the deepening of energy market reforms, the development and modernisation of energy infrastructures, energy efficiency, energy savings and the use of renewable energy sources are key concerns for both parties. An enhanced energy co-operation

between Azerbaijan and the EU could boost the necessary reforms and, together with an enhanced investment climate, facilitate the attraction of further necessary investment both from IFIs and the private sector in Azerbaijan's energy sector;

3. Azerbaijan is rapidly becoming a key producer as well as potentially an important transit country for hydrocarbon supplies to the EU from the Caspian Basin and Central Asia. The successful completion of the Baku-Tbilisi-Ceyhan oil pipeline provides an economically attractive route for large volumes of crude oil from Azerbaijan and other Caspian Basin producers to reach European and world markets. Additional opportunities for the delivery of Caspian basin hydrocarbons may also be expected to develop in the region. In addition, the development of Shah Deniz gas production, and the possible transit of natural gas from the Caspian region into EU markets remain high on the agenda. In this context, ensuring a safe, transparent, reliable and secure transit system is of great importance for both the EU and Azerbaijan. With a view to enhancing European energy security, both sides particularly stress the vital role of the development of all means of transportation from the Caspian region, including the Baku-Tbilisi-Erzurum gas pipeline, and relevant multimodal transportation projects.
4. Azerbaijan is an active participant in the European Commission's initiative launched at the Ministerial Conference in Baku in November 2004 to enhance energy cooperation between the EU, the Black Sea region, Caspian Sea littoral States and their neighbours;
5. Azerbaijan's hydrocarbon industry has developed rapidly in the last decade with the activities of major oil and gas companies. In line with the State Programme for the Development of the Fuel and Energy Sector of Azerbaijan (in Annex), it is of paramount importance for the Azerbaijan energy sector to enhance its own human resources, expertise and skills.

Both sides recognize that, in order to adopt a comprehensive and balanced approach in terms of respective commitments and incentives and given the linkages between the various energy sub-sectors, they resolve to cooperate in four specific areas:

1. Establishment of a strategy and a programme for the gradual harmonisation of Azerbaijani legislation with the Community legislation in the energy field leading to the convergence of the electricity and gas markets.
2. Enhancing the safety and security of energy supplies and transit systems from Azerbaijan and Caspian basin to the EU.
3. Development of a comprehensive energy demand management policy in Azerbaijan, including concrete energy saving measures, and measures to tackle climate change, making use also of the relevant mechanisms under the Kyoto protocol. In this context, the development of renewable energies should also be priority.
4. Technical Cooperation and the exchange of expertise.

1. GRADUAL HARMONISATION OF AZERBAIJANI LEGISLATION WITH THE COMMUNITY LEGISLATION IN THE ENERGY FIELD LEADING TO THE CONVERGENCE OF THE ELECTRICITY AND GAS MARKETS.

- 1.1 Both sides will devote their best endeavours to enable the gradual convergence of the Azerbaijan electricity and gas markets into the European Union's internal energy market. For this to be realized, the gradual implementation of key elements of the acquis communautaire on energy, environment, competition and renewables is required. With the help of the EU technical assistance, and in compliance with the Partnership and Cooperation Agreement and European Neighbourhood Policy Action Plan provisions, Azerbaijan will endeavour gradually to harmonise its legislation with the relevant Community rules in line with a time table to be agreed upon by both parties.
- 1.2 In order to allow a smooth transition from the existing market structure to an open market, Azerbaijan will also endeavour to cover the following issues:

- a) Reform of electricity tariffs and gas pricing.
- b) Approaches to ease the impact of reforms on vulnerable customers where appropriate,
- c) The reduction of unregulated losses, and network losses,
- d) An increase in energy efficiency necessary to reduce demand,
- e) Measures to improve the collection of electricity and gas bills,
- f) Diversity and security of supply, including energy diversification by, e.g., renewable energy sources, whilst maintaining a free market framework,
- g) Optimisation of the energy mix in electricity generation with a view to increase efficiency, environmental safety, operational reliability, and security of supply.

1.3 With a view to facilitating the creation of an open market, Azerbaijan will endeavour, where necessary, to create or strengthen the role of institutions for the operation of an open electricity and gas market, namely:

- a) at a date to be agreed upon by the parties, an Energy Regulatory Authority independent of the interests of the electricity and gas industry; having, as a minimum, the responsibilities referred to in the Electricity and Gas Directives¹;
- b) at a date to be agreed upon by the parties, electricity and gas transmission system operators; having the tasks referred to, and fulfilling the criteria contained in the relevant articles of the Electricity and Gas Directives² with respect to their independence from other activities not related to transmission.

¹ Article 23 of the 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, published in the Official Journal L176 of 15.7.2003, and Article 25 of the Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC, published in the Official Journal L176 of 15.7.2003.

² Articles 9 and 10 of the 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, published in the Official Journal L176 of 15.7.2003, and Articles 8 and 9 of the Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC, published in the Official Journal L176 of 15.7.2003

1.4 In terms of development and evolution of the energy sector in Azerbaijan and as laid out in the Neighbourhood Policy Action Plan, the Government of Azerbaijan is undertaking the necessary structural reform of the sector, in accordance with the State Programme for the Development of the Fuel and Energy Sector in Azerbaijan and Azerbaijan's State Programme for the Utilization of Alternative and Renewable Energy Sources. The principal objectives of the State Programmes include:

- determination of priority development targets in accordance with best practices and standards,
- the improvement of operational effectiveness of delivery and utilization of energy users,
- establishment (encouragement) of investment and environmental safety in the energy sector,

The implementation of these State Programmes with the support by both Parties will reinforce the market reforms mentioned above under this Section.

1.5 Both sides note Azerbaijan's successful implementation of the Extractive Industries Transparency Initiative (EITI) and that further cooperation can be foreseen under the European Neighbourhood Policy Instrument.

1.6 Both sides recognize the importance of cooperation foreseen under EU technical assistance programmes, in particular Twinning Programme, for supporting Azerbaijan's energy sector in its progressive integration into the EU energy market.

2. ENHANCING THE SAFETY AND SECURITY OF ENERGY SUPPLIES AND TRANSIT SYSTEMS FROM AZERBAIJAN AND CASPIAN BASIN TO THE EU.

2.1 Azerbaijan has exported oil for more than a century. The successful completion of the Baku–Tbilisi–Ceyhan pipeline will allow substantial new volumes of oil to be exported in addition

to existing routes via the Northern Early Oil Pipeline through Russia, the Western Early Oil pipeline to Supsa in Georgia and by rail to Batumi in Georgia. Oil production is expanding rapidly, and exported oil is expected to reach more than 1,1 m bpd in 2008. In addition, increased transit of oil from Caspian Sea basin through Azerbaijan towards the EU and international markets is being developed. In this context, Azerbaijan's decision to participate as a full partner in hydrocarbon infrastructure projects in the EU and its neighbourhood countries aiming at increasing supplies from the Caspian Sea basin to the EU would represent a further significant move towards the closer integration of Azerbaijan with the EU energy market.

Stressing the importance of the Agreement signed between Azerbaijan and Kazakhstan on the transportation of oil from Kazakhstan through the Baku-Tbilisi-Ceyhan pipeline both sides agree to cooperate for the further development of this energy corridor.

- 2.2 The Azerbaijan gas transmission system consists of some 4000 km of major pipelines and 7 compressor stations, which ensure gas supplies to the internal market. At present gas is supplied from Russia and to a lesser extent from Iran.
- 2.3 With the coming on-stream of new gas supplies from Azerbaijan's Shah Deniz field, being developed by major oil and gas companies, gas will be exported from 2006 to Turkey and Georgia via the South Caucasus Pipeline. However, plans for further gas development for domestic needs as well as for exports raise the question for rehabilitation of existing, and the development of new, gas infrastructures.
- 2.4 In addition, the possibility of gas being supplied from Caspian Sea basin through a new corridor for delivery to Azerbaijan and also for onward transmission to the EU, is the subject of joint studies.
- 2.5 Given the importance to Azerbaijan and the EU of the existing oil and gas supply network, and its potential for development and expansion in the future, the parties will work towards a joint cooperation programme in the following areas:

- a) assessment, where appropriate, of the existing hydrocarbon transit and supply network, with a view to developing an infrastructure modernization plan, if deemed necessary,
- b) examine ways to enhance safety and security of Azerbaijan transit and export pipeline network,
- c) assist Azerbaijan in the establishment of its own energy supply security, particularly in the field of gas,
- d) identify and promote additional sources and supply routes for gas and oil to Azerbaijan and onwards to the EU,
- e) promote the harmonization of technical norms and standards in Azerbaijan's hydrocarbon sector with EU industrial practices,
- f) aligning the quality and environmental standards for oil products with those of the EU,
- g) assist Azerbaijan where appropriate in its implementation of the "Oil and Gas Chapter" objectives in the State Programme for the Fuel and Energy Sector in Azerbaijan,
- h) assist Azerbaijan to approximate its environmental standards in oil and gas extraction and transport industries to the EU standards,
- i) assist Azerbaijan in the reduction of gas flaring and venting.

2.6 The above areas of cooperation in hydrocarbon programmes will be able to draw upon both Azerbaijani technical expertise and EU technical assistance, as may be necessary.

3. DEVELOPMENT OF A COMPREHENSIVE ENERGY DEMAND MANAGEMENT POLICY

- 3.1 Both sides attach particular importance to setting in place a sustainable energy policy in Azerbaijan's energy sector which includes demand management, transparency of energy tariffs, the promotion of energy efficiency, the development of renewable energy sources and replacement fuels, respect of the objectives outlined in the UN Framework Convention on Climate Change and implementation and continuation of the mechanisms of the Kyoto Protocol. In this context, the EU will include Azerbaijan in all the European programmes which deal with these matters.
- 3.2 In view of developing energy efficiency measures and alternative energy sources in Azerbaijan, both sides will facilitate the implementation of the Azerbaijani National Alternative Energy Programme 2004-2013 and take steps to develop an Action Plan for its implementation, including reinforcing the institutions dealing with energy efficiency and renewable energy sources.

4. TECHNICAL COOPERATION AND THE EXCHANGE OF EXPERTISE

- 4.1 Both sides will step up cooperation in the areas of energy technology and exchange of expertise, including technical support for the EU-Azerbaijan Strategic Partnership in energy. The possibilities for cooperation in this field (to be defined jointly) include:
- Twinning of future Azerbaijan regulatory bodies with EU regulatory bodies in the field of energy;
 - Introduction of modern European technology into the Azerbaijan energy sector (research and development);
 - Exchange of expertise regarding security and safety in the field of energy;
 - Promotion of cross investment;

- Appropriate training targeted at the priority issues identified in the Strategic Partnership;
- Dissemination and communication of information to develop know-how and the acquisition of technological skills.

5. FINAL CONSIDERATIONS

Given the need to have recourse to specialist expertise to support the implementation of this Strategic Partnership, the European Union's technical assistance and financial support may be used, in particular through the European Neighbourhood and Partnership Instrument (ENPI).

Both sides also agreed that the possibility of having strategic partnership in other fields, according to the priorities jointly defined, merits serious consideration. Azerbaijan gives priority, inter alia, to education, agriculture and transport.

The Energy and Transport Sub-committee and any other relevant future sub-committee which could be set up under the EU-Azerbaijan Partnership and Cooperation Agreement may be used to implement this Strategic Partnership. Specific consultative process including industry may also be set up.

The present document records political intent alone and provides for no legal commitment. However, it is a basis for possible future discussions between the parties concerning a legal agreement, elaboration of which will depend upon the development of the relevant issues emanating from this Memorandum of Understanding.

This Strategic Partnership shall enter into force on the date of its signature by both Parties.

Done in _____ on _____ in Azerbaijani and English languages, both texts being equally authentic.

On behalf of the Republic of Azerbaijan

On behalf of the European Union
